Heckerling Institute on Estate Planning

Finding the Success in Succession

Steven B. Gorin
Cristin Conley Keane
Melissa J. Willms
Joshua E. Husbands, Moderator

Entity Classification for Federal Income Tax Purposes

- Partnership (GP, LP, LLP, LLLP, multi-member LLC by default)
- C Corporation (Corporation, single or multi-member LLC by election)
- S Corporation (Corporation, single or multi-member LLC by election)
- Disregarded Entity (single-member LLC by default)

Considerations in Structuring or Converting Entities

- Expectation of income from operations (II.E.1.a., II.E.1.b.)
  - If reinvested in business, current C corporation lower rate may be attractive
  - If distributed to owners, pass-through is likely still preferable
- Expectation of losses from operations (II.G.4.)
  - Flow through to owners of pass-through entities
  - Carried forward in C corporation
- Potential sale of business
  - C corporation allows for possibility of Section 1202 benefit (II.Q.7.k.)
  - Pass-through provides ability to sell assets and generate majority capital gain
- Family business
  - Partnership allows Section 754 basis adjustment (II.Q.8.e.iii.)
- Potential life of business
  - Family business vs. hedge fund
  - Permissible owners of entity (II.A.2.f., II.A.2.j.)

C Corporation – Overview I

- C Corporation income taxed at 21% rate
  - Top individual rate is 37%
    - Even with Section 199A deduction, rate is likely to be more than 30% for individuals with pass-through business income
  - Dividends to non-corporate shareholders taxed at preferential rate of 20% plus the 3.8% NIIT for certain taxpayers
- Who might benefit?
  - Business that operates in multiple states in order to avoid individual owners filing returns in various states
  - Businesses that are growing rapidly and prefer to self-finance growth
    - Cash flow can be improved in short-term by decreasing outflow of cash for tax liability
- C corporations are not eligible for Section 199A deduction

C Corporation – Overview II

- Shareholder cannot use losses incurred by corporation to offset other income
  - Corporate losses are reflected on its return; they are not passed through to shareholders
  - Consider losses in structuring new entity if clients insist upon C corporation status
- Shareholder can only take a loss on an equity investment (e.g., corporate stock) when the equity becomes worthless
  - Capital losses generally may only offset capital gain; shareholder may deduct $1,500 ($3,000 if married filing jointly) per year against ordinary income
  - Non-corporate shareholder may be able to take an ordinary loss for up to $50,000 ($100,000 if married filing jointly)
- If shareholder loans money to corporation, shareholder may be able take a loss in year loan becomes worthless
  - Bad debt deduction will generally be capital loss

C Corporation – Double Taxation

- C Corporation means double level of taxation
- Ways to avoid double taxation
  - Section 1202 Qualified Small Business Stock
  - Payment to shareholder of salary and bonus
    - Deduction would offset C corp-level tax; shareholder would pay ordinary rate on compensation income
    - Risk of recharacterization of compensation as dividend (would increase taxable income of corporation but shareholder may be eligible for preferential dividend rate)
- Convert to S Corporation
  - Consider limitations on eligible shareholders (generally U.S. individuals and certain trusts)
  - Built-in gain arising prior to S election will be added to entity level tax if assets are sold within 5 years of election (II.P.3.b.)

C Corporation – Risks

- Moving to C corporation to take advantage of lower rate involves tax risk
- Accumulated Earnings Tax (II.Q.7.a.vi.)
    - Corporation with retained accumulated taxable income has risk that IRS will seek to apply Section 531 to impose 20% tax on excess accumulated earnings
    - Case law looks at whether taxable income was accumulated for reasonable needs of business or whether done to avoid recognition of taxable income by shareholders
    - Corporations receive accumulated earnings credit of $250,000 ($150,000 for service business) less amount accumulated at end of prior year
    - Treasury officials have said they will look at issue more closely in light of lower corporate rate

C Corporation – Risks II

- Personal Holding Company (II.A.1.e.)
  - 20% tax on undistributed personal holding company income
  - C Corporation in which 5 or fewer individuals own stock and receive 60% or more of adjusted gross income (AGI) from passive sources, including:
    - Rent
    - Royalty
    - Interest
    - Dividend
    - Annuities
  - AGI calculated by excluding capital gain, 1231(b) gain, and certain other adjustments
- S Election Caution: If a C corporation makes S election and has earnings and profits, S corporation can be subject to excess passive investment income tax (II.P.3.b.iii.)

S Corporation – Overview I

- Single level of taxation
  - No corporate level tax; all items passed through to shareholders
  - Shareholders receive K-1 reporting proportionate share of net income or net loss and other specially stated items
- Ownership limitations
  - Only non-corporate, U.S. shareholders (note NRA exception for ESBTs as of 1/1/18)
  - Only one class of equity
    - No preferred stock
    - May have voting and non-voting stock
    - Difficult to raise capital
    - Difficult to set up employee incentive equity (compared to partnerships)
- Shareholder-employees can minimize FICA liability through maximizing dividend distributions and reducing salary (II.A.2.c.)
  - Dividends should not be subject to FICA
  - Dividends should not be subject to NIIT for shareholder-employees (II.I.8.)

S Corporation – Overview II

- Shareholder may deduct proportionate share of losses incurred by S corporation subject to passive loss and basis limitations
  - Shareholder must make active or passive determination of character of losses
    - Similar determination to that made under the NIIT rules
  - If passive activity for shareholder, then losses can only be used to offset other passive income or are suspended and carried forward
  - Losses may be deducted up to the shareholder's basis in the stock
- Shareholder's tax basis
  - Equity investment
  - Loan by shareholder to corporation (II.G..4.d.ii.)
    - Outside loan incurred by corporation cannot be used to increase shareholder's basis for purpose of deducting losses
- S corporation tax accounting is much easier than partnership tax accounting
- Pass-through income is eligible for 199A deduction

Tax Partnership – Overview

- Flexible
- Single level of taxation
  - No corporate level tax; all items passed through to partners
  - Pass-through income eligible for 199A deduction
  - Partners receive K-1 reporting in accordance with partnership agreement
    - Type of economic arrangement can make accounting extremely complex
- Generally permits tax-free contribution and distribution of property
- Ownership considerations
  - Multiple classes of equity are permitted (unlike S corporations)
  - Economic rights can be divorced from voting rights
- Partner can use allocable share of partnership debt to increase own basis in partnership interest for purposes of deducting partnership losses
  - Contrast with S corporation rules that don't allow debt to increase stock basis
  - Losses are subject to passive loss and basis limitations (same as with S corporations)

Tax Partnership – Compensation Issues

- Partners do not receive W-2 compensation income
- Partners can minimize FICA liability through maximizing distributions and reducing salary or guaranteed payments
  - Limited partnership provides more certainty than an LLC with respect to FICA liability on distributions (II.L.4.)
  - Distributions should not be subject to NIIT for partners who actively participate in business (II.I.8.)
- Can issue sweat equity to key employees/service providers
  - Capital interest can be issued but will result in income to employees when issued
  - Profits interest can be structured so that recipients do not have gain upon grant or vesting; deferral until liquidity event (II.M.4.f.iii.)
  - Important difference from corporations

Tax Partnership – Compensating with Capital Interest

- Taxable upon receipt or when vested
  - Can make 83(b) election to treat value at date of issuance as income rather than wait until vesting
  - Ordinary income to service provider
  - Ordinary deduction to partnership
- Service provider receives capital account credit for value of partnership interest included in income
- Allows service provider to share in current value of partnership <u>plus</u> appreciation
- Service provider receives K-1 and can benefit from taxation at long-term capital gain rate if asset or equity sale (subject to new carried interest holding period rules)

Tax Partnership – Compensating with Profits Interest

- If recipient partner would not receive anything if partnership liquidated, it is a profits interest
- Allows partnership to issue profits interest to service provider income-tax free
  - Service provider may make "protective" 83(b) election in case safe harbor is not satisfied
  - "Protective" 83(b) election can ensure partnership interest is taken into account at lowest value (usually date of grant)
- Allows service provider to share in increase in value of partnership above current value
- Not subject to Section 409A
- Service provider must be treated as partner from date of issuance
  - Must receive K-1 even if no income allocation
  - Service provider could receive phantom income and should request tax distributions

Conversion from Corporation to Tax Partnership (II.P.3.a.)

- Many options to implement: state law conversion/merger, check-the-box election, corporate liquidation and distribution of assets to shareholders followed by formation of tax partnership, or corporate drop-down of assets followed by distribution of tax partnership interests in liquidation
- Corporate gain
  - Corporation recognizes gain on deemed sale of assets equal to difference between FMV of assets less tax basis of assets
  - C corporation gain taxed at 21%
  - S corporation gain flows through to shareholders, increasing basis in stock, but may have ordinary income because of depreciation recapture
- Shareholder gain
  - Shareholders recognize gain on value on actual or deemed distribution of interests in tax partnership less tax basis in stock of corporation
- Generally not tax efficient (but there is a complex tax-free way to move growth to partnership (II.E.7.))

Conversion from Tax Partnership to Corporation (II.P.3.c.)

- Many options to implement: state law conversion/merger, distribution of assets to shareholders followed by formation of tax partnership, or partnership drop-down of assets followed by liquidation of tax partnership

- Generally tax efficient

- Concern if debt exceeds tax basis of assets
  - Recognition of gain under Section 357(c)

- Concern with unvested partnership profits interests

Structuring the Sale –
Overview of Asset Sale vs. Equity Sale

- Buyers generally prefer to purchase assets
  - Purchase price is allocated among assets that will generate depreciation or amortization deductions
  - With changes to accelerated depreciation, buyers have stronger incentive for asset deal
  - Liability limited to those items expressly assumed by buyer
  - Seller will pay tax on gain inherent in each asset, which may include ordinary items
- Sellers generally prefer to sell equity
  - Assets retain historical basis
  - Seller desires one level of taxation and capital gain treatment of stock
- Business needs may dictate equity sale
  - Licenses
  - Regulatory concerns
  - Anti-assignment provisions
  - Retitling of assets

Tips and Tricks With S Corporations and LLCs

- Charging Orders for LLCs – many states' laws provide asset protection features for LLC interests obtained by creditors via involuntary transfers
- Voting and Non-Voting Shares – LLC versus S corporation (II.A.2.i.i.(b).)
- Rev Rul 81-15 – law of the land and safe harbor for corporate share ownership but there is no corresponding ruling for LLC interests (II.A.2.i.i.(b))
- F reorganizations – may provide useful alternatives for S corporations using LLCs for planning (II.P.3.h and II.A.2.g)

QSSTs and ESBTs (III.A.3.e.)

- Qualified Subchapter S Trusts (“QSSTs”)
  - Beneficiary must elect
  - Only one income beneficiary allowed
  - All FAI to beneficiary at least annually
  - Form 2553 or letter request
  - Elect by 2 months, 15 days after stock transferred
  - Income tax to beneficiary unless stock sold
- Electing Small Business Trusts (“ESBTs”)
  - Trustee makes election
  - Multiple trust beneficiaries allowed
  - Election made by letter request
  - Elect by 2 months, 15 days after stock transferred or after end of 2-year holding period for stock transferred by death
  - Income always taxed to trust at highest rate

Buy-Sell Agreements

- See Willms sample LLC buy-sell agreement checklist in materials

  - Funding the Buy-Sell (II.Q.4.a)
  - Life insurance
  - Establishing Estate Tax Values (II.Q.4.h)

Buy-Sell Agreements

Life insurance topics covered:

- Transfer for Value Rule; Basis (II.Q.4.b)
- Income Tax Issues in Transferring Life Insurance; Code § 1035 (II.Q.4.c)
- Income Tax on Distributions or Loans from Contract (Including Surrender of Policy) (II.Q.4.d)
- Income Tax Issues When the Owner Who Is Not the Insured Dies (II.Q.4.e)
- Split-Dollar Arrangements (II.Q.4.f)
- Income Tax Trap for Business-Owned Life Insurance (II.Q.4.g)

Buy-Sell Redemption Example (II.Q.4.h.)

- Company is worth $4M
- A owns 75% of the company
- A’s estate would want to be bought out for $3M (75% of $4M)
- Company then buys a $3M policy insuring A’s life, so it could buy A’s interest when A dies (if able to keep policy until then)

Buy-Sell Redemption Example (II.Q.4.h.)

- On A’s death, however, the company is worth $7M ($4M normal value + $3M life insurance)
- Should the Company have to pay 75% of $7M for A’s interest, because of this life insurance?
- Higher price certainly would not honor the parties’ intent

Buy-Sell Redemption Example (II.Q.4.h.)

- If A's estate gets \$3M instead of 75% of \$7M, does that mean that A has bequeathed the difference to the company's other owners?
- Imposing estate tax on A's estate for money that the estate will never receive is certainly an unfair result

Buy-Sell Redemption Example (II.Q.4.h.)

- On the other hand, if the company's other owner was A's son or some other natural object of A's bounty, then perhaps A's goal was essentially to bequeath the difference to that other owner
- In the latter case, A's estate should pay estate tax on the difference and – depending on A's intent – perhaps recover the extra estate tax from that other owner

Establishing Estate Tax Values (II.Q.4.h.)

Reg. § 20.2031-2(h):

- "Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime"
- "Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death"

Establishing Estate Tax Values (II.Q.4.h.)

Reg. § 20.2031-2(h):

- "Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that:
  - the agreement represents a bona fide business arrangement and
  - not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth"
- "See section 2703 and the regulations at § 25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990."

Establishing Estate Tax Values (II.Q.4.h.)

Code § 2703(a) provides that the value of any property shall be determined without regard to:

- “any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right)” ***or***

or

- “any restriction on the right to sell or use such property”

Establishing Estate Tax Values (II.Q.4.h.)

Code § 2703(b) - (a) does not apply if meet each of the following requirements:

- It is a bona fide business arrangement
- It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth
- Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction

Establishing Estate Tax Values (II.Q.4.h.)

Blount (decided 2004 & 2005):

- Buy-sell did not comply regarding restricting sale during life
- Excess value passed to ESOP benefitting non-family members
- Tax Court imposed estate tax on this excess value
- 11^{th} Circuit reversed (next slide)

Establishing Estate Tax Values (II.Q.4.h.)

Blount 11th Circuit:

- "The Tax Court properly determined that the 1981 agreement, as amended by the 1996 agreement, had no effect for purposes of determining the value of the BCC shares in Blount's estate and that the fair market value of the corporation was the proper basis for tax assessment"
- "The Tax Court erred when it ignored the amended agreement's creation of a contractual liability for BCC, which the insurance proceeds were committed to satisfy"
- "We reject the Tax Court's inclusion of the insurance proceeds paid upon the death of the insured shareholder as properly included in the computation of the company's fair market value"

Establishing Estate Tax Values (II.Q.4.h.)

Connelly (E.D. Mo. 9/2021):

- Agreed with *Blount* Tax Court
- Held that 11th Circuit's reasoning is "demonstrably erroneous"
- Pointed out that remaining owner's 23% stock was worth more than decedent's 77% stock
- Willing seller of decedent's stock would not accept that result

Establishing Estate Tax Values (II.Q.4.h.)

Questions re *Connelly*:

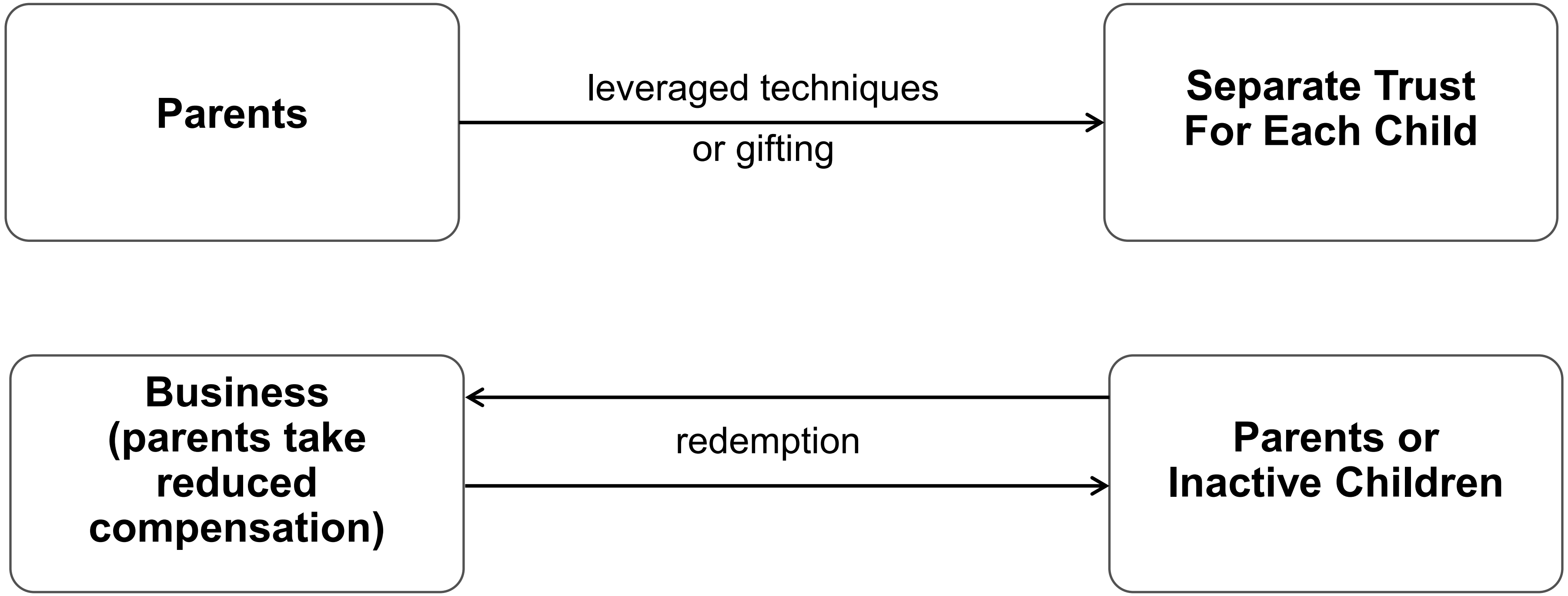
- If the buy-sell agreement is disregarded, will the resulting liquidity also be disregarded?
- In that case, the stock needs to be value based on:
  - lack of marketability and
  - how much control a hypothetical willing buyer of the company's stock would have over the company

Establishing Estate Tax Values (II.Q.4.h.)

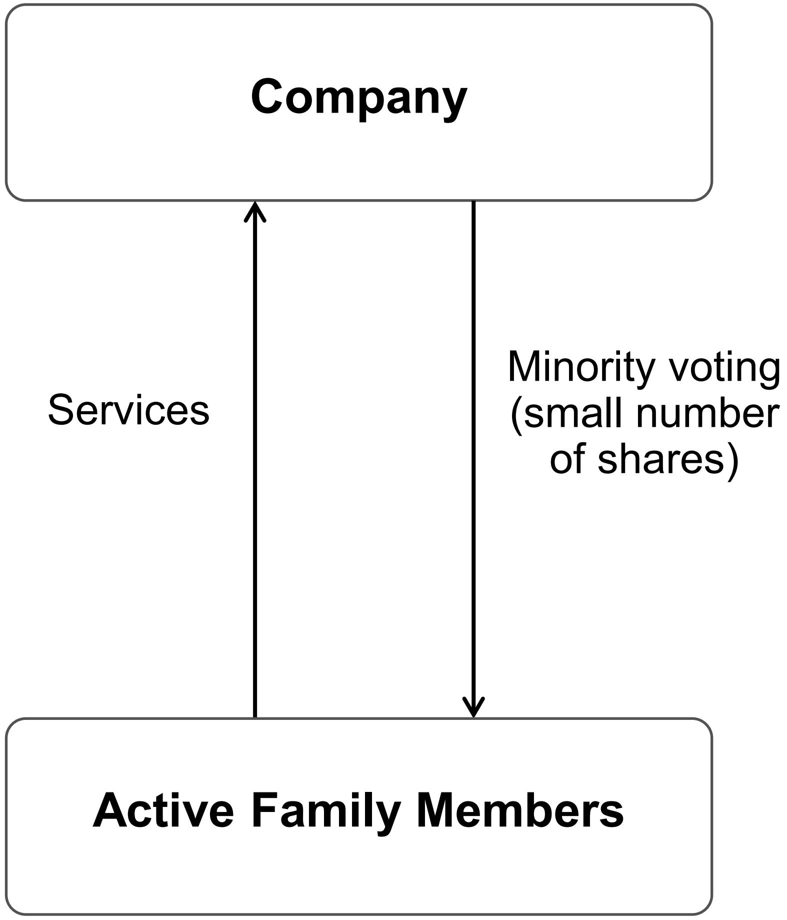
Planning after *Connelly*:

- Whether *Blount* Tax Court and *Connelly* are right or wrong, consider avoiding the issue by using a cross-purchase
- Cross-purchase involves risk, so consider life insurance LLC (II.Q.4.i)
- Cross-purchase also avoids S Corporation Receipt of Life Insurance Proceeds (II.Q.7.b.iii.)

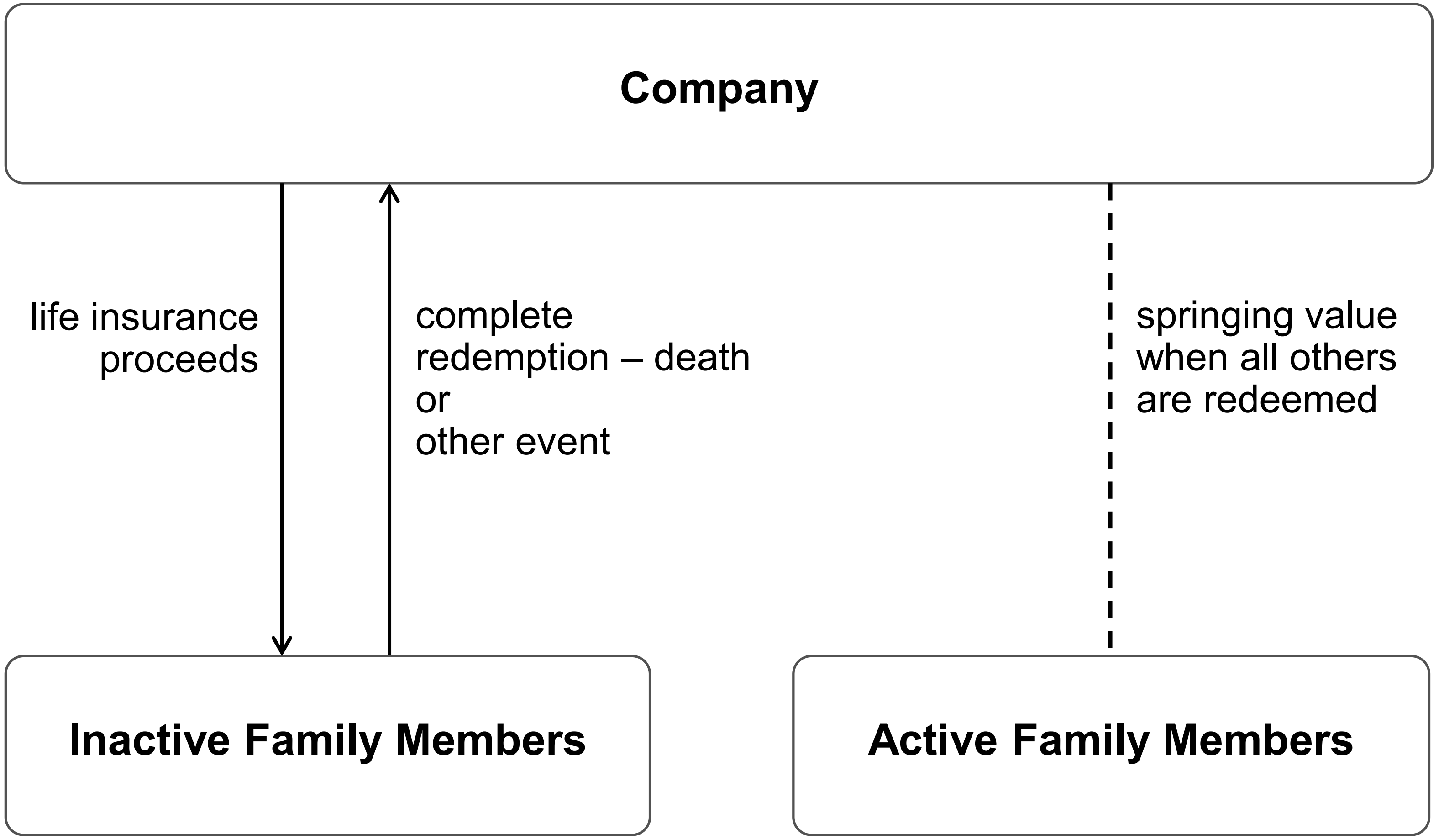
Succession Planning Using Redemptions When Parent is Living
(II.M.4.e.ii.)



Succession Planning Using Redemptions Funded by Life Insurance (II.M.4.e.iii.)



Succession Planning Using Redemptions Funded by Life Insurance (II.M.4.e.iii.)



Employer Owned Life Insurance Requirement To Avoid Income Taxation (II.Q.4.g.)

- Company owned policy issued or materially changed after August 17, 2006
- 5% or greater owner or a highly compensated employee

Employer Owned Life Insurance Requirements To Avoid Taxation

- Notice and consent must be obtained <u>on or before</u> policy issuance
- Notice can be stand-alone or can be incorporated into buy-sell agreement, but need to make sure signed <u>on or before</u> policy issuance
- Notice can be drafted by attorneys or provided by agents – make sure a qualified tax advisor reviews whatever the agent provides
- Form 8925 – must be attached to corporate income tax return annually

Employer Owned Life Insurance
Consent For Owner Who Is Not an Employee

Notice and Consent

For ___________
Under I.R.C. Section 101(j)(4)

I acknowledge notification that _______________ (the "Employer") intends to obtain a policy insuring my life with a maximum face amount of $_______. Although the Employer does not employ me, I understand that my ownership in the Employer makes me considered an "employee" for purposes of I.R.C. Section 101(j). Therefore:

(A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.

(B) I consent to being insured under these contracts and that such coverage may continue after I no longer own an interest in the Employer or otherwise terminate employment.

(C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

Employer Owned Life Insurance Consent For An Employee

Notice and Consent

For ___________

Under I.R.C. Section 101(j)(4)

I acknowledge notification that ____________ (the "Employer") intends to obtain a policy insuring my life with a maximum face amount of $________, and:

(A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.

(B) I consent to being insured under these contracts and that such coverage may continue after I terminate employment.

(C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

Employer Owned Life Insurance
What To Do If You Don’t Have Notice

- Best option – get new policies, but this does not always work
- See if relief is available – do you have procedure in place and accidentally made a mistake, then you fix it in a short time?
- Buy-sell agreement can protect if the agreement includes notice and consent

Buy-Sell Agreements

- 736(b) redemption planning (II.Q.8.b.ii.)

What is Being Transferred and to Whom

- Four elements of ownership
  - Equity – ex. common stock, liquidation value
  - Income – ex. profits interest, preferred interest, reverse freeze
  - Growth – ex. carried interest
  - Control (only option for S corp) – ex. voting vs. nonvoting, general vs. limited
- Possible successor owners
  - Family members
  - Employees
  - Third party
- Equality of value versus “fair”

Community Property Issues

- Management of community property – joint vs. one spouse
- Entity structure doesn't always protect marital property character
- Migratory clients
- Use of transmutation vs. partition
- Entity interest held in irrevocable trust should protect character as to beneficial owner
- Risk of inadvertent ownership
  - Consider how income from separate property is treated
  - Ex. Texas LLC and mineral interests

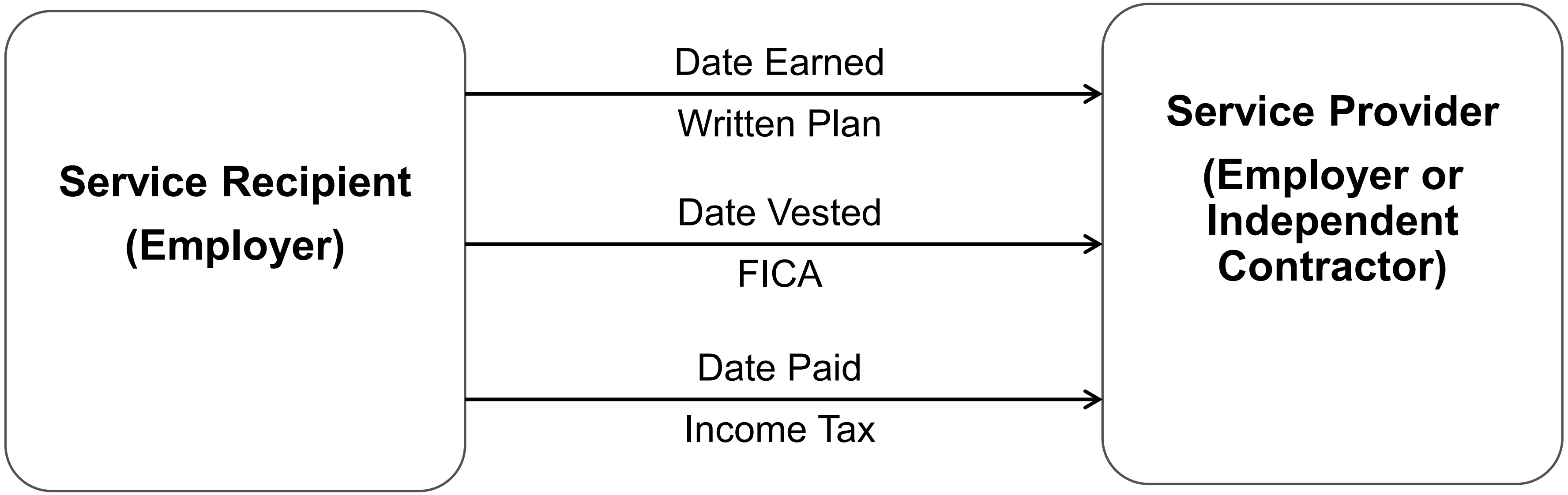
Deferred Compensation (II.Q.1.d. and II.M.4.d.)

- Using nonqualified deferred compensation to facilitate a sale
- Introduction to Code § 409A nonqualified deferred compensation rules

Deferred Compensation
(II.Q.1.c.i., II.M.4.d.)

- Income tax dynamics are similar to partnership exit strategy, but not as favorable now that the deduction may save less to the service recipient than tax on the income received by the service provider
- Careful in buy-sell agreement not to make it a substitute for purchase price
- Balance sheet effect (II.Q.8.b.ii.(e)). Contrast against profits interests and Code § 736(a)(1) payments)

Timeline for FICA and Income Taxation of Deferred Compensation (II.Q.1.d.iii.)



Deferred Compensation

Code § 409A Violation Incurs (II.M.4.d.)

- Acceleration of income taxation
- 20% penalty
- Interest on previously deferred tax

Deferred Compensation

- Written plan when legally binding
- Reasonable compensation overlay
- § 409A applies with impermissible triggers, acceleration, or re-deferral

Deferred Compensation – Permissible Delay (II.M.4.d.ii.)

- $150,000 per Year Current Compensation
- $100,000 Annual Retirement Payments 2023-2032
- End of 20222, Wants to Push Back Retirement

Deferred Compensation – Permissible Delay (II.M.4.d.ii.)

Agree in 2022

- 2020 work will generate $50,000 compensation paid in 2023 and $100,000 compensation paid in 2033
- 2023 cash paid $150,000
  - $100,000 previously scheduled deferred compensation
  - $50,000 from 2020 work
- 2023-2032 stream of payments stays intact
- 2033 retirement payment added

BUY-SELL AGREEMENT
PRE-DRAFTING CONSIDERATIONS
Provided by Melissa Willms

1. **Potential Purchaser**
   Determine identity of prospective purchaser:
   a. Company itself; or
   b. Other Member

2. **Triggering Events**
   Determine which events will cause option or obligation to arise (triggering event), such as:
   a. Death of Member;
   b. Offer made by third party to Member to purchase interests;
   c. Retirement of Member-employee;
   d. Resignation of Member-employee;
   e. Disability of Member-employee; or
   f. Divorce of Member-employee.

3. **Transfer of Interests**
   a. Ascertain whether party ultimately obligated to sell should be bound to sell all or only part of shares held by him.
   b. Ascertain whether upon a triggering event, a Member can transfer his units to a party not currently a Member in the company (e.g. family member). (Can Member allow another party to enter into management of a company with little or no experience?)
   c. Determine whether prospective purchaser should have:
      1. Option to purchase units; or
      2. Obligation to purchase units

4. **Methods of Valuation**
   Determine at which of the following prices shares will be sold:
   a. Agreed price that is noted each year by Member on schedule attached to agreement;
   b. Fair market value according to appraisal;
   c. Book value of shares as of:
      i. Date of Death; or
      ii. Close of year preceding death
   d. Amount of bona fide offer made by third party.
   e. Formula

5. **Funding**
   Determine whether such funding will be:
   a. Mandatory
   b. Optional

   Determine whether will be funded by:
   a. Life Insurance:

Determine following:

1. Insurer
2. Insured parties
3. Amount of face value of each policy
4. Amount of premiums
5. Legal owner of each policy
6. Party obligated to pay premiums
7. Disposition of policy on lives of remaining Members owned by deceased Member.
8. Will insurance policy earn a cash value to assist with lump sum payment?
9. Business insurance policy insuring life of Member and upon death, proceeds used to purchase units of deceased or disabled Member.

b. Deferred Compensation Plan

c. Sinking Fund

6. **Method of Payment**

Determine whether purchase price of units is to be paid in:

a. One lump sum; or

b. Installments.
   1. Amount of each installment.
   2. Amount of down payment.
   3. Schedule of payment:
      (i) Monthly
      (ii) Quarterly
      (iii) Annual
   4. Number of payments
   5. Amount of interest

Determine whether:

a. Promissory note should be executed.

b. Security for note should be required.

Ascertain whether the payment plan is different depending on the triggering event.

Finding the Success in Succession
(Excerpted from
Structuring Ownership of Privately-Owned Businesses:
Tax and Estate Planning Implications)

SECTION 2

Steven B. Gorin
Thompson Coburn LLP
St. Louis, MO

 (Printed March 10, 2022.) This is not intended to be comprehensive; many portions only lightly touch the surface; and not all of the issues are updated at the same time (in fact, the author does not systematically refresh citations), so some parts may be less current than others. The author invites suggested changes, whether substantive or to point out typos (the author does not have a second set of eyes reviewing the author's work). The views expressed herein reflect the author's preliminary thoughts when initially written and are not necessarily those of Thompson Coburn LLP (or even of the author). Before using any information contained in these materials, a taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor. Tax advisors should research these issues independently rather than rely on these materials.

This document may be cited as Gorin, [number and name of part as shown in the Table of Contents], "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications" (printed 3/17/2022), available by emailing the author at sgorin@thompsoncoburn.com. The author refers to this document not as a "treatise" or "book" but rather as his "materials," because the author views this as a mere compilation of preliminary ideas (albeit a large compilation) and not as a scholarly work. To receive quarterly a link to the most recent version, please complete http:\www.thompsoncoburn.com\forms\gorin-newsletter.

TABLE OF CONTENTS

Finding the Success in Succession

Steven B. Gorin[*]
Thompson Coburn LLP
St. Louis, Missouri

I. Introduction

This document is excerpted from "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," a fully searchable few thousand page PDF that discusses how federal income, employment and transfer taxes and estate planning and trust administration considerations affect how one might structure a business and then transition the business through ownership changes, focusing on structural issues so that readers can plan the choice of entity or engage in estate planning with an eye towards eventual transfer of ownership in the business.

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

You might also check out the author's blog at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions.

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

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

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All references to the "Code" are to the Internal Revenue Code of 1986, as amended. All references to a "Reg." section are to U.S. Treasury Regulations promulgated under the Code.

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

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

Code § 541 is intended to require most C Corporations with excess investment income to pay dividends.[61] "Undistributed personal holding company income" is the excess of a personal holding company's adjusted taxable income[62] over dividends paid or deemed paid.[63] Dividends paid or deemed paid include dividends paid during or shortly after[64] the taxable year, consent dividends[65] for the taxable year, and dividends carried over from a prior year[66] for purposes of this test.[67]

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

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

[63] Code § 545(a).

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

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

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

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

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

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

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

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

[67] Code § 561.

Code § 542(a) provides that, unless excluded from this tax,[68] a corporation is a "personal holding company" if:

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

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

In calculating adjusted ordinary gross income, any business income is based on gross receipts, not net income.[69]

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

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

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

[69] Reg. § 1.542-2 begins:

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

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

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

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

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

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

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

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

(ii) margin accounts, or

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

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

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

(B) the sum of-

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(ii) deductions for royalties paid or accrued, and

(iii) deductions which are specifically allowable under sections other than section 162, equals or exceeds 25 percent of the amount by which the ordinary gross income exceeds the sum of the royalties paid or accrued and the amounts allowable as deductions under section 167 (relating to depreciation) with respect to copyright royalties.

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

(5) *Produced film rents*.

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

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

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

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

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

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

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

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

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

(7) *Personal service contracts*.

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

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

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

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

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

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

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

(ii) property taxes,

(iii) interest, and

(iv) rent,

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

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

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

(ii) property and severance taxes,

(iii) interest, and

(iv) rent,

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

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

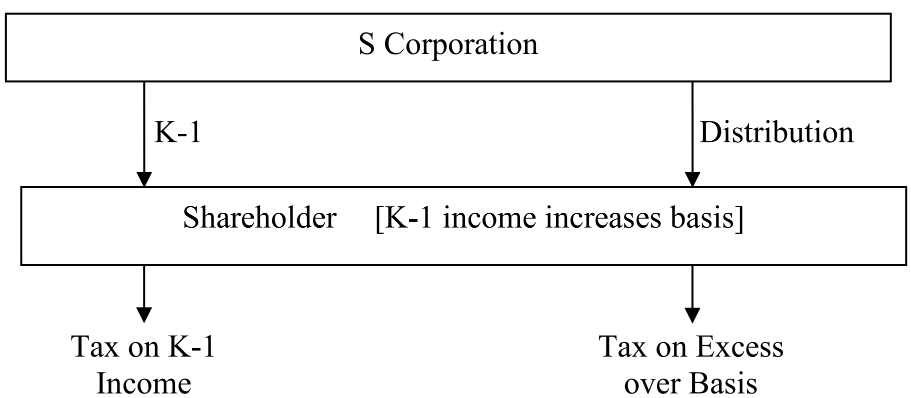
(i) interest received on a direct obligation of the United States held for sale to customers in the ordinary course of trade or business by a regular dealer who is making a primary market in such obligations, and

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

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

II.A.2. S Corporation

An S corporation is an entity taxed as a corporation whose income generally is taxed to its owners rather than being taxed to the entity itself;[70] the entity issues a Schedule K-1 to its owners each year to report the income. If the entity was never a C corporation:



Rather than using a corporation as the state law entity, consider using a limited liability company (or other unincorporated entity) that elects taxation as an S corporation.[71] Compared to a traditional corporation, an LLC or other unincorporated entity might offer better protection from an owner's creditors,[72] provide more flexibility in making distributions to pay the seller's taxes after a change in control,[73] allow the

[70] Code § 1363. See Hill and Anderson, "Computing S corporation Taxable Income: Unraveling the Mysteries of Section 1363(b)," *Business Entities* (WG&L), July/Aug. 2009.
[71] See text accompanying fn. 362 for how such an entity makes an S election.
[72] See part II.F.1 Business Entities and Creditors Generally.
[73] See part III.B.2.j.ii.(f) Distribution after Transfer.

parties to control future actions,[74] and provide a nongrantor trust a better opportunity to materially participate[75] to avoid the 3.8% tax on net investment income.[76] However, there might be a slight risk that the LLC might not qualify for the S corporation exemption from self-employment tax.[77]

Note that, in the case of a seller-financed sale of goodwill, using a C corporation causes a triple tax, an S corporation causes a double tax, and a partnership causes a single tax.[78] When an owner dies, the assets of a sole proprietorship (including an LLC owned by an individual that has not elected corporate taxation) or a partnership (including an LLC owned by more than one person that has not elected corporate taxation) can obtain a basis step-up (or down) when an owner dies, whereas the assets of a C corporation or an S corporation do not receive a new basis.[79] For what might be an ideal structure, see part II.E Recommended Structure for Entities.

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

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

An existing corporation would like to start paying dividends to its shareholders. However, as a regular corporation (described by tax practitioners as a C corporation), it would pay tax on its earnings, and its shareholders would pay tax on the dividends. The shareholders make an S election, so that they (rather than the corporation itself) are taxed on the corporation's earnings. The shareholders will not be taxed on dividends, to the extent that the dividends represent earnings that constitute reinvested earnings while the corporation was an S corporation.[80]

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

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

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

As new business owners, clients should be concerned with double taxation - once when the company earns profits, and again when the company pays dividends. Even if a reduced capital gain tax rate applies to dividends, one must add up two levels of federal income tax and two levels of state income tax. However, partnership income tax might not be desirable, either, since the owners generally must pay self-

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[74] See part II.F.3 Limited Partnerships and LLCs as Control Vehicles.
[75] See parts II.K.1.a Counting Work as Participation and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues (under II.K.2.b Participation by an Estate or Nongrantor Trust).
[76] See parts II.I 3.8% Tax on Excess Net Investment Income and II.I.8.a General Application of 3.8% Tax to Business Income.
[77] See part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election.
[78] See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis.
[79] See part II.H.2 Basis Step-Up Issues.
[80] See part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally, especially fn. 4649.

employment tax (under which the owner in effect pays the company's and the employee's share of Social Security and Medicare tax) on all of her share of the company's earnings. Instead, the client might want to pay payroll taxes on only what they receive as compensation and not pay self-employment tax on money that is reinvested in the business. As the business grows, clients do not want to pay self-employment tax on a return of their investment, just on compensation they receive for services they perform. It is possible that an S corporation may be an appropriate entity. However, in many cases taxpayers are better off starting as an LLC taxed as a partnership until undistributed self-employment earnings become material, then switch to a limited partnership with an S corporation general partner. See part II.E Recommended Structure for Entities, especially parts II.E.2.b and II.E.7.b Flowcharts: Migrating LLC into Preferred Structure.

Some tax professionals advise using an S corporation instead of a partnership to avoid Self-Employment (FICA) tax.[81] We will see later how a partnership is a much better entity for exit strategies than is a C corporation or even an S corporation.[82] Furthermore, aggressively characterizing payments to employee-shareholders as distributions rather than compensation can lead to penalties[83] and potentially loss of the tax preparer's license;[84] to avoid that problem, consider using a partnership of S corporations,

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

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

[83] For a summary of cases, see Looney and Levitt, "Compensation Reclassification Risks for C and S corporations," *Journal of Taxation* (May 2015). Note the tips provided by Kirkland, "Helping S corporations avoid unreasonable compensation audits: Find out what entries on Forms 1120S may trigger these audits," *Journal of Accountancy* (6/1/2015). See IRS Fact Sheet 2008-25, "Wage Compensation for S corporation Officers," http://www.irs.gov/uac/Wage-Compensation-for-S-Corporation-Officers and "S Corporation Compensation and Medical Insurance Issues," https://www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues (lasted visited 9/2/2017), as well as http://www.irs.gov/Businesses/Valuation-of-Assets (which includes reasonable compensation issues); Rev. Rul. 74-44; *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990) (law firm); *Joly v. Commissioner*, T.C. Memo 1998-361 (20% penalty assessed when S corporation treated compensation as loans); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990) (accounting firm); *Dunn & Clark, P.A. v. Commissioner*, 853 F.Supp. 365 (D. Idaho 1994) (law firm); *Wiley L. Barron, CPA, Ltd. v. Commissioner*, T.C. Summary Opinion 2001-10 (CPA firm); *Yeagle Drywall Co. v. Commissioner*, T.C. Memo. 2001-284 (drywall construction business); *Veterinary Surgical Consultants P.C. v. Commissioner*, 117 T.C. 141 (2001) (consulting and surgical services provided to veterinarians); *Joseph M. Grey, P.C. v. Commissioner*, 119 T.C. 121 (2002) (accounting firm); *Nu-Look Design Inc. v. Commissioner*, 356 F.3d 290 (3rd Cir. 2004) (residential home improvement company); see *Herbert v. Commissioner*, T.C. Summary Opinion 2012-124 (taxpayer claimed only $2,400 of compensation; IRS alleged $55,000 in compensation; court used taxpayer's approximately $30,000 average annual compensation; penalties do not appear to have been imposed on wages but were imposed on other items); *Sean McAlary Ltd, Inc. v. Commissioner*, T.C. Summary Opinion 2013-62 (taxpayer penalized for failing to report any compensation; court reject IRS' expert's reliance on merely a percentage of gross receipts, instead computing an hourly wage based on its view of the cases: "the employee's qualifications, the nature, extent, and scope of the employee's work, the size and complexity of the business, prevailing general economic conditions, the employee's compensation as a percentage of gross and net income, the employee/shareholder's compensation compared with distributions to shareholders, the employee/shareholder's compensation compared with that paid to non-shareholder/employees, prevailing rates of compensation for comparable positions in comparable concerns, and comparable compensation paid to a particular shareholder/employee in previous years where the corporation has a limited number of officers"). The IRS might even recharacterize purported repayments of open account indebtedness as compensation, even when the amounts significantly exceed the K-1 income; see *Glass Blocks Unlimited v. Commissioner*, T.C. Memo. 2013-180, discussed in fn. 1191. For more detailed summaries and additional cases, see Christian & Grant, "¶34.06. Reasons for Payment of Salaries," *Subchapter S Taxation* (WG&L). However, it appears that, in a professional services firm, the IRS might concede that a significant portion of distributions are not subject to FICA. See footnote 3391.

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

so that any income that each corporation accumulates is not subject to FICA/self-employment tax and any payments actually made to the owner are subjected to FICA to the extent they constitute reasonable compensation.[85]

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

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

Some owners who are also officers try to pay themselves outside of the payroll system and call it nonemployee compensation. However, as officers, they are employees,[86] and payments to them for

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and penalties." Wong's license was revoked, but the revocation was stayed and Wong was suspended from practice for 60 days and placed on probation for 3 years.

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

[86] Reg. § 31.3121(d)-1(b) provides:

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

Rev. Rul. 71-86 addressed the following:

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

The ruling concluded:

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

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

services are wages.[87] Rev. Rul. 82-83 held that a corporation that treats officers as independent contractors rather than as employees when they are performing duties normally within the scope of duties of a corporate officer is absolutely not entitled to relief under section 530 of the Revenue Act of 1978:

> Sections 3121(d) and 3401(c) of the Internal Revenue Code, applicable to the Federal Insurance Contributions Act and income tax withholding, respectively, provide that the term "employee" includes any officer of a corporation. Section 3306(i), applicable to the Federal Unemployment Tax Act, includes within the meaning of the term "employee" the meaning assigned by section 3121(d).
>
> Section 31.3121(d)-1(b) of the Employment Tax Regulations states that, generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any pay is considered not to be an employee of the corporation. For instance, directors of corporations in their capacity as such are not employees of the corporations.
>
> Rev. Rul. 71-86, 1971-1 C.B. 285, holds that when an individual who is the president and sole shareholder, except for qualifying shares, of a closely held corporation performs services as an officer of the corporation, the president is an employee for purposes of employment taxes and income tax withholding, even though all services performed and the amount of compensation for them are under the individual's complete control.
>
> Rev. Rul. 73-361, 1973-2 C.B. 331, holds that a stockholder-officer of an electing small business corporation who performs substantial services as an officer of the corporation is its employee for purposes of the FICA, the FUTA, and income tax withholding.
>
> In *Royal Theatre Corp. v. United States*, 66 F.Supp. 301 (D. Kan. 1946), the sole shareholder and president of two corporations contracted with each for him to manage each corporation's operations and to determine matters of policy for each corporation. The court observed that compensation an

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

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

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

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

[87] See fn. 86 and *Veterinary Surgical Consultants P.C. v. Commissioner*, 117 T.C. 141 (2001) (consulting and surgical services provided to veterinarians); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990) (accounting firm); *Durando v. U.S.*, 70 F.3d 548 (9th Cir. 1995) (amount shown on Form 1099-MISC did not constitute earnings that a shareholder could use to create a self-employed person's retirement plan).

officer receives for services as an officer is subject to social security taxes, and held that the contracts by which the president of each corporation purportedly managed the affairs of each corporation as an independent contractor could be disregarded in determining the reality of the situation.

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

Based on a couple of dismissals it procured,[88] the IRS takes the position that the Tax Court has no jurisdiction to review the IRS' determinations of employment taxes on shareholder-employees and has instructed its examiners how to attain this result;[89] the IRS asserts that the analysis does not change when

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[88] About 15 months after the IRS issued PMTA cited in fn 89, in *Azarian, P.A. v. Commissioner*, 897 F.3d 943 (2018), the Eighth Circuit agreed with the Tax Court that the Tax Court had no jurisdiction when the amount of wages was an issue and the service provider was admittedly an employee.

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

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

the service recipient uses a professional employer organization (PEO) to pay compensation to its sole corporate officer, even when the PEO issues Forms W-2 using its own EIN.[90] In this context, employment

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

Similarly, in *Patricia Arroyo DDS, Corp., Alex Mansilla and Mercedes P. Arroyo v. Commissioner*, Docket No. 5874-15, the Tax Court dismissed the case with respect to Patricia Arroyo DDS Corp. (DDS Corp.) for lack of jurisdiction finding that the Service had not made any determinations for purposes of section 7436. In this case the Service determined that the amounts treated as salaries paid to the corporate officers and reported on Form W-2 as wages were artificially low, recharacterized higher amounts as salaries, and thus as wages, based on nationwide market information, and assessed additional employment taxes. Petitioners asserted that the amounts treated as salaries paid by DDS Corp were appropriate and contended the Court had jurisdiction as to the amount of employment taxes owed. On February 23, 2017, the Tax Court issued an Order dismissing the case for lack of jurisdiction. The Tax Court stated that petitioner consistently treated the corporate officers as employees and contested only respondent's determination that the compensation paid to the corporate officers was inadequate. The Court stated that because respondent did not make a determination with respect to either of the two requisite matters specified in section 7436(a)(1) or (2), the Court lacked jurisdiction to determine the correct amount of employment taxes due as a result of respondent's determination that DDS Corp under-reported corporate officers' wages during the tax years at issue.

[90] CCA 201735021, in which:

The duties of the PEO under the contract include: 1) administering Taxpayer payroll, designated benefits, and personnel policies and procedures related to the Assigned Employees; 2) providing human resource administration and payroll administration with respect to the Assigned Employees; 3) furnishing and keeping workers compensation insurance covering the Assigned Employees; 4) processing and paying wages from its own accounts to the Assigned Employees based on the hours and wage information reported by the Taxpayer and 5) filing all employment tax returns (i.e., Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, and Form 941, Employer's Quarterly Federal Tax Return) with the Government and furnishing information returns to the workers.

The PEO's duties under the contract, however, were limited to only those wages that were reported and verified by the Taxpayer to the PEO for each pay period. In the event the Taxpayer paid wages to the Assigned Employees that were not reported to the PEO, the contract provides that the Taxpayer will be "solely responsible for damages of any nature out of the Client's failure to report payment of unreported wages to any of the Assigned Employees".

For the taxable quarters included in the [Redacted Text] taxable year, as well as the [Redacted Text] taxable year, the Taxpayer's corporate officer received wage payments through the PEO. These wages were reported on a Form W-2, Wage and Tax Statement, issued by the PEO (under the PEO's EIN) and included on Forms 940 and 941 filed under the PEO's EIN. During this same year, the corporate officer also received distributions directly from the Taxpayer reported on a Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., under the Taxpayer's EIN. The distributions were not reported or verified by the Taxpayer to the PEO as wages so were not included on the employment tax returns filed under the PEO EIN.

The CCA asserted:

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

taxes mean Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) taxes, and Federal income tax withholding.[91]

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

> For all years at issue in these cases, the Commissioner argues that the firm did not pay employment taxes on all the wages that Ward received. The disagreement is largely about what the firm calls the "officer compensation" that it paid Ward.[8] The firm acknowledges that some of this compensation was salary or wages, but says the rest constituted distributions of the firm's earnings and profits.[9]
>
> > [8] The firm didn't claim to pay any "officer compensation" in 2013. Ward instead claimed $48,136 as "Wages/Draws" on her personal return. Like the officer compensation from the previous two years, the Commissioner argues it's all wages.
> >
> > [9] The firm also says that portions of those distributions should not be taxed because they were returns of Ward's basis in the firm. Under section 1368(a) and (b) an S corporation shareholder doesn't have to include distributions from the corporation in income if she has basis in the corporation that exceeds the amount distributed. Unfortunately for the firm, even if we were to accept that it paid Ward distributions in any amount, there is no evidence of what basis, if any, she had in the firm for any of the years before us.
>
> The parties now agree that Ward is indeed an employee of the firm. (Under the Code, officers are employees. Sec. 3121(d)(1).) Any compensation paid to Ward in her role as an officer is considered wages. See *Joseph M. Grey Pub. Accountant, P.C. v. Commissioner*, 119 T.C. 121, 129-130 (2002), *aff'd*, 93 F. App'x 473 (3d Cir. 2004). It's settled law that the firm is liable for employment taxes on these wages.
>
> The firm offers no evidence other than Ward's own testimony that any of these payments were anything but compensation. The firm, therefore, is liable for employment taxes on all amounts that the Commissioner identified as officer compensation.[10]
>
> > [10] The firm, while acknowledging that Ward was an employee who received compensation, nonetheless requests at various points in its brief that Ward's compensation be taxed directly to her as self-employment income. Since there's no evidence that Ward's work for the firm was as anything other than its officer, we deny this request.

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[91] Footnote 1 of PMTA 2017-05, cited in fn. 89. Regarding the 0.9% additional Medicare tax on earned income over $250,000 (married filing jointly), $125,000 (married filing separately), or $200,000 (all others), PMTA 2019-006 (6/28/2019) concluded:

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

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

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

Here are some ways that taxpayers trip themselves up:

- Sometimes they try to deduct various expenses on Schedule C, which reports income as a sole proprietor. This position asserts that expenses are netted against their income.
    - The IRS will say that the income constitutes Form W-2 wages, and the expenses are deductible as employee business expenses (Form 2106). Employee business expenses constitute miscellaneous itemized deductions, from which 2% of the taxpayer's adjusted gross income is subtracted. This reduced number is subject to other limitations imposed on itemized deductions and also is disallowed in computing alternative minimum tax.
    - If the owner-employee had run these expenses through the company using an "accountable plan,"[92] then they would be fully deductible (subject to any limitations imposed on business deductions) and netted against business income. By not using this mechanism, the owner-employee forgoes the benefits of an accountable plan.
- Qualified retirement plans (including Code § 401(k) plans) provide current deductions and provide tax-deferred income and growth (as well as protection from creditors). For an S corporation, contributions are based only on wage income (as one taxpayer discovered the hard way).[93] Properly declaring wages gives the owner-employee an opportunity to develop a thoughtful qualified retirement plan.

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

II. Worker Classification

For the purposes of respondent's determination, "employee" is defined for FICA and FUTA purposes to include "any officer of a corporation". See secs. 3121(d)(1) and (2), 3306(i). For purposes of income tax withholding under section 3402, the term "employee" also includes "an officer of a corporation". See sec. 3401(c). FICA and FUTA impose "employment taxes" that employers must pay and are obligated to withhold in addition to income tax withholding under

[92] Reg. § 1.62-2.

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

section 3402. Employers are required to make periodic deposits of amounts withheld from employees' wages and amounts corresponding to the employer's share of FICA and FUTA tax. Secs. 6302, 6157; secs. 31.6302-1, 31.6302(c)-3, Employment Tax Regs.

III. Petitioner's Corporate Officers

An officer of a corporation who performs more than minor services and receives remuneration for such services is a "statutory" employee for employment tax purposes. See *Joseph M. Grey Pub. Accountant, P.C. v. Commissioner*, 119 T.C. 121, 126 (2002), *aff'd*, 93 F. App'x 473 (3d Cir. 2004); *Central Motorplex, Inc. v. Commissioner*, T.C. Memo. 2014-207; *Glass Blocks Unlimited v. Commissioner*, T.C. Memo. 2013-180; *Nu-Look Design, Inc. v. Commissioner*, T.C. Memo. 2003-52, 85 T.C.M. (CCH) 927, 931 (2003), *aff'd*, 356 F.3d 290 (3d Cir. 2004); secs. 31.3121(d)-1(b), 31.3306(i)-1(c), 31.3401(c)-1(f), Employment Tax Regs. An officer can escape statutory employee status only if he performs no services (or only minor services) for that corporation and neither receives nor is entitled to receive any remuneration, directly or indirectly, for services performed. See *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 141, 144-145 (2001), *aff'd sub nom. Yeagle Drywall Co. v. Commissioner*, 54 F. App'x 100 3d Cir. 2002); secs. 31.3121(d)-1(b), 31.3306(i)-1(e), 31.3401(c)-1(f), Employment Tax Regs.

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

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

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

Petitioner did pay Hacker Corp. money classified as management fees on its general ledger for the years at issue in the following amounts: $382,650 in 2005, $378,484 in 2006, $0 in 2007, and $204,514 in 2008. From these management fees, Hacker Corp. paid Form W-2 wages to the

Hackers for 2005 through 2008 of $73,848, $40,000, $53,847, and $58,462, supposedly for the services the Hackers were to render to petitioner under an oral management contract. Petitioner has submitted no evidence of a management agreement, either written or oral, with Hacker Corp. Likewise, petitioner has submitted no evidence, written or otherwise, as to a service agreement directing the Hackers to perform substantial services on behalf of Hacker Corp. to benefit petitioner, or even a service or employment agreement between the Hackers and Hacker Corp. Therefore, there is no evidence in the record that Mr. Hacker or Mrs. Hacker performed services in a capacity other than as a corporate officer.

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

IV. Reasonableness of Compensation

Petitioner also contends that, even if the Court determines that its corporate officers are statutory employees, the determination of additional wages paid to the Hackers should be no more than the difference between what was paid to the Hackers as Form W-2 employees of Hacker Corp. and the reasonable wage determinations of respondent. Petitioner's arguments are misguided in that wages paid by Hacker Corp. do not offset reasonable compensation requirements for the services provided by petitioner's corporate officers to petitioner. Whatever wages paid for whatever purposes by Hacker Corp. to the Hackers as employees of the S corporation will be better addressed in relation to respondent's notice of deficiency for the Hackers' individual income tax, in consideration that Hacker Corp. is a wholly owned S corporation.

Additionally, petitioner contends that the notice of determination is flawed in that the determined compensation reflects requirements of higher educational qualifications than either Mr. Hacker or Mrs. Hacker has achieved, since Mr. Hacker did not graduate from college and Mrs. Hacker has only an associate's degree in child development. While petitioner has not further developed this contention in its briefs and there was limited trial testimony on the topic, whatever higher educational qualifications might be required have been far eclipsed by the Hackers' practical experience, professional qualifications, success in running day care centers, and ownership prerogatives.

Reasonableness of compensation is a question determined by all the facts and circumstances of the case. *E.g.*, *Glass Blocks Unlimited v. Commissioner*, at *13; *Joly v. Commissioner*, T.C. Memo. 1998-361, 1998 WL 712528, at *4, *aff'd without published opinion*, 211 F.3d 1269 (6th Cir. 2000). Factors affecting the reasonableness of compensation include the employee's role in the company, comparisons of the employee's salary to those paid by similar companies for similar services, and the character and condition of the company. *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1245-1246 (9th Cir. 1983), *rev'g* T.C. Memo. 1980-282; see also *Pepsi-Cola Bottling Co. of Salina, Inc. v. Commissioner*, 528 F.2d 176, 179 (10th Cir. 1975), *aff'g* 61 T.C. 564 (1974). The Court does not find persuasive petitioner's evidence that the services provided by the Hackers were worth something less than respondent's determination. Once again, although the issue was passingly addressed in evidence at trial, petitioner's briefs have failed to show why respondent's determination is unreasonable and, accordingly, petitioner has not carried its burden to show that the amounts respondent determined are unreasonable compensation.

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

For the S corporation's earnings to avoid self-employment tax, the S corporation must actually have received the income. See part II.G.25 Taxing Entity or Individual Performing Services.

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

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

A trust owning stock in an S corporation may be converted into a QSST – a trust in which the beneficiary pays the tax on the trust's current and accumulated income.[94] See part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs for discussions of how to:

- Tax the beneficiary on the trust's taxable income to avoid it being taxed at the trust's high income tax rates, a tax differential that has become more pronounced after 2012.
- Avoid unfavorable income taxation of a trust for a spouse after divorce.
- Sell the beneficiary's assets to a trust to freeze the beneficiary's estate while allowing the beneficiary to benefit from the assets' income.

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

The courts have created special rules expanding Code § 2036 to cause partnerships to be disregarded for estate tax purposes, artificially increasing the value included in the owner's estate unless the taxpayer proves that each entity was created for a "legitimate and significant nontax reason;"[95] this increase may

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

cause double inclusion of the appreciation of the retained partnership interest.[96] S corporation owners can avoid this issue by retaining voting stock and transferring nonvoting stock.[97]

Although the "check-the-box" rules generally apply for all tax purposes,[98] an LLC case held that state law property attributes control for gift tax purposes.[99] "Partnership" and "corporation" are not defined for gift and estate purposes, so it is unclear how the rules described in the prior paragraph may apply to an LLC taxed as an S corporation. To deal with that uncertainty, consider converting the LLC to a corporation taxed as an S corporation (or a single member disregarded entity of such a corporation) in a tax-free organization as described in part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization and elaborated upon in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

Code § 6166 provides estate tax deferral for closely-held businesses.[100] Tiered structures create significant limitations on the election and sometimes uncertainty as to whether the election is available.[101] However, if an S corporation is structured with multiple wholly owned subsidiaries, the parent of all of the subsidiaries should be treated as one entity for purposes of Code § 6166;[102] no authority directly addresses this conclusion, so one might consider obtaining a private letter ruling confirming this result (if the IRS is willing to rule on this issue, which likely would be only for a decedent).[103]

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

S corporations include the following disadvantages relative to partnership taxation:

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

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

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

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

[99] *Pierre*, a 2009 reviewed Tax Court opinion described in fn. 3921, held that, for gift tax purposes, the transfer of a partial interest in an LLC must be valued as an interest in the LLC as an entity rather than an interest in the underlying assets, even though before the transfer all of the assets were deemed owned directly by the sole member for income tax purposes. *Pierre* squarely held that the check-the-box rules do not override property rights, because state law property rights are fundamental to gift taxation. See part III.B.1.e Valuation Issues. *Mirowski v. Commissioner*, T.C. Memo. 2008-74, approved the nontax reasons for forming a single member LLC that was disregarded for income tax purposes, which approval was helpful when gifts of LLC interests were made later. *Mirowski* did not address the check-the-box rules.

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

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

[102] See part II.A.2.g Qualified Subchapter S Subsidiary, especially the text accompanying fns. 183-192.

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

- Perhaps more difficult to deduct start-up losses.[104]

- Less advantageous seller-financed sales to key employees or others.[105]

- No inside basis step-up when an owner sells in a taxable sale or dies.[106]

- Possible unavailability of a tax-free split-up of the entity, which might be very important when a trust terminates and is divided among beneficiaries.[107]

- The sale of S corporation stock and an S corporation's actual or deemed sale of its assets constitute unrelated business income per se, so charitable strategies are much less attractive.[108] Same with any K-1 income from an S corporation; if a marital trust terminates in favor of charity, consider converting the S corporation to an LLC taxed as an S corporation, so that the S corporation can be liquidated into a partnership or disregarded entity retroactive to immediately after the surviving spouse's death by the LLC revoking its election to be taxed as a corporation within 75 days after death.[109]

A structure that avoids these concerns, saves self-employment tax the way an S corporation would, and reduces the possibility of the 3.8% tax on net investment income being imposed on rent income is described in part II.E Recommended Structure for Entities. This structure is a limited partnership that has an S corporation general partner, which can avoid Code § 2036 issues and provide a limited partnership's superior income tax attributes. Owners of entities taxed as partnerships and owners of S corporations should consider migrating towards this structure.[110]

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

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

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

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

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

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104 See part II.G.4.c Basis Limitations for Deducting Partnership and S Corporation Losses.
105 See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis.
106 See parts II.H.2 Basis Step-Up Issues and II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation.
107 See generally part II.Q.7 Exiting from or Dividing a Corporation; for the steps required to have a tax-free corporate split-up, see part II.Q.7.f.ii Code § 355 Requirements. For partnership divisions, see part II.Q.8 Exiting From or Dividing a Partnership.
108 See part II.Q.6 Contributing a Business Interest to Charity to place context to part II.Q.6.d.ii UBTI Related to an S Corporation. Also, a charitable remainder trust cannot hold stock in an S corporation. See fn. 4683 in part II.Q.7.c S Corporation Owned by a Trust Benefitting Charity.
109 Reg. § 301.7701-3(c)(iii).
110 For migrating an S corporation, see parts II.Q.7.h Distributing Assets; Drop-Down into Partnership and II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

a limited partnership must have at least two separate owners – a general partner and a limited partner.[111] However, because an S corporation cannot have another S corporation as a shareholder unless the other latter is the former's sole shareholder,[112] the general partner needs to be dissolved, which would be a taxable event.[113]

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

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

For asset protection planning purposes,[114] consider using a limited liability limited partnership (LLLP) that makes an S election.[115] An LLLP is a limited partnership that uses the registration process for a limited liability partnership to protect the general partner from liability.

To avoid creating a second class of stock, be careful not to include partnership capital account provisions in the partnership agreement.[116]

An existing corporation may convert to such an entity on a tax-free basis.[117]

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

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

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

Also, distributions from a former C corporation may be taxable dividends, if they exceed certain S corporation earnings. See part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations. If the S election is not made effective until after the entity is first taxed as a C corporation, then one needs to determine whether the entity earned any earning and profits as a C corporation that generate a taxable dividend for distributions in excess of those S corporation earnings.[118]

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[111] See part II.C.11 Limited Partnership.
[112] See part II.A.2.e.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity.
[113] See part II.Q.7.a.vii Corporate Liquidation.
[114] See part II.F Asset Protection Planning.
[115] For why I suggest a limited partnership over an LLC, see part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election.
[116] See part II.A.2.i Single Class of Stock Rule and especially fn. 364 in part II.B Limited Liability Company (LLC).
[117] Code § 368(a)(1)(F), described more fully in part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.
[118] *Franklin v. Commissioner*, T.C. Memo. 2016-207, explained:

> An S corporation may have accumulated earnings and profits from a variety of sources, including (1) as a carryover from years in which it was a C corporation, before it became as S corporation, see *Cameron v. Commissioner*, 105 T.C. 380, 384 (1995), *aff'd sub nom. Broadaway v. Commissioner*, 111 F.3d 593 (8th Cir. 1997), and (2) as the result of certain reorganizations and the like, see sec. 1371(c)(2); see also James S. Eustice, Joel D. Kuntz, and John A. Bogdanski, *Federal Income Taxation of S Corporations*, para. 8.04[8][b], at 8-74 (5th ed. 2015). FDI was incorporated on March 24, 1989, and elected S corporation status effective March 27, 1989. Given the three-day period between its incorporation and S election, it is likely that FDI never accumulated earnings and profits as a

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

S elections are made on IRS Form 2553, filed no later than two months and 15 days after the beginning of the tax year the election is to take effect;[119] an S corporation elects to treat its subsidiary as a disregarded entity[120] using Form 8869, with the same deadline and similar relied for later filing. The instructions to IRS Form 2553 and 8869 discuss when an extension of time to file might be granted. The S election may be rescinded during the period during which an election could have been made timely.[121]

An election on Form 2553 is valid only if all persons who are shareholders[122] in the corporation on the day on which such election is made consent to such election.[123] An executor or administrator of the shareholder's estate may consent to a new S election on behalf of a decedent.[124] When a married couple owns stock as tenants in common, joint tenants, or tenants by the entirety, each tenant in common, joint

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> C corporation. Moreover, although the record is silent, from the nature of its business as construction/contractor it also seems likely that it was never involved in reorganizations or other transactions referred to in section 1371(c)(2). See *Briggs v. Commissioner*, T.C. Memo. 2000-380, 2000 WL 1847580, at *4 n. 9. We find, accordingly, that FDI had no accumulated earnings and profits.

[119] The procedure for corporations electing S corporation status also applies to unincorporated entities, which do not need to (and usually should not) elect corporate income taxation before making the S election. See text accompanying fns. 362-363 in part II.B Limited Liability Company (LLC).

[120] See fn. 144, which also recommends that the corporate subsidiary convert into a limited liability company that is treated a disregarded entity to avoid potential issues relating to future ownership.

[121] See text accompanying fns. 3935-3937.

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

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

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

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

It held:

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

tenant and tenant by the entirety must consent to the election.[125] Although the consent of each spouse who has a community property interest is required,[126] the IRS waives the consent requirement if certain procedures are followed, the election failed to include the signature of a community property spouse who was a shareholder solely pursuant to state community property law, and both spouses have reported all their K-1 items on all affected federal income tax returns.[127] The deemed owner (whether the grantor or, in the case of a QSST election, the beneficiary) of a grantor trust must sign the consent,[128] even if the trust is an ESBT (but the trustee of the ESBT must also sign).[129]

One may verify that Form 2553 was filed by filing Form 8821 with the Internal Revenue Service.[130] Obtain a signed Form 8821, call the IRS, then fax Form 8821 to the person who will provide the verification.[131]

An election that is timely filed for any taxable year and that would be valid except for the failure of any shareholder to file a timely consent can be granted additional time to file by the district director or director of the service center with which the corporation files its income tax return if (1) there was reasonable cause for the failure to file the consent, (2) the request for the extension of time is made within a reasonable time under the circumstances, and (3) treating the election as valid will not jeopardize the government's interest.[132] Consents must be filed within the extended period of time by all persons who have not previously consented to the election and were shareholders of the corporation at any time during the period beginning as of the date of the invalid election and ending on the date on which an extension of time is granted.[133]

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[125] Reg. § 1.1362-6(b)(2)(i).

[126] Reg. § 1.1362-6(b)(2)(i). For a community property trust's eligibility to hold stock, see fn. 5675, found in part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust.

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

[128] Letter Ruling 201516009.

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

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

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

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

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

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

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

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

[133] Reg. § 1.1362-6(b)(3)(iii)(B).

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

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

Letter Ruling 201714014 provided relief for a late S election and a late QSub[134] election.[135]

If the corporation comes in for relief for late filing due to mistakes and not all eligible shareholders have consented, the IRS might grant relief while requiring the corporation to work out with the District Director those eligible shareholders' late consents.[136]

If the corporation has an ineligible shareholder at the time of the election and does not realize the issue, the election is invalid, but inadvertent termination relief would give the S election retroactive application if the ineligible shareholder is eliminated.[137]

The following parts reproduce in their entirety (including apparently non-substantive typos) flowcharts the IRS kindly provided when it kindly gave taxpayers 3 years and 75 days from the effective date of the S election:[138]

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[134] See part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

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

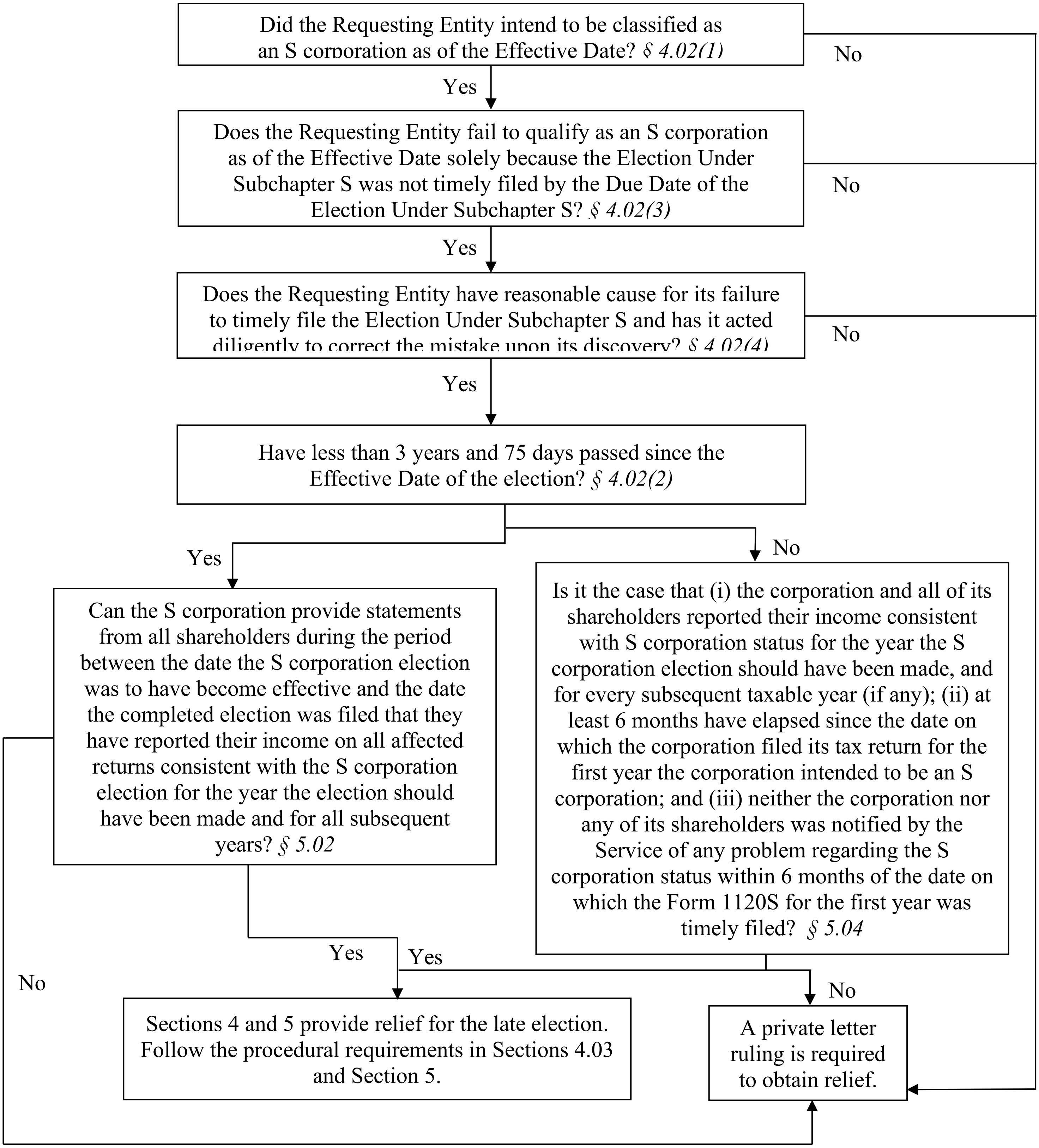
> X was formed on D1 under the laws of State. X's initial shareholders are trusts that X represents are eligible S corporation shareholders. X represents that it filed Form 2553, Election by a Small Business Corporation, to be treated as an S corporation effective D2. However, X received no acceptance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

[136] Letter Ruling 201714018, referring to the relief in the text accompanying fns. 132-133.

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

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

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



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

Did the Requesting Entity intend for the subsidiary corporation to be classified as a QSub as of the Effective Date?
§ 4.02(1)

No

Yes

Have less than 3 years and 75 days passed since the Effective Date of the election?
§ 4.02(2)

No

Yes

Does the subsidiary corporation fail to qualify as a QSub as of the Effective Date solely because the Election Under Subchapter S was not timely filed by the Due Date of the Election Under Subchapter S?
§ 4.02(3)

No

Yes

Does the Requesting Entity have reasonable cause for its failure to timely file the Election Under Subchapter S and has it acted diligently to correct the mistake upon its discovery?
§ 4.02(4)

No

Yes

Is it the case that (i) the subsidiary corporation satisfies the QSub requirements and (ii) all assets, liabilities, and items of income, deduction, and credit of the QSub have been treated as assets, liabilities, and items of income, deduction, and credit of the S Corporation on all affected returns consistent with the QSub election for the year the election was intended to be effective and for all subsequent years?
§ 7.02

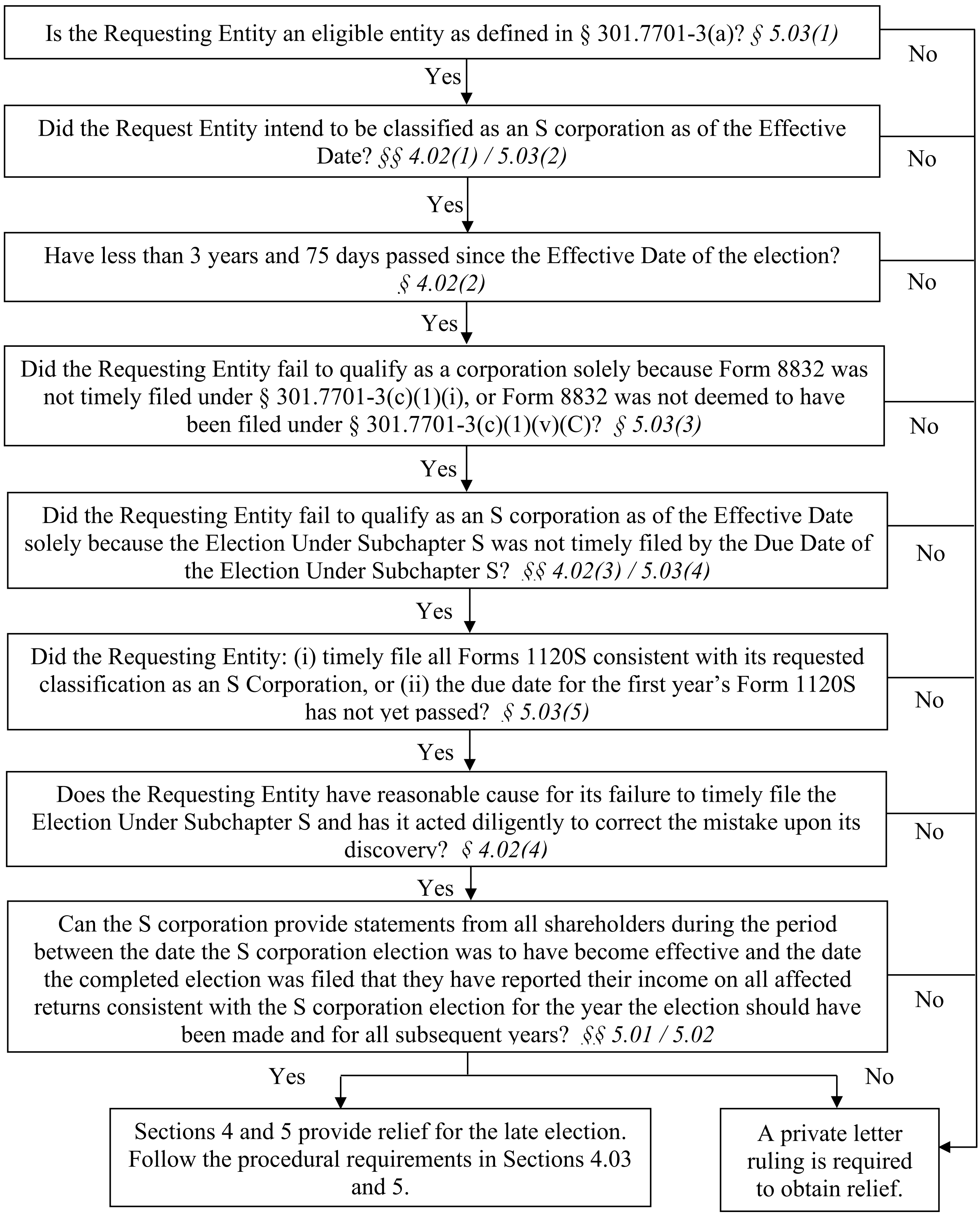
No

Yes

Sections 4 and 7 provide relief for the late election. Follow the procedural requirements in Sections 4.03 and Section 7.

A private letter ruling is required to obtain relief.

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



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

To be eligible for an S election, a corporation must be a domestic corporation that is not an ineligible corporation and does not have:[139]

- more than 100 shareholders,[140]
- a shareholder who is a person (other than an estate, an eligible trust,[141] or a qualified retirement plan[142] or charity[143]) who is not an individual,[144]
- a nonresident alien as a shareholder, and

---

[139] Code § 1361(b)(1).

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

> As a Kentucky nonstock, nonprofit corporation subject to the provisions of the Act, Waterfront had no stock and could issue no stock. Consequently, petitioner does not fall within the four corners of the regulation which "[o]rdinarily" treats as an S corporation shareholder "the person who would have to include in gross income dividends distributed with respect to the stock of the corporation (if the corporation were a C corporation)". Sec. 1.1361-1(e)(1), Income Tax Regs. (emphasis added).
>
> Furthermore, petitioner did not otherwise possess an ownership interest in Waterfront equivalent to that of a shareholder. Because he was president and a director of Waterfront, the Act, along with Waterfront's articles of incorporation, expressly prohibited any part of Waterfront's income or profit from being distributed to him or inuring to his benefit. See Ky. Rev. Stat. Ann. sec. 273.237. 10 In the light of this nondistribution constraint, treating petitioner as a shareholder of Waterfront would be fundamentally incompatible with the purpose and operation of subchapter S, which generally taxes an S corporation's income currently at the shareholder level.
>
> Furthermore, petitioner lacked dissolution rights in Waterfront typical of a shareholder. None of Waterfront's assets could be distributed to him upon Waterfront's dissolution. See Ky. Rev. Stat. Ann. sec. 273.303. 11 Consistent with the constraints of the Act, Waterfront's articles of incorporation provide that, upon its dissolution, its assets shall be distributed for exempt purposes within the meaning of section 501(c)(3) or shall be distributed to an entity established for public purposes.
>
> Petitioner asserts that in August 2012 he "assumed complete control over the planning of the fashion week event" and began "treating … [it] as a for-profit business". Even assuming that this is true, any such actions would not give rise to ownership rights in Waterfront greater than those afforded by the Act and Waterfront's articles of incorporation. Control over Waterfront was vested in its three directors, as fiduciaries entrusted with the duties and powers imposed upon them by the Act and the articles of incorporation. See Ky. Rev. Stat. Ann. sec. 273.215(1); *Ballard v. 1400 Willow Council of Co-Owners, Inc.*, 430 S.W.3d 229, 241 (Ky. 2013).
>
> In the light of these various considerations, we conclude that petitioner, as an officer and director of Waterfront, subject to the constraints of the Act and Waterfront's articles of incorporation, lacked ownership rights in Waterfront equivalent to those of a shareholder for purposes of applying subchapter S.

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

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

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

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

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

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

- more than 1 class of stock.

However, a domestic trust that is an electing small business trust (ESBT)[145] may have a nonresident alien (NRA) as a permissible current distributee.[146] Thus, one may give or bequeath stock to an NRA by making sure the gift or bequest is to a trust that has an ESBT election in place. If and to the extent that the NRA is the deemed owner of the ESBT, for "all ESBTs after December 31, 2017"[147] the items of income, deduction, and credit from that grantor portion must be reallocated from the grantor portion to the S portion of the ESBT,[148] thereby being subjected to U.S. income tax.

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

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

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

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

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

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

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

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

See fn 5836 in part III.A.3.e.ii.(a) Qualification as an ESBT where the last two sentences of Reg. § 1.1361-1(m)(4)(i) provide that NRAs count toward the 100-sharholder limit but do not count for purposes of the prohibition against NRA shareholders.

[147] Reg. § 1.641(c)-1(k).

[148] Reg. § 1.641(c)-1(b) provides:

> (1) *Grantor portion* -
>
> (i) *In general*. Subject to paragraph (b)(1)(ii) of this section, the grantor portion of an ESBT is the portion of the trust that is treated as owned by the grantor or another person under subpart E of the Code.
>
> (ii) *Nonresident alien deemed owner*. If, pursuant to section 672(f)(2)(A)(ii), the deemed owner of a grantor portion of the ESBT is a nonresident alien, as defined in section 7701(b)(1)(B) (NRA), the items of income, deduction, and credit from that grantor portion must be reallocated from the grantor portion to the S portion, as defined in paragraph (b)(2) of this section, of the ESBT.
>
> (2) *S portion*
>
> (i) *In general*. Subject to paragraph (b)(2)(ii) of this section, the S portion of an ESBT is the portion of the trust that consists of S corporation stock and that is not treated as owned by the grantor or another person under subpart E of the Code.
>
> (ii) *NRA deemed owner of grantor portion*. The S portion of an ESBT also includes the grantor portion of the items of income, deduction, and credit reallocated under paragraph (b)(1)(ii) of this section from the grantor portion of the ESBT to the S portion of the ESBT.

Reg. § 1.641(c)-1(*l*)(6) provides:

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

As mentioned above, a person who does not hold formal legal title but has a community property interest in stock is counted as a shareholder whose consent is required.[149] Accordingly, consider making sure that the spouse of each shareholder, who lives or has lived in a community property state, is not and does not become a nonresident alien.[150] *Deckard v. Commissioner*, 155 T.C. No. 8 (2020), explained:

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

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Presumably the Example refers to a domestic trust, because a foreign trust is never an eligible shareholder. See fn 5719 in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation. I seriously doubt that a revocable trust created by an NRA can ever qualify as a domestic trust, but I have not researched the issue.

[149] See part II.A.2.e.ii Procedure for Making the S Election; Verifying the S Election; Relief for Certain Defects in Making the Election, especially fns. 126-127.

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

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

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

> *Example (1)*. In 1990, W, a U.S. citizen, married H, a citizen of a foreign country. At all times H is a nonresident alien under section 7701(b)(1)(B). Under the foreign country's law, all property acquired by a husband and wife during the existence of the marriage is community property and owned jointly by the husband and wife. In 1996 while residing in the foreign country, W formed X, a U.S. corporation, and X simultaneously filed an election to be an S corporation. X issued all of its outstanding stock in W's name. Under the foreign country's law, X's stock became the community property of and jointly owned by H and W. Thus, X does not meet the definition of a small business corporation and therefore could not file a valid S election because H, a nonresident alien, has a current interest in the stock.
>
> *Example (2)*. Assume the same facts as Example 1, except that in 1991, W and H filed a section 6013(g) election allowing them to file a joint U.S. tax return and causing H to be treated as a U.S. resident for purposes of chapters 1, 5, and 24 of the Internal Revenue Code. The section 6013(g) election applies to the taxable year for which made and to all subsequent taxable years until terminated. Because H is treated as a U.S. resident under section 6013(g), X does meet the definition of a small business corporation. Thus, the election filed by X to be an S corporation is valid.
>
> Letter Ruling 202149004 provided inadvertent termination relief in a situation similar to Example (1).

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

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

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

If an individual holds S corporation stock through a disregarded entity, the individual and not the disregarded entity is treated as the shareholder, whether the disregarded entity is a single member LLC,[151] is a partnership of disregarded entities all taxed to the same person (and therefore the partnership itself is disregarded),[152] or is an unincorporated entity owned by a married couple as community property that the couple elects to treat as disregarded.[153] Note, of course, that such a disregarded entity[154] or nominee[155] could easily be transformed into a partnership, thereby becoming an ineligible shareholder; however,

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[151] Letter Rulings 9739014 and 200008015, which are implicitly reinforced by fn. 155.

[152] Letter Rulings 200008015 and 200513001 (the latter expressly mentioning that Rev. Rul. 2004-77 disregards a partnership of disregarded entities all taxed to the same person), which are implicitly reinforced by the part of Reg. § 1.1361-1(e)(1) that is reproduced in fn. 155. Also see fn. 333 in part II.B Limited Liability Company (LLC), discussing generally when an LLC with more than one member constitutes a disregarded entity.

[153] Letter Ruling 201610007. For disregarding such an entity, see Rev. Proc. 2002-69, which is described in fn. 351, found in part II.B Limited Liability Company (LLC). Rev. Proc. 2002-69 allows a married couple to disregard the entity by reporting its activity directly on their tax returns. In Letter Ruling 201610007, the couple filed partnership tax returns, which the Letter Ruling ruled was an inadvertent termination. The IRS approved the S election so long as the couple elected to disregard the entity as provided in Rev. Proc. 2002-69 for all open taxable years.

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

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

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

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

In light of the regulation expressly authorizing nominees, the Letter Rulings in fns. 151 and 152 ignoring disregarded entities seem doubly well-grounded (grounded in the check-the-box regulations and this regulation).

Note also that a partnership that has long ago wound up its operations might be an eligible shareholder. See fn. 159.

inadvertent termination relief may be available.[156] Bequeathing a partnership interest to the only other partner through one's will generally is not enough to prevent the partnership from being a separate entity, because the process of estate administration causes the estate itself to have a legal life.[157] Query whether a nonprobate transfer through a transfer on death statute[158] might be considered instantaneous, because any claims are asserted after the transfer to the beneficiary, not before. Having the partnership term end upon the death of the grantor of multiple grantor trusts that are the sole partners might prevent the stock from being considered owned by a partnership,[159] but I would not recommend that in planning mode. Rather than hold S corporation stock in a partnership that is a disregarded entity and risk the need for an inadvertent termination ruling, consider whether the S corporation's business can be moved to a

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[156] Letter Ruling 200841007 granted relief as follows:

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

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

Letter Rulings 8948015 (partnership and individuals transfer to empty shell), 8934020 (transfer to empty shell), 8926016 (transfer to empty shell), 9010042 (transfer to empty shell), and 9421022 (transfer to empty shell) ignored transitory ownership by a partnership of an S corporation as part of a series of immediately effective transactions. See also parts II.A.2.j.ii Disregarding Transitory Owners and II.P.3.c.i Formless Conversion, text accompanying fn. 3871 (formless conversion of a partnership to an S corporation the same as a Code § 351 followed by a liquidation of the partnership, and the transitory ownership of the S corporation by the partnership is disregarded).

[157] Rev. Rul. 62-116.

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

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

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

This case preceded Reg. § 1.1361-1(e)(1), which allows a partnership to hold S corporation stock as a nominee; see fn. 155.

partnership;[160] such an arrangement can be done seamlessly via merger or conversion statutes through a reorganization under Code § 368(a)(1)(F),[161] and the IRS generally accepts using a partnership to avoid concerns over ineligible shareholders.[162]

If an S corporation that is a partner in a partnership gives its stock to an employee of the partnership as compensation, which presumably would be treated as contributing the stock to the partnership and the partnership then transferring the stock as compensation to the employee,[163] the partnership will not be treated as a momentary owner of the S corporation stock.[164]

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

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

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

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

Special family attribution rules ameliorate the 100-shareholder limitation.[165]

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

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

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

[163] Presumably such a transfer would be analogous to a shareholder's transfer of stock to an employee of the corporation described in part II.M.4.c.i When a Gift to a Service Provider Is Compensation and Not a Gift, fn. 3556.

[164] Letter Ruling 200009029.

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

In counting the number of shareholders, the following are treated as 1 shareholder:[166]

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

The term "members of a family" means a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant.[167]

An individual is considered to be a common ancestor only if, on the applicable date, the individual is not more than six generations removed from the youngest generation of shareholders who otherwise would be members of the family.[168] "Applicable date" means the latest of the date the S election is made, the earliest date that a member of the family holds stock in the S corporation, or October 22, 2004.[169] The test is only applied as of the applicable date, and lineal descendants (and spouses) more than six generations removed from the common ancestor will be treated as members of the family even if they acquire stock in the corporation after that date.[170]

The members of a family are treated as one shareholder solely for purposes of counting shareholders.[171] Each member of the family who owns or is deemed to own stock must be an eligible shareholder.[172]

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

[166] Code § 1361(c)(1)(A).

[167] Code § 1361(c)(1)(B)(i). Any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by the individual, and any eligible foster child of an individual (under Code § 152(f)(1)(C)), shall be treated as a child of such individual by blood. Code § 1361(c)(1)(C).

[168] Code § 1361(c)(1)(B)(ii). For purposes of the preceding sentence, a spouse (or former spouse) shall be treated as being of the same generation as the individual to whom such spouse is (or was) married.

[169] Code § 1361(c)(1)(B)(iii).

[170] Reg. § 1.1361-1(e)(3)(i).

[171] Reg. § 1.1361-1(e)(3)(i).

[172] Reg. § 1.1361-1(e)(3)(i).

Although a person may be a member of more than one family under these rules, each family (not all of whose members are also members of the other family) will be treated as one shareholder.[173]

In counting shareholders, the estate or grantor trust of a deceased member of the family will be considered to be a member of the family during the period in which the estate or trust (such trust during the two years the trust is eligible) holds stock in the S corporation, and the members of the family also include:[174]

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

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

An S corporation can own a wholly[175] owned subsidiary, which the Code calls a "qualified subchapter S subsidiary"[176] and the regulations and this author refer to as a QSub.[177] A Qsub may own another QSub, in which case the ultimate parent makes the Qsub election at every level.[178]

A QSub is any domestic corporation that is not an ineligible corporation,[179] is wholly owned by an S corporation, and that the parent elects to treat as a QSub.[180] The parent files Form 8869 no more than

[173] Reg. § 1.1361-1(e)(3)(i).
[174] Reg. § 1.1361-1(e)(3)(ii).
[175] If an S corporation owns less than all of another corporation, that other corporation is not eligible to be an S corporation; however, inadvertent termination relief may be available. Letter Ruling 202017020.
[176] Code § 1361(b)(3), especially Code § 1361(b)(3)(B).
[177] Reg. § 1.1361-2(a).
[178] Reg. § 1.1361-2(d), Example (1).
[179] Referring to Code § 1362(b)(2), which provides that the following are ineligible to make an S election:

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

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

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

12 months before or 2 months and 15 days after the election's effective date.[181] For relief for a late election, see part II.A.2.e.ii Procedure for Making the S Election; Verifying the S Election; Relief for Certain Defects in Making the Election, especially part II.A.2.e.iv Relief for Late QSub Elections. If a QSub was timely but was ineffective due to the subsidiary's failure to meet all the requirements of Code § 1361(b)(3)(B) at the time the election was made, relief for inadvertent ineffectiveness may be available.[182]

A QSub is not treated as a separate corporation, and all of the QSub's assets, liabilities, and items of income, deduction, and credit are treated as assets, liabilities, and such items (as the case may be) of its parent;[183] this treatment applies for all purposes of the Code, except as provided in regulations.[184] Reg. § 1.1361-4(a)(1) states that this rule applies "for Federal tax purposes," except for certain provisions it references:[185]

- If the parent or a QSub is a bank, then the special bank rules govern items of income, deduction, and credit at the bank entity level; however, after applying those rules, all of the QSub's assets, liabilities, and items of income, deduction, and credit, as determined in accordance with the special bank rules, are treated as the parent's.[186]

- A QSub is treated as a separate corporation for purposes of its Federal tax liabilities with respect to any taxable period for which the QSub was treated as a separate corporation, Federal tax liabilities of any other entity for which the QSub is liable, and refunds or credits of Federal tax.[187]

- A QSub is treated as a separate corporation for purposes of Federal employment taxes and withholding.[188]

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[181] Reg. § 1.1361-3(a)(4). If the parent is a newly formed holding company and the subsidiary is electing to be a QSub, see fn 3955 in part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.
[182] Letter Ruling 202015003.
[183] CCA 201552026 asserts that a parent may not take a Code § 165(g)(3) worthless stock deduction with respect to its QSub's stock.
[184] Code § 1361(b)(3)(A).
[185] Rev. Rul. 2008-18 explains:

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

[186] Reg. § 1.1361-4(a)(3), especially Reg. § 1.1361-4(a)(3)(ii), Example (2).
[187] Reg. § 1.1361-4(a)(6).
[188] Reg. § 1.1361-4(a)(7) provides:

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

- A QSub is treated as a separate corporation for purposes of certain excise taxes,[189] none of which seem to have anything to do with estate, gift, or generation-skipping transfer taxes.[190]

- QSubs separately file certain information returns,[191] none of which seem to have anything to do with estate, gift, or generation-skipping transfer taxes.[192]

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

> (1) *General rule*. Any entity that has an employer identification number (EIN) will retain that EIN if a QSub election is made for the entity under § 1.1361-3 or if a QSub election that was in effect for the entity terminates under § 1.1361-5.
>
> (2) *EIN while QSub election in effect*. Except as otherwise provided in regulations or other published guidance,[193] a QSub must use the parent S corporation's EIN for Federal tax purposes.

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[189] Reg. § 1.1361-4(a)(8) provides:

> (i) *In general*. A QSub is treated as a separate corporation for purposes of—
> (A) Federal tax liabilities imposed by Chapters 31, 32 (other than section 4181), 33, 34, 35, 36 (other than section 4461), 38, and 49 of the Internal Revenue Code, or any floor stocks tax imposed on articles subject to any of these taxes;
> (B) Collection of tax imposed by Chapters 33 and 49 of the Internal Revenue Code;
> (C) Registration under sections 4101, 4222, and 4412;
> (D) Claims of a credit (other than a credit under section 34), refund, or payment related to a tax described in paragraph (a)(8)(i)(A) of this section or under section 6426 or 6427; and
> (E) Assessment and collection of an assessable payment imposed by section 4980H and reporting required by section 6056.
>
> (ii) *Effective/applicability date*.
> (A) Except as provided in this paragraph (a)(8)(ii), paragraph (a)(8) of this section applies to liabilities imposed and actions first required or permitted in periods beginning on or after January 1, 2008.
> (B) References to Chapter 49 in paragraph (a)(8) of this section apply to taxes imposed on amounts paid on or after July 1, 2012.
> (C) Paragraph (a)(8)(i)(E) of this section applies for periods after December 31, 2014.

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

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

[191] Reg. § 1.1361-4(a)(9) provides:

> (i) *In general*. Except to the extent provided by the Secretary or Commissioner in guidance (including forms or instructions), paragraph (a)(1) of this section shall not apply to part III of subchapter A of chapter 61, relating to information returns.
> (ii) *Effective/applicability date*. This paragraph (a)(9) is effective on August 14, 2008.

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

[193] [my footnote – not in the regulation itself:] See fn 185 and accompanying text.

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

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

If a corporation becomes a QSub as the result of an S corporation in which its new parent obtains the subsidiary's former tax attributes, it needs to keep its EIN for two purposes:[194]

- A QSub is treated as a separate corporation for certain federal tax purposes, such as employment and various excise taxes.[195]

- As described in Reg. § 301.6109-1(i)(3) above, it must use its old tax ID when its QSub status terminates.[196]

- None of this changes the QSub's need to use its parent's tax ID for regular federal income tax purposes, as described in Reg. § 301.6109-1(i)(3) above.

QSubs have some nice uses. First, suppose one would like to drop all of an S corporation's assets into a partnership, per part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons. The shareholders can contribute their stock to a new corporation and make a QSub election for the old S corporation, both as part of a tax-free reorganization,[197] then merge the QSub into a new

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

[195] See fn 185 and accompanying text. Rev. Rul. 2008-18, Situation 2, involves the following facts:

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

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

> In Situation 2, consistent with Rev. Rul. 64-250, Z's original S election does not terminate but continues for Newco. Newco must obtain a new EIN. Z must retain its EIN (EIN 33-3333333) even though a QSub election is made for Z and must use its original EIN any time the QSub is otherwise treated as a separate entity for federal tax purposes (including for employment and certain excise taxes) or if the QSub election terminates.

[196] Rev. Rul. 2008-18, Situation 1, involves the following facts:

> B, an individual, owns all of the stock in Y, an S corporation. Y's EIN is 22-2222222. In Year 1, B forms Newco and contributes all of the Y stock to Newco. Newco meets the requirements for qualification as a small business corporation and timely elects to treat Y as a qualified subchapter S subsidiary (QSub), effective immediately following the transaction. The transaction meets the requirements of a reorganization under § 368(a)(1)(F). In Year 2, Newco sells a 1% interest in Y to D.

Rev. Rul. 2008-18, Situation 1, concludes:

> In Situation 1, consistent with Rev. Rul. 64-250, Y's original S election does not terminate but continues for Newco. Newco must obtain a new EIN. Y must retain its EIN (EIN 22-2222222) even though a QSub election is made for it and must use its original EIN any time the QSub is otherwise treated as a separate entity for federal tax purposes (including for employment and certain excise taxes) or if the QSub election terminates. In Year 2, when Newco sells a 1% interest of Y to D, Y's QSub election terminates pursuant to § 1361(b)(3)(C). Y must use its original EIN of 22-2222222 following the termination of Y's QSub election.

[197] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization, especially fn. 3955, which includes the procedure when one combines such a reorganization with a QSub

disregarded LLC as a disregarded transaction, even if the new LLC converts to a partnership immediately thereafter;[198] this transaction is diagrammed and explained in part II.E.7.c.i.(b) Use F Reorganization to Form LLC. A QSub might also allow a tiered structure to qualify for Code § 6166 estate tax deferral[199] when it might not have qualified or on more favorable terms than might otherwise have applied.[200] It might also be used to preserve the AAA of a corporation whose S election is revoked.[201] In the latter case, following the recommended reorganization the QSub election could be immediately terminated;[202] terminating it the same day as the day the QSub election is made prevents the 5-year waiting period for

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election. Consider whether the election to treat the old S corporation as a QSub should be made before merging into the LLC, out of concern that the surviving LLC is not taxed as a corporation and therefore can no longer make a QSub election on behalf of the old S corporation. See Letter Rulings 201501007 and 201724013.

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

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

(ii) The merger of Y into T causes a termination of Y's QSub election. The new corporation Newco) that is formed as a result of the termination is immediately merged into T, an entity that is disregarded for Federal tax purposes. Because, at the end of the series of transactions, the assets continue to be held by X for Federal tax purposes, under step transaction principles, the formation of Newco and the transfer of assets pursuant to the merger of Newco into T are disregarded. The sale of 21 percent of T is treated as a sale of a 21 percent undivided interest in each of T's assets. Immediately thereafter, X and Z are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

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

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

[200] See part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders, especially the text accompanying fns. 100-103.

[201] See part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation, especially fns. 3856-3858.

[202] Reg. § 1.1361-3(b), "Revocation of QSub election," provides in paragraphs (1) and (2):

(1) *Manner of revoking QSub election*. An S corporation may revoke a QSub election under section 1361 by filing a statement with the service center where the S corporation's most recent tax return was properly filed. The revocation statement must include the names, addresses, and taxpayer identification numbers of both the parent S corporation and the QSub, if any. The statement must be signed by a person authorized to sign the S corporation's return required to be filed under section 6037.

(2) *Effective date of revocation*. The revocation of a QSub election is effective on the date specified on the revocation statement or on the date the revocation statement is filed if no date is specified. The effective date specified on the revocation statement cannot be more than two months and 15 days prior to the date on which the revocation statement is filed and cannot be more than 12 months after the date on which the revocation statement is filed. If a revocation statement specifies an effective date more than two months and 15 days prior to the date on which the statement is filed, it will be effective two months and 15 days prior to the date it is filed. If a revocation statement specifies an effective date more than 12 months after the date on which the statement is filed, it will be effective 12 months after the date it is filed.

re-electing QSub status[203] from applying.[204] The revocation of the QSub election is treated as forming a new C corporation.[205]

If the parent later owns less than all of the stock of the subsidiary, the subsidiary becomes a C corporation.[206] Consider merging a QSub into a wholly owned LLC that is a disregarded entity, so that its pass-flow status is not lost if ownership of part of the entity is transferred or if potential changes in capital structure cause equity to be deemed to be issued (it was suggested to me that an underpriced warrant issued in a financing might cause problems), but beware state income taxation if a state in which the

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[203] Reg. § 1.1361-5(c)(1). Code § 1361(b)(3)(D) provides:

> *Election after termination*. If a corporation's status as a qualified subchapter S subsidiary terminates, such corporation (and any successor corporation) shall not be eligible to make-
> (i) an election under subparagraph (B)(ii) to be treated as a qualified subchapter S subsidiary, or
> (ii) an election under section 1362(a) to be treated as an S corporation,
> before its 5th taxable year which begins after the 1st taxable year for which such termination was effective, unless the Secretary consents to such election.

[204] Reg. § 1.1361-3(b)(4) provides:

> *Revocation before QSub election effective*. For purposes of Section 1361(b)(3)(D) and § 1.1361-5(c) (five-year prohibition on re-election), a revocation effective on the first day the QSub election was to be effective will not be treated as a termination of a QSub election.

Eustice, Kuntz & Bogdanski, *Federal Income Taxation of S Corporations* (WG&L), ¶ 3.08[3][g][ii] Revocation, includes this example:

> X, an S corporation, files a proper qualified subchapter S subsidiary election for its wholly owned subsidiary, S, on January 1, 2016, effective on that date. On March 10 of the same year, while S is still an eligible qualified subchapter S subsidiary, X changes its mind and files a revocation of the election, effective January 1. Because the intended effective date is less than two months and fifteen days prior to the filing of the revocation statement, the revocation is effective, as stated, on January 1. Because this was also the first day on which the election was to be effective, S is not barred from being a qualified subchapter S subsidiary, or an S corporation, in the years 2016 to 2020.

RIA Checkpoint ¶ 254:182 Termination by Revocation includes an example making the same point. See Reg. § 1.1361-3(b)(2) in fn 202, supporting retroactive revocation in this manner.

[205] Reg. § 1.1361-5(b)(1)(i) provides:

> *In general*. If a QSub election terminates under paragraph (a) of this section, the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation. The tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. For purposes of determining the application of section 351 with respect to this transaction, instruments, obligations, or other arrangements that are not treated as stock of the QSub under § 1.1361-2(b) are disregarded in determining control for purposes of section 368(c) even if they are equity under general principles of tax law.

Reg. § 1.1361-5(b)(3), Example (5) provides:

> X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X subsequently revokes the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the revocation from its S corporation parent in a deemed exchange for Y stock. On a subsequent date, X sells 21 percent of the stock of Y to Z, an unrelated corporation, for cash. Assume that under general principles of tax law including the step transaction doctrine, the sale is not taken into account in determining whether X is in control of Y immediately after the deemed exchange of assets for stock. The deemed exchange by X of assets for Y stock and the deemed assumption by Y of its liabilities qualify under section 351 because, for purposes of that section, X is in control of Y within the meaning of section 368(c) immediately after the transfer.

[206] Reg. § 1.1361-5(a)(1)(iii) and Code § 1361(b)(3)(b)(i). Reg. § 1.1361-5(b)(3), Example (1) provides:

> X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X sells 21 percent of the Y stock to Z, an unrelated corporation, for cash, thereby terminating the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Y stock immediately before the termination from the S corporation. The deemed exchange by X of assets for Y stock does not qualify under section 351 because X is not in control of Y within the meaning of section 368(c) immediately after the transfer as a result of the sale of stock to Z. Therefore, X must recognize gain, if any, on the assets transferred to Y in exchange for its stock. X's losses, if any, on the assets transferred are subject to the limitations of section 267.

company is subject to income tax does not treat a QSub as a disregarded entity[207] and that a disregarded entity subsidiary might not have as strong an argument that Code § 6166 estate tax deferral applies.[208]

On the reverse side, if an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation in a generally tax-free transaction.[209]

A Qsub might be spun off. Bloomberg BNA's Tax Management Weekly Report (11/11/2019) described Letter Ruling 201945016:

> The IRS issued 13 rulings on an S corporation's ("Distributing") proposed reorganization entailing a transfer of assets to a controlled qualified subchapter S subsidiary with Controlled then assuming certain liabilities (the "Contribution"), and distribution of all of the Controlled stock proportionately to each of a group of "Split-Off Shareholders" in exchange for all of their Distributing stock, pursuant to equalization of the value of Controlled and Distributing (the "Distribution"). Ruling (1) Upon the Distribution, Controlled will no longer be a QSub. Ruling (2) The Contribution followed by the Distribution will qualify as a reorganization under tax code Section 368(a)(1)(D), with Distributing and Controlled each "a party to a reorganization" within the meaning of Section 368(b). Rulings (3), (4), (7), (8) No gain or loss will be recognized by relevant entities in the Contribution or the Distribution. Rulings (5), (9) The basis of assets transferred in the Contribution and in the Distribution won't change upon the moment of transfer. Rulings (6), (10) The holding period for the recipient for a given asset will include that of the previous owner in the Contribution and in the Distribution. Rulings (11),(12) Any earnings and profits will be allocated between Distributing and Controlled in accordance with Section 312(h) and regulations, and Distributing's accumulated adjustments account will be allocated between Distributing and Controlled in a similar manner. Ruling (13) Distributing's momentary ownership of Controlled stock won't cause Controlled to have an ineligible shareholder for any portion of its first taxable year under Section 1361(b)(1)(B); therefore Controlled will be permitted to elect to be an S corporation for its first taxable year provided it otherwise qualifies and makes such election effective immediately upon its QSub termination.

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

Always provide that stock cannot be transferred to any person if such a transfer would make the corporation fail to be a "small business corporation" under Code § 1361(b)(1).[210] Because the tax laws change, the restriction should be as simple and broad as the preceding sentence. Define "transfer" to be any event that causes federal tax law to treat ownership as having changed, which might include a trust no longer being a wholly-owned grantor trust[211] even though shares have not changed hands.

Notwithstanding these protections, problems might occur – especially if the company does not have a qualified tax advisor approve every transfer other than to an individual who is a US citizen. The

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

[208] See part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders, especially the text accompanying fns. 100-102.

[209] Reg. § 1.1361-4(a)(2)(i), which further provides that, subject to certain transition rules that apply to pre-2001 QSub elections, "the tax treatment of the liquidation or of a larger transaction that includes the liquidation will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine." Reg. § 1.1361-4(a)(2)(ii) illustrates this liquidation concept, including the Example (1) a liquidation that under Code §§ 332 and 337 is tax-free to the parent and subsidiary, respectively. For the latter, see part II.Q.7.a.vii Corporate Liquidation.

[210] See part II.A.2.f Shareholders Eligible to Hold S Corporation Stock.

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

consequences of losing an S election are harsh,[212] including loss of AAA[213] and possible built-in gain tax.[214]

Fortunately, Code § 1362(f), "Inadvertent invalid elections or terminations," provides that a corporation "shall be treated as an S corporation or a qualified subchapter S subsidiary, as the case may be, during the period specified by the Secretary" if:

> (1) an election under subsection (a) or section 1361(b)(3)(B)(ii) by any corporation -
>
> > (A) was not effective for the taxable year for which made (determined without regard to subsection (b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or
> >
> > (B) was terminated under paragraph (2) or (3) of subsection (d) or section 1361(b)(3)(C),
>
> (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent,
>
> (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken -
>
> (A) so that the corporation for which the election was made or the termination occurred is a small business corporation or a qualified subchapter S subsidiary, as the case may be, or
>
> (B) to acquire the required shareholder consents, and
>
> (4) the corporation for which the election was made or the termination occurred, and each person who was a shareholder in such corporation at any time during the period specified pursuant to this subsection , agrees to make such adjustments (consistent with the treatment of such corporation as an S corporation or a qualified subchapter S subsidiary, as the case may be) as may be required by the Secretary with respect to such period.

Reg. § 1.1362-4(b), "Inadvertent termination or inadvertently invalid election," provides:

> For purposes of paragraph (a) of this section, the determination of whether a termination or invalid election was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination or invalid election was inadvertent. The fact that the terminating event or invalidity of the election was not reasonably within the control of the corporation and, in the case of a termination, was not part of a plan to terminate the election, or the fact that the terminating event or circumstance took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event or circumstance, tends to establish that the termination or invalidity of the election was inadvertent.

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[212] See parts II.E.2.b Converting from S Corporation to C Corporation and II.P.3.d Conversion from S Corporation to C Corporation.

[213] See parts II.Q.7.b Redemptions or Distributions Involving S Corporations and II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation**.**

[214] See part II.P.3.b.ii Built-in Gain Tax on Former C Corporations under Code § 1374.

The legislative history to Code § 1362(f) explains:[215]

> If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.
>
> The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers. For example, if a corporation, in good faith, determined that it had no earnings and profits, but it is later determined on audit that its election terminated by reason of violating the passive income test for three consecutive years because the corporation in fact did have accumulated earnings, if the shareholders were to agree to treat the earnings as distributed and include the dividends in income, it may be appropriate to waive the terminating events, so that the election is treated as never terminated. Likewise, it may be appropriate to waive the terminating event when the one class of stock requirement was inadvertently breached, but no tax avoidance had resulted. It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

Accordingly, the IRS provides retroactive relief, so long as taxpayers cannot get some benefit they would have not received had they not followed the rules. Therefore, the IRS may require adjustments to avoid unfair benefits.[216] By allowing retroactive reinstatement, the IRS is allowing the corporation to avoid corporate level tax; it would not be difficult to imagine a shareholder disagreeing with the relief and refusing to pay tax on K-1 income, whipsawing the IRS for having allowed the corporation to avoid tax. To avoid this whipsaw, everyone who might be affected by the relief must consent. Reg. § 1.1362-4(e), "Corporation and shareholder consents," provides:

> The corporation and all persons who were shareholders of the corporation at any time during the period specified by the Commissioner must consent to any adjustments that the Commissioner may require. Each consent should be in the form of a statement agreeing to make the adjustments. The statement must be signed by the shareholder (in the case of shareholder consent) or a person authorized to sign the return required by section 6037 (in the case of corporate consent). See § 1.1362-6(b)(2) for persons required to sign consents. A shareholder's consent statement should include the name, address, and taxpayer identification numbers of the corporation and shareholder, the number of shares of stock owned by the shareholder, and the dates on which the shareholder owned any stock. The corporate consent statement should include the name, address, and taxpayer identification numbers of the corporation and each shareholder.

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[215] Senate Explanation of the Subchapter S Revision Act, P.L. 97-354 (10/19/82), "(e) Inadvertent terminations (secs. 1362(f))."

[216] Reg. § 1.1362-4(d), "Adjustments," provides:

> The Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation or QSub during the period specified by the Commissioner. In the case of stock held by an ineligible shareholder that causes an inadvertent termination or invalid election for an S corporation under section 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of the S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent the loss of any revenue due to the holding of stock by an ineligible shareholder (for example, a nonresident alien).

If caught and corrected soon enough (generally 3 years and 75 days after the transfer), one can obtain automatic relief;[217] otherwise, correction might require an expensive and potentially time-consuming private letter ruling.[218] As described above, either relief has the stated requirement that all shareholders consent to relief for inadvertent termination. Obtaining such consent might be difficult, for example, if the owner is no longer a shareholder or is incapacitated, deceased, or simply uncooperative. A shareholder agreement should grant the company an irrevocable[219] durable power of attorney to sign such consents.

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

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

Consider using provisions found in the ACTEC Shareholders Agreement Form 2007,[220] which uses as a general reference the ACTEC Shareholders Agreement Outline 2011.[221]

II.A.2.i. Single Class of Stock Rule

S corporations cannot have more than one class of stock.[222]

Use great caution to strip any partnership tax and accounting provisions from any operating agreement or partnership agreement forms if an unincorporated entity makes the election.[223] Letter Ruling 200548021 refers to the operating agreement as a governing provision for purposes of Reg. § 1.1361-1(l)(2)(i). Letter Rulings 201136004 and 201351017 allowed relief for inadvertent ineligibility to make an S election where perhaps the capital account partnership provisions had not been stripped out and were later caught; same with Letter Ruling 201528025, which definitely involved capital account partnership provisions that had not been stripped out and were later caught.[224] Letter Ruling 201949009 involved not only

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

[218] See parts II.A.2.e.ii Procedure for Making the S Election; Verifying the S Election; Relief for Certain Defects in Making the Election (and its companion parts II.A.2.e.iii Relief for Late S corporation Elections Within 3+ Years, II.A.2.e.iv Relief for Late QSub Elections, and II.A.2.e.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity) and III.A.3.c.iii.(a) General Description of Deadlines for QSST and ESBT Elections (and its companion, part III.A.3.c.iii.(b) Flowchart Showing Relief for Late QSST & ESBT Elections).

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

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

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

[222] Code § 1361(b)(1)(D).

[223] For how to make the election and related strategy, see fns 362-366 and accompanying text in part II.B Limited Liability Company (LLC).

[224] Letter Ruling 202110010 said that among offending provisions that was later removed to qualify for inadvertent termination relief was:

partnership provisions but also issued profits interests that needed to be cured to cure the S election being ineffective due to those provisions. Same with Letter Ruling 202124002, which included curative action regarding profits interests issued to employees:

> Company and its shareholders represent that Company and its shareholders will file amended returns for Years as needed to reflect units that vested in Years and as necessary to reflect additional income and taxes resulting from the vesting of those units. Company also represents that it will amend Agreement to provide for identical rights to distribution and liquidation proceeds in accordance with § 1.1361-1(*l*).

The IRS will not rule on whether a state law limited partnership violates the single class of stock rule. Rev. Proc. 2021-3, § 3.01(106), which rule originated in Rev. Proc. 99-51.

Preferred stock having been issued when an S election is made makes the election ineffective, but the IRS may grant relief retroactively if all defects are cured.[225] Similarly, preferred stock being issued after an S election is made can be cured.[226]

Issuing a profits interest[227] would violate the single class of stock rule, but it can qualify for inadvertent termination relief.[228] If a profits interest is desirable, the S corporation should form an LLC subsidiary[229] and have the LLC issue profits interests.

> … in the event X is liquidated within the meaning of § 1.704-1(b)(2)(ii)(g) of the Income Tax Regulations, distributions shall be made to the members who have positive capital accounts in compliance with § 1.704-1(b)(2)(ii)(b)(2).

[225] Letter Rulings 201716009 and 201751007.

[226] Letter Ruling 201949003, with the following fixes having occurred in addition to the usual representations of inadvertence and promise to make any adjustments the IRS requires:

> X represents that on or about Date 5 it became aware that the issuance of the preferred stock may have inadvertently terminated its S corporation election. X represents that on Date 6 it took corrective action and (1) converted the preferred stock to common stock, (2) voted to cancel and retire all preferred stock, and (3) amended and restated its Articles of Incorporation to authorize only a single class of stock. X represents that as of Date 6 all issued and outstanding shares of preferred stock have been cancelled and retired. X also represents that its shareholders have taken into account their pro rate shares of X's separately and non-separately computed items pursuant to § 1366 and have made any adjustments to stock basis as required under § 1367. Furthermore, X represents that its shareholders have accounted for any distributions made under § 1368.

[227] For profits interests, see part II.M.4.f Issuing a Profits Interest to a Service Provider.

[228] In Letter Ruling 201949009, an LLC made an S election. Later:

> On Date 3, X's Operating Agreement included provisions regarding partnerships. Section 4(j) of the Operating Agreement provides, in part, that it is intended that X will be treated as a partnership for federal income tax purposes and that each Member will be treated as a partner of a partnership for tax purposes. Section 4(a) provides, in part, that X shall have two (2) classes of Units: Class A Units and Profits Units. Sections, 4, 8, and 19 of the Operating Agreement state that a Profits Interest only shares in liquidation proceeds due to profits earned after the issuance of the Profit Unit. On Date 4 and Date 5, X issued Profits Interests.
>
> When X's shareholders discovered the effect of the partnership provisions and the issuance of the Profits Interests, X canceled the Profits Interests between Date 6 and Date 7. X amended its operating agreement on Date 8 to remove the partnership provisions and the Profits Interest provisions and to provide identical distribution and liquidation rights to X's shareholders.

The ruling held:

> Based solely on the facts submitted and representations made, we conclude that X's S corporation election terminated on Date 3 because X had more than one class of stock due to the provisions in the Operating Agreement. We also conclude that the termination of X's S corporation was inadvertent within the meaning of § 1362(f). Accordingly, under the provisions of § 1362(f), X will be treated as an S corporation from Date 3 until Date 9, provided that X's S corporation election was otherwise valid and not otherwise terminated under § 1362(d).

[229] See part II.E.7.c.i Corporation Forms New LLC.

Letter Ruling 202149004 provided inadvertent termination relief for the following:

> On Date 3, X entered into an agreement with C, a shareholder in X, to purchase additional shares of stock in X. The agreement contained an anti-dilution provision with respect to C's shares in X such that C would maintain a fixed ownership percentage in X. X represents that the agreement is a governing provision within the meaning of § 1.1361-1(l)(2)(i) of the Income Tax Regulations and that the effect of the anti-dilution provision in the agreement caused X to have more than one class of stock. Consequently, had X's S corporation election been effective Date 1, it would have terminated on Date 3. Upon learning that it had more than one class of stock, X amended the agreement with C pursuant to which the anti-dilution provision was stricken, and B's ownership interest was adjusted to exclude the application of the anti-dilution provision.

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

The issues discussed in this part II.A.2.i.i apply to C corporations as well, except to the extent they specify S corporations.

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

Differences in voting rights do not by themselves create a second class of stock.[230] Generally, if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, a corporation is treated as having only one class of stock.[231] Thus, the corporation may issue voting and nonvoting stock, each of which confers identical rights to distribution and liquidation proceeds. This capital structure also avoids gift and estate tax problems under the anti-freeze valuation rules of Chapter 14.[232]

A shareholder being wrongfully shut out from participating in management did not cause the shareholder to lose status as a shareholder when the shareholder continued to enjoy the financial benefits of being a shareholder.[233]

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[230] Code § 1361(c)(4).

[231] Reg. § 1.1361-1(*l*)(1), which provides:

> *General rule*. A corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in paragraph (*l*)(4) of this section (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

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

[233] *Enis v. Commissioner*, T.C. Memo. 2017-222, reasoning:

> In determining stock ownership for Federal income tax purposes, the Court must look to the beneficial ownership of shares, not mere legal title. See *Ragghianti v. Commissioner*, 71 T.C. 346, 349 (1978), *aff'd*, 652 F.2d 65 (9th Cir. 1981). Cases concluding that a shareholder did not have beneficial ownership have considered both agreements between shareholders that removed ownership and provisions in the corporation's governing articles affecting ownership rights. See *Dunne v. Commissioner*, 2008 WL 656496, at *9. Mere interference with a "shareholder's participation in the corporation as a result of a poor relationship between the shareholders … does not amount to a deprivation of the economic benefit of the shares." *Id*. (citing *Hightower v. Commissioner*, T.C. Memo. 2005-274, *aff'd* without published opinion, 266 F.App'x 646 (9th Cir. 2008)); *Kumar v. Commissioner*, T.C. Memo. 2013-184.

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

The retention of the right to vote (directly or indirectly) shares of stock of a "controlled corporation" causes estate inclusion of the transferred stock.[234]

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

If the trustee consults with the grantor regarding how to vote stock the trust owns, the IRS may take the position that the grantor has indirectly retained the right to vote in conjunction with the trustee and that therefore the stock is includible in the grantor's estate for estate tax purposes.[235] If the grantor is the trustee over transferred nonvoting stock, the fact that nonvoting stock can vote in extraordinary matters, such as mergers or liquidations, will not cause Code § 2036 inclusion.[236]

> Petitioners contend that while Mrs. Enis was issued NLS shares, the removal of her power to exercise shareholder rights, as well as the actions of Dr. Ginsburg, removed the beneficial ownership of her shares. Petitioners, therefore, assert that they are not required to include pro rata shares of NLS' income. Petitioners identified no agreement or provisions in the corporation's governing articles removing beneficial ownership. *Kumar* does not support their position that a violation of the shareholders agreement could deprive them of the beneficial ownership of their shares. In *Kumar* we found that in the absence of an agreement passing the taxpayer's rights to his stock to another shareholder, a poor relationship between shareholders does not deprive one shareholder of the economic benefit of his shares. *Kumar v. Commissioner*, at *3. We, therefore, held that the taxpayer retained beneficial ownership. *Id*.
>
> Further, petitioners cited no authority, nor are we aware of any, that allows shareholders to exclude their shares of an S corporation's income because of poor relationships with other shareholders. While the relationships among the shareholders of NLS deteriorated, those poor relationships did not deprive Mrs. Enis of the economic benefit of her NLS shares. Indeed, ultimately, she sold her shares in 2014 for $436,165.

[234] Code § 2036(b)(1).

[235] Rev. Rul. 80-346. TAM 9515003 argued that a taxpayer could not invoke Rev. Rul. 80-346 to argue for estate inclusion of voting stock:

> As the court noted in *In re Steen v. United States*, *supra*, allowing a taxpayer to disavow the form of the transaction (in this case, the explicit terms of the trust instrument) under these circumstances, would encourage inappropriate tax planning and unwarranted litigation and places the Service in an untenable administrative position. Accordingly, we doubt that a court would allow a taxpayer to disavow the trust instrument under the circumstances presented here.[2]
>
> [2] We note that the Tax Court has held that a taxpayer is precluded from even arguing against the form of the transaction in the absence of strong proof. Other courts have adopted an even more restrictive rule. *Estate of Robinson v. Commissioner*, 101 T.C. 499, 513-514 (1993).

The TAM concluded:

> However, we doubt that the decedent detrimentally "relied" on the revenue ruling and structured the transaction to ensure that the transferred stock would be includible in the gross estate on his death. On the contrary, the decedent was advised by counsel and, no doubt, created the trust in order to EXCLUDE the stock from his gross estate. If the intent was to ensure the stock was included in the gross estate, the trust instrument would have expressly provided for the decedent's retention of voting rights. Further, if the decedent had in some way relied on Rev. Rul. 80-346 in creating the trust, then consistency would require that the transfer be reported on the gift tax return as a transfer with a retained interest. This was not done.
>
> Finally, even though A, as executrix, followed the revenue ruling in including the stock in the gross estate, nonetheless, we do not believe that, as discussed above, the estate can gain a tax advantage by now disavowing the form of the transaction.

For more about the TAM and arguing estate tax inclusion, see fn 5455 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

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

However, if the grantor transfers nonvoting stock and retains the voting stock, the transferred nonvoting stock will not be includible in the grantor's estate for estate tax purposes.[237]

Typically, the S corporation starts with one type of voting stock. Then it issues a stock dividend of nonvoting stock. The stock dividend does not constitute a taxable distribution.[238] The author's tendency is to distribute 19 shares of nonvoting stock for each share of voting stock. This allows the voting stock to retain a significant portion, yet allows the original owner to shift 95% of the distribution and liquidation rights when transferring the nonvoting stock to the next generation.

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

One should consider filing Form 8937 to report the issuance of nonvoting shares.[239] It is due 45 days after issuing the shares or, if earlier, on January 15 following the calendar year of the issuance.[240] However, "an S corporation can satisfy the reporting requirement for any organizational action that affects the basis if it reports the effect of the organizational action on a timely filed Schedule K-1 (Form 1120S) for each shareholder and timely gives a copy to all proper parties." [241] These deadlines and exceptions are from the December 2011 instructions to Form 8937; be sure to check the instructions, as well as the IRS' webpage for future developments regarding Form 8937.[242]

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

Issue nonvoting shares will not remove grandfathering from Code § 2703.[243]

If the corporation is a C corporation, then the stock issuance will not blow the Code § 1202 exclusion of gain on sale of qualified small business stock.[244]

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[237] See Code § 2036(b) (transfers of voting stock in a controlled corporation can be included in the transferor's estate for estate tax purposes if the transferor retains strings such as voting rights), Rev. Rul. 80-346 (even informal strings on voting stock held in trust can bring it into the settlor's estate), and both Rev. Rul. 81-15 and Prop. Reg. § 20.2036-2 (the settlor's retention of voting stock outside of a trust will not cause the Code § 2036(b) inclusion of nonvoting stock transferred in trust); *Boykin v. Commissioner*, T.C. Memo. 1987-134 (same conclusion as Rev. Rul. 81-15 but without citing it). Rev. Rul. 81-15 does not appear to recognize that even nonvoting stock has some limited voting rights; fortunately, Prop. Reg. § 20.2036-2(a) seems to recognize and approve of such a retention, as mentioned in fn. 236. Given that estate tax definitions regarding business entities tend to be sparse, one might also look to income tax rules regarding when the right to vote is significant. For purposes of determining whether a corporation was eligible to file a consolidated return, which turned on the presence of voting stock, voting for directors constituted a critical part of the right to vote. *Alumax Inc. v. Commissioner*, 109 T.C. 133 (1197), *aff'd* 165 F.3d 822 (11th Cir. 1999).

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

[239] Code § 6045(g).

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

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

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

[243] See part II.Q.4.h Establishing Estate Tax Values, especially fn. 4387.

[244] See fn 4980 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

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

Future reallocations between voting and nonvoting stock would not create income tax consequences.[245] However, to avoid a taxable gift, a swap of voting for nonvoting stock (or vice versa) should consider the disparity in their values.[246] It is not unusual for even minority voting shares to have 3%-5% more value than nonvoting shares, so one might consider consulting a qualified appraiser when doing a swap like this.

A redemption plan did not cause second-class-of-stock issues when its purposes were to ensure that voting power and economic ownership between A and A's family and B and B's family remain approximately equal and to prevent an individual shareholder from owning a disproportionate amount of voting versus nonvoting common stock.[247]

II.A.2.i.i.(e). Example of Recapitalizing Voting and Nonvoting

Suppose there were 100 shares – all voting – and the grantor gave 20 shares to the trust.

Here are the steps:

1. Amend articles of incorporation to allow nonvoting
2. Give 19 shares of nonvoting for every share of voting, meaning:
   a. Grantor has 80 voting and 1,520 nonvoting
   b. Trust has 20 voting and 380 voting
3. Then grantor transfers to the trust nonvoting shares pursuant to a formula[248] (which will likely be 21 shares) in exchange for all of the trust's 20 voting shares.

Code § 1036[249] allows step 4 to be income tax-free, even if the trust is not a grantor trust.

II.A.2.j. Overcoming Above Rules

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

The S corporation can contribute its assets to an entity taxed as a partnership with an ineligible shareholder as a member,[310] with another S corporation as a member (to avoid the limitation on number of

[245] Code § 1036. Voting trust certificates are also eligible for an income tax-free swap. Letter Ruling 200618004.
[246] *Bosca v. Commissioner*, T.C. Memo. 1998-251.
[247] Letter Ruling 201506003.
[248] Use the principles of part III.B.3.d Disclaimers, found in part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.
[249] See fn 6438 in part III.B.2.h.iii Swap Power (Code § 1036 generally) and fn 654 in part II.D.4.a.i Classifying an Investment Trust (voting trust certificates).
[310] Reg. § 1.701-2(d), Example (2).

shareholders),[311] with profits interests issued to (former) employees,[312] or with an investor who wants a non-pro rata equity interest in the business.

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

In corporate reorganizations, sometimes transitory entities are created, or transitory stock ownership occurs, to achieve some state law objective. For example:[313]

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

If a corporation owns stock in an S corporation that is undergoing such a transaction so that the ownership is transitory, the transaction's being disregarded also means that the transitory stock ownership does not terminate the S corporation's S election.[314]

For disregarding transitory partnerships that own S corporation stock, see part II.A.2.f Shareholders Eligible to Hold S Corporation Stock, especially fn. 156.

II.E.1.a. Taxes Imposed on C Corporations

For taxable years beginning after December 31, 2017, all C corporations pay tax at a flat 21% rate, unless some industry-specific exclusions, such as those for insurance companies, apply.[698] However, if a

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[311] Rev. Rul. 94-43, which Letter Ruling 201544020 cited as authority for holding that the following did not cause a violation of the 100-shareholder limit:

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

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

[312] For profits interests, see part II.M.4.f Issuing a Profits Interest to a Service Provider.

[313] Rev. Rul. 78-250.

[314] Letter Ruling 201330018. See also Letter Ruling 201314031 (transitory ownership in a split-off). For a discussion of F reorganizations, see part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization, especially fn. 3955.

[698] Code § 11(a), (b). Code § 11(c) provides that corporate income tax does not apply to a corporation subject to a tax imposed by:

> (1) section 594 (relating to mutual savings banks conducting life insurance business),

C corporation receives a dividend from another corporation, only part of that dividend is taxed,[699] reducing the effective tax rate to 10.5% for dividends from unrelated companies or zero or 7.35% for dividends from affiliates.

Biden would raise the top corporate income tax rate to 28% and increase the top income tax rate on dividends to 39.6% (before 3.8% net investment income tax).

In addition to taxes on annual operations, consider:

- Dividends to shareholders, which are distributions out of a corporation's current or accumulated earnings and profits, are subject to regular tax at capital gain rates[700] (if qualified dividends)[701] and the 3.8% tax on net investment income.[702] However, Biden proposed that high-income taxpayers' long-term capital gains would be taxed at 39.6% instead of 20%.

- A corporation that does not pay dividends may become subject to the 20% accumulated earnings tax or personal holding company income tax. See part 0 No distributions under Biden's plan:

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(2) subchapter L (sec. 801 and following, relating to insurance companies), or
(3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts).

Code § 11(d), "Foreign corporations," provides:

In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882.

[699] See fns. 9-13 in part II.A.1.a C Corporations Generally.

[700] Code §§ 1(h)(3), 1(h)(11)(A).

[701] Code § 1(h)(11)(B) provides the following parameters for "qualified dividend income":

(i) *In general*. The term "qualified dividend income" means dividends received during the taxable year from-
(I) domestic corporations, and
(II) qualified foreign corporations.
(ii) *Certain dividends excluded*. Such term shall not include-
(I) any dividend from a corporation which for the taxable year of the corporation in which the distribution is made, or the preceding taxable year, is a corporation exempt from tax under section 501 or 521,
(II) any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.), and
(III) any dividend described in section 404(k).
(iii) *Coordination with section 246(c)*. Such term shall not include any dividend on any share of stock-
(I) with respect to which the holding period requirements of section 246(c) are not met (determined by substituting in section 246(c) "60 days" for "45 days" each place it appears and by substituting "121-day period" for "91-day period"), or
(II) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Elaborating on Code § 1(h)(11)(B)(i)(II), Code § 1(h)(11)(C) provides rules for qualified foreign corporations.

Code § 1(h)(11)(D) provides special rules:

(i) *Amounts taken into account as investment income*. Qualified dividend income shall not include any amount which the taxpayer takes into account as investment income under section 163(d)(4)(B). [My note: This relates to income against which investment interest may be deducted. See part II.G.21.a Limitations on Deducting Business Interest Expense, which mentions in passing investment interest expense.]
(ii) *Extraordinary dividends*. If a taxpayer to whom this section applies receives, with respect to any share of stock, qualified dividend income from 1 or more dividends which are extraordinary dividends (within the meaning of section 1059(c)), any loss on the sale or exchange of such share shall, to the extent of such dividends, be treated as long-term capital loss.
(iii) *Treatment of dividends from regulated investment companies and real estate investment trusts*. A dividend received from a regulated investment company or a real estate investment trust shall be subject to the limitations prescribed in sections 854 and 857.

[702] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

Biden Plan	
Distributing 50% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-36,800
Net Income after Income Tax	$63,200

So, effective tax rates under current law are 55.8% distributing all earnings, 42.8% distributing half of the earnings, and 29.8% distributing none of the earnings.

Effective tax rates under the Biden plan are 72.6% distributing all earnings, 54.7% distributing half of the earnings, and 36.8% distributing none of the earnings.

- Incentives to Declare Dividends.

- A corporation that distributes property to its shareholders generally is subject to tax on the excess of value over basis (but cannot deduct a loss). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

II.E.1.a.i. Corporate Tax Rates in Moderate Tax States

Let's examine the effects of earning $100,000 taxable income inside the corporation and distributing various proportions of the net after-tax profits, assuming the taxpayer lives in a state that imposes moderate (5%) income tax on corporations and individuals. The individual in a top bracket is assumed taxed at a rate of 48.4%, consisting of 39.6% capital gain tax, 3.8% net investment income tax, and 5% state income tax. The individual in a modest bracket is assumed taxed at a rate of 20%, consisting of 15% capital gain tax, no net investment income tax, and 5% state income tax.

Distributing 100% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Income Taxes at 28.8% or 20%	-21,312	-14,800
Net Cash to Owner	$52,688	$59,200

Note that the tax rates above seem somewhat high – 47.3% or 40.8%, depending on whether the shareholder is in a high or modest bracket. The corporation might try paying more compensation to avoid double taxation, but compensation income is taxed at ordinary income rates, and the employer's and employee's share of FICA combines to add tax equal to 2.5%-13.3%.[703] So, add that tax to the employee's federal, state, and local income tax rate and compare to the above. Consider, however, that a corporation cannot deduct more than reasonable compensation - see part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment – and in 2017 the IRS has instructed its examiners how to prevent taxpayers from contesting the issue in Tax Court.[704]

Here is the same chart under Biden, with federal corporate tax rate increased from 21% to 28% and the top federal income tax rate on dividends increased from 20% to 39.6%:

Biden Plan		
Distributing 100% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-33,000	-33,000
Net Income after Income Tax	$67,000	$67,000
Income Taxes at 48.4% or 20%	-32,428	-13,400
Net Cash to Owner	$34,572	$53,600

Returning to current law:

Distributing 50% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Distribution to Owner	$37,000	$37,000
Income Taxes at 28.8% or 20%	-10,656	-7,400
Net Cash to Owner	$26,344	$29,600
Corporate Cash Plus Shareholder Cash	$63,344	$66,600

[703] The tax hit is 2.9%-15.3%, as described in part II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships, text accompanying fn 708-710. However, the employer's deduction for half of this amount at an assumed 26% rate lowers the effective rate to 2.5%-13.3%.

[704] See fns. 89-91 in part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax.

Here is the same chart under Biden, with federal corporate tax rate increased from 21% to 28% and the top federal income tax rate on dividends increased from 20% to 39.6%:

Biden Plan		
Distributing 50% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-33,000	-33,000
Net Income after Income Tax	$67,000	$67,000
Distribution to Owner	$33,500	$33,500
Income Taxes at 48.4% or 20%	-16,214	-6,700
Net Cash to Owner	$17,286	$26,800
Corporate Cash Plus Shareholder Cash	$50,786	$60,300

Returning to current law:

Distributing None of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-26,000
Net Income after Income Tax	$74,000

Here is the same chart under Biden, with federal corporate tax rate increased from 21% to 28%:

Biden Plan	
Distributing None of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-33,000
Net Income after Income Tax	$67,000

II.E.1.a.ii. Corporate Tax Rates in California

Let's examine the effects of earning $100,000 taxable income inside the corporation and distributing various proportions of the net after-tax profits, assuming the taxpayer lives in California, which imposed an 8.84% corporate tax rate. The individual in a top bracket is assumed taxed at a rate of 37.1%, consisting of 20% capital gain tax, 3.8% net investment income tax, and 13.3% state income tax.

Distributing 100% of Corporate Net Income After Income Tax	
Corporate Taxable Income	\$100,000
Federal and State Income Tax	-29,800
Net Income after Income Tax	\$70,200
Income Taxes at 37.1%	-26,044
Net Cash to Owner	\$44,156

Note that the effective annual tax rate above seems somewhat high at just under 56%. The corporation might try paying more compensation to avoid double taxation, but compensation income is taxed at ordinary income rates, and the employer's and employee's share of FICA combines to add tax equal to 2.5%-13.3%.[705] So, add that tax to the employee's federal, state, and local income tax rate and compare to the above. Consider, however, that a corporation cannot deduct more than reasonable compensation - see part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment – and in 2017 the IRS has instructed its examiners how to prevent taxpayers from contesting the issue in Tax Court.[706]

Biden would raise the top corporate income tax rate to 28% and increase the top income tax rate on dividends to 39.6% (before 3.8% net investment income tax). This would increase the top corporate rate in California to approximately 36.8% (28% + 8.84%) and the top individual rate for dividends of 56.7%, consisting of 39.6% capital gain tax, 3.8% net investment income tax, and 13.3% state income tax.

Biden Plan	
Distributing 100% of Corporate Net Income After Income Tax	
Corporate Taxable Income	\$100,000
Federal and State Income Tax	-36,800
Net Income after Income Tax	\$63,200
Income Taxes at 56.7%	-35,834
Net Cash to Owner	\$27,366

705 The tax hit is 2.9%-15.3%, as described in part II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships, text accompanying fn 708-710. However, the employer's deduction for half of this amount at an assumed 26% rate lowers the effective rate to 2%-13%.

706 See fns. 89-91 in part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax.

Here’s distributing half of the profits:

Distributing 50% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-29,800
Net Income after Income Tax	$70,200
Distribution to Owner	$35,100
Income Taxes at 37.1%	-13,022
Net Cash to Owner	$22,078
Corporate Cash Plus Shareholder Cash	$57,178

Distributing half under Biden’s plan:

Biden Plan	
Distributing 50% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-36,800
Net Income after Income Tax	$63,200
Distribution to Owner	$31,600
Income Taxes at 56.7%	-17,917
Net Cash to Owner	$13,683
Corporate Cash Plus Shareholder Cash	$45,283

No distributions under current law:

Distributing None of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-29,800
Net Income after Income Tax	$70,200

No distributions under Biden's plan:

Biden Plan	
Distributing 50% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-36,800
Net Income after Income Tax	$63,200

So, effective tax rates under current law are 55.8% distributing all earnings, 42.8% distributing half of the earnings, and 29.8% distributing none of the earnings.

Effective tax rates under the Biden plan are 72.6% distributing all earnings, 54.7% distributing half of the earnings, and 36.8% distributing none of the earnings.

II.E.1.a.iii. Incentives to Declare Dividends

Many years ago, Congress incentivized corporations to declare dividends, through the imposition of two taxes:

- Personal holding company tax. A personal holding company is taxed on 20% of its undistributed personal holding company income. See part II.A.1.e Personal Holding Company Tax.

- Accumulated earnings tax. Generally, a C corporation that accumulates funds could be subject to the 20% accumulated earnings tax on its excess undistributed accumulated earnings and profits. The corporation needs to articulate specific reasons why its needs to reinvest its earnings. For details, see part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax. This tax does not apply to personal holding companies (as used in the preceding bullet point). If the company not a personal holding company but is a mere holding or investment company, the tax kicks in if undistributed earnings exceed $125,000.[707]

Each of these taxes can be avoided by paying sufficient dividends. The corporation may manage these taxes by actual or deemed dividends; see the relevant tax for rules on the extent to which this is permitted and how to do it.

II.E.1.b. Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships

Generally, S corporations and partnerships do not pay entity-level income tax; instead, their owners pay tax on their distributive share of the entity's income. However, some state or local governments do impose an entity-level tax, which may be in addition to imposing income tax on the owners' distributive share of the entity's income.

Tax reform in 2017 introduced a deduction of up to 20% of business earnings. See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

[707] See fn 4625 in part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax.

An owner of a partnership or sole proprietorship also generally pays tax self-employment ("SE") tax on income from a trade or business, subject to various exceptions; see part II.L Self-Employment Tax (FICA). SE tax is 15.3% OASDI and Medicare taxes until the taxpayer reaches the taxable wage base ($142,800 in 2021 and $147,000 in 2022),[708] then is 2.9% Medicare tax until it reaches 3.8%, when the supplemental Medicare tax (employee's portion) kicks in.[709] The employer's portion of SE tax, which is 7.65% up to the taxable wage base and 1.45% thereafter, is deductible in determining adjusted gross income (not as an itemized deduction).[710]

An owner of an S corporation or partnership may pay the 3.8% tax on net investment income ("NII"); see part II.I 3.8% Tax on Excess Net Investment Income (NII). SE income is excluded from NII.[711] The deduction for the employer's share of SE tax makes SE tax preferable to NII tax, except to the extent that the income would be below the taxable wage base.

To the extent that an owner's distributive share of a partnership's or S corporation's income is reinvested, the owner's basis in the partnership interest[712] or stock[713] increases. Generally, an owner can withdraw the earnings tax-free, merely reducing basis in the owner's partnership interest or stock. See parts II.Q.8.b.i Distribution of Property by a Partnership and II.Q.7.b Redemptions or Distributions Involving S Corporations. However, an S corporation that distributes property triggers tax on the gain,[714] which gain is taxed at its shareholders' respective income tax rates and in many cases does not qualify for favorable capital gain rates.[715]

Let's examine the effects of earning $100,000 taxable income inside the entity, assuming the taxpayer lives in a state that imposes moderate (5%) income tax on corporations and individuals:

An individual in a top bracket might be taxed at a rate of 34.6%-45.8%, consisting of:

- 29.6%-37% ordinary income tax (depending on whether the Code § 199A 20% deduction is available)
- zero-3.8% net investment income tax (working in the business may avoid this tax, and exceptions to SE tax may apply as well), and
- 5% state income tax.

Biden wants to raise the top bracket from 37% to 39.6% and disallow the Code § 199A deduction for such individuals. An individual in a top bracket might be taxed at a rate of 44.6%-48.4%, consisting of:

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708 See http://www.ssa.gov/OACT/COLA/cbb.html for the current amount.

709 See fns 3284-3286 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.

710 Code § 164(f), "Deduction for one-half of self-employment taxes," provides:

(1) *In general*. In the case of an individual, in addition to the taxes described in subsection (a), there shall be allowed as a deduction for the taxable year an amount equal to one-half of the taxes imposed by section 1401 (other than the taxes imposed by section 1401(b)(2)) for such taxable year.

(2) *Deduction treated as attributable to trade or business*. For purposes of this chapter, the deduction allowed by paragraph (1) shall be treated as attributable to a trade or business carried on by the taxpayer which does not consist of the performance of services by the taxpayer as an employee.

711 As to SE income being excluded from NII, see fn 2213 in part II.I.5 What is Net Investment Income Generally.

712 Code § 705.

713 Code § 1367.

714 See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

715 See parts II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

- 39.6% ordinary income tax,
- zero-3.8% net investment income tax (working in the business may avoid this tax, and exceptions to SE tax may apply as well), and
- 5% state income tax.

An individual in a modest bracket might be taxed at a rate of 27.4%-46.2%, consisting of:

- 22.4%-28% ordinary income tax (depending on whether the Code § 199A 20% deduction is available, and the wage limitations[716] and restrictions on types of businesses do not apply to modest income taxpayers)
- zero-13.2% SE tax income tax (after considering the deduction for one-half of SE tax)
- 5% state income tax.

In California, the rates are as follows, as described in part II.Q.1.a.ii California Scenarios:

S corporation income rate:	29.6%-37%	federal
	13.3%	state individual
	1.5%	state entity
	zero-3.8%	NII tax
	44.4%-55.6%	

Partnership income rate:	29.6%-37%	federal
	13.3%	state
	zero-3.8%	NII or SE tax
	42.9%-54.1%	

II.E.7. Migrating into Partnership Structure

Compelling reasons to migrate from S corporation taxation to partnership include parts II.Q.8.e.iii.(a) Illustration of Inside Basis Issue and II.Q.1.a.i.(f) Partnership Use of Same Earnings as S Corporation in Sale of Goodwill, the latter illustrating substantial savings using a partnership when engaging in a seller-financed sale.

II.E.7.a. Overview of How to Migrate into Desired Structure

Moving an existing LLC, that is taxed as a partnership or as a disregarded entity, into this structure is relatively straightforward. The member or members form an S corporation. The S corporation contributes to a new limited partnership cash equal to 1/99 of the appraised value of the LLC's business, in exchange for a 1% interest as a general partner. The member or members contribute their interests in the LLC to the partnership in exchange.

[716] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

Forming the S corporation and the limited partnership are not taxable events,[1063] so long as the liabilities are not shifted (or reallocated) too much from the members of the LLC to the corporate general partner.[1064] Any gain inherent in the contributed assets will be taxed to the original owners when those assets are sold.[1065] The work-in-process, appreciated inventory, and accounts receivable would tend to be the assets to watch, and accounts receivable would not be a concern if the LLC's income was reported using the accrual method. Given that the S corporation would probably have been formed with a modest cash contribution and therefore would have not contributed such assets, the only gain likely to receive a special allocation would be those inherent in the LLC. If reallocation of liability becomes an issue, the original members can guarantee the debts to get the debts allocated to them.

These two transactions are illustrated in part II.E.7.b Flowcharts: Migrating LLC into Preferred Structure, including parts II.E.7.b.i Using Cash Contribution to Fund New S Corporation and II.E.7.b.ii Using LLC to Fund New S Corporation.

This migration would be much more involved if the business is operated inside a corporation. Converting a corporation into a partnership would trigger gain.[1066] Instead, generally the corporation would move its assets into an LLC and then contribute that LLC to the limited partnership.[1067] The corporate partner would receive a preferred return on this invested capital (for which it receives a capital account),[1068] with at least 10% of the value of its equity being an interest in the residual profits (the "common interest"), and the individuals would receive the rest of the common interest as limited partners; although receiving only a pure preferred partnership interest would not violate the disguised sale rules,[1069] providing a significant interest in common helps support the corporate partner's role as a true partner, especially if the preferred payments are, for all practical purposes, extremely likely to occur. The considerations about debt reallocation described above would also apply. In some cases, a C corporation might retain certain assets, collect them in due course, and then make an S election. For more information on this conversion, see part II.Q.7.h.viii Value Freeze as Conservative Alternative, especially fn 4912 (explaining why we recommend a common interest equal to at least 10% of the contributed equity). However, this 10% recommendation does not apply where other factors prevail, such as a marketplace business model or where the preferred partner has significant economic risk of loss from operations.

Note that starting as an LLC and migrating into the structure permits giving the corporate partner only a small common interest, whereas starting as a corporation and migrating requires giving the corporate partner both preferred and substantial common interests.

[1063] See part II.M.1. Taxation on Formation of Entity: Comparison between Partnership and Corporation.

[1064] If formed as described above, the concern would be that the reallocation of liabilities from a partner would be a deemed cash distribution that would generate gain if and to the extent that it exceeds the basis of that partner's partnership interest; see part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions. If formed as described below, where the partners contribute to the S corporation their interests as general partner, then, in addition to the issue described above, a shareholder would have gain to the extent that the debt the corporation assumed exceeds the basis of the partnership interest the shareholder contributes to the corporation; see part II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities.

[1065] See part II.P.1.a.i Allocations of Income in Partnerships.

[1066] See part II.P.3.a From Corporations to Partnerships and Sole Proprietorships.

[1067] The corporation would do this either gradually or in one fell swoop, as described in part II.E.7.c.i Corporation Forms New LLC, including parts II.E.7.c.i.(a) Direct Formation of LLC and II.E.7.c.i.(b) Use F Reorganization to Form LLC.

[1068] The exchange for a capital account (not intended to be redeemed in any manner in the first several years) and preferred payments (made from operating cash flow) can easily be done in a nontaxable manner that prevents the disguised sale rules from applying. See part II.M.3 Buying into or Forming a Partnership, particularly part II.M.3.e Exception: Disguised Sale. If any owners are members of the same family or if any owner might split up his ownership in the corporate general partner from his interest as a limited partner when making transfers to family members, see parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

[1069] As illustrated in part II.E.7.c.ii Moving New LLC into Preferred Structure.

Finally, if a business entity lacks a noncompete binding those with the key client/customer contacts:

- They can also migrate over time by letting the old entity wind down and doing business in a new entity taxed as a partnership, with the new entity leasing equipment from the old entity until the new entity is ready to buy new equipment to replace the old equipment as the latter becomes obsolete. Practical issues in collecting receivables in the old entity vs. doing business in the new entity require close consultation with the corporate/partnership's income tax preparer.

- The corporation's business might be worth very little if those with those contacts left and took those contacts with them. Consider obtaining an appraisal of the corporation's assets on that basis, which would minimize its capital account in the new entity. Those with the contacts sign a non-compete agreement with the new partnership, thereby establishing that they are providing that value to the partnership and deserve an interest in the partnership.

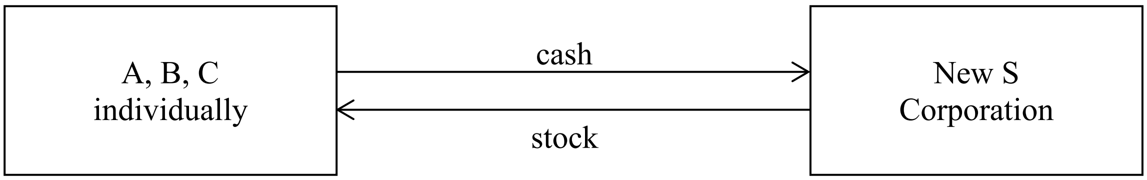
The strategy I propose envisions a limited partnership, so that the individual owners can avoid part II.L Self-Employment Tax (FICA) as limited partners; see part II.L.4 Self-Employment Tax Exclusion for Limited Partners' Distributive Shares. If that exclusion is repealed or avoiding self-employment tax is no longer an objective,[1070] the individuals might simply become members of the new LLC.

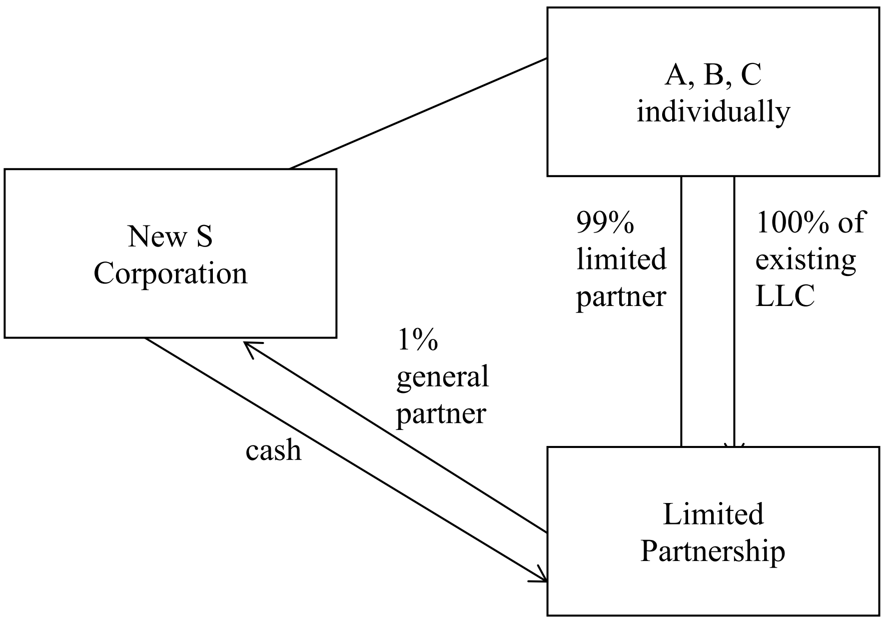
[1070] If the part II.I.8 Application of 3.8% Tax to Business Income exclusion from II.I 3.8% Tax on Excess Net Investment Income (NII) is repealed and the individual owners already receive compensation over the taxable wage based described in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax, then self-employment (SE) tax may be more attractive than net investment income tax, because the employer portion of SE tax is deductible for income tax purposes, making it a lower rate in many cases.

Also, any migration directly or indirectly involving real estate may require consideration of real estate transfer tax or fees or property tax reassessment.

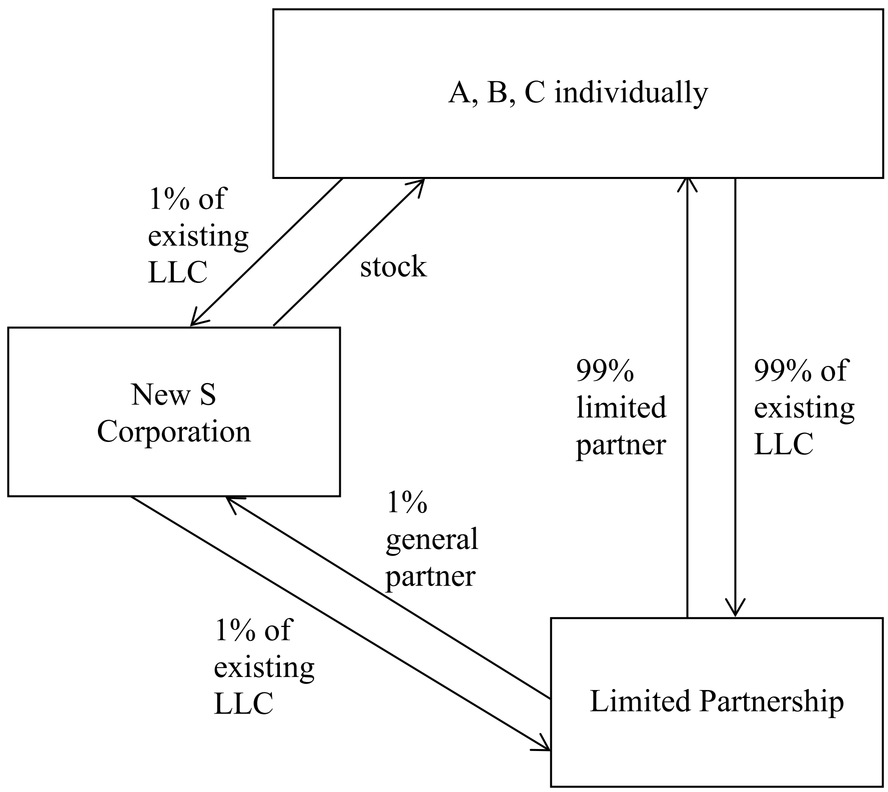
II.E.7.b. Flowcharts: Migrating LLC into Preferred Structure

II.E.7.b.i. Using Cash Contribution to Fund New S Corporation





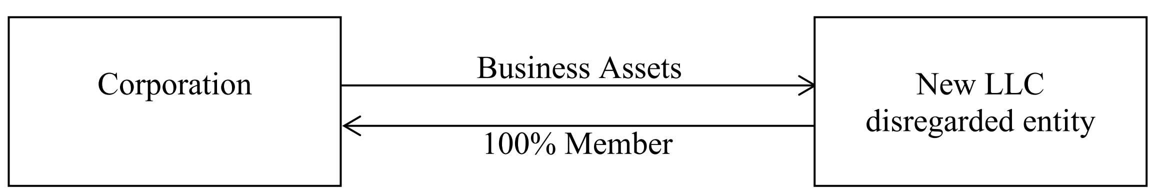
II.E.7.b.ii. Using LLC to Fund New S Corporation



II.E.7.c. Flowcharts: Migrating Existing Corporation into Preferred Structure

II.E.7.c.i. Corporation Forms New LLC

II.E.7.c.i.(a). Direct Formation of LLC



Advantages

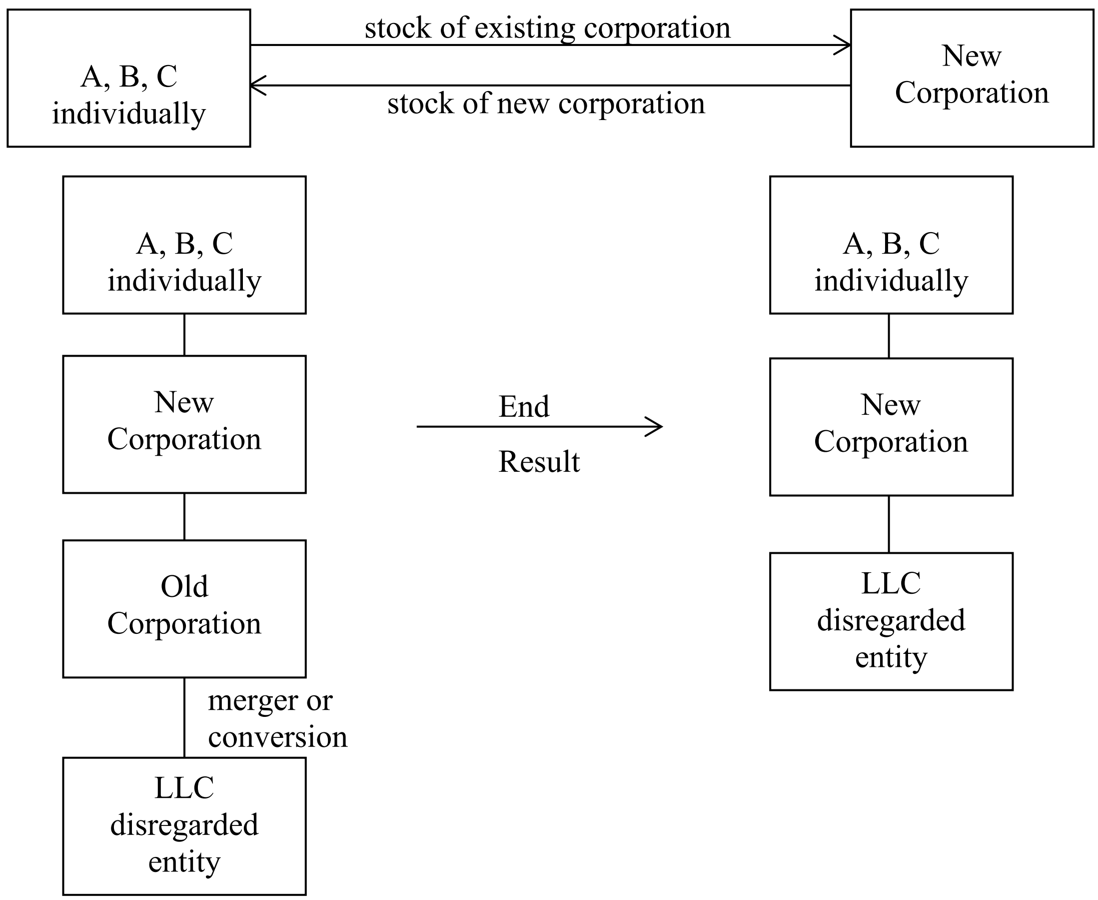
- Corporation can keep nonbusiness assets
- Corporation can keep business assets that would generate complications if transferred to the limited partnership structure and then had income recognition event
- New LLC can stay as a disregarded entity for a while as transition to new structure and get everyone used to working in LLC structure

Disadvantages

- Piecemeal transfer of assets

- Some assets not readily transferable

II.E.7.c.i.(b). **Use F Reorganization to Form LLC**



<u>Advantage</u>

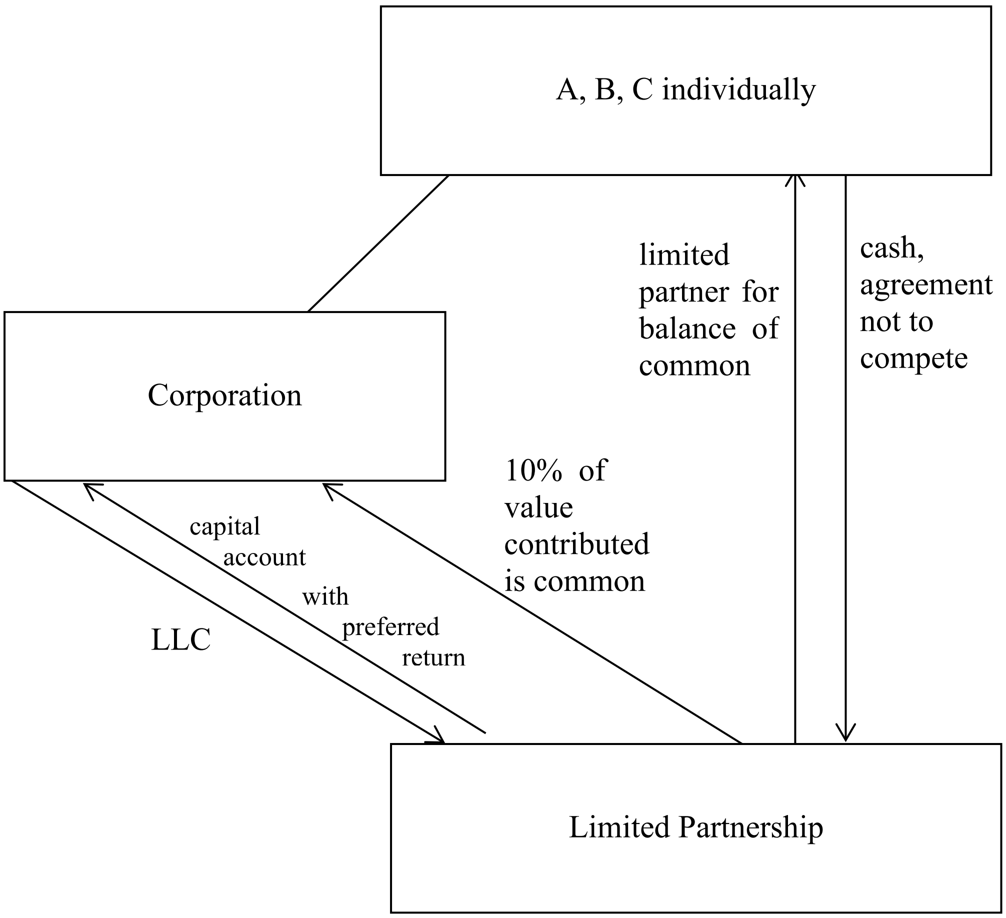
- Moves all assets in one fell swoop

<u>Disadvantages</u>

- No selectivity of retained assets
- Contribution of stock of old corporation to new corporation and merger or conversion of old corporation into new corporation need to be done at the same time
- If S corporation involved, new corporation does new S election and old corporation does qualified subchapter S subsidiary election.

See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. For an S corporation, see also part II.A.2.g Qualified Subchapter S Subsidiary (QSub), especially fn. 198.

II.E.7.c.ii. Moving New LLC into Preferred Structure



II.E.7.c.iii. Migrating Gradually Over Time

A company might have its employees and intellectual property locked down so tightly that the migrations described in the preceding provisions of this part II.E.7 Migrating into Partnership Structure result in a large value and large preferred return that might be so large that they cause very significant estate tax issues that seem impossible to overcome. Consider:

- A corporation that needs to migrate to these structures to obtain income tax efficiencies.

- Any type of company that is subject to estate tax and difficult to move into a structure outside the estate tax system. For example, it might have too low a cash flow to make a GRAT or a sale to an irrevocable grantor trust be efficient.

In those cases, consider that, in today's economy and global environment, businesses need to reinvent themselves – sometime gradually, sometimes quickly – to keep up with or try to out-perform their competitors.

The company might reinvent itself over time through a sister company that is held in the business structure recommended in this part II.E Recommended Structure for Entities. For example, the senior generation makes gifts or loans to new trusts that establish this structure. The new trusts own the S corporation and limited partnership (or LLC, in the case of a state such as Tennessee).

For examples of new activities, see part III.B.1.a Business Opportunities.

Certain IRS responses to such movement and generally successful taxpayer responses are described in parts III.B.1.a.v Sending Business and III.B.1.a.vi Asset Transfers to Children or Their Businesses.

If the business being transitioned is a corporation, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

II.G.4. Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner

As described further below in this part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner, a loan to an S corporation or a partnership or a guarantee of a third party loan to a partnership can generate current deductions of losses that the loan finances, whereas a loan to a C corporation or a loan guarantee to an S or C corporation does not. Losses financed by even third-party loans remain subject to parts II.G.4.c Basis Limitations for Deducting Partnership and S Corporation Losses (including parts II.G.4.d Basis Limitation for Shareholders in an S Corporation and II.G.4.e Basis Limitations for Partners in a Partnership, the latter being complicated by part II.C.3 Allocating Liabilities (Including Debt)), II.G.4.j At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities), and II.G.4.l.ii Net Operating Loss Deduction.

Furthermore, a worthless loan to a C corporation is difficult to deduct and might or might not qualify for ordinary loss treatment, and such a deduction might be subject to a 7-year statute of limitations rather than a 3-year statute of limitations (as would a deduction for worthless stock).

II.G.4.a. Loans to Businesses or Business Associates

II.G.4.a.i. Loans to Businesses – Whether AFR Is Required

Generally, loans between corporations and shareholders are subject to the Code § 7872 rules governing below-market loans.[1126]

However, loans between partners and partnerships are subject to those rules only if one of the principal purposes of the interest arrangements of which is the avoidance of any Federal tax.[1127]

[1126] Code § 7872(c)(1)(C).

[1127] Whitmire, Nelson, McKee, et al, "¶3.08. Partner and Member Loans," *Structuring & Drafting Partnership Agreements: Including LLC Agreements*, conclude:

> If no interest is charged on partner-to-partnership loans, or if interest is charged at less than the applicable "federal rate," interest may be imputed under § 7872 if (1) the loan is determined to be a "tax avoidance loan" under § 7872(c)(1)(D) or (2) the loan is an "other below-market loan" described in regulations promulgated under § 7872(c)(1)(E). At present, no regulations have been proposed that would generally treat garden-variety partner-to-partnership loans as below-market loans or tax-avoidance loans.

Code § 2701 provides a backstop in a family partnership. See part III.B.7.c.i.(b) CCA 201442053 Discusses Profits Interest in a Partnership That Was a Straight-Up Partnership before the Transfer.

II.G.4.a.ii. Bad Debt Loss – Must be Bona Fide Debt

Only a bona fide debt qualifies for purposes of Code § 166.[1128] The debt must arise from "a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money."[1129] For this purpose, an accrual method taxpayer's account receivable is deemed to be an

[1128] Reg. § 1.166-1(c).

[1129] Reg. § 1.166-1(c). *Rutter v. Commissioner*, T.C. Memo. 2017-174, elaborated:

> A bona fide debt is a debt that arises from "a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." *Kean v. Commissioner*, 91 T.C. 575, 594 (1988); sec. 1.166-1(c), Income Tax Regs. A gift or contribution to capital is not considered a "debt" for purposes of section 166. *Kean*, 91 T.C. at 594. Whether a purported loan is a bona fide debt for tax purposes is determined from the facts and circumstances of each case. See *A.R. Lantz Co. v. United States*, 424 F.2d 1330, 1333 (9th Cir. 1970); *Gross v. Commissioner*, 401 F.2d 600, 603 (9th Cir. 1968), *aff'g* T.C. Memo. 1967-31; *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980).

Rutter held that advances not documented with promissory notes were equity, not debt. See fn. 1798 in part II.G.21 Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense. *Povolny Group, Inc. v. Commissioner*, T.C. Memo. 2018-37, elaborated:

> We note first that the purported loans had none of the standard indicia of debt: no formal loan documentation, no set maturity date, and no interest payments. See, *e.g.*, *Hardman v. United States*, 827 F.2d 1409, 1412 (9th Cir. 1987) (formal loan documentation tends to show bona fide debt); *Estate of Mixon v. United States*, 464 F.2d 394, 404 (5th Cir. 1972) (fixed maturity date is characteristic of debt); *Am. Offshore, Inc.*, 97 T.C. at 605 (lack of interest payments suggests equity). We recognize that "transactions between closely held corporations and their shareholders are often conducted in an informal manner." *Epps v. Commissioner*, T.C. Memo. 1995-297, 1995 WL 389638, at *4. But because of the amount of the purported loans at issue here - over $300,000 - the lack of any loan documentation whatsoever weighs against a finding of debt. See i*d*. (lack of formality weighs against debt finding where payment was $112,000). The only documents Povolny produced about the purported loans were printouts of QuickBooks entries. At trial Povolny discussed a two-page printout from Archetone Limited's QuickBooks labeled "A/R Archetone International" that lists the $241,000 in payments that Archetone Limited deducted as "bad debt." The $74,000 that PG paid and that Archetone Limited deducted that same year as "Loss on Archetone International Expenses Paid" appears in two separate entries from PG's QuickBooks: one entitled "Quarterly Distributions" and another called "Due from Related Parties Write off - Archetone." 9 But we don't just look at the label a corporation sticks on a transaction; we look for proof of its substance. See, *e.g.*, *Shedd*, 2000 WL 1337177, at *4. And there's none of that here - Povolny apparently didn't even give his CPA anything beyond such QuickBooks printouts. This strongly suggests that Povolny was simply trying to recast some of the investment in the failed Algerian hospital project as loans to recoup some of the loss. In other words, it wasn't bona fide debt.
>
> 9 This fact is also relevant to the PG-wage issue that we'll discuss in the next section- *i.e.*, whether PG's $74,000 in payments to Archetone International's and Archetone Limited's creditors were "loans" to those entities or compensation to Povolny. But there was another adjustment for those payments: Archetone Limited's $74,000 deduction - which flowed through to the Povolnys—was also disallowed by the Commissioner. There was some confusion at trial and in the briefs about this deduction. The Povolnys argued on brief that the $74,000 deduction was part of Archetone Limited's bad-debt deduction for 2011. So we've focused on that argument here. But even if it wasn't part of Archetone Limited's bad-debt deduction for 2011 - for example, if it was a current claimed business expense by Archetone Limited—the Commissioner says that that adjustment was still appropriate because Povolny "failed to provide documentation or explanation for Archetone Limited having a business purpose for paying Archetone International's expenses." Povolny didn't have anything to say about that at trial or on brief, so we deem that issue conceded. See Rule 34(b)(4); *McNeil v. Commissioner*, T.C. Memo. 2011-150, 2011 WL 2559802, at *1 n.3, *aff'd* 451 F.App'x 622 (8th Cir. 2012).
>
> Archetone International's lack of capital also suggests that what the Povolnys deducted weren't bona fide debts. A transferee's undercapitalization is strong evidence that the transfer is a capital contribution. *Am. Offshore, Inc.*, 97 T.C. at 604. Here, Archetone International had no capital at all - Povolny testified that it "had no funds or wasn't capitalized, so it basically was capitalized through the assets that Archetone, Limited had." This complete lack of capitalization weighs heavily in favor of finding that the payments at issue were capital contributions and not bona fide debt.
>
> Along the same lines, repayment dependent on earnings suggests that an advance is more likely to be equity. *Estate of Mixon*, 464 F.2d at 405; *Am. Offshore, Inc.*, 97 T.C. at 602; *Calumet Indus., Inc.*, 95 T.C. at 287-88; *Provost v. Commissioner*, T.C. Memo. 2000-177, 2000 WL 687889, at *5. And because Archetone International had no capital

enforceable obligation to the extent that the income such debt represents has been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year.[1130] Conversely, worthless debts arising from unpaid wages, salaries, fees, rents, and similar items of taxable income are not deductible under Code § 166 unless the income such items represent has been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year.[1131]

A gift or contribution to capital is not a debt for purposes of Code § 166.[1132] See part II.G.21 Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense. For example, in a Code § 166 case, *2590 Associates, LLC v. Commissioner*, T.C. Memo. 2019-3, cited 13 factors from *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972),[1133] because the case was appealable to the Fifth Circuit, then commented:

> The factors are not of equal importance, and no single factor is determinative. See *Dillin v. United States*, 433 F.2d 1097, 1100 (5th Cir. 1970); *Segel v. Commissioner*, 89 T.C. 816, 827 (1987). Some factors may not be relevant in a given situation. *Estate of Mixon*, 464 F.2d at 402.
>
> The object of the inquiry is not to count the factors but to evaluate them. *Tyler v. Tomlinson*, 414 F.2d 844, 848 (5th Cir. 1969). The factors aid in our determination of whether the parties intended to create indebtedness with a reasonable expectation of repayment and whether that expectation comported with economic reality. See *Estate of Mixon*, 464 F.2d at 407. The Court of Appeals for the Fifth Circuit recognizes that the "real issue for tax purposes has long been held to be the extent to which the transaction complies with arm's length standards and normal business practice." *Id.* at 402-403. We apply special scrutiny to transactions between entities in the same corporate family or with shared ownership. See *Kean v. Commissioner*, 91 T.C. at 594; *Malone & Hyde, Inc. v. Commissioner*, 49 T.C. 575, 578 (1968); *Vinikoor v. Commissioner*, T.C. Memo. 1998-152.

> at the time of the purported loans, the only potential source of repayment was earnings on its single contract - the Algerian hospital. This, too, weighs against finding that a bona fide debt existed. The evidence we have, then, shows no formal signs that a debt existed, and the underlying economics of the situation strongly suggests that Povolny was once again just using one of his companies' funds to pay another of the companies' debts. We therefore find that Archetone Limited's advances to Archetone International did not create bona fide debt.

[1130] Reg. § 1.166-1(c), which continues:

> For example, a debt arising out of gambling receivables that are unenforceable under state or local law, which an accrual method taxpayer includes in income under section 61, is an enforceable obligation for purposes of this paragraph.

[1131] Reg. § 1.166-1(e).

[1132] Reg. § 1.166-1(c). *Rutter v. Commissioner*, T.C. Memo. 2017-174, elaborated:

> Advances made by an investor to a closely held or controlled corporation may properly be characterized, not as a bona fide loan, but as a capital contribution. See *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968); *Shaw v. Commissioner*, T.C. Memo. 2013-170, 106 T.C.M. (CCH) 54, 56, *aff'd*, 623 F. App'x 467 (9th Cir. 2015). In general, advances made to an insolvent debtor are not debts for tax purposes but are characterized as capital contributions or gifts. See *Dixie Dairies Corp.*, 74 T.C. at 497; *Davis v. Commissioner*, 69 T.C. 814, 835-836 (1978). For an advance to constitute a bona fide loan, the purported creditor must expect that the amount will be repaid. See *CMA Consol., Inc. v. Commissioner*, T.C. Memo. 2005-16, 89 T.C.M. (CCH) 701, 724.

Povolny Group, Inc. v. Commissioner, T.C. Memo. 2018-37, had a similar result, only the lender was a related corporation, so the payment to the related corporation was a dividend from the payor to the shareholder, followed by a contribution to capital from the shareholder to the recipient. (The case is also mentioned in fn. 1798 in part II.G.21.b When Debt Is Recharacterized as Equity.) For dividend treatment, see fn 4595 in part II.Q.7.a.iv Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303.

[1133] *Mixon* is described in the text accompanying fn 1799 in part II.G.21.b When Debt Is Recharacterized as Equity.

2590 Associates criticized the IRS for not addressing the 13 factors from *Mixon* and found a bona fide debt when the loan was made and when the lender contributed it to a business in exchange for equity.[1134]

Not being due yet does not prevent a Code § 166 deduction.[1135]

Rather, the debt must become worthless during the tax year.[1136]

II.G.4.a.iii. Character of Bad Debt

Where any nonbusiness debt held by a noncorporate taxpayer becomes worthless within the taxable year, the resulting loss is a short-term capital loss;[1137] note that reporting a large short-term capital loss might

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[1134] After reviewing the overall situation, the court held:

> Under the 13 factors considered by the Court of Appeals for the Fifth Circuit, we find that a bona fide debt existed between Perkins Rowe and 2590 Associates. Respondent did not address the 13 factors used by the Court of Appeals. 2590 Associates held a promissory note with a fixed maturity date and accrued interest at an above-market rate. The interest rate increased upon default, and the note provided for an award of attorney's fees for any collection actions. We find that at the time of the 2008 note's transfer, 2590 Associates intended to collect the debt from Perkins Rowe. Mr. Spinosa believed that Perkins Rowe would succeed and would repay the debt. 2590 Associates had the right to enforce payment. However, as the note was unsecured, collection attempts would have been futile. Mr. Spinosa credibly testified that he believed the Perkins Rowe development could be successful at the time Mr. Saban contributed the note to 2590 Associates and even after the foreclosure case's filing. Mr. Spinosa had extensive experience in real estate investments, and he was optimistic that Perkins Rowe would be successful despite the difficulties it encountered. The source of repayment was not limited to Perkins Rowe's income. There is no evidence of a thin capitalization. In fact, the 2008 appraisal performed for KeyBank indicated that there was substantial equity in Perkins Rowe. The 2008 note was not given to acquire capital assets. Each of these factors weighs in favor of the existence of a bona fide debt.
>
> Two factors weigh against a bona fide debt, the note's subordination to secured creditors and Perkins Rowe's failure to repay the debt and accrued interest. Finally, two remaining factors for us to address are Perkins Rowe's ability to obtain outside loans and the nature of the relationship between 2590 Associates and Perkins Rowe. We find both factors to be neutral in the light of the other factors supporting the existence of a bona fide debt. By the time of the 2008 note's execution, Perkins Rowe had been attempting to refinance the construction loan for nearly one year. Ultimately, the loan was not refinanced, and the property was foreclosed on. However, at the time of the 2008 note and even after the foreclosure case began, Mr. Spinosa believed he could work out a refinancing and continued to negotiate with lenders and potential investors. Mr. Spinosa was able to amend the terms of the construction loan agreement in 2008, and all but one lender agreed to a refinancing deal after the foreclosure began. Nor do we find the relationship between Perkins Rowe and 2590 Associates, discussed *infra*, to negate the other factors supporting a bona fide debt. On the basis of the Court of Appeals for the Fifth Circuit's 13 factors, we find that the debt between Perkins Rowe and 2590 Associates was bona fide.

[1135] Reg. § 1.166-1(c).

[1136] *2590 Associates, LLC v. Commissioner*, T.C. Memo. 2019-3, explained:

> For a section 166 deduction, the debt must become worthless during the tax year, *i.e.*, it must have had value at the beginning of the year and become worthless during that year. *Milenbach v. Commissioner*, 106 T.C. 184, 204 (1996), *aff'd in part, rev'd in part on other grounds*, 318 F.3d 924 (9th Cir. 2003). A debt's worthlessness is determined by identifiable events that occurred to render the debt worthless during the year. *Am. Offshore, Inc. v. Commissioner*, 97 T.C. 579, 594 (1991). A debt becomes worthless when the taxpayer has no reasonable expectation of repayment. *Crown v. Commissioner*, 77 T.C. 582, 598 (1981). Some objective factors considered by the Court in determining worthlessness include the value of property securing the debt, the debtor's earning capacity, events of default, the debtor's refusal to pay, actions to collect the debt, any subsequent dealings between the parties, and the debtor's lack of assets. *Am. Offshore, Inc. v. Commissioner*, 97 T.C. at 594-595. No single factor is conclusive. *Id.* at 595. The determination of when a debt becomes worthless depends upon the particular facts and circumstances of each case. *Riss v. Commissioner*, 56 T.C. 388, 407 (1971), *aff'd*, 478 F.2d 1160 (8th Cir. 1973). At trial we held that respondent has the burden of proof with respect to the issue of worthlessness in 2011. We find that respondent has failed to satisfy his burden of proof and that the debt became worthless in 2011.

[1137] Code § 166(d)(1). Capital losses are deductible only against the sum of capital gains plus $3,000. Short-term capital gains are taxed using ordinary income tax rates, so short-term capital losses from bad debts have the most benefit for taxpayers with short-term capital gains.

stand out, given that the IRS now matches proceeds and basis on sale and the basis would not match any report to the IRS by a broker. Code § 166(d)(2) provides that "nonbusiness debt" means a debt other than:[1138]

> (A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or
>
> (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

After reciting the above, Reg. § 1.166-5(b) provides:

> The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C). See § 1.165-5, relating to losses on worthless securities.

[1138] Code § 166(d)(1).

When part or all of a debt, which is not a security[1139] and is not a nonbusiness debt, becomes worthless, the taxpayer holding the debt can deduct the worthless portion,[1140] if the taxpayer charges off the loan.[1141] Nonbusiness bad debts must be wholly worthless to be deductible;[1142] the debtor's filing of bankruptcy does not show that the debt is wholly worthless if the creditor files a claim.[1143] In contrast, a business bad

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[1139] Code § 166(e) provides, "This section shall not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C)."

[1140] Code § 166(a), which allows a taxpayer to deduct a debt that is worthless in whole or in part, with Reg. § 1.166-3(a)(2)(iii) providing:

> Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the district director the amount thereof which is worthless and the part thereof which has been charged off.

Rutter v. Commissioner, T.C. Memo. 2017-174, elaborated:

> The Commissioner's disallowance of a deduction under section 166(a)(2) will be sustained so long as he exercises his discretion reasonably. *Brimberry v. Commissioner*, 588 F.2d 975, 977 (5th Cir. 1979), *aff'g* T.C. Memo. 1976-209; *Portland Mfg. Co. v. Commissioner*, 56 T.C. 58, 72 (1971), *aff'd* on other grounds, 35 A.F.T.R.2d (RIA) 75-1439, 75-1 U.S. Tax Cas. (CCH) para. 9449 (9th Cir. 1975). His exercise of discretion will not be set aside unless it is arbitrary and unreasonable. *Ark. Best Corp. & Subs. v. Commissioner*, 800 F.2d 215, 221 (8th Cir. 1986), *aff'g* in part, *rev'g* in part 83 T.C. 640 (1984), *aff'd* on other grounds, 485 U.S. 212 (1988).
>
> Petitioner has not made the showing that the statute and the regulations require. First, he has not established to the Commissioner's satisfaction, or ours, the amount of the debt that was worthless at year-end 2009. Sec. 1.166-3(a)(2)(iii), Income Tax Regs. The $8.55 million number he chose for the writedown (reduced from the $10 million "placeholder" figure Mr. Bardoff had used initially) appears to have been selected because it approximated the income petitioner realized earlier in 2009 from another of his startup companies. He made no effort to tie this writedown to IM's actual financial condition or ability to repay.
>
> Second, petitioner did not show that any portion of his advances became worthless during 2009. He appears to have had a reasonable hope of recovering on his investments; that is presumably why he continued to advance another $37.75 million to IM during 2010-2013. See *Crown*, 77 T.C. 582, 598 (1981); *Flood v. Commissioner*, T.C. Memo. 2001-39, 81 T.C.M. (CCH) 1175, 1180 ("A debt becomes worthless in the tax year in which a creditor, using sound business judgment, abandons all reasonable hope of recovery[.]"); sec. 1.166-2(a), Income Tax Regs. Conversely, if any portion of the debt was worthless, petitioner did not show that it became worthless in 2009 rather than in some earlier year. See *Hirsch v. Commissioner*, 124 F.2d 24, 31 (9th Cir. 1941) ("A taxpayer should not be permitted to close his eyes to the obvious, and to carry accounts on his books as good when in fact they are worthless, and then deduct them in a year subsequent to the one in which he must be presumed to have ascertained their worthlessness." (citing *Avery v. Commissioner*, 22 F.2d 6, 7-8 (5th Cir. 1927))), *aff'g* 42 B.T.A. 566 (1940).

After reviewing the parties' contentions and testimony, the court concluded:

> In sum, the IRS did not abuse its discretion in determining that petitioner was not entitled to a deduction of $8.55 million for a partially worthless debt for 2009. Even if petitioner established that his advances were debt and that this debt was a business debt, he did not meet the requirements for deducting a partially worthless debt under section 166(a)(2) and section 1.166-3(a)(2)(iii), Income Tax Regs.[7]
>
> [7] Given our disposition, we need not address respondent's contention that petitioner's deduction should be disallowed because the documents implementing the writedown were executed in February or March 2010 and backdated to 2009.

[1141] LAFA 20153501F argued that the taxpayer created a reserve rather than charging off the debt:

> The purpose of the charge-off requirement is to perpetuate evidence of a taxpayer's election to abandon part of the debt as an asset. *Findley v. Commissioner*, 25 T.C. 311, 319 (1955), *aff'd per curium*, 236 F.2d 959 (3d Cir. 1956) (emphasis added). An increase in a general reserve account does not constitute the required charge off. *International Proprietaries. Inc. v. Commissioner*, 18 T.C. 133 (1952). The taxpayer's intent to abandon the charged-off portion of the debt must be reflected in its books and records. *ld.*

[1142] Reg. § 1.166-5(a)(2). *Rutter v. Commissioner*, T.C. Memo. 2017-174, elaborated:

> To give rise to a deduction under section 166(a)(1), a debt must have become wholly worthless during the tax year. Sec. 1.166-3(b), Income Tax Regs.; see *Bodzy v. Commissioner*, 321 F.2d 331, 335 (5th Cir. 1963), *aff'g* in part, *rev'g* in part T.C. Memo. 1962-40. In the case of a partially worthless debt, section 166(a)(2) provides that, "[w]hen satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction." "Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the district director the amount thereof which is worthless and the part thereof which has been charged off." Sec. 1.166-3(a)(2)(iii), Income Tax Regs.

[1143] *Bunch v. Commissioner*, TC Memo. 2014-177, held:

debt is deductible when partially or wholly worthless, as *Bercy v. Commissioner*, T.C. Memo. 2019-118, described:

> Section 166(a) allows a deduction for the taxable year in which a business debt becomes wholly or partially worthless. The year in which a debt becomes worthless is fixed by identifiable events that make it reasonable for the lender to abandon any hope of recovery. *Crown v. Commissioner*, 77 T.C. 582, 598 (1981). "When a debt becomes worthless is to be decided by the trier of fact." *Am. Off-shore, Inc. v. Commissioner*, 97 T.C. 579, 594 (1991) (citing *Cole v. Commissioner*, 871 F.2d 64, 66 (7th Cir. 1989), *aff'g* T.C. Memo. 1987-228).
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> Ascertaining when a debt becomes worthless requires "examination of all the circumstances." *Dallmeyer v. Commissioner*, 14 T.C. 1282, 1291 (1950). There is no standard test or formula for determining worthlessness, but relevant factors include the debtor's solvency, the lender's collection efforts, and subsequent dealings between the parties. See *Lucas v. Am. Code Co.*, 280 U.S. 445, 449 (1930); *Aston v. Commissioner*, 109 T.C. 400, 415 (1997); *Am. Offshore, Inc.*, 97 T.C. at 594; sec. 1.166-2(a), Income Tax Regs. The taxpayer must establish objective facts from which worthlessness can be determined; mere belief that a debt has gone bad is insufficient. *Fox v. Commissioner*, 50 T.C. 813, 822-823 (1968), *aff'd per curiam*, 70-1 U.S. Tax Cas. (CCH) para. 9373 (9th Cir. 1970). A taxpayer is not required to take legal action to enforce payment where it "would in all probability not result in the satisfaction of execution on a judgment." Sec. 1.166-2(b), Income Tax Regs.
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> In evaluating a taxpayer's contention that a debt has become wholly or partially worthless, we give weight to the creditor's "soundly exercised business judgment." *Portland Mfg. Co. v. Commissioner*, 56 T.C. 58, 73 (1971). We do not require a creditor to pursue "theoretical possibilities" of recovery that ignore the "realities of the business environment." *ABC Beverage Corp. v. Commissioner*, T.C. Memo. 2006-195, 92 T.C.M. (CCH) 268, 272. "Whether a bad debt deduction is proper must be analyzed according to `reasonableness, commonsense and economic reality." *Id.* At 271 (quoting *Scoville Mfg. Co. v. Fitzpatrick*, 215 F.2d 567, 570 (2d Cir. 1954)).

A loss may be a business bad debt only if the taxpayer was engaged in a trade or business and the debt was proximately related to that trade or business;[1144] and whether the debt has a proximate relationship to the taxpayer's trade or business turns on the taxpayer's dominant motivation in making the loan.[1145] *Bercy v. Commissioner*, T.C. Memo. 2019-118, described one taxpayer's lending business, viewing the business' scope broadly:

> We find that Mr. Bercy was engaged in a distinct trade or business of lending money. Aside from his activities on behalf of Argus and Astin-Carr,[3] Mr. Bercy personally made loans to a variety of borrowers, solely for his own account, on a regular basis. His personal lending activity was substantial, comprising numerous loans totaling an estimated $25 million. And he engaged in this activity with the intent of making a profit.

Even if we were to accept that the proof of claim established the amount of petitioners' loss, the document does not establish that petitioners had no hope of recovery in 2006. On the contrary, it tends to establish the reverse: By filing a proof of claim in Mortgage Co.'s bankruptcy, petitioners took the requisite step to secure a place in the order of distribution from the bankruptcy estate and thereby increased their odds of recovering at least some of the loaned funds.

[1144] *Bercy v. Commissioner*, T.C. Memo. 2019-118, citing *Putoma Corp. v. Commissioner*, 66 T.C. 652, 673 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

[1145] *Bercy v. Commissioner*, T.C. Memo. 2019-118, citing *Putoma Corp.*, 66 T.C. at 673.

3 Argus was engaged in the business of making real estate loans, and Mr. Bercy supplied capital to Argus directly (as a shareholder of that S corporation) and through Astin-Carr (an entity he wholly owned). Petitioners do not contend that Mr. Bercy should be deemed to be in the lending business solely by virtue of the activities conducted by his S corporation. *Cf. Dagres v. Commissioner*, 136 T.C. 263, 289 (2011) (holding that managing member of an LLC was deemed to carry on the lending business of his LLC).

Mr. Aken credibly testified that he approached Mr. Bercy because he knew that Mr. Bercy was in the lending business. The fact that the two men were unrelated negated any familial motivation for the loan. Mr. Bercy agreed to lend only after investigating Girari's business and finances, performing due diligence as he did for his other loans. To hedge his bet he secured as a co-lender Mr. Levitt, with whom he had previously joined in making a personal property loan. His behavior in connection with the Girari loan was consistent with his general business practices, and that loan was proximately related to his trade or business of lending money. See *Ruppel v. Commissioner*, T.C. Memo. 1987-248, 53 T.C.M. (CCH) 829, 834 ("Since we have held that petitioner was in the trade or business of lending money, it follows that the most significant loans created with respect to that business were proximately related to it unless the facts show some other reason for the loan.").

Respondent concedes that "Mr. Bercy was admittedly engaged in the business of real estate lending." But respondent contends that making personal property loans was outside the scope of that business. And in respondent's view, the scale of Mr. Bercy's non-real-estate lending activity was insufficiently robust to constitute a "trade or business" distinct from his business of real estate lending.

We are not persuaded to construe the term "trade or business" so narrowly in this context. When previously considering the status of loans as "business debts" under section 166, we have not segmented the taxpayer's lending business according to the nature of the loan or type of customer. Rather, we have simply asked whether the taxpayer was in the business of lending money, separate and distinct from any other gainful employment he or she may have had. See, *e.g.*, *Yaryan v. Commissioner*, T.C. Memo. 2018-129, at *26 ("The parties agree that petitioners were not in a trade or business of lending funds."); *Owens v. Commissioner*, T.C. Memo. 2017-157, 114 T.C.M. (CCH) 188, 194 (inquiring whether the taxpayer's "personal lending was a trade or business"); *Hatcher v. Commissioner*, T.C. Memo. 2016-188, 112 T.C.M. (CCH) 415, 418 (finding that the taxpayer "was not engaged in the trade or business of lending money"), *aff'd*, 726 F. App'x 207 (5th Cir. 2018); *Ruppel*, 53 T.C.M. (CCH) at 832 (requiring the taxpayer to show "that he was in the trade or business of lending money"); *Jessup v. Commissioner*, T.C. Memo. 1977-289, 36 T.C.M. (CCH) 1145, 1150 (finding that the taxpayer was "in the business of making loans").

When a manager of venture capital funds loaned money to a business associate who provided leads on companies in which the venture capital funds might invest, with the expectation that the lender would receive carried interests in the venture capital fund, the loan was made in the trade or business of managing venture capital funds.[1146] Key is whether the lender merely expects a normal investor's return (not a trade or business)[1147] or is "flipping" businesses.[1148]

If a loss is not connected with a trade or business, generally it must be incurred in any transaction entered into for profit.[1149] That standard requires that the taxpayer's "primary reason for investing … was to make

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[1146] *Dagres v. Commissioner*, 136 T.C. 263 (2003). This case involved a number of factors when taking a bad debt deduction, such that it is worth reproducing the heart of the court's analysis:

> …We have held that the General Partner L.L.C.s' activity was not mere investment but was the trade or business of managing venture capital funds. Consequently, it follows that Mr. Dagres was in that trade or business.
>
> However, as we have noted, Mr. Dagres was also an investor (i.e., of his portion of 1 percent of the Venture Fund L.P.'s capital), and if his loan to Mr. Schrader was proximately related to his investment interest, then the resulting bad debt was not a business bad debt. Moreover, Mr. Dagres was also a salaried employee of BMC and was therefore in the trade or business of being an employee. If his loan to Mr. Schrader was proximately related to his employment, rather than to the venture capital business, then the deduction of the resulting bad debt loss is severely limited. See *supra* part II.A. We must therefore determine to which of these activities--his investment, his employment, or his venture capital management--the loan was proximately related.
>
> In *United States v. Generes*, 405 U.S. at 103, the Supreme Court indicated that when determining whether a bad debt has a proximate relation to a taxpayer's trade or business and therefore qualifies as a business bad debt, the question to ask is whether the "dominant motivation" for the loan was business; a merely "significant motivation" is insufficient to show a proximate relation. In *Generes*, the Supreme Court held that the dominant motivation for the taxpayer's lending money to his company was not the business motive of protecting his modest salary; rather, in addition to protecting his son-in-law's livelihood, he was motivated to protect his sizable investment in the company. *Id.* at 106. Accordingly, non-business motives prompted the loan, and therefore the loss was not a business bad debt.
>
> In this case, however, Mr. Dagres's compensation for his work as a manager of the Venture Fund L.P.s--*i.e.*, his share of the 20-percent profits interest and the 2-percent management fee--exceeded by twenty-fold his share of the return on the 1-percent investment. Moreover, although his salary from BMC (i.e., his share of the management fees) was significant in absolute terms (nearly $11 million in five years, of which he received almost $2.6 million in the year of the loan), his carry was clearly dominant ($43 million of capital gains in those same five years, of which $40 million was carry received in the year of the loan). He lent $5 million to Mr. Schrader to protect and enhance what he considered a valuable source of leads on promising companies in which, as Member Manager of General Partner L.L.C.s, he could invest the money of the Venture Fund L.P.s, help manage those companies, and earn substantial income in the form of carry. Mr. Dagres's carry significantly exceeded both his salary and his return on his own investment. We are satisfied that venture capital motives and not employment or investment motives were the primary motivation for his loan. It is that venture capital business motive that characterizes the subsequent bad debt loss.

[1147] *Rutter v. Commissioner*, T.C. Memo. 2017-174, elaborated:

> … we have held that a taxpayer is not in the business of being a "promoter" where he is entitled to no compensation other than a normal investor's return. See, *e.g.*, *Dagres*, 136 T.C. at 281-282 (noting that a promoter "receives not just a return on his own investment but compensation attributable to his services"); *Deely v. Commissioner*, 73 T.C. 1081, 1095-1096 (1980) (stating that, "in order for a promoter to be engaged in a trade or business for tax purposes he must do so for `compensation other than the normal investor's return'" (quoting *Millsap v. Commissioner*, 46 T.C. 751, 756 (1966), *aff'd*, 387 F.2d 420 (8th Cir. 1968))); *Ackerman v. Commissioner*, T.C. Memo. 2009-80, 97 T.C.M. (CCH) 1392, 1414 (finding no trade or business as "promoter" where taxpayer did not receive fees or commissions for providing advisory services). Here, petitioner received no fees, commissions, or other compensation for his services. He expected to receive the return that equity investors normally hope for, namely, long-term gain upon appreciation or sale of IM's assets.

[1148] *Rutter v. Commissioner*, T.C. Memo. 2017-174, suggested:

> A taxpayer may be able to show that he is engaged in business as a "promoter" or "trader" if he establishes that his goal is to earn profits by "flipping" assets, *i.e.*, making quick and profitable sales of real estate, securities, or other property. See, *e.g.*, *Assaderaghi v. Commissioner*, T.C. Memo. 2014-33. Central to these holdings is that the taxpayer aimed for profit from frequent short-term sales, not from patient long-term investment. "It is the early resale which makes the profits income received directly for services, for the longer an interest is held, the more profit becomes attributable to the successful operation of the corporate business." *Deely*, 73 T.C. at 1093-1094; see *Millsap*, 46 T.C. at 756-757.

[1149] Code § 165(c)(2). Code § 165(c)(3) also allows a taxpayer to deduct nonbusiness losses that "arise from fire, storm, shipwreck, or other casualty, or from theft."

an economic profit, or in other words, a profit without consideration to any tax benefit flowing from the [investment]."[1150]

See also part II.G.4.l.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit.

For deducting loans to corporations, see part II.G.4.b C Corporations, particularly fns. 1156-1158.

II.G.4.a.iv. Extension of Statute of Limitations for Deduction for Bad Debt or Worthless Securities

Code § 6511(d) provides a 7-year statute of limitations of certain deductions for bad debt or worthless securities rather than the normal 3-year statute of limitations.

II.G.4.a.v. Tax Effect of Loan to S Corporation or Partnership

Loans to S corporations or partnerships can allow the owner who is a lender to deduct losses against the owner's basis in the loan; this generally generates ordinary losses and, to the extent of those losses, that one does not need to worry about whether writing off that part of the loan would be a business bad debt or a nonbusiness bad debt. See part II.G.4.c Basis Limitations for Deducting Partnership and S Corporation Losses.

However, a loan to a partnership can backfire if the loan is not repaid until the partnership is rescued by an angel investor's infusing capital. In that case, the lending partner would contribute the loan to the partnership in exchange for a partnership interest. Unfortunately, often the founder will receive only pennies on the dollar for the founder's original investment (capital and debt):

- To the extent that the amount of debt contributed to the partnership exceeds the value of the partnership interest that the lending partner received in exchange for that debt, the partnership will have cancellation of indebtedness (COD) income.[1151] Generally, partnership agreements require income to be allocated to a partner to the extent that the partner deducted losses against the debt. Therefore, the lending partner would be allocated all of this COD income; this allocation essentially is a recapture of the lending partner's prior losses and gives the lending partner basis in the partnership interest.

- If, instead of lending money to the partnership, the partner had contributed the money, the partner would have avoided this COD income. Providing a priority return of capital might be adequate to let that partner be repaid. If enough money is at stake to justify the complexity, consider providing a preferred partnership interest instead of a loan.[1152] Realistically, the only way the loan would be repaid

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[1150] *McElroy v. Commissioner*, T.C. Memo. 2014-163, citing:

> *See Fox v. Commissioner*, 82 T.C. 1001, 1018-1027 (1984); *see also Friedman v. Commissioner*, 869 F.2d 785, 789-790 (4th Cir. 1989), *aff'g Glass v. Commissioner*, 87 T.C. 1087 (1986); *cf. Surloff v. Commissioner*, 81 T.C. 210, 233 (1983) (noting that an intent to make a profit for purposes of section 162 requires an intent to make an economic profit, independent of tax savings).

See also part II.G.18 Economic Substance for the possibility of penalties for tax-motivated transactions not entered into for either profit or a Congressionally approved tax benefit (such as a tax credit).

[1151] Code § 108(e)(8); Reg. § 1.108-8 (subsection (c) has a specific example, but the example involved a creditor who was not also a partner). If and to the extent that the value of the partnership interest issued in exchange for the debt is attributable to accrued interest, the lender partner is taxed on that interest. Reg. § 1.721-1(d)(2).

[1152] The preferred partnership interest must not be a substitute for debt. The fact that the partner already has a regular partnership interest should help significantly; *see, e.g.*, parts II.G.21 Debt vs. Equity; Potential Denial of Deduction for Business Interest would be if the partnership makes money. Furthermore, a preferred return could be high enough to provide reward commensurate with risk. If the preferred return needs to be eliminated in an angel investor rescue, the restructuring would generate any adverse consequences.

See part II.C.3.d Deducting Interest Expense on Debt Incurred by a Partnership, which applies to S corporations to a large degree.

II.G.4.b. C Corporations: Losses Incurred by Business, Owner, or Employee

C corporations are taxed on their own operations. C corporations that have losses carry them back or forward to other years; C shareholders generally may not take current deductions for a decrease in the value of their stock unless the stock becomes worthless.[1153] A taxpayer who tried to deduct his C corporation's losses, claiming that the he incurred the losses and the C corporation was merely his agent, was penalized for taking that position.[1154]

Expense and III.B.7.c.viii Creative Bonus Arrangements (discussing when a financial interest might rise to the level of being a partner). The interest component should not be based on fixed or variable interest rates, because then it looks like a loan under Code § 707(a). Instead, it would be a preference on cash flow and structured so as not to be a guaranteed payment; *see* Reg. § 1.707-1(c).

[1153] *Bilthouse v. U.S.*, 553 F.3d 513 (7th Cir. 2009), held:

> The worthlessness of a stock as of a particular year is a factual inquiry, varying according to the circumstances of each case. *Boehm v. Comm'r*, 326 U.S. 287, 293 (1945); see *United States v. Davenport*, 412 F. Supp. 2d 1201, 1207 (W.D. Okla. 2005). Although section 165(g) does not define "worthless," most courts consider both the liquidating value and the potential value of the company to determine the year of worthlessness. See *Morton v. Comm'r*, 38 B.T.A. 1270, 1278 (B.T.A. 1938), aff'd 112 F.2d 320 (7th Cir. 1940) (worthlessness of stock depends on current liquidating value and potential value); see also *Delk v. Comm'r*, 113 F.3d 984, 986 (9th Cir. 1997); *Figgie Int'l, Inc. v. Comm'r.*, 807 F.2d 59, 62 (6th Cir. 1986).

Continuing to earn substantial revenue suggests that the corporation might not be worthless. *In Re: Carpenter*, 118 A.F.T.R.2d 2016-XXXX (Bankruptcy. Ct. MT 9/15/2016) held that stock became worthless when the corporation ceased operations and its creditor seized its assets. The court applied the following:

> The tax court set forth a test for determining whether stock is worthless:
>
> > The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss. If the assets of the corporation exceed its liabilities, the stock has liquidating value. If its assets are less than its liabilities but there is a reasonable hope and expectation that the assets will exceed the liabilities of the corporation in the future, its stock, while having no liquidating value, has potential value and can not be said to be worthless. The loss of potential value, if that exists, can be established ordinarily with satisfaction only by some "identifiable event" in the corporation's life which puts an end to such hope and expectation.
>
> *Morton v. Comm'r*, 38 B.T.A. 1270, 1278–1279 (1938), *aff'd* 112 F.2d 320 (7th Cir. 1940). The Ninth Circuit more recently echoed this test:
>
> > Securities may not be considered worthless, even when they have no liquidating value, if there is a reasonable hope and expectation that they will become valuable in the future. *Lawson v. Commissioner*, 42 B.T.A. 1103, 1108, 1940 WL 144 (1940). But, "such hope and expectation may be foreclosed by the happening of certain events such as the bankruptcy, cessation from doing business, or liquidation of the corporation, or the appointment of a receiver...." *Morton v. Commissioner*, 38 B.T.A. 1270, 1278, 1938 WL 165 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940). To establish worthlessness, the taxpayer "must show a relevant identifiable event ... which clearly evidences destruction of both the potential and liquidating values of the stock." *Austin Co. v. Commissioner*, 71 T.C. 955, 970, 1979 WL 3593 (1979). The burden of establishing worthlessness is on the taxpayer. *Figgie Int'l Inc. v. Commissioner*, 807 F.2d 59, 62 (6th Cir. 1986).
>
> *Delk v. C.I.R.*, 113 F.3d 984, 986 (9th Cir. 1997). *See also Textron, Inc . v. U.S.*, 418 F.Supp. 39, 44-47 (D. RI 1976) (requiring that the stock be wholly worthless and that the "deduction for a worthless security be claimed for the year in which said security becomes worthless without the benefit of hindsight").

[1154] *Barnhart Ranch, Co. v. Commissioner*, T.C. Memo. 2016-170.

A founding shareholder might be able to take an ordinary loss of up to $50,000 ($100,000 for joint returns) on the sale of stock under Code § 1244.[1155]

A shareholder who loans money to a C corporation that cannot repay the loan might be stuck deducting the loan as a nonbusiness bad debt, which is deducted as a short term capital loss (deductible each year against only capital gains plus up to $3,000 of other income) rather than an ordinary loss;[1156] alternatively, if the primary purpose of the debt is to preserve the shareholder's job and therefore would be bad debt, presumably the deduction would be an employee business expense, deductible as a miscellaneous itemized deduction; miscellaneous itemized deductions are allowable for regular income tax purposes only to the extent that they exceed 2% of the taxpayer's adjusted gross income and are not deductible at all for alternative minimum tax purposes.[1157] The shareholder must prove that the debt was bona fide and then became worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment.[1158]

For a very brief overview of the principles of this part II.G.4.b, see *Aleamoni v. Commissioner*, T.C. Summ. Op. 2016-21.

[1155] See part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation. A trust or estate is not eligible for this treatment. Part II.J.11.b Code § 1244 Treatment Not Available for Trusts.

[1156] *Haury v. Commissioner*, T.C. Memo 2012-215. Advances that were not documented as loans were treated as equity in *Ramig v. Commissioner*, 110 A.F.T.R.2d 2012-6450 (9th Cir. 2012), an "unpublished" opinion affirming an unpublished Tax Court opinion. Same result in *Herrera v. Commissioner*, T.C. Memo. 2012-308 (imposing accuracy-related penalty), which focused on lack of consistent documentation, the lack of interest payments, and the lack of a Form 1099 reporting cancellation of indebtedness income, and which cited 13 factors from the Fifth Circuit, the weight to each of which varies by case:

> (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement."

The Fifth Circuit affirmed, at 112 A.F.T.R.2d 2013-6858 (11/11/2013), commenting:

> … the Treasury Regulations provide that a guaranty payment only qualifies for a bad debt deduction if "[t]here was an enforceable legal duty upon the taxpayer to make the payment." Treas. Reg. § 1.166–9(d)(2). Voluntary payments do not qualify. See id. § 1.166–1(c) ("A gift ... shall not be considered a debt for purposes of section 166."); *see also Piggy Bank Stations, Inc. v. Comm'r*, 755 F.2d 450, 452–53 (5th Cir. 1985).

[1157] See part II.G.4.a Loans to Businesses or Business Associates, especially fn. 1146.

[1158] *Shaw v. Commissioner*, T.C. Memo 2013-170 (taxpayer failed to prove that the advance was a bona fide loan and not a capital contribution and also failed to prove worthless; 20% accuracy-related penalty imposed), *aff'd* 116 A.F.T.R.2d ¶ 2015-5471 (9th Cir. 2015); *Alpert v. Commissioner*, TC. Memo. 2014-70 (similar result outside a corporate setting).

II.G.4.c. Basis Limitations for Deducting Partnership and S Corporation Losses

II.G.4.c.i. Overview of Pass-Through Basis Limitations

Owners generally may deduct losses to the extent of the owners' basis in their S stock[1159] or partnership interest;[1160] this basis includes certain debt basis, as described below.

Page E-10 of the 2019 Instructions to Schedule E explains what happens when losses have been limited by basis and no longer are:

> **Losses Not Allowed in Prior Years Due to the Basis or At-Risk Rules**
>
> - Enter your total prior year unallowed losses that are now deductible on a separate line in column (i) of line 28. Do not combine these losses with, or net them against, any current year amounts from the partnership or S corporation.
>
> - Enter "PYA" in column (a) of the same line.

For basis limitations, see parts II.G.4.d Basis Limitation for Shareholders in an S Corporation, II.G.4.e Basis Limitations for Partners in a Partnership, and II.G.4.g Limitations on Deducting Charitable Contributions. These basis limitations provide more optionality for S corporations than for partnerships:

- When an S corporation borrows from a third party, its owners do not get basis for the borrowing, even if they provide very strong guarantees to the lenders. An owner gets basis from a loan only if the owner is the lender. However, if an owner borrows from a lender and loans that money to the S corporation, the owner gets basis. In such a back-to-back loan, the owner may take a security interest in the company's assets and then assign that security interest to the lender, so that the lender has a

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[1159] See Code § 1366(d) and Rev. Rul. 2008-16, discussing losses generally and specifically how charitable contributions interact with these limitations. If the shareholder later transfers stock without having been able to use the losses, the losses are permanently disallowed. Reg. § 1.1366-2(a)(5).

T.D. 9682 (2014), finalizing regulations using debt to deduct losses as described in part II.G.4.d.ii.(a) Limitations on Using Debt to Deduct S Corporation Losses, commented on stock basis:

> The preamble to the proposed regulations requested comments regarding the basis treatment when an S corporation shareholder or a partner contributes the shareholder's or partner's own note to an S corporation or a partnership. An S corporation shareholder does not increase his basis in the stock of his S corporation under section 1366(d)(1)(A) from a contribution of his own note. See Rev. Rul. 81-187 (1981-2 CB 167) (holding that a shareholder who (i) merely executed and transferred the shareholder's demand note to the shareholder's wholly owned S corporation, and (ii) made no payment on the note until the following year had a zero basis in the note until the following year when the shareholder made a payment on the note). The preamble to the proposed regulations described as one potential model § 1.704-1(b)(2)(iv)(d)(2), which provides that a partner's capital account is increased with respect to non-readily tradable partner notes only (i) when there is a taxable disposition of such note by the partnership, or (ii) when the partner makes principal payments on such note. One commentator recommended consideration of, and consistency with, § 1.166-9(c) (regarding contributions of debt to capital). Another commentator noted that courts have applied the "actual economic outlay" standard to determine when shareholders increase their bases in their S corporation stock. See, for example, *Maguire v. Commissioner*, T.C. Memo. 2012-160. This commentator requested that the final regulations provide that actual economic outlay does not apply to determinations of a shareholder's stock basis under section 1366(d)(1)(A). To expedite finalization of the proposed regulations, the scope of these final regulations is limited to basis of indebtedness. The Treasury Department and the IRS continue to study issues relating to stock basis and may address these issues in future guidance.

[1160] See Code § 704(d). See also Collins, "Charitable Gifts of Partnership Interests and Partnership Property," ACTEC Business Planning Committee (Summer 2008).

security interest in the company's assets. By choosing between a back-to-back loan and a direct loan from a lender to the company, the owner can determine how much basis is available to absorb losses.

- When a partnership borrows from a third party, its owners are allocated the liabilities and get basis for the borrowing. Guarantees may change how the liabilities are allocated among the owners, but they do not change whether the liabilities are allocated to the owners as a whole.

The at-risk rules are in part II.G.4.j At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities). An example of their application is a partner who is allocated a liability but has not guaranteed or otherwise become subjected to paying that liability out-of-pocket; the at-risk rules may prevent that partner from deducting losses against the basis created by that liability. Sometimes partners guarantee liabilities to support losses (which guarantees the IRS will respect only if real), but the most common guarantees are required by lenders.

Suppose a nongrantor trust owns an interest in an S corporation[1161] or a partnership that incurs losses suspended by the basis limitation. When the trust terminates, the suspended losses are lost forever, with no tax benefit.[1162] This reinforces my inclination to draft trusts that last the beneficiary's lifetime, with the beneficiary becoming trustee when appropriate, rather than terminating and artificially forcing the issue of suspended losses going away.

Compare this part II.G.4.c to parts II.K.2.d Effect of Death of an Individual or Termination of Trust on Suspended Passive Losses and II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. The idea is that suspending a loss and using it against income in a high-earning year may be better than using the loss right away against modest income or income that the standard deduction or itemized deductions already protect from tax.

[1161] Beware of the limitations described in part III.A.3 Trusts Holding Stock in S Corporations.

[1162] In the case of an S corporation, see Reg. § 1.1366-2(a)(6), reproduced in part II.G.4.d.i Basis Limitation Generally. In the case of a partnership, see the fn 1204 and accompanying text in part II.G.4.e Basis Limitations for Partners in a Partnership.

II.G.4.c.ii. Effect of Nontaxable Items on Basis in Pass-Through Entities

The basis of a partnership interest is increased by nontaxable income[1163] and decreased by nondeductible expenses.[1164] Similarly, the basis of S corporation stock is increased by nontaxable income[1165] and decreased by nondeductible expenses.[1166]

Despite this basis increase, nontaxable income does not increase AAA – the amount an S corporation that had been a C corporation can distribute before dipping into its earnings and profits that make part or all of a distribution be a taxable dividend. See part II.P.3.b.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds, which is fleshed out in part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations. If the S corporation has no C corporation earnings and profits or never was a C corporation, this paragraph is a nonissue.

May nontaxable income that generate basis that supports losses? Theoretically, yes. However, consider Code § 265(a)(1), which provides:

> *Expenses*. Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

Manocchio v. Commissioner, 78 T.C. 989 (1982), was a unanimous reviewed decision, with the following Official Tax Court Syllabus at 989-990:[1167]

[1163] Code § 705(a)(1)(B), referring to "income of the partnership exempt from tax under this title."

[1164] Code § 705(a)(2)(B), referring to "expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account."

[1165] Code § 1367(a)(1)(B), referring to "any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1)." Code § 1366(a), "Determination of shareholder's tax liability," provides:

> (1) *In general*. In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's
>
> (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and
>
> (B) nonseparately computed income or loss.
>
> For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).
>
> (2) *Nonseparately computed income or loss defined*. For purposes of this subchapter, the term "nonseparately computed income or loss" means gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items described in paragraph (1)(A).

[1166] Code § 1367(a)(1)(B), referring to "any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1)." Code § 1366(a)(1) is reproduced in fn 1165.

[1167] At 997, the court pointed out:

> Moreover, we do not view our decision in this case as having any effect on the exemption provided by 38 U.S.C. sec. 3101(a) with respect to flight-training benefits. Although it is true that petitioner is left in the identical situation, from the standpoint of tax consequences, as if he had received a taxable reimbursement, in which case section 265 would not bar his deduction, there will obviously be instances where the veteran's flight-training expenses will be nondeductible irrespective of section 265. For example, the expenses might not satisfy the conditions for deductibility imposed by section 1.162-5, Income Tax Regs., or, assuming they do, the veteran might not have sufficient itemized

> During 1977, petitioner, an airline pilot and an Air Force veteran, attended a flight-training course which maintained and improved skills required in his trade or business. Pursuant to 38 U.S.C. sec. 1677 (1976), he received checks from the Veterans' Administration (VA) totaling 90 percent of the cost of the classes and endorsed them over to the flight-training school. Because the payments received were exempt from taxation under 38 U.S.C. sec. 3101(a) (1976), petitioner did not report them on his 1977 Federal income tax return. He did, however, deduct the entire cost of the flight-training course, including the portion which had been reimbursed by the VA. *Held*, the reimbursed flight-training expenses are allocable to a class of tax-exempt income - the reimbursement - and, therefore, are nondeductible under sect. 265(1), I.R.C. 1954. *Held*, further, respondent is not estopped from disallowing a deduction for such amounts.

Although a couple of cases had held reimbursed expenses were not deductible, a large majority of the court viewed Code § 265 as the strongest ground for disallowance. The Ninth Circuit affirmed, 710 F.2d 1400 (1983), but on the grounds that reimbursed expenses are not deductible; it declined to pass on the merits of Code § 265. *Benningfield v. Commissioner*, 81 T.C. 408 (1983), which did not involve tax-exempt income, cited with approval the Ninth Circuit's opinion that reimbursed expenses are not deductible.

Relying on the Tax Court in *Manocchio*, Rev. Rul. 83-3 disallows deductions attributable to tax-exempt income when a veteran incurs educational expenses allocable to veterans benefits that are exempt from taxation or a student incurs educational expenses if allocable to a scholarship that is excluded from gross income under Code § 117.[1168] Rev. Rul. 83-3 describes how to allocate expenses in those cases. Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts* (WG&L), ¶ 22.7. Expenses Related to Tax-Exempt Income, recites a litany of cases generally consistent with this disallowance.

If income is exempt from tax because the recipient is a tax-exempt organization, related expenditures are similarly nondeductible.[1169]

> deductions to take advantage of the deduction. In either of these situations, he would realize additional taxable income in the absence of the exemption provision.
>
> In short, there is nothing in the legislative history of the relevant veterans' provisions to suggest that Congress intended for a veteran to have both an exemption and a tax deduction where his reimbursed flight-training expenses otherwise qualify as deductible business-related education. On the other hand, the legislative purpose behind section 265 is abundantly clear: Congress sought to prevent taxpayers from reaping a double tax benefit by using expenses attributable to tax-exempt income to offset other sources of taxable income. This is precisely what petitioner is attempting to do here, and in our judgment, the application of section 265(1) to disallow the reimbursed portion of the flight-training expense deduction is both reasonable and equitable.

[1168] It also disallowed deductions when a minister incurs interest and taxes paid on a personal residence to the extent that the amounts expended are allocable to a rental allowance excluded from gross income under Code § 107. Rev. Rul. 85-96 modifies the formula for a minister, but Rev. Rul. 87-32 changes how that rule is applied, obsoleting Rev. Rul. 85-96 and also recognizing that then-new Code § 265(a)(6) prevents Code § 265 from denying a deduction for "interest on a mortgage on, or real property taxes on, the home of the taxpayer by reason of the receipt of an amount as (A) a military housing allowance, or (B) a parsonage allowance excludable from gross income under section 107."

[1169] *Anclote Psychiatric Center Inc. v. Commissioner*, T.C. Memo. 1998-273:

> We are satisfied that the FPCF liabilities are allocable to petitioner's hospital income in the periods prior to the sale of the hospital and that section 265(1) applies. That being the case, the fact that those payments might have been deductible under section 162(a) had petitioner's hospital business produced taxable income becomes irrelevant since section 265(1) prevails over section 162(a) by disallowing deductions falling within its ambit which are "otherwise allowable". See *supra* note 12 [citing Code § 265]; see also *Stroud v. United States*, 906 F.Supp. 990, 996 (D.S.C. 1995), *affd. in part and vacated in part* without published opinion 94 F.3d 642 (4th Cir. 1996); *Rickard v. Commissioner*, 88 T.C. 188, 193-194 (1987). The fact that the nontaxability of the hospital income derived from petitioner's status rather than from the character of the income as such does not prevent the application of

A corollary to the idea that reimbursed expenses are not deductible is the tax benefit rule, which states that reimbursements of previously deducted expenses are income. Some tax preparers take the position that one may deduct the expenses in one year and then not recapture the income in a later year if an exception to the tax benefit rule provides relief. For further discussion of tax issues, see part II.G.4.m.iii Tax Benefit Rule.

When a loan is forgiven under the rules of the SBA Paycheck Protection Program (PPP), the debt cancellation is not taxable. However, the debt is forgiven only if certain expenses are incurred, so Notice 2020-32 confirms that those expenses are not deductible in the amount of the loan forgiveness and Rev. Rul. 2020-27 provides procedures. However, Rev. Rul. 2021-2 revoked Notice 2020-32 and Rev. Rul. 2020-27 due to section 278(a) of the Consolidated Appropriations Act, 2021, the latter which provides:

> UNITED STATES TREASURY PROGRAM MANAGEMENT AUTHORITY. For purposes of the Internal Revenue Code of 1986 -
>
> (1) no amount shall be included in the gross income of a borrower by reason of forgiveness of indebtedness described in section 1109(d)(2)(D) of the CARES Act,
>
> (2) no deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income provided by paragraph (1), and
>
> (3) in the case of a borrower that is a partnership or S corporation -
>
> (A) any amount excluded from income by reason of paragraph (1) shall be treated as tax exempt income for purposes of sections 705 and 1366 of the Internal Revenue Code of 1986, and
>
> (B) except as provided by the Secretary of the Treasury (or the Secretary's delegate), any increase in the adjusted basis of a partner's interest in a partnership under section 705 of the Internal Revenue Code of 1986 with respect to any amount described in subparagraph (A) shall equal the partner's distributive share of deductions resulting from costs giving rise to forgiveness described in section 1109(d)(2)(D) of the CARES Act.

Rev. Proc. 2021-48, § 3. "Timing Of Tax-Exempt Income," provides:

> .01. *Overview*. Subject to section 3.03 of this revenue procedure, a taxpayer that received a PPP Loan may treat tax-exempt income resulting from the partial or complete forgiveness of such PPP Loan as received or accrued:

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section 265(1). As we stated in *Rickard v. Commissioner*, *supra* at 193-194, where the tax exemption attaching to the taxpayer's farm income derived from his status as an Indian and the location of the farm on Indian land:

> The legislative purpose behind section 265 is abundantly clear: Congress sought to prevent taxpayers from reaping a double tax benefit by using expenses attributable to tax-exempt income to offset other sources of taxable income. *Manocchio v. Commissioner*, 78 T.C. 989, 997 (1982), *affd.* 710 F.2d 1400 (9th Cir. 1983). More importantly, the Supreme Court has concluded that Congress intended to limit deductions to those expenses related to taxed income. *Rockford Life Insurance Co. v. Commissioner*, 292 U.S. 382 (1934). *** [Fn. refs. omitted.)

Nor is it relevant that the tax-exempt income to which FPCF relates was earned by petitioner in an earlier year. In *Stroud v. United States*, *supra*, the taxpayer was denied a deduction for amounts paid in the taxable year because of a breach of contract to provide medical service in return for a tax-exempt scholarship received in an earlier year.

We hold that the FPCF payments in question are not deductible.

(1) As, and to the extent that, the taxpayer pays or incurs eligible expenses as described in section 2.01(2). Under this section 3.01(1), a taxpayer that has elected to use the safe harbor provided under Revenue Procedure 2021-20 will be treated as paying or incurring the eligible expenses during the taxpayer's immediately subsequent taxable year following the taxpayer's 2020 taxable year in which the expenses were actually paid or incurred, as described in Revenue Procedure 2021-20;

(2) When the taxpayer files an application for forgiveness of the PPP Loan; or

(3) When the PPP Loan forgiveness is granted.

.02. *Amended returns*. Taxpayers may report tax-exempt income pursuant to section 3.01 on a timely filed original or amended Federal income tax return, information return or administrative adjustment request (AAR) under § 6227 of the Code. *See also* Revenue Procedure 2021-50, 2021-49 I.R.B. ___, released November 18, 2021, allowing an eligible partnership to file an amended Form 1065, *U.S. Return of Partnership Income, as an alternative to filing an AAR, and furnish a corresponding amended Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc.*, to each of its partners. Partners and shareholders that receive amended Forms K-1 as provided in this section 3.02 must file amended Federal income tax returns, information returns or AARs, as applicable, consistent with the Forms K-1 received.

.03. *When PPP Loan is not fully forgiven*. Unless otherwise provided in the 2021 filing year form instructions, if the taxpayer receives forgiveness for an amount of the PPP Loan that is less than the amount that the taxpayer previously treated as tax-exempt income, the taxpayer must make appropriate adjustments on an amended Federal income tax return, information return or AAR, as applicable, for the taxable year(s) in which the taxpayer treated tax-exempt income from the forgiveness of such PPP Loan as received or accrued. Partners and shareholders that receive amended Forms K-1 as provided in this section 3.03 must file amended Federal income tax returns, information returns or AARs, as applicable, consistent with the Forms K-1 received.

.04. *Reporting consistent with this revenue procedure*. The IRS will publish form instructions for the 2021 filing season that will detail how taxpayers can report consistently with sections 3.01 through 3.03 of this revenue procedure. However, taxpayers do not need to wait until the instructions are published to apply this revenue procedure.

.05. *Gross receipts application*. To the extent tax-exempt income resulting from the partial or complete forgiveness of a PPP Loan is treated as gross receipts under a particular Federal tax provision, including but not limited to § § 448(c) and 6033 of the Code, section 3 of this revenue procedure applies for purposes of determining the timing and, to the extent relevant, reporting of such gross receipts.

Rev. Proc. 2021-49 provides additional guidance. Rather than reciting details, here is an excerpt, § 1, "Purpose":

.01. This revenue procedure provides guidance for partnerships and consolidated groups regarding amounts excluded from gross income (tax exempt income) and deductions relating to the Paycheck Protection Program (PPP) and certain other COVID-19 relief programs. More specifically:

(1) This revenue procedure provides guidance for partners and their partnerships regarding:

(a) allocations under § 704(b) of the Internal Revenue Code (Code) of tax exempt income arising from the forgiveness of PPP Loans, the receipt of certain grant proceeds, or the subsidized payment of certain principal, interest and fees;

(b) allocations under § 704(b) of the Code of deductions resulting from expenditures attributable to the use of forgiven PPP Loans or certain grant proceeds, or subsidized payments of certain interest and fees; and

(c) the corresponding adjustments to be made with respect to the partners' bases in their partnership interests under § 705 of the Code.

(2) This revenue procedure also provides guidance under § 1502 of the Code and § 1.1502-32 of the Income Tax Regulations regarding the corresponding basis adjustments for stock of subsidiary members of consolidated groups as a result of tax exempt income arising from certain forgiven PPP Loans, grant proceeds, or subsidized payment of certain principal, interest and fees.

.02. For guidance on the timing of tax exempt income arising from forgiven PPP Loans, see Rev. Proc. 2021-48, 2021-49 I.R.B. ___, released on November 18, 2021.

Similarly, Rev. Proc. 2021-50, § 1, "Purpose," provides:

> This revenue procedure allows eligible partnerships to file amended partnership returns for taxable years ending after March 27, 2020 using a Form 1065, U.S. Return of Partnership Income (Form 1065), with the "Amended Return" box checked, and issue an amended Schedule K-1, Partner's Share of Income, Deductions, Credits, etc. (Schedule K-1), to each of its partners. An eligible partnership may file an amended return under Rev. Proc. 2021-48, 2021-49 I.R.B.___, or Rev. Proc. 2021-49, 2021-49 I.R.B. ___, if the requirements of section 3 of this revenue procedure are met. In order to take advantage of the option to amend provided in this revenue procedure, amended partnership returns must be filed, and corresponding Schedules K-1 must be furnished, on or before December 31, 2021.

Although tax exempt income increases the basis of an owner of a partnership or S corporation, it does not increase an S corporation's AAA, which means that it will not support a tax-free distribution from an S corporation that has earnings & profits from any prior existence as a C corporation. See part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations (discussing such proceeds as tax exempt income).

The *Journal of Accountancy* (11/1/2020) summarizes accounting issues relating to PPP loan forgiveness.[1170]

II.G.4.d. Basis Limitation for Shareholders in an S Corporation

II.G.4.d.i. Basis Limitation Generally

As to S corporations, Code § 1366(d)(1), "Cannot exceed shareholder's basis in stock and debt," provides:

[1170] https://www.journalofaccountancy.com/issues/2020/nov/coronavirus-pandemic-accounting-judgments.html.

The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

The extent to which they may use debt in addition to this is described in part II.G.4.d.ii Using Debt to Deduct S Corporation Losses.

Code § 1367(a) provides the general rules for calculating basis in S corporation stock (Code § 1366 being items in the K-1 the corporation issues the shareholder):

(1) *Increases in basis*. The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:

(A) the items of income described in subparagraph (A) of section 1366(a)(1),

(B) any nonseparately computed income determined under subparagraph (b) of section 1366(a)(1), and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion.

(2) *Decreases in basis*. The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

(A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,

(B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),

(C) any nonseparately computed loss determined under subparagraph (b) of section 1366(a)(1),

(D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account,[1171] and

[1171] Reg. § 1.1367-1(c)(2) provides:

Noncapital, nondeductible expenses. For purposes of section 1367(a)(2)(D), expenses of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account (noncapital, nondeductible expenses) are only those items for which no loss or deduction is allowable and do not include items the deduction for which is deferred to a later taxable year. Examples of noncapital, nondeductible expenses include (but are not limited to) the following: illegal bribes, kickbacks, and other payments not deductible under section 162(c); fines and penalties not deductible under section 162(f); expenses and interest relating to tax-exempt income under section 265; losses for which the deduction is disallowed under section 267(a)(1); the portion of meals and entertainment expenses

(E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(11)(B) .

The decrease under subparagraph (b) by reason of a charitable contribution (as defined in section 170(c)) of property shall be the amount equal to the shareholder's pro rata share of the adjusted basis of such property.

"The shareholder bears the burden of establishing his basis in an S corporation."[1172]

Code § 1366(d)(2), "Indefinite carryover of disallowed losses and deductions," provides:

(A) *In general*. Except as provided in subparagraph (B), any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

(B) *Transfers of stock between spouses or incident to divorce*. In the case of any transfer described in section 1041(a) of stock of an S corporation, any loss or deduction described in subparagraph (A) with respect such stock shall be treated as incurred by the corporation in the succeeding taxable year with respect to the transferee.

Implementing Code § 1366(d)(2), Reg. § 1.1366-2(a)(6), "Nontransferability of losses and deductions," provides:

(i) *In general*. Except as provided in paragraph (a)(6)(ii) of this section, any loss or deduction disallowed under paragraph (a)(1) of this section is personal to the shareholder and cannot in any manner be transferred to another person. If a shareholder transfers some but not all of the shareholder's stock in the corporation, the amount of any disallowed loss or deduction under this section is not reduced and the transferee does not acquire any portion of the disallowed loss or deduction. If a shareholder transfers all of the shareholder's stock in the corporation, any disallowed loss or deduction is permanently disallowed.

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disallowed under section 274; and the two-thirds portion of treble damages paid for violating antitrust laws not deductible under section 162. For basis adjustments necessary to coordinate sections 1367 and 362(e)(2), see § 1.362-4(f)(ii).

Among loss disallowances that lose basis under Code § 267 is part II.Q.7.h.iii.(b) Nondeductible Loss to Corporation When It Distributes Property to Shareholders.

[1172] *Hall v. Commissioner*, T.C. Memo. 2014-171, citing *Broz v. Commissioner*, 137 T.C. 46, 60 (2011), *aff'd* 727 F.3d 621 (6th Cir. 2013). The taxpayers asked for trouble and got it:

> [The CPA firm] did not prepare a basis schedule for Mr. Hall's basis in Ophthalmic Associates. Instead, [the CPA firm's forensic accountant] testified that he analyzed gross receipts to estimate Mr. Hall's basis. Mr. Hall and Mrs. Hall did not offer into evidence the purported analysis used by [the CPA] to estimate Mr. Hall's basis. Instead, Mr. Hall and Mrs. Hall offered into evidence monthly bank statements for Ophthalmic Associates for January 2005 and December 2006. We note that Mr. Hall and Mrs. Hall did not share these bank statements with respondent before trial pursuant to the Court's pretrial order. Mrs. Hall testified that during the weekend before trial she realized that two of the deposits were actually loans made to Ophthalmic Associates. Mr. Hall and Mrs. Hall did not provide sufficient evidence for us to find that these amounts were loans. We are not required to accept Mr. Hall and Mrs. Hall's self-serving testimony. See *Tokarski v. Commissioner*, 87 T.C. 74, 77 (1986). We find that petitioners have failed to prove that Mr. Hall and Mrs. Hall had a basis in Ophthalmic Associates in an amount greater than respondent determined.

(ii) *Exceptions for transfers of stock under section 1041(a)*. If a shareholder transfers stock of an S corporation after December 31, 2004, in a transfer described in section 1041(a), any loss or deduction with respect to the transferred stock that is disallowed to the transferring shareholder under paragraph (a)(1) of this section shall be treated as incurred by the corporation in the following taxable year with respect to the transferee spouse or former spouse. The amount of any loss or deduction with respect to the stock transferred shall be determined by prorating any losses or deductions disallowed under paragraph (a)(1) of this section for the year of the transfer between the transferor and the spouse or former spouse based on the stock ownership at the beginning of the following taxable year. If a transferor claims a deduction for losses in the taxable year of transfer, then under paragraph (a)(5) of this section, if the transferor's pro rata share of the losses and deductions in the year of transfer exceeds the transferor's basis in stock and the indebtedness of the corporation to the transferor, then the limitation must be allocated among the transferor spouse's pro rata share of each loss or deduction, including disallowed losses and deductions carried over from the prior year.

(iii)*Examples*. The following examples illustrates the provisions of paragraph (a)(6)(ii) of this section:

Example (1). A owns all 100 shares in X, a calendar year S corporation. For X's taxable year ending December 31, 2006, A has zero basis in the shares and X does not have any indebtedness to A. For the 2006 taxable year, X had $100 in losses that A cannot use because of the basis limitation in section 1366(d)(1) and that are treated as incurred by the corporation with respect to A in the following taxable year. Halfway through the 2007 taxable year, A transfers 50 shares to B, A's former spouse in a transfer to which section 1041(a) applies. In the 2007 taxable year, X has $80 in losses. On A's 2007 individual income tax return, A may use the entire $100 carryover loss from 2006, as well as A's share of the $80 2007 loss determined under section 1377(a) ($60), assuming A acquires sufficient basis in the X stock. On B's 2007 individual income tax return, B may use B's share of the $80 2007 loss determined under section 1377(a) ($20), assuming B has sufficient basis in the X stock. If any disallowed 2006 loss is disallowed to A under section 1366(d)(1) in 2007, that loss is prorated between A and B based on their stock ownership at the beginning of 2008. On B's 2008 individual income tax return, B may use that loss, assuming B acquires sufficient basis in the X stock. If neither A nor B acquires any basis during the 2007 taxable year, then as of the beginning of 2008, the corporation will be treated as incurring $50 of loss with respect to A and $50 of loss with respect to B for the $100 of disallowed 2006 loss, and the corporation will be treated as incurring $60 of loss with respect to A and $20 with respect to B for the $80 of disallowed 2007 loss.

Example (2). Assume the same facts as Example 1, except that during the 2007 taxable year, A acquires $10 of basis in A's shares in X. For the 2007 taxable year, A may claim a $10 loss deduction, which represents $6.25 of the disallowed 2006 loss of $100 and $3.75 of A's 2007 loss of $60. The disallowed 2006 loss is reduced to $93.75. As of the beginning of 2008, the corporation will be treated as incurring half of the remaining $93.75 of loss with respect to A and half of that loss with respect to B for the remaining $93.75 of disallowed 2006 loss, and if B does not acquire any basis during 2007, the corporation will be treated as incurring $56.25 of loss with respect to A and $20 with respect to B for the remaining disallowed 2007 loss.

II.G.4.d.ii. Using Debt to Deduct S Corporation Losses

II.G.4.d.ii.(a). Limitations on Using Debt to Deduct S Corporation Losses

Owners of S corporations generally may not deduct losses financed by the corporation's debt except to the extent that the shareholders are the lenders;[1173] instead of guaranteeing a corporation's bank loan,[1174] S corporation shareholders should borrow and then loan the proceeds to the corporation to deduct the loss.[1175]

[1173] Code § 1366(d)(1)(B) allows deductions against:

> the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

Code § 1367(c)(2) provides:

> (A) *Reduction of basis*. If for any taxable year the amounts specified in subparagraphs (B), (C), (D), and (E) of subsection (a)(2) exceed the amount which reduces the shareholder's basis to zero, such excess shall be applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.
>
> (B) *Restoration of basis*. If for any taxable year beginning after December 31, 1982, there is a reduction under subparagraph (A) in the shareholder's basis in the indebtedness of an S corporation to a shareholder, any net increase (after the application of paragraphs (1) and (2) of subsection (a)) for any subsequent taxable year shall be applied to restore such reduction in basis before any of it may be used to increase the shareholder's basis in the stock of the S corporation.

Reg. § 1.1366-2(a)(2)(i) provides:

> *In general*. The term basis of any indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis (as defined in § 1.1011-1 and as specifically provided in section 1367(b)(2)) in any bona fide indebtedness of the S corporation that runs directly to the shareholder. Whether indebtedness is bona fide indebtedness to a shareholder is determined under general Federal tax principles and depends upon all of the facts and circumstances.

[1174] Reg. § 1.1366-2(a)(2)(ii) provides:

> *Special rule for guarantees*. A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, then the shareholder may increase the shareholder's basis of indebtedness to the extent of that payment.

[1175] Reg. § 1.1366-2(a)(2)(iii), Examples (2) (shareholder borrowed from another S corporation she owned and loaned the proceeds to the loss corporation) and (4) (no basis in loan for guarantee, but guarantor received basis in indebtedness when she made payments to the bank because the corporation no longer could).

To cut down on controversy in this area,[1176] regulations focus on whether the corporation's debt to the shareholder is bona fide[1177] and intend to override the "actual economic outlay" doctrine that had been developed.[1178] The preamble to the Proposed Regulations explained:[1179]

> The key requirement of these proposed regulations is that purported indebtedness of the S corporation to a shareholder must be bona fide indebtedness to the shareholder. These proposed regulations do not attempt to provide a different standard for purposes of section 1366 as to what constitutes bona fide indebtedness. Rather, general Federal tax principles — many of which have developed outside of section 1366 — determine whether indebtedness is bona fide.

[1176] Starr, "How to Obtain Debt Basis in an S Corporation? Use Bona Fide Indebtedness, Say Proposed Rules, Journal of Taxation," *Journal of Taxation* (obtained from the *Journal*'s preview service; probably published November 2012). The author of this article suggests that the Proposed Regulations adopted the recommendations of the American Bar Association's Section of Taxation (the "Tax Section"),

http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/072610comments.authcheckdam.pdf, in which the author participated. The Tax Section's comments on the Proposed Regulations are at

http://www.americanbar.org/content/dam/aba/administrative/taxation/091712comments2.authcheckdam.pdf (9/17/2012).

T.D. 9682 (7/23/2014) adopted the proposed regulations with very few changes. Reg. § 1.1366-5(b) allows taxpayers to rely on Reg. § 1.1366-2(a)(2) with respect to indebtedness between an S corporation and its shareholder that resulted from any transaction that occurred in a year for which the period of limitations on the assessment of tax has not expired before July 23, 2014.

Reg. § 1.1366-2(a)(2) preempts case law, which provided unpredictable results. See *Russell v. Commissioner*, T.C. Memo. 2008-246 (shareholders co-signing loans made by others did not provides basis; also, adjusting journal entries regarding loans were not respected because timing was suspicious), *aff'd per curiam United Energy Corporation v. Commissioner*, 106 AFTR.2d 2010-6056 (8th Cir. 2010). On the other hand, the fact that a loan made directly to the shareholder was repaid by the corporation did not mean that the corporation was deemed to have borrowed the money. *Gleason v. Commissioner*, T.C. Memo. 2006-191. If a creditor obtains a judgment against a shareholder who guaranteed a loan to the corporation, the shareholder is not deemed to have made a loan to the corporation until the shareholder actually makes a payment to the creditor. *Montgomery v. Commissioner*, T.C. Memo. 2013-151.

[1177] See part II.G.21.b When Debt Is Recharacterized as Equity for various cases determining whether debt was bona fide.

[1178] The preamble to the proposed regulations, REG-1342042-07, explained:

> The frequency of disputes between S corporation shareholders and the government regarding whether certain loan transactions involving multiple parties, including back-to-back loan transactions, create shareholder basis of indebtedness demonstrates the complexity of and uncertainty about this issue for both shareholders and the government. The Treasury Department and the IRS propose these regulations to clarify the requirements for increasing basis of indebtedness and to assist S corporation shareholders in determining with greater certainty whether their particular arrangement creates basis of indebtedness. These proposed regulations require that loan transactions represent bona fide indebtedness of the S corporation to the shareholder in order to increase basis of indebtedness; therefore, an S corporation shareholder need not otherwise satisfy the "actual economic outlay" doctrine for purposes of section 1366(d)(1)(B).

The IRS had attacked loans that seem too circular. See, e.g. TAM 200619021, which was upheld in *Kerzner v. Commissioner*, T.C. Memo. 2009-76 (S corp. paid rent to partnership owned by its shareholders, partnership then loaned rent to its partners, who then loaned the same money to the S corp.). The preamble to the Proposed Regulations summarized these cases, some of which are cited in the *Kerzner* case as well. See Example 4 of the regulations, discussed in fn. 1183, for comments on the circular flow of funds and the *Kerzner* case.

[1179] The preamble cites the following cases as examples:

> *Knetsch v. U.S.*, 364 U.S. 361 (1960) (disallowing interest deductions for lack of actual indebtedness); *Geftman v. Comm'r*, 154 F.3d 61, 68-75 (3d Cir. 1998) (based on the objective attributes and the economic realities of the transaction, holding that the transaction at issue was not a bona fide debt); *Estate of Mixon v. U.S.*, 464 F.2d 394, 402 (5th Cir. 1972) (discussion of factors indicative that debt is bona fide); *Litton Business Systems, Inc. v. Comm'r*, 61 T.C. 367, 376-77 (1973).

The article at footnote 1176 discusses the approaches recommended by the AICPA and the Section of Taxation of the American Bar Association took regarding what is bona fide debt.

Final Regulations retained this rule, without any changes.[1180]

The Regulations provide some helpful examples:

- A shareholder who lends money to an S corporation has basis of indebtedness, even if the shareholder's wholly-owned disregarded (for income tax purposes) LLC makes the loan.[1181] Query whether the at-risk rules might limit the loss.

- If a shareholder borrows money from one S corporation he wholly owns and lends it to another S corporation, the loan to the S corporation gives the shareholder basis of indebtedness.[1182]

- If one S corporation borrows from another S corporation and the lending corporation distributes the loan to the person who is the sole shareholder of both corporations, the distribution of the loan gives the shareholder basis of indebtedness.[1183] Until the loan is distributed, however, the owner of the

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[1180] T.D. 9682 (2014) included commented on the actual economic outlay test:

> Courts developed the actual economic outlay standard, which requires that shareholders be made "poorer in a material sense" to increase their bases of indebtedness. Some courts concluded that an S corporation shareholder was not poorer in a material sense if the shareholder borrowed funds from a related entity and then lent those funds to his S corporation. See, for example, *Oren v. Commissioner*, 357 F.3d 854 (8th Cir. 2004), *aff'g*, T.C. Memo. 2002-172. Instead of applying the actual economic outlay standard, the proposed regulations provided that shareholders receive basis of indebtedness if it is bona fide indebtedness of the S corporation to the shareholder.
>
> One commentator suggested that language be added to the regulations providing that actual economic outlay is no longer the standard used to determine whether a shareholder obtains basis of indebtedness. After considering this comment, the Treasury Department and the IRS believe that the proposed regulations clearly articulate the standard for determining basis of indebtedness of an S corporation to its shareholder, and further discussion of the actual economic outlay test in the regulations is unnecessary. Accordingly, the final regulations adopt the rule in the proposed regulations without change.
>
> With respect to guarantees, however, the final regulations retain the economic outlay standard by adopting the rule in the proposed regulations that S corporation shareholders may increase their basis of indebtedness only to the extent they actually perform under a guarantee. The final regulations make some minor changes to clarify the treatment of guarantees, including changing the heading to reiterate that the rule for guarantees is distinguished from the general rule adopting a bona fide indebtedness standard and moving the guarantee example after the examples illustrating the general rule consistent with the order of the regulations.

[1181] Reg. § 1.1366-2(a)(2)(iii), Example 1.

[1182] Reg. § 1.1366-2(a)(2)(iii), Example 2.

[1183] Reg. § 1.1366-2(a)(2)(iii), Example 3. Make sure that the distribution of the loans is well documented contemporaneously, as did <u>not</u> happen in *Broz v. Commissioner*, 137 T.C. 46 (2011), *aff'd* 727 F.3d 621 (6th Cir. 2013). T.D. 9682, adopting final regulations, commented on Example 4:

> The Treasury Department and the IRS recognize that there are numerous ways, including certain circular cash flows, in which an S corporation can become indebted to its shareholder. The proposed regulations included Example 4 as an example of a loan originating between two related entities that is restructured to be from the S corporation to the shareholder to show that the debt need not originate between the S corporation and its shareholder, provided that the resulting debt running between the S corporation and the shareholder is bona fide. The Treasury Department and the IRS are aware, however, of cases involving circular flow of funds that do not result in bona fide indebtedness. See, for example, *Oren v. Commissioner*, 357 F.3d at 859 (purported loans, although meeting all the proper formalities, lacked substance); *Kerzner v. Commissioner*, T.C. Memo. 2009-76, at 5 (transaction lacked substance because money wound up right where it started and shareholder was merely a conduit through which the money flowed). Whether a restructuring results in bona fide indebtedness depends on the facts and circumstances. Because the Treasury Department and the IRS believe that the examples in the proposed regulations adequately illustrate that a restructuring of a debt that did not originate between the shareholder and the S corporation may result in basis of indebtedness as long as the resulting debt is bona fide, these final regulations do not contain additional examples.

lending S corporation cannot receive basis for the loan, according to cases that applied to a taxable year before the Regulations applied.[1184]

[1184] *Messina v. Commissioner*, T.C. Memo. 2017-213, *aff'd* 124 A.F.T.R.2d 2019-7144 (9th Cir. 12/27/2019), rejecting taxpayers' arguments that the lending S corporation be treated as a mere agent for its owners rather than being respected as an entity. The court rejected the taxpayers' assertion that *Commissioner v. Bollinger*, 485 U.S. 340 (1988), or *Lee v. Commissioner*, T.C. Memo. 1976-265, allowed taxpayers to disregard the form of the transaction they chose. *Meruelo v. Commissioner*, T.C. Memo. 2018-16, had a similar result, reasoning:

> Finally, in *Yates* and *Culnen* the transactions alleged to create basis were actually booked as loans. The corporations contemporaneously recorded shareholder loans on their ledgers, and payments of principal and interest were made on the loans. *Yates*, 82 T.C.M. (CCH) at 806-807; *Culnen*, 79 T.C.M. (CCH) at 1934-1935. Here, by contrast, the transactions were contemporaneously booked as capital contributions, payroll expenses, or inter-company accounts payable and receivable. Merco's net accounts payable to affiliates were recharacterized as "shareholder loans" only after the close of each year, when Mr. Carerras prepared the tax returns and adjusted Merco's book entries to match. No payments of principal or interest were ever made on these supposed "shareholder loans." See *Broz*, 137 T.C. at 52-53 (rejecting incorporated pocketbook theory where corporation made year-end adjustments reclassifying advances as shareholder loans); *Wilson v. Commissioner*, T.C. Memo. 1991-544 (rejecting reclassification of transactions on the basis of year-end journal entries).
>
> For these reasons, we find that petitioner has not carried his burden of proving that he used the 11 Merco affiliates as an "incorporated pocketbook" to pay Merco's expenses. Under this theory, as under his back-to-back loan theory, petitioner seeks to disavow the form of inter-company extensions of credit in an effort to generate basis for himself.[7] Because petitioner has not established the existence of bona fide indebtedness running from Merco directly to him, he is not entitled to the increased basis he claims. *Hitchins*, 103 T.C. at 715; sec. 1.1366-2(a)(2)(i), Income Tax Regs. [The 2014 regulations did not apply, but the court said that they would not have helped the taxpayer even if they had applied.]
>
> [7] Petitioner errs in seeking to accomplish the same result by invoking the doctrine of "constructive receipt." See sec. 1.451-2(a), Income Tax Regs. This doctrine addresses a timing issue, *viz.*, whether an item of income is includible in a taxpayer's gross income regardless of actual receipt. It has no conceivable relevance in determining whether a taxpayer has made an actual economic outlay sufficient to create increased basis in the stock or indebtedness of an S corporation.

The Eleventh Circuit affirmed, *Meruelo v. Commissioner*, 923 F.3d 938 (2019). Among its holdings, it rejected the taxpayer's attempt to recharacterize intercompany loans:

> Meruelo also argues that his accountant's end-of-year reclassification of the intercompany transfers, as reflected on his tax returns and on the annual adjustments to the line-of-credit from the 2004 Note, were sufficient to establish that the transactions amounted to shareholder, but we disagree. "After-the-fact reclassification cannot satisfy the requirement that the debt run directly from the S corporation to the taxpayer/shareholder, and courts have previously rejected efforts by taxpayers to establish debt basis in an S corporation using this method." *Broz v. Comm'r*, 727 F.3d 621, 627 (6th Cir. 2013); *Ruckriegel v. Comm'r*, 91 T.C.M. (CCH) 1035 (2006) (ruling that yearend reclassification of intercorporate loans as back-to-back loans through the taxpayer was insufficient to provide debt basis); *Burnstein v. Comm'r*, 47 T.C.M. (CCH) 1100 (1984) (same). Because the transactions were contemporaneously classified as transactions between the affiliates and Merco, the designation Meruelo's accountant gave them at the end of the year does not govern. And we agree with the Tax Court that the accountant's adjustments to "a notional line of credit, uniformly made after the close of each relevant tax year, do not suffice to create indebtedness to [Meruelo] where none in fact existed."

The Eleventh Circuit agreed with the Tax Court in rejecting the taxpayer's incorporated pocketbook theory, concluding:

> As the Tax Court explained, no court has ever ruled that a group of non-wholly owned entities that both receive and disburse funds in this fashion can constitute an incorporated pocketbook. And Meruelo failed to establish that he habitually paid third parties on his behalf through the putative incorporated-pocketbook companies. Meruelo's evidence established only that the Merco affiliates regularly paid the expenses of other companies within the affiliate group - not his personal expenses. See *Broz*, 727 F.3d at 628 (affirming Tax Court's rejection of taxpayers' "incorporated pocketbook" argument where the taxpayers failed to establish that they habitually paid third parties through the entities); *Messina v. Comm'r*, 114 T.C. Memo. 2017-213, at *32–33 (2017) (rejecting theory on the same ground); *Ruckriegel*, 91 T.C.M. (CCH) 1035 (same).

- If a shareholder makes payment with respect to a loan guarantee, the payment gives the shareholder basis of indebtedness.[1185]

When the shareholder is named as a co-borrower but really is just a guarantor, the shareholder is not deemed to have borrowed the money and loaned it to the corporation.[1186]

[1185] Reg. § 1.1366-2(a)(2)(iii), Example (4), "Guarantee," which is reproduced in fn 6079 in part III.B.1.a.ii.(a) Gift Tax Issues Involving Loan Guarantees. For a taxable year before the regulation was effective, see *Franklin v. Commissioner*, T.C. Memo. 2016-207, describing when an S corporation's creditor, ARCO, seized property of the taxpayer who owned the S corporation:

> On the basis of his testimony, applying a preponderance-of-the-evidence standard, we find that, in 2007, ACRO seized and sold petitioner's property and applied the proceeds, $496,000, to FDI's indebtedness to it pursuant to petitioner's obligation as a guarantor. That gave rise to an indebtedness from FDI to petitioner in an equal amount. See *Putnam v. Commissioner*, 352 U.S. 82, 85 (1946) ("The familiar rule is that, instanter upon the payment by the guarantor of the debt, the debtor's obligation to the creditor becomes an obligation to the guarantor[.]"); *Perry v. Commissioner*, 47 T.C. 159, 164 (1966), *aff'd*, 392 F.2d 458 (8th Cir. 1968). Petitioner's basis in that indebtedness increased the limitation on the amount of FDI's losses and deductions that he could take into account. See sec. 1366(d)(1)(B); see also Rev. Rul. 70-50, 1970-1 C.B. 178 (1970) ("Payment by a shareholder-guarantor of a loan made by a bank to an electing small business corporation is treated as an indebtedness of the corporation to the shareholder for purposes of computing his portion of a net operating loss.").[7] That is not so with respect to the remaining $500,000 that petitioner claims he guaranteed. As we said in *Raynor v. Commissioner*, 50 T.C. 762, 770-771 (1968): "No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation." See also *Borg v. Commissioner*, 50 T.C. 257 (1968). Petitioner may, therefore, deduct the $343,939 passthrough loss from FDI that he reported on his 2007 Form 1040.
>
> [7] Although entitled to consideration, revenue rulings do not have the force of law. *Dixon v. United States*, 381 U.S. 68, 73 (1965); see, *e.g.*, *Murray v. Commissioner*, T.C. Memo. 2012-213, 2012 WL 3030366, at *2 n.3.

For a taxable year before the regulation was effective, *Phillips v. Commissioner*, TC Memo 2017-61, held that judgments against a shareholder did not constitute an "economic outlay" (fn. 1178) until the shareholder paid on a guarantee.

For a taxable year before the regulation was effective, the sole owner of an S corporation that liquidated failed to prove that he had assumed the debt when the loan continued to show the corporation as the borrower. *Tinsley v. Commissioner*, T.C. Summary Opinion 2017-9. Although common sense suggests that the sole owner had assumed the debt because presumably the business was operated as a sole proprietorship, the taxpayer did not prove the form of business post-liquidation and bizarrely kept the loan in the liquidated corporation's name when it was renewed after liquidation; presumably the lender did not care about that detail because he personally guaranteed the loan, and payments were made (with the owner not proving who was making post-liquidation payments on the loan).

[1186] *Hargis v. Commissioner*, T.C. Memo. 2016-232, *aff'd Hargis v. Koskinen*, 121 A.F.T.R.2d 2018-2206 (8th Cir. 6/22/2018), applied the old economic outlay test (fn. 1178), but the analysis seems consistent with the bona fide loan requirement under Reg. § 1.1366-2 (fn. 1179). The Tax Court stated:

> …. Petitioners ask us to view petitioner's comaking and guaranty arrangements constructively as back-to-back loans from the lenders to petitioner and from petitioner to the operating companies.
>
> The "substance over form" argument advanced by petitioners here has been mostly rejected by this Court in past cases…..
>
> In the case at hand none of the proceeds of the loan agreements entered into by petitioner and his operating companies were ever advanced to petitioner individually….
>
> None of the notes petitioner signed as coborrower or guarantor were collateralized by petitioner's own property….
>
> Lastly, petitioners provided no convincing evidence that any of the lenders looked to petitioner as the primary obligor on the loans received by the operating companies….
>
> Because the form of the transactions shows the indebtedness existed directly between the operating companies and the lenders, and because petitioners have not shown that the substance of those transactions should be viewed differently from their form, we conclude that petitioner's role as comaker or guarantor of the operating companies' notes did not entitle him to claim basis in the indebtedness of the operating companies under section 1366(d)(1).

II.G.4.d.ii.(b). Consequences of Using Shareholder Debt to Deduct S Corporation Losses

When losses are deducted against the basis in a loan, the shareholder's basis in the loan is less than the principal, generally causing income recognition when principal payments are made.[1187]

When the corporation's later income gives the shareholder basis, the loan's basis is restored before the stock's basis increases.[1188]

When the debt to the shareholder is evidenced by a note or other written instrument held at least one year, the debt is a capital asset and repayment will result in long-term capital gain.[1189] However, if the debt is not evidenced by a written instrument (*e.g.*, open account debt), the income upon repayment will be ordinary income;[1190] open account debt also risks being recharacterized as a contribution to capital, the repayment of which might be recharacterized as a distribution that might then be recharacterized as disguised compensation.[1191] Unless a taxpayer objectively substantiates both the existence of a loan and

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[1187] When losses are deducted against the loan's basis, with under Code § 1367(b)(2)(A) making the loan's basis less than the principal that is owed, refinancing by repaying the loan from the shareholders to the corporation might cause a creditor-shareholder to recognize income. Any net increase (the amount by which the shareholder's pro rata share of the items described in Code § 1367(a)(1), relating to income items and excess deduction for depletion, exceed the items described in Code § 1367(a)(2), relating to losses, deductions, noncapital, nondeductible expenses, certain oil and gas depletion deductions, and certain distributions) in any subsequent taxable year of the corporation is applied to restore that reduction. Reg. § 1.1367-2(c)(1), interpreting Code § 1367(b)(2)(B). Some taxpayers argued that Code § 118(a) excludes contributions to capital from income, and therefore such contributions constituted tax-exempt income that increased basis in the loan; the Tax Court and Second Circuit held that such contributions are not tax-exempt income because they are not income at all. *Nathel v. Commissioner*, 131 T.C. 262 (2008), *aff'd* 615 F.3d 83 (2nd Cir. 2010).
Special rules apply to "open account" debt - shareholder advances not evidenced by separate written instruments and repayments on the advances, the aggregate outstanding principal of which does not exceed $25,000 of indebtedness of the S corporation to the shareholder at the close of the S corporation's taxable year. Reg. § 1.1367-2(a)(2), (d)(2), (e) (Exs. 7 & 8). See Bailey, "Managing S corporation Open Account Debt," *Practical Tax Strategies* (11/2013).
[1188] Code § 1367(b)(2)(B).
[1189] Rev. Rul. 64-162.
[1190] Rev. Rul. 68-537.
[1191] *Glass Blocks Unlimited v. Commissioner*, T.C. Memo. 2013-180, upheld the IRS determination of wages, resulting in payroll taxes and penalties on what the taxpayer claimed to be repayment of open account debt. In testing for contribution to capital vs. loan treatment, the court held that:

> factors include: (1) the names given to the documents that would be evidence of the purported loans; (2) the presence or absence of a fixed maturity date; (3) the likely source of repayment; (4) the right to enforce payments; (5) participation in management as a result of the advances; (6) subordination of the purported loans to the loans of the corporation's creditors; (7) the intent of the parties; (8) the capitalization of the corporation; (9) the ability of the corporation to obtain financing from outside sources; (10) thinness of capital structure in relation to debt; (11) use to which the funds were put; (12) the failure of the corporation to repay; and (13) the risk involved in making the transfers. *Calumet Indus., Inc. v. Commissioner*, 95 T.C. 257, 285 (1990).

But for the court's view that the taxpayer was lying (testified in court that he worked 20 hours per week when he told the IRS examiner that he worked full time and all evidence supported his statements to the IRS), the situation appeared sympathetic. The company barely broke even, and the relatively modest payments to the shareholder-employee that were recharacterized as wages were much larger than his K-1 income. The taxpayer would have paid lower employment taxes if the entity had been taxed as sole proprietorship.
On the other hand, after citing the same 13 factors, *Scott Singer Installations, Inc. v. Commissioner*, TC Memo 2016-161, *acq.* 2017-15 I.R.B. 1072 (see fn. 1192 for the limited scope of acquiescence and hostility toward the court's decision), held:

> No single factor is controlling. *Dixie Dairies Corp. v. Commissioner*, 74 T.C. at 493. However, the ultimate question is whether there was a genuine intention to create a debt, with a reasonable expectation of repayment, and whether that intention comported with the economic reality of creating a debtor-creditor relationship. *Litton Bus. Sys., Inc. v. Commissioner*, 61 T.C. 367, 377 (1973).
>
> Transfers to closely held corporations by controlling shareholders are subject to heightened scrutiny, however, and the labels attached to such transfers by the controlling shareholder through bookkeeping entries or testimony have

that payments made were in repayment of that loan, the IRS will assert that the payment of personal expenses by an S corporation on behalf of its corporate officer/employee constitute wages subject to Federal employment taxes.[1192]

> limited significance unless these labels are supported by other objective evidence. *E.g.*, *Boatner v. Commissioner*, T.C. Memo. 1997-379, 1997 WL 473162, at *3, *aff'd without published opinion*, 164 F.3d 629 (9th Cir. 1998).
>
> Rather than analyze every factor on the debt-equity checklists, we confine our discussion to those points we find most pertinent. In our analysis we look at the relative financial status of petitioner at the time the advances were made; the financial status of petitioner at the time the advances were repaid; the relationship between Mr. Singer and petitioner; the method by which the advances were repaid; the consistency with which the advances were repaid; and the way the advances were accounted for on petitioner's financial statements and tax returns. After looking at all these criteria in the light of the other factors traditionally distinguishing debt from equity, particularly the intent factor, we believe Mr. Singer intended his advances to be loans and we find that his intention was reasonable for a substantial portion of the advances. Consequently, we also find that petitioner's repayments of those loans are valid as such and should not be characterized as wages subject to employment taxes.

With the same result – no wage income - *Goldsmith v. Commissioner*, T.C. Memo. 2017-020, followed *Scott Singer*, pointing out (emphasis in original):

> There's no rule that an S corporation *has* to pay its sole shareholder a wage, especially when it's bleeding money the way G&A did. The real question is one of fact—were the payments a return of capital, repayments of loans, or wages? See *Scott Singer Installations, Inc., v. Commissioner*, T.C. Memo. 2016-161.

1192 A.O.D. 2017-04 (4/17/2017), taking the position in the text above and strongly criticizing *Scott Singer Installations, Inc. v. Commissioner*, TC Memo 2016-161, *acq.* 2017-15 I.R.B. 1072 (see fn. 1191):

> The critical factor in determining the appropriate tax treatment is whether the payments are remuneration (i.e., compensation) for services provided to the employer. The Service disagrees with the Court's reasoning, which failed to properly address the critical issue of whether the payments made by Taxpayer to creditors on behalf of Mr. Singer were compensation for his services and thus wages under the applicable statutory and regulatory provisions. The Service's position is that the Court incorrectly decided that no portion of the payment of personal expenses by Taxpayer on behalf of Mr. Singer should be characterized as wages subject to Federal employment taxes. Whether advances made to a corporation by a shareholder-officer are characterized as loans rather than capital contributions does not control whether a payment made by the corporation to the shareholder-officer is compensation for services and therefore properly characterized as wages. The Court failed to acknowledge that, similar to debt repayments, wages are also paid in a recurring nature and may be paid even if a business is operating at a loss.
>
> In focusing on the intention to create a debtor-creditor relationship and whether Mr. Singer had a reasonable expectation of repayment of the advances, the Court failed to analyze or even cite the relevant statutory or regulatory provisions governing the definition of wages for Federal employment tax purposes. Nor did the Court review its own substantial body of case law that repeatedly rejects taxpayers' attempted characterizations of payments to officers who perform substantial services as something other than compensation for services. The Court failed to analyze why precedents concerning officer compensation were not applicable. See *Veterinary Surgical Consultants PC v. Commissioner*, 117 T.C. 141 (2001) (stating that "the characterization of the payment to [president] as a distribution of net income is but a subterfuge for reality;" and holding the payments constituted remuneration for services performed by the [president] and were subject to employment taxes). See *also Glass Blocks Unlimited v. Commissioner*, T.C. Memo 2013-180 (holding that "[a]n employer cannot avoid Federal employment taxes by characterizing payments to its employee, sole officer and shareholder as something other than wages where such payments represent remuneration for services rendered"). See *Smith v. Commissioner*, T.C. Memo. 1995-410 (finding that payments of personal living expenses made by a wholly owned corporation on behalf of its president/employee and sole shareholder, who received no salary in the year at issue, are properly characterized as wages when they represent remuneration for employment).
>
> Several circuit courts have also rejected arguments that officers who perform substantial services received something other than compensation for those services. See *Joseph M. Grey Accountant, P.C. v. Commissioner*, 119 T.C. 121 (2002), *aff'd* 93 Fed. Appx. 473 (3rd Cir. 2004) (holding that money taken from corporate account by the sole shareholder and president of the corporation to pay for his needs as they arose was wages subject to employment taxes); *Joly v. Commissioner*, 211 F.3d 1269 (6th Cir. 2000) (holding that distributions to controlling shareholders were wages despite an express written agreement that any excess distributions would be treated as loans); *Joseph Radtke S.C. v. United States*, 895 F.2d 1196, 1197 (7th Cir. 1990) (holding that dividends paid by the corporation to the only significant employee, who otherwise received no salary for his substantial services, were in fact wages subject to employment taxes because the payments "were clearly remuneration for services performed"); *David E. Watson,*

When a loan has basis less than principal, basis is prorated, meaning that part of each payment is recovery of basis and part is income.[1193] To avoid this, a shareholder may contribute the loan to the capital of the corporation, getting increased stock basis to the extent of the loan's basis (without the corporation reporting cancellation of indebtedness income),[1194] against which distributions may be taken, fully tax-free (assuming AAA is sufficient or no prior C corporation earnings and profits).[1195] If a shareholder makes a non-pro rata contribution to capital of loans owed to that shareholder, consider the nontax issue: the shareholder will not receive a non-pro rata distribution on liquidation of the corporation;[1196] note that, in a partnership, non-pro rata distributions would be permitted, so a non-pro rata contribution could be repaid through a non-pro rata distribution.

I have seen tax preparers report fictitious loans on S corporation tax returns, taking the position that a distribution was made and loaned back to the corporation. They do this because a shareholder's position as an unsecured creditor may be better than as an owner if the corporation gets sued or goes into bankruptcy. It is not unusual for the tax preparer to forget to impute interest as well. This fictitious loan is a bad idea, not only because of the issues described in the preceding paragraph but also because a smart litigator for the creditor will argue that this constitutes cooking the books, and what else about the books may be cooked? Instead of risking this vulnerability, the corporation should document a formal line of credit with the shareholder, not only accruing but also paying annual interest.[1197] Any distributions that generate such a loan from the shareholder should either be documented through corporate action or should actually be made, with the latter being the stronger case and preferably merely be the shareholder loaning

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> *P.C. v United States*, 668 F.3d 1008 (8th Cir. 2012) (holding that the proper legal analysis was whether the payments at issue were made as remuneration for services performed; rejecting the argument that taxpayer intent controls when characterizing payments and finding dividend distributions should properly be characterized as wages, despite repeated assertions by the taxpayer that there is no statute, regulation, or rule requiring an employer to pay minimum compensation); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90, 93 (9th Cir. 1990) (holding that the only stockholder of an S corporation, who "donated" his services and withdrew earnings in the form of dividends, actually received wages; stating that regardless of how an employer chooses to characterize payments made to employees, "the true analysis is whether the payments are for remuneration for services rendered").
>
> While none of the courts in the cases cited above found the existence of a debtor-creditor relationship, the applicable employment tax regulations defining the scope of wages as all remuneration for employment does not cease to apply even if such debtor-creditor relationship is present. As previously noted, the regulations expressly provide that an employer's characterization of the payment is irrelevant. Accordingly, when a corporation makes any payment of personal expenses to or on behalf of a shareholder-officer, the question must be asked - is the payment being made as remuneration for services? If so, then the payment is wages. While the Service may recognize a payment from a corporation to its shareholder-officer who is also an employee as a loan repayment, the taxpayer must provide objective evidence that both substantiates that a bona fide loan exists between the parties and substantiates that the payment from the taxpayer to the employee was specifically in repayment of that loan and is separate from compensation paid to the employee for the performance of services for the taxpayer.

See also https://www.irs.gov/businesses/small-businesses-self-employed/s-corporation-employees-shareholders-and-corporate-officers (last visited 9/2/2017).

[1193] Rev. Rul. 64-162.

[1194] See part II.M.2.a Initial Incorporation – Generally. Code § 108(e)(6) provides, "Indebtedness contributed to capital," provides:

> Except as provided in regulations, for purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital -
>
> (A) section 118 shall not apply, but
>
> (B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

[1195] See part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally.

[1196] Rights to distributions must be proportionate to stock ownership, as described in part II.A.2.i Single Class of Stock Rule.

[1197] This might be a demand note with interest at the blended rate that applies to such notes. See part III.B.1.a.i.(c) Demand Loans.

part (whether a small part or a large part) of distributions that are made to pay taxes or once the earnings have been determined.

This line of credit concept may also be useful when selling to an irrevocable grantor trust.[1198] I prefer to get the debt that the trust owes the seller paid as soon as possible. If distributions to make those payments strain the corporation's cash flow, the seller could loan the sales proceeds to the corporation, using whatever terms seem appropriate.

II.G.4.e. Basis Limitations for Partners in a Partnership

Generally, partners may deduct losses only to the extent of basis.[1199] Not all deductions are subject to these rules,[1200] but the those deductions would reduce basis[1201] and therefore can cause their deductions to be suspended.[1202] The basis limitation limits the loss not only for regular income tax purposes but also for purposes of part II.L.2.a Types of Income Subject to Self-Employment Tax.[1203]

Code § 704(d) provides:

> (1) *In general*. A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred.
>
> (2) *Carryover*. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.
>
> (3) *Special rules*.

1198 See generally part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust

1199 Reg. § 1.704-1(d)(2) provides:

> In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the taxable year, the basis shall first be increased under section 705(a)(1) and decreased under section 705(a)(2), except for losses of the taxable year and losses previously disallowed. If the partner's distributive share of the aggregate of items of loss specified in section 702(a)(1), (2), (3), (8), and (9) exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704(d) must be allocated to his distributive share of each such loss. This allocation shall be determined by taking the proportion that each loss bears to the total of all such losses. For purposes of the preceding sentence, the total losses for the taxable year shall be the sum of his distributive share of losses for the current year and his losses disallowed and carried forward from prior years.

1200 Reg. § 1.704-1(d)(2), reproduced in fn. 1199, implicitly does not suspend the following deductions under Code § 702(a):

> (4) charitable contributions (as defined in section 170(c)),
> (5) dividends with respect to which section 1(h)(11) or part VIII of subchapter B applies,
> (6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,
> (7) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary…

Confirming this interpretation, see fn. 1233 in part II.G.4.g.ii Basis Limitations on Deducting Charitable Contributions Made by an S corporation or a Partnership.

1201 Code § 705(a)(2)(B). See also fn. 1234 in part II.G.4.g.ii Basis Limitations on Deducting Charitable Contributions Made by an S corporation or a Partnership.

1202 The first sentence of Reg. § 1.704-1(d)(2), reproduced in fn. 1199, provides that "In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the taxable year, the basis shall first be … decreased under section 705(a)(2)…."

1203 CCA 202009024, which applied this principle to a partnership, but a similar analysis would apply to a.

(A) *In general*. In determining the amount of any loss under paragraph (1), there shall be taken into account the partner's distributive share of amounts described in paragraphs (4) and (6) of section 702(a).

(B) *Exception*. In the case of a charitable contribution of property whose fair market value exceeds its adjusted basis, subparagraph (A) shall not apply to the extent of the partner's distributive share of such excess.

Implementing Code § 704(d), Reg. § 1.704-1(d), "Limitation on allowance of losses," provides:

(1) A partner's distributive share of partnership loss will be allowed only to the extent of the adjusted basis (before reduction by current year's losses) of such partner's interest in the partnership at the end of the partnership taxable year in which such loss occurred. A partner's share of loss in excess of his adjusted basis at the end of the partnership taxable year will not be allowed for that year. However, any loss so disallowed shall be allowed as a deduction at the end of the first succeeding partnership taxable year, and subsequent partnership taxable years, to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero (before reduction by such loss for such year).

(2) In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the taxable year, the basis shall first be increased under section 705(a)(1) and decreased under section 705(a)(2), except for losses of the taxable year and losses previously disallowed. If the partner's distributive share of the aggregate of items of loss specified in section 702(a)(1), (2), (3), (8), and (9) exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704(d) must be allocated to his distributive share of each such loss. This allocation shall be determined by taking the proportion that each loss bears to the total of all such losses. For purposes of the preceding sentence, the total losses for the taxable year shall be the sum of his distributive share of losses for the current year and his losses disallowed and carried forward from prior years.

(3) For the treatment of certain liabilities of the partner or partnership, see section 752 and § 1.752-1.

(4) The provisions of this paragraph may be illustrated by the following examples:

Example (1). At the end of the partnership taxable year 1955, partnership AB has a loss of $20,000. Partner A's distributive share of this loss is $10,000. At the end of such year, A's adjusted basis for his interest in the partnership (not taking into account his distributive share of the loss) is $6,000. Under section 704(d), A's distributive share of partnership loss is allowed to him (in his taxable year within or with which the partnership taxable year ends) only to the extent of his adjusted basis of $6,000. The $6,000 loss allowed for 1955 decreases the adjusted basis of A's interest to zero. Assume that, at the end of partnership taxable year 1956, A's share of partnership income has increased the adjusted basis of A's interest in the partnership to $3,000 (not taking into account the $4,000 loss disallowed in 1955). Of the $4,000 loss disallowed for the partnership taxable year 1955, $3,000 is allowed A for the partnership taxable year 1956, thus again decreasing the adjusted basis of his interest to zero. If, at the end of partnership taxable year 1957, A has an adjusted basis of his interest of at least $1,000 (not taking into account the disallowed loss of $1,000), he will be allowed the $1,000 loss previously disallowed.

Example (2). At the end of partnership taxable year 1955, partnership CD has a loss of $20,000. Partner C's distributive share of this loss is $10,000. The adjusted basis of his interest in the partnership (not taking into account his distributive share of such loss) is $6,000. Therefore, $4,000 of the loss is disallowed. At the end of partnership taxable year 1956, the partnership has no taxable income or loss, but owes $8,000 to a bank for money borrowed. Since C's share of this liability is $4,000, the basis of his partnership interest is increased from zero to $4,000. (See sections 752 and 722, and §§ 1.752-1 and 1.722-1.) C is allowed the $4,000 loss, disallowed for the preceding year under section 704(d), for his taxable year within or with which partnership taxable year 1956 ends.

Example (3). At the end of partnership taxable year 1955, partner C has the following distributive share of partnership items described in section 702(a): long-term capital loss, $4,000; short-term capital loss, $2,000; income as described in section 702(a)(9), $4,000. Partner C's adjusted basis for his partnership interest at the end of 1955, before adjustment for any of the above items, is $1,000. As adjusted under section 705(a)(1)(A), C's basis is increased from $1,000 to $5,000 at the end of the year. C's total distributive share of partnership loss is $6,000. Since without regard to losses, C has a basis of only $5,000, C is allowed only $5,000/$6,000 of each loss, that is, $3,333 of his long-term capital loss, and $1,667 of his short-term capital loss. C must carry forward to succeeding taxable years $667 as a long-term capital loss and $333 as a short-term capital loss.

If a partner who is selling her partnership interest plans to contribute assets to the partnership and wants to use that contribution to provide basis to deduct losses suspended under Code § 704(d), the contribution must be made on or before the sale.[1204] Thus, as is the case with S corporations, the taxpayer can deduct such losses only while the taxpayer still owns the partnership interest.

Partners generally may deduct losses financed by certain obligations (including bank loans to the partnership) to the extent permitted by the Code § 465 at-risk rules. Although loan guaranties can cause debt to be allocated to the guarantor instead of to other partners, contributing the partner's own promissory note to a partnership does not constitute such a guarantee.[1205] For a discussion of the Code § 465 at-risk

[1204] *Sennett v. Commissioner*, 80 T.C. 825, 831 (1983), *aff'd* 752 F2d 428 (9th Cir. 1985), holding (emphasis in original):

> Applying section 706(c)(2)(A)(i) to the facts in the instant case, the taxable year of PPP with respect to petitioner closed in December 1968, when he sold his entire interest in PPP. That being the case, petitioner paid 80 percent of his share of PPP's losses for 1967 and 1968 to PPP after the close of his last partnership year with PPP which fails to come within the provisions of section 704(d) which allows the deduction "at the end of the partnership year in which such excess is repaid to the partnership." Such a construction of section 704(d) is not only supported by section 706(c)(2)(A)(i) but is confirmed by the language of the report of the Senate Finance Committee, quoted above (S. Rept. 1622, *supra*) wherein it explains that the loss is deductible *only at the end of the partnership year in which the loss is repaid, either directly, or out of future profits*. The payment from the partner to the partnership could not be paid out of future profits if the partner had previously sold his partnership interest because he would have no right to share in the future profits.

Although Code § 706(c)(2)(A) has since been changed, as of 5/18/2019 it still directly supports *Sennett*.

[1205] *VisionMonitor Software, LLC v. Commissioner*, T.C. Memo. 2014-182. The court's analysis of not obtaining basis for contributing the notes is described in fn. 3452. In discussing the loan issue, the court reasoned:

> VisionMonitor argues that the notes in this case, like the assumption of debt in *Gefen*, were necessary to persuade a third party to kick in more funding to a cash-strapped partnership. But unlike the partner in Gefen, neither Mantor nor Smith were guaranteeing a preexisting partnership debt to a third party. And they did not directly assume any of VisionMonitor's outside liabilities—these notes are their liability to VisionMonitor, not an assumption or guaranty of VisionMonitor's debt to a third party. Mantor did sign a resolution in 2007 that included a promise "to provide *** personal credit to the company vendors *** to ensure continued uninterrupted operations"—but there's no evidence that either he or Smith ever actually provided that credit. And there's also no evidence that Mantor or Smith were

rules, as well as the Code § 752 treatment of certain nonrecourse or other liabilities, see part II.G.4.j At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities).

Among liabilities that create basis are "debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps."[1206] However, an obligation counts: [1207]

> only if, when, and to the extent that incurring the obligation-
>
> (A) Creates or increases the basis of any of the obligor's assets (including cash);
>
> (B) Gives rise to an immediate deduction to the obligor; or
>
> (C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

For more information, see part II.C.3 Allocating Liabilities (Including Debt).

> personally obliged under the VisionMonitor partnership agreement to contribute a fixed amount for a specific, preexisting partnership liability.

[1206] Reg. § 1.752-1(a)(4)(ii). Letter Ruling 201608005 gave the owners of partnership P basis for certain obligations owed to O under construction contract guarantees:

> Before P is entitled to receive payments under the contracts and, explicitly, to receive the Notice to Proceed payments, P is required to provide certain guarantees and also to deliver to O irrevocable standby letters of credit. The letters of credit secure P's obligations to perform under the contracts and cover O's damages in the event of non-performance or default by P. The amount of the letters of credit securing P's obligations roughly corresponds to the amount of the Notice to Proceed payments.
>
> The contracts provide that if P fails to prosecute the work in a diligent and efficient manner, or if P abandons the project or repudiates any of its obligations, a default occurs. In that event, O is entitled to several remedies, including seeking specific performance (that is, obtaining judicial enforcement requiring to make good on its obligation to perform the work) and recovery from P of costs, damages, losses, and expenses (that is, requiring P to make good on its obligation to cover O's damages in the event of nonperformance). Specifically, the contracts allow O to draw-down directly against the letters of credit in the event of a default by P.

The Letter Ruling discussed certain authority:

> Revenue Ruling 95-26, 1995-1 C.B. 131, concludes that a partnership's obligation to deliver securities in a short sale transaction constitutes a section 752 liability under a definition of partnership liability similar to the definition quoted above. The Revenue Ruling reasons that a short sale creates such a liability inasmuch as: (1) a short sale creates an obligation to return the borrowed securities, citing *Deputy v. Du Pont*, 308 U.S. 488, 497-98 (1940), 1940-1 C.B. 118; and (2) the partnership's basis in its assets is increased by the amount of cash received on the sale of the borrowed securities. Therefore, the Revenue Ruling concludes that the partners' bases in their partnership interests are increased under section 722 to reflect their shares of the partnership's liability under section 752. In *Salina Partnership LP v. Commissioner*, T.C. Memo 2000-352, the Tax Court examined the policy underlying section 752 and the analysis of Revenue Ruling 95-26 and held that a partnership's obligation to close its short sale by replacing borrowed securities represented a partnership liability within the meaning of section 752.

The Letter Ruling held:

> Based solely on the facts submitted and the representations made, we conclude that P's obligations under the contracts to proceed with performing work and to incur costs in performing the work, and the corresponding obligations to satisfy O's remedies in the event P were to default or suspend work, constitute liabilities under section 752 upon and to the extent P receives the Notice to Proceed payments but has not yet reported the related income.

[1207] Reg. § 1.752-1(a)(4)(i).

In a partnership setting, generally no income is recognized on the repayment of a debt until distributions (including deemed distributions when the partner's share of partnership debt is reduced) exceed basis.[1208]

If a partner loans money to the partnership that is a start-up venture and it is possible that the partnership might need a capital infusion by another party in which the debt is converted to equity, the later capital infusion might trigger ordinary income taxation.[1209] One might consider using preferred equity instead of loaning the money to the partnership.

II.G.4.f. Comparing C Corporation Loss Limitations to Those for Partnership and S Corporation Losses

Thus, partnership and S corporations are better for deducting losses against debt than C corporations, because they permit ordinary loss treatment for any portion of the debt not repaid. For partnerships and S corporations, the deduction comes not when the note is worthless but rather every year as the owner's distributive share of the entity's income or loss. Contrast this against needing to prove the C corporation's inability to pay the debt and the additional restrictions imposed on the nature of the loss – partnership and S corporation deducting in calculating adjusted gross income (the most valuable way to deduct anything) compared to a C corporation shareholder's short-term capital loss or miscellaneous itemized deduction.

Rutter v. Commissioner, T.C. Memo. 2017-174, is a good example of this. The taxpayer, a "world-renowned scientist in the field of biotechnology," struck it rich. Then he poured tens of millions of dollars into a new losing business, hoping to replicate his earlier success. First, he used documented loans, which he later converted to preferred stock. Eventually he made advances to the business that were not documented by loans and that never paid interest. The Tax Court held that the advances constituted equity, and even if it might be reversed on that issue the advances would have been nonbusiness bad debts, deductible as capital losses when wholly worthless. If the entity had been taxed as a partnership and his investment structured as a partnership interest, his advances could have generated annually deductible losses.

If one exits from a C corporation that has lost money, see part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244.

II.G.4.g. Limitations on Deducting Charitable Contributions

In addition to limitations described in this part II.G.4.g, also see part II.J.4.c.ii Individual Contribution Deduction Requirements, which is part of a contrast with fiduciary income tax in part II.J.4.c Charitable Distributions.

II.G.4.g.i. Charitable Deduction vs. Business Expense

Deductions for charitable contributions made by C corporations are limited to 10% of their taxable income,[1210] whereas such contributions made by S corporations and partnerships are deducted at the

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[1208] Code §§ 752(a), (b) and 731(a)(1). For a scathing critique of proposed regulations under Code § 752, see Lipton, "Proposed Regulations on Debt Allocations: Controversial, and Deservedly So," *Journal of Taxation* (WG&L), Vol. 120, No. 4 (April 2014); Schneider and O'Connor, "The IRS Did What to the Partnership Debt Allocation and Disguised Sale Rules?!?" *TM Real Estate Journal* (BNA), Vol. 30 No. 8 (8/6/2014).

[1209] See part II.G.4.a.v Tax Effect of Loan to S Corporation or Partnership, especially the text accompanying fns. 1151-1152.

[1210] Code § 170(b)(2)(A). For a very helpful chart, see Wittenbach, Milani, and Riegel, "Charting The Interactions Of The Charitable Contribution Deduction For Corporations," *Taxation of Exempts* (WG&L) May/Jun 2017, which is saved as Thompson Coburn doc. no. 6568468 (chart in PDF embedded at bottom of first page). For how this rule interacts with the net operating loss (NOL) deduction, see fn 1385 in part II.G.4.l.ii Net Operating Loss Deduction.

owner level, subject to limitations due to basis,[1211] percentage (20%-50%) of modified adjusted gross income if the taxpayer is an individual[1212] or if the taxpayer is a fiduciary with unrelated business taxable income,[1213] and certain reductions of itemized deductions (for individuals).[1214]

IR News Release 2021-27 explains:

> **New law increases deduction limit for corporate cash contributions for disaster relief; IRS provides recordkeeping relief**
>
> The Internal Revenue Service today explained how corporations may qualify for the new 100% limit for disaster relief contributions and offered a temporary waiver of the recordkeeping requirement for corporations otherwise qualifying for the increased limit.
>
> The Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA of 2020), enacted Dec. 27, temporarily increased the limit, to up to 100% of a corporation's taxable income, for contributions paid in cash for relief efforts in qualified disaster areas.
>
> Under the new law, qualified disaster areas are those in which a major disaster has been declared under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act. This does not include any disaster declaration related to COVID-19. Otherwise, it includes any major disaster declaration made by the President during the period beginning on Jan. 1, 2020, and ending on Feb. 25, 2021, as long as it is for an occurrence specified by the Federal Emergency Management Agency as beginning after Dec. 27, 2019, and no later than Dec. 27, 2020. For a list of disaster declarations, visit FEMA.gov.
>
> Qualified contributions must be paid by the corporation during the period beginning on Jan. 1, 2020, and ending on Feb. 25, 2021. Cash contributions to most charitable organizations qualify for this increased limit. Contributions made to a supporting organization or to establish or maintain a donor advised fund do not qualify.
>
> A corporation elects the increased limit by computing its deductible amount of qualified contributions using the increased limit and by claiming the amount on its return for the tax year in which the contribution was made.
>
> Corporations must meet the usual recordkeeping requirements that apply to charitable contributions, including obtaining a contemporaneous written acknowledgment (CWA) from the charity. The CWA must be obtained before the corporation files its return, but no later than the due date, including extensions, for filing that return.
>
> The TCDTRA of 2020 added an additional substantiation requirement for qualified contributions. For corporations electing this increased limit, a corporation's CWA must include a disaster relief

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[1211] See part II.G.4.g.ii Basis Limitations on Deducting Charitable Contributions Made by an S corporation or a Partnership.

[1212] Code § 170(b)(1).

[1213] See parts II.Q.6.d Unrelated Business Taxable Income and II.Q.7.c S Corporation Owned by a Trust Benefitting Charity, especially part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. As described in that part (including Code §§ 681 and 512(e)), the focus is on S corporations because all S corporation K-1 income received by a nongrantor trust deducting charitable contributions is per se unrelated business income, but partnerships can generate unrelated business income, too. Trusts without unrelated business income can deduct all of their charitable contributions, if and to the extent paid from gross income. Code § 642(c)(1). However, Code § 642(c) does not apply to an ESBT. See fn 5875 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview.

[1214] Code § 68.

statement, stating that the contribution was used, or is to be used, by the eligible charity for relief efforts in one or more qualified disaster areas.

Because of the timing of the new law, the IRS recognizes that some corporations may have obtained a CWA that lacks the disaster relief statement. Accordingly, the agency will not challenge a corporation's deduction of any qualified contribution made before Feb. 1, 2021, solely on the grounds that the corporation's CWA does not include the disaster relief statement.

For additional details on the recordkeeping rules for substantiating gifts to charity, see Publication 526, Charitable Contributions, available on IRS.gov. More information about other coronavirus-related relief, can be found at IRS.gov.

The 50% limit in the preceding sentence is 60% for cash contributions made in any taxable year beginning after December 31, 2017, and before January 1, 2026[1215] and is increased to 100% in 2020 for certain cash contributions, as part of broader relief provided in the CARES Act, § 2205, "Modification of Limitations on Charitable Contributions during 2020"“

(a) TEMPORARY SUSPENSION OF LIMITATIONS ON CERTAIN CASH CONTRIBUTIONS.

(1) IN GENERAL. Except as otherwise provided in paragraph (2), qualified contributions shall be disregarded in applying subsections (b) and (d) of section 170 of the Internal Revenue Code of 1986.

(2) TREATMENT OF EXCESS CONTRIBUTIONS. For purposes of section 170 of the Internal Revenue Code of 1986-

(A) INDIVIDUALS. In the case of an individual-

(i) LIMITATION. Any qualified contribution shall be allowed as a deduction only to the extent that the aggregate of such contributions does not exceed the excess of the taxpayer's contribution base (as defined in subparagraph (H) of section 170(b)(1) of such Code) over the amount of all other charitable contributions allowed under section 170(b)(1) of such Code.

(ii) CARRYOVER. If the aggregate amount of qualified contributions made in the contribution year (within the meaning of section 170(d)(1) of such Code) exceeds the limitation of clause (i), such excess shall be added to the excess described in section 170(b)(1)(G)(ii).

(B) CORPORATIONS. In the case of a corporation-

(i) LIMITATION. Any qualified contribution shall be allowed as a deduction only to the extent that the aggregate of such contributions does not exceed the excess of 25 percent of the taxpayer's taxable income (as determined under paragraph (2) of section 170(b) of such Code) over the amount of all other charitable contributions allowed under such paragraph.

[1215] Code § 170(b)(1)(G)(i).

(ii) CARRYOVER. If the aggregate amount of qualified contributions made in the contribution year (within the meaning of section 170(d)(2) of such Code) exceeds the limitation of clause (i), such excess shall be appropriately taken into account under section 170(d)(2) subject to the limitations thereof.

(3) QUALIFIED CONTRIBUTIONS.

(A) IN GENERAL. For purposes of this subsection, the term "qualified contribution" means any charitable contribution (as defined in section 170(c) of the Internal Revenue Code of 1986) if -

(i) such contribution is paid in cash during calendar year 2020 to an organization described in section 170(b)(1)(A) of such Code, and

(ii) the taxpayer has elected the application of this section with respect to such contribution.

(B) EXCEPTION. Such term shall not include a contribution by a donor if the contribution is-

(i) to an organization described in section 509(a)(3) of the Internal Revenue Code of 1986, or

(ii) for the establishment of a new, or maintenance of an existing, donor advised fund (as defined in section 4966(d)(2) of such Code).

(C) APPLICATION OF ELECTION TO PARTNERSHIPS AND S CORPORATIONS. In the case of a partnership or S corporation, the election under subparagraph (A)(ii) shall be made separately by each partner or shareholder.

(b) INCREASE IN LIMITS ON CONTRIBUTIONS OF FOOD INVENTORY. In the case of any charitable contribution of food during 2020 to which section 170(e)(3)(C) of the Internal Revenue Code of 1986 applies, subclauses (I) and (II) of clause (ii) thereof shall each be applied by substituting "25 percent" for "15 percent."

(c) EFFECTIVE DATE. This section shall apply to taxable years ending after December 31, 2019.

The Consolidated Appropriations Act, 2021, § 213, "Modification of Limitations on Charitable Contributions," extended the 100% limited for individuals' qualified cash contributions:

(a) IN GENERAL. Subsections (a)(3)(A)(i) and (b) of section 2205 of the CARES Act are each amended by inserting ''or 2021'' after ''2020''.

(b) CONFORMING AMENDMENT. The heading of section 2205 of the CARES Act is amended by striking ''modification of limitations on charitable contributions during 2020'' and inserting ''temporary modification of limitations on charitable contributions''.

(c) EFFECTIVE DATE. The amendments made by this section shall apply to contributions made after December 31, 2020.

The Consolidated Appropriations Act, 2021, § 304(a), "SPECIAL RULES FOR QUALIFIED DISASTER RELIEF CONTRIBUTIONS," provides:

(1) IN GENERAL. In the case of a qualified disaster relief contribution made by a corporation-

(A) section 2205(a)(2)(B) of the CARES Act shall be applied first to qualified contributions without regard to any qualified disaster relief contributions and then separately to such qualified disaster relief contribution, and

(B) in applying such section to such qualified disaster relief contributions, clause (i) thereof shall be applied-

(i) by substituting ''100 percent'' for ''25 percent'', and

(ii) by treating qualified contributions other than qualified disaster relief contributions as contributions allowed under section 170(b)(2) of the Internal Revenue Code of 1986.

(2) QUALIFIED DISASTER RELIEF CONTRIBUTION. For purposes of this subsection, the term ''qualified disaster relief contribution'' means any qualified contribution (as defined in section 2205(a)(3) of the CARES Act) if -

(A) such contribution-

(i) is paid, during the period beginning on January 1, 2020, and ending on the date which is 60 days after the date of the enactment of this Act, and

(ii) is made for relief efforts in one or more qualified disaster areas,

(B) the taxpayer obtains from such organization contemporaneous written acknowledgment (within the meaning of section 170(f)(8) of such Code) that such contribution was used (or is to be used) for relief efforts described in subparagraph (A)(ii), and

(C) the taxpayer has elected the application of this subsection with respect to such contribution.

(3) CROSS-REFERENCE. For the suspension of the limitation on qualified disaster relief contributions made by an individual during 2020, see section 2205(a) of the CARES Act.

Additional limitations apply to contributions of ordinary income and capital gain property.[1216]

Transfers of property to a Code § 170(c) organization bearing a direct relationship to the taxpayer's trade or business that are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or business expenses[1217] rather than as charitable contributions.[1218] Note that some trade or business expenses, such as entertainment, are

[1216] Code § 170(e).
[1217] Reg. § 1.162-15(a)(1) provides that any amounts characterized as Code § 170 charitable contributions are not deductible as Code § 162 business expenses. Rul. 84-110 amplifies Rev. Rul. 73-113 (fn. 1218) by providing that expenditures of serving as a public official are Code § 162 business expenses, even if not engaged in for profit (in the ruling, the expenses were much more than the annual income), because Code § 7701(a)(26) eliminates the profit motive as a requirement for being in the business of serving as a public official.
[1218] Reg. § 1.170A-1(c)(5); Rev. Rul. 73-113, which provides, "Whether a particular transfer was made with a reasonable expectation of a financial return, commensurate with the amount of the transfer, is a question of fact."

disallowed.[1219] As an aside, when an individual formed and funded a nonprofit corporation that never sought a tax exemption from the IRS, which corporation ran an event to benefit a charity, that individual was unable to treat the corporation as an S corporation and deduct the losses from the event, because the founder could not and did not own the nonprofit corporation.[1220]

A taxpayer that promises to donate a portion of its sales or profits to organizations that it specifies may deduct those donations as business expenses so long as the expenditure is not expressly precluded from being deducted (the latter including lobbying expenses).[1221]

However, Rev. Proc. 2019-12 provides new rules for when a business entity makes a charitable contribution that qualifies for a state tax credit. Below are rules for C corporations, followed by rules for pass-through entities.

If a C corporation makes a payment to or for the use of a Code § 170(c) organization and receives or expects to receive a tax credit that reduces a state or local tax imposed on the C corporation in return for such payment, the C corporation may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of Code § 162(a) to the extent of the credit received or expected to be received, without needing to prove the business purpose for that part.[1222] Thus, a C corporation that receives a 100% tax credit deducts the entire contribution as a business expense without needing to prove business purposes,[1223] and a C corporation that receives an 80% tax credit deducts 80% as a business

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[1219] Code § 274(a), "Entertainment, amusement, recreation, or qualified transportation fringes," includes:

(1) *In general*. No deduction otherwise allowable under this chapter shall be allowed for any item—
   (A) *Activity*. With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or
   (B) *Facility*. With respect to a facility used in connection with an activity referred to in subparagraph (A).
(2) *Special rules*. For purposes of applying paragraph (1) —
   (A) Dues or fees to any social, athletic, or sporting club or organization shall be treated as items with respect to facilities.
   (B) An activity described in section 212 shall be treated as a trade or business.
   (C) Repealed.
(3) *Denial of deduction for club dues*. Notwithstanding the preceding provisions of this subsection, no deduction shall be allowed under this chapter for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose.

[1220] *Deckard v. Commissioner*, 155 T.C. No. 8 (2020). Given that the event seemed consistent with the charity's goals, the organizer should have asked the charity to form a single member LLC for the event, and then he could have taken a charitable contribution deduction for the event's losses that he funded.

[1221] CCA 201543013, which discussed the customers' charitable intent:

> Here, it does not appear that Taxpayer's customers have a right to a share of the amounts in Program X. The [promise to make certain donations] does not by itself appear to give the customers control over these funds such that Taxpayer is the agent of the customer or is acting as a mere conduit for the dispersal of these funds.
>
> You have indicated that factual development of this issue is ongoing. If you wish to pursue the agency theory, we suggest that you develop the facts consistent with the criteria set out in *National Carbide v. Commissioner*, 336 U.S. 422 (1949) and *Commissioner v. Bollinger*, 485 U.S. 340 (1988). If you wish to pursue a conduit theory, you may want to review *Seven-Up Co. v. Commissioner*, 14 T.C. 965 (1950) *acq. in result*, 1974-2 C.B. 1. It does not appear from the facts supplied so far that the funds in Program X belong to and are donated by Taxpayer's customers.

[1222] Rev. Proc. 2019-12, § 3.02. Rev. Proc. 2019-12, § 2 reasons:

> To the extent a C corporation receives or expects to receive a state or local tax credit in return for a payment to an organization described in section 170(c), it is reasonable to conclude that there is a direct benefit to the C corporation's business in the form of a reduction in the state or local taxes the C corporation would otherwise have to pay and, therefore, to the extent of the amount of the credit received or expected to be received, there is a reasonable expectation of financial return to the C corporation commensurate with the amount of the transfer.

[1223] Rev. Proc. 2019-12, § 3.03(1) provides:

expense without needing to prove business purposes and 20% if and to the extent that taxpayer proves a business purpose.[1224]

Under certain conditions, pass-through entities, such as partnerships and S corporations but not disregarded entities, may deduct contributions that provide credits against tax imposed at an entity level (a "specified pass-through entity").[1225] If a specified pass-through entity makes a qualified payment and receives or expects to receive a credit against a state or local tax other than income tax, the specified pass-through entity may treat such payment as a Code § 162(a) expense to the extent of the credit received or expected to be received.[1226] "Good" taxes, credits against which count under this rule, include excise[1227] or real property tax[1228] that the entity pays.

Rev. Proc. 2019-12 follows up on questions raised about a business' charitable deductions in light of administrative action limiting charitable contributions that generate state tax credits and should be analyzed in the context of that action.[1229]

Regulations codify Rev. Proc. 2019-12, with some modifications. The preamble to the proposed regulations explained:[1230]

> *Example 1*. A, a C corporation engaged in a trade or business, makes a payment of $1,000 to an organization described in section 170(c). In return for the payment, A receives or expects to receive a dollar-for-dollar state tax credit to be applied to A's state corporate income tax liability. Under section 3 of this revenue procedure, A may treat the $1,000 payment as meeting the requirements of an ordinary and necessary business expense under section 162.

1224 Rev. Proc. 2019-12, § 3.03(2) provides:

> *Example 2*. B, a C corporation engaged in a trade or business, makes a payment of $1,000 to an organization described in section 170(c). In return for the payment, B receives or expects to receive a tax credit equal to 80 percent of the amount of this payment ($800) to be applied to B's local real property tax liability. Under section 3 of this revenue procedure, B may treat $800 as meeting the requirements of an ordinary and necessary business expense under section 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by this revenue procedure.

1225 Rev. Proc. 2019-12, § 4.02 provides:

> *Specified pass-through entity*. An entity will be considered a specified pass-through entity described in this section 4.02 only if each of the requirements set forth in section 4.02(1) through (4) is satisfied.
>
> (1) The entity is a business entity other than a C corporation that is regarded for all federal income tax purposes as separate from its owners under section 301.7701-3;
> (2) The entity operates a trade or business within the meaning of section 162;
> (3) The entity is subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity; and
> (4) In return for a payment to an organization described in section 170(c), the entity receives or expects to receive a state or local tax credit that the entity applies or expects to apply to offset a state or local tax described in section 4.02(3) of this revenue procedure other than a state or local income tax.

1226 Rev. Proc. 2019-12, § 4.03 "safe harbor."

1227 Rev. Proc. 2019-12, § 4.04(1), Example 1.

1228 Rev. Proc. 2019-12, § 4.04(2), Example 2, which provides:

> S is an S corporation engaged in a trade or business and is owned by individuals C and D. S makes a payment of $1,000 to an organization described in section 170(c). In return for the payment, S receives or expects to receive a state tax credit equal to 80 percent of the amount of this payment ($800) to be applied to S's local real property tax liability incurred by S in carrying on its trade or business. Under applicable state and local law, the real property tax is imposed at the entity level (not the owner level). Under section 4 of this revenue procedure, S may treat $800 of the payment as meeting the requirements of an ordinary and necessary business expense under section 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by this revenue procedure.

1229 See text accompanying fn 1402 in part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.

1230 [REG-107431-19], RIN 1545-BP40 (12/17/2019).

> In the interest of providing certainty for taxpayers, the Treasury Department and the IRS believe that it is appropriate to propose regulations to incorporate the safe harbors set out in Rev. Proc. 2019-12 and to request comments on these safe harbors. Thus, these proposed regulations propose amending § 1.162-15(a) to incorporate the Rev. Proc. 2019-12 safe harbors. These proposed regulations also propose amending § 1.170A-1(c)(5) and (h)(3)(viii) to provide cross references to § 1.162-15(a). The Treasury Department and the IRS specifically request comments on whether the safe harbors should be expanded to apply to an individual who is carrying on a trade or business or an activity described in section 212.
>
> The proposed regulations propose additional revisions to § 1.162-15(a) to more clearly reflect the current state of the law regarding a taxpayer's payment or transfer to an entity described in section 170(c). If the taxpayer's payment or transfer bears a direct relationship to its trade or business, and the payment is made with a reasonable expectation of commensurate financial return, the payment or transfer to the section 170(c) entity may constitute an allowable deduction as a trade or business expense under section 162, rather than a charitable contribution under section 170. See § 1.170A-1(c)(5); *Marquis v. Commissioner*, 49 T.C. 695 (1968). A proposed example illustrates that this rule applies regardless of whether the taxpayer expects to receive a state or local tax credit in return.
>
> The proposed revisions are also consistent with the decision in *American Bar Endowment*, which states that a payment to an entity described in section 170(c) may have a dual character—part charitable contribution and part business expense. 477 U.S. at 117. Under *American Bar Endowment* and § 1.170A-1(h), if a taxpayer makes a payment to an entity described under section 170(c) in an amount that exceeds the fair market value of the benefit that the taxpayer receives or expects to receive in return, and this excess amount is paid with charitable intent, the taxpayer is allowed a charitable contribution deduction under section 170 for this excess amount.
>
> In addition, the proposed regulations propose to add a cross-reference to § 1.170A-1(h) (payments to section 170(c) entities in exchange for consideration), which provides more detailed rules for determining whether a payment, or a portion of a payment, to an entity described in section 170(c) may be deducted under section 162(a) or section 170.

After discussing comments to Notice 2019-12, the preamble said:[1231]

> Under these proposed regulations, an individual who itemizes deductions and who makes a payment to a section 170(c) entity in exchange for a state or local tax credit may treat as a payment of state or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is or will be disallowed under § 1.170A-1(h)(3). This treatment is allowed in the taxable year in which the payment is made, but only to the extent that the resulting credit is applied pursuant to applicable state or local law to offset the individual's state or local tax liability for such taxable year or the preceding taxable year. Any unused credit permitted to be carried forward may be treated as a payment of state or local tax under section 164 in the taxable year or years for which the carryover credit is applied in accordance with state or local law. The safe harbor for individuals applies only to payments of cash and cash equivalents.
>
> The proposed regulations are not intended to permit a taxpayer to avoid the limitations of section 164(b)(6). Therefore, the proposed regulations provide that any payment treated as a state or local tax under section 164, pursuant to the safe harbor provided in § 1.164-3(j) of the proposed

[1231] [REG-107431-19], RIN 1545-BP40 (12/17/2019).

regulations, is subject to the limitations on deductions in section 164(b)(6). Furthermore, the proposed regulations are not intended to permit deductions of the same payments under more than one provision. Thus, the proposed regulations provide that an individual who relies on the safe harbor in § 1.164-3(j) to deduct qualifying payments under section 164 may not also deduct the same payments under any other section of the Code.

After reviewing the history of quid pro quo cases, the preamble said:[1232]

The quid pro quo principle is thus equally applicable regardless of whether the donor expects to receive the benefit from the donee or from a third party. In either case, the donor's payment is not a charitable contribution or gift to the extent that the donor expects a substantial benefit in return. Accordingly, the Treasury Department and the IRS propose amendments to § 1.170A-1(h) that address a donor's payments in exchange for consideration in order for the regulation to reflect existing law. Specifically, these proposed amendments revise paragraph (h)(4) to provide definitions of "in consideration for" and "goods and services" for purposes of applying the rules in § 1.170A-1(h). Under the proposed regulations, a taxpayer will be treated as receiving goods and services in consideration for a taxpayer's payment or transfer to an entity described in section 170(c) if, at the time the taxpayer makes the payment or transfer, the taxpayer receives or expects to receive goods or services in return.

The proposed regulations do not amend the language of § 1.170A-13(f)(6) which discusses "in consideration for" for purposes of determining whether the taxpayer provides proper substantiation of its charitable contribution. Section 1.170A-13(f) details the requirements of a contemporaneous written acknowledgment, including a statement of whether the donee organization provides any goods or services in consideration for any cash or other property transferred to the donee organization and a description and a good faith estimate of the value of those goods or services. See § 1.170A-13(f)(2)(ii) and (iii). These substantiation provisions refer only to written acknowledgments from donee organizations and do not address the application of quid pro quo principles to benefits received from parties other than donees. The Treasury Department and the IRS request comments on whether guidance concerning substantiation and reporting of quid pro quo benefits provided or expected to be provided by third parties, including state governments, would be beneficial to taxpayers in demonstrating that they have given more than they received or expected to receive and to the IRS in administering the proposed regulation. In addition, the Treasury Department and the IRS request comments regarding the manner by which donors, donees, or third parties may report or provide substantiation for the value or type of consideration received or expected to be received from third parties.

For additional clarity, the proposed regulation amends the language in § 1.170A-1(h)(2)(i)(B) to clarify that the fair market value of goods and services includes the value of goods and services provided by parties other than the donee. Also, the proposed regulation adds a definition of "goods and services" that is the same as the definition in § 1.170A-13(f)(5). Finally, the proposed regulation revises the cross-references defining "in consideration for" and "goods and services" in paragraphs (h)(1) and (h)(3)(iii) to be consistent with the proposed definitions provided in paragraph (h)(4).

The proposed regulations would be prospective, but taxpayers would be able to rely on them for any post-2017 payments and transfers.

[1232] [REG-107431-19], RIN 1545-BP40 (12/17/2019).

The preamble to the final regulations, T.D. 9907 (8/7/2020), explains:

> The Treasury Department and the IRS adopt the proposed regulations with clarifications in response to the written comments received and testimony provided.
>
> First, the final regulations retain the proposed amendments to § 1.162-15(a). The final regulations continue to clarify that a taxpayer's payment or transfer to a section 170(c) entity may constitute an allowable deduction as a trade or business expense under section 162, rather than a charitable contribution under section 170. The final regulations also retain the examples demonstrating the application of this rule with minor clarifying changes.
>
> Second, the final regulations retain the safe harbors under section 162 to provide certainty with respect to the treatment of payments made by business entities to an entity described in section 170(c). The final regulations provide safe harbors under section 162 for payments made by a business entity that is a C corporation or specified passthrough entity to or for the use of an organization described in section 170(c) if the C corporation or specified passthrough entity receives or expects to receive State or local tax credits in return. To the extent that a C corporation or specified passthrough entity receives or expects to receive a State or local tax credit in return for a payment to an organization described in section 170(c), it is reasonable to conclude that there is a direct benefit and a reasonable expectation of commensurate financial return to the C corporation's or specified passthrough entity's business in the form of a reduction in the State or local taxes that the entity would otherwise be required to pay. Thus, the final regulations provide safe harbors that allow a C corporation or specified passthrough entity engaged in a trade or business to treat the portion of the payment that is equal to the amount of the credit received or expected to be received as meeting the requirements of an ordinary and necessary business expense under section 162. The safe harbors for C corporations and specified passthrough entities apply only to payments of cash and cash equivalents. The safe harbor for specified passthrough entities does not apply if the credit received or expected to be received reduces a State or local income tax.

Reg. § 1.162-15, "Contributions, dues, etc.," restates subsection (a), "Payments and transfers to entities described in section 170(c)":

(1) *In general*. A payment or transfer to or for the use of an entity described in section 170(c) that bears a direct relationship to the taxpayer's trade or business and that is made with a reasonable expectation of financial return commensurate with the amount of the payment or transfer may constitute an allowable deduction as a trade or business expense rather than a charitable contribution deduction under section 170. For payments or transfers in excess of the amount deductible under section 162(a), see § 1.170A-1(h).

(2) *Examples*. The following examples illustrate the rules of paragraph (a)(1) of this section:

(i) *Example (1)*. A, an individual, is a sole proprietor who manufactures musical instruments and sells them through a website. A makes a $1,000 payment to a local church (which is a charitable organization described in section 170(c)) for a half-page advertisement in the church's program for a concert. In the program, the church thanks its concert supporters, including A. A's advertisement includes the URL for the website through which A sells its instruments. A reasonably expects that the advertisement will attract new customers to A's website and will help A to sell more musical instruments. A may treat the $1,000 payment as an expense of carrying on a trade or business under section 162.

(ii) *Example (2)*. P, a partnership, operates a chain of supermarkets, some of which are located in State N. P operates a promotional program in which it sets aside the proceeds from one percent of its sales each year, which it pays to one or more charities described in section 170(c). The funds are earmarked for use in projects that improve conditions in State N. P makes the final determination on which charities receive payments. P advertises the program. P reasonably believes the program will generate a significant degree of name recognition and goodwill in the communities where it operates and thereby increase its revenue. As part of the program, P makes a $1,000 payment to a charity described in section 170(c). P may treat the $1,000 payment as an expense of carrying on a trade or business under section 162. This result is unchanged if, under State N's tax credit program, P expects to receive a $1,000 income tax credit on account of P's payment, and under State N law, the credit can be passed through to P's partners.

(3) *Safe harbors for C corporations and specified passthrough entities making payments in exchange for State or local tax credits*.

(i) *Safe harbor for C corporations*. If a C corporation makes a payment to or for the use of an entity described in section 170(c) and receives or expects to receive in return a State or local tax credit that reduces a State or local tax imposed on the C corporation, the C corporation may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of the credit received or expected to be received.

(ii) *Safe harbor for specified passthrough entities*.

(A) *Definition of specified passthrough entity*. For purposes of this paragraph (a)(3)(ii), an entity is a specified passthrough entity if each of the following requirements is satisfied -

(1) The entity is a business entity other than a C corporation and is regarded for all Federal income tax purposes as separate from its owners under § 301.7701-3 of this chapter;

(2) The entity operates a trade or business within the meaning of section 162;

(3) The entity is subject to a State or local tax incurred in carrying on its trade or business that is imposed directly on the entity; and

(4) In return for a payment to an entity described in section 170(c), the entity described in paragraph (a)(3)(ii)(A)(1) of this section receives or expects to receive a State or local tax credit that the entity applies or expects to apply to offset a State or local tax described in paragraph (a)(3)(ii)(A)(3) of this section.

(B) *Safe harbor*. Except as provided in paragraph (a)(3)(ii)(C) of this section, if a specified passthrough entity makes a payment to or for the use of an entity described in section 170(c), and receives or expects to receive in return a State or local tax credit that reduces a State or local tax described in paragraph (a)(3)(ii)(A)(3) of this section, the specified passthrough entity may treat such payment as an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of credit received or expected to be received.

(C) *Exception*. The safe harbor described in this paragraph (a)(3)(ii) does not apply if the credit received or expected to be received reduces a State or local income tax.

(iii) *Definition of payment*. For purposes of this paragraph (a)(3), payment is defined as a payment of cash or cash equivalent.

(iv) *Examples*. The following examples illustrate the rules of paragraph (a)(3) of this section.

(A) *Example (1). C corporation that receives or expects to receive dollar-for-dollar State or local tax credit*. A, a C corporation engaged in a trade or business, makes a payment of $1,000 to an entity described in section 170(c). In return for the payment, A expects to receive a dollar-for-dollar State tax credit to be applied to A's State corporate income tax liability. Under paragraph (a)(3)(i) of this section, A may treat the $1,000 payment as an expense of carrying on a trade or business under section 162.

(B) *Example (2). C corporation that receives or expects to receive percentage-based State or local tax credit*. B, a C corporation engaged in a trade or business, makes a payment of $1,000 to an entity described in section 170(c). In return for the payment, B expects to receive a local tax credit equal to 80 percent of the amount of this payment ($800) to be applied to B's local real property tax liability. Under paragraph (a)(3)(i) of this section, B may treat $800 as an expense of carrying on a trade or business under section 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by paragraph (a)(3)(i) of this section.

(C) *Example (3). Partnership that receives or expects to receive dollar-for-dollar State or local tax credit*. P is a limited liability company classified as a partnership for Federal income tax purposes under § 301.7701-3 of this chapter. P is engaged in a trade or business and makes a payment of $1,000 to an entity described in section 170(c). In return for the payment, P expects to receive a dollar-for-dollar State tax credit to be applied to P's State excise tax liability incurred by P in carrying on its trade or business. Under applicable State law, the State's excise tax is imposed at the entity level (not the owner level). Under paragraph (a)(3)(ii) of this section, P may treat the $1,000 as an expense of carrying on a trade or business under section 162.

(D) *Example (4). S corporation that receives or expects to receive percentage-based State or local tax credit*. S is an S corporation engaged in a trade or business and is owned by individuals C and D. S makes a payment of $1,000 to an entity described in section 170(c). In return for the payment, S expects to receive a local tax credit equal to 80 percent of the amount of this payment ($800) to be applied to S's local real property tax liability incurred by S in carrying on its trade or business. Under applicable local law, the real property tax is imposed at the entity level (not the owner level). Under paragraph (a)(3)(ii) of this section, S may treat $800 of the payment as an expense of carrying on a trade or business under section 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by paragraph (a)(3)(ii) of this section.

(v) *Applicability of section 170 to payments in exchange for State or local tax benefits*. For rules regarding the availability of a charitable contribution deduction under section 170 where a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c) and receives or expects to receive a State or local tax benefit in return for such payment, see § 1.170A-1(h)(3).

(4) *Applicability dates*. Paragraphs (a)(1) and (2) of this section, regarding the application of section 162 to taxpayers making payments or transfers to entities described in section 170(c), apply to payments or transfers made on or after December 17, 2019. Section 1.162-15(a), as it appeared in the April 1, 2020 edition of 26 CFR part 1, generally applies to payments or transfers made prior to December 17, 2019. However, taxpayers may choose to apply paragraphs (a)(1) and (2) of this section to payments and transfers made on or after January 1, 2018. Paragraph (a)(3) of this section, regarding the safe harbors for C corporations and specified passthrough entities making payments to section 170(c) entities in exchange for State or local tax credits, applies to payments made by these entities on or after December 17, 2019. However, taxpayers may choose to apply the safe harbors of paragraph (a)(3) to payments made on or after January 1, 2018.

New Reg. § 1.162-15(d), "Cross reference," provides:

For provisions dealing with expenditures for institutional or "good will" advertising, see § 1.162-20(a)(2).

Reg. § 1.164-3, "Definitions and special rules," adds subsection (j), "Safe harbor for payments by individuals in exchange for State or local tax credits":

(1) *In general*. An individual who itemizes deductions and who makes a payment to or for the use of an entity described in section 170(c) in consideration for a State or local tax credit may treat as a payment of State or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is disallowed under § 1.170A-1(h)(3). This treatment as payment of a State or local tax is allowed in the taxable year in which the payment is made to the extent that the resulting credit is applied, consistent with applicable State or local law, to offset the individual's State or local tax liability for such taxable year or the preceding taxable year.

(2) *Credits carried forward*. To the extent that a State or local tax credit described in paragraph (j)(1) of this section is not applied to offset the individual's applicable State or local tax liability for the taxable year of the payment or the preceding taxable year, any excess State or local tax credit permitted to be carried forward may be treated as a payment of State or local tax under section 164(a) in the taxable year or years for which the carryover credit is applied in accordance with State or local law.

(3) *Limitation on individual deductions*. Nothing in this paragraph (j) may be construed as permitting a taxpayer who applies this safe harbor to avoid the limitation of section 164(b)(6) for any amount paid as a tax or treated under this paragraph (j) as a payment of tax.

(4) *No safe harbor for transfers of property*. The safe harbor provided in this paragraph (j) applies only to a payment of cash or cash equivalent.

(5) *Coordination with other deductions*. An individual who deducts a payment under section 164 may not also deduct the same payment under any other Code section.

(6) *Examples*. In the following examples, assume that the taxpayer is an individual who itemizes deductions for Federal income tax purposes.

(i) *Example (1)*. In year 1, Taxpayer A makes a payment of $500 to an entity described in section 170(c). In return for the payment, A receives a dollar-for-dollar State income tax credit. Prior to application of the credit, A's State income tax liability for year 1 was more than $500. A applies the $500 credit to A's year 1 State income tax liability. Under paragraph (j)(1) of this section, A treats the $500 payment as a payment of State income tax in year 1. To determine A's deduction amount, A must apply the provisions of section 164 applicable to payments of State and local taxes, including the limitation in section 164(b)(6). See paragraph (j)(3) of this section.

(ii) *Example (2)*. In year 1, Taxpayer B makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, B receives a dollar-for-dollar State income tax credit, which under State law may be carried forward for three taxable years. Prior to application of the credit, B's State income tax liability for year 1 was $5,000; B applies $5,000 of the $7,000 credit to B's year 1 State income tax liability.

Under paragraph (j)(1) of this section, B treats $5,000 of the $7,000 payment as a payment of State income tax in year 1. Prior to application of the remaining credit, B's State income tax liability for year 2 exceeds $2,000. B applies the excess credit of $2,000 to B's year 2 State income tax liability. For year 2, under paragraph (j)(2) of this section, B treats the $2,000 as a payment of State income tax under section 164. To determine B's deduction amounts in years 1 and 2, B must apply the provisions of section 164 applicable to payments of State and local taxes, including the limitation under section 164(b)(6). See paragraph (j)(3) of this section.

(iii) *Example (3)*. In year 1, Taxpayer C makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, C receives a local real property tax credit equal to 25 percent of the amount of this payment ($1,750). Prior to application of the credit, C's local real property tax liability in year 1 was more than $1,750. C applies the $1,750 credit to C's year 1 local real property tax liability. Under paragraph (j)(1) of this section, for year 1, C treats $1,750 of the $7,000 payment as a payment of local real property tax for purposes of section 164. To determine C's deduction amount, C must apply the provisions of section 164 applicable to payments of State and local taxes, including the limitation under section 164(b)(6). See paragraph (j)(3) of this section.

(7) *Applicability date*. This paragraph (j) applies to payments made to section 170(c) entities on or after June 11, 2019. However, a taxpayer may choose to apply this paragraph (j) to payments made to section 170(c) entities after August 27, 2018.

Prop. Reg. § 1.170A-1(h)(3) includes:

(iii) *In consideration for*. For purposes of paragraph (h) of this section, the term in consideration for has the meaning set forth in paragraph (h)(4)(i) of this section.

(viii) *Safe harbor for payments by C corporations and specified passthrough entities*. For payments by a C corporation or by a specified passthrough entity to an entity described in section 170(c), where the C corporation or specified passthrough entity receives or expects to receive a State or local tax credit that reduces the charitable contribution deduction for such payments under paragraph (h)(3) of this section, see § 1.162-15(a)(3) (providing safe harbors under section 162(a) to the extent of that reduction).

(ix) *Safe harbor for individuals*. Under certain circumstances, an individual who itemizes deductions and makes a payment to an entity described in section 170(c) in consideration for a State or local tax credit may treat the portion of such payment for which a charitable contribution deduction is disallowed under paragraph (h)(3) of this section as a payment of State or local taxes under section 164. See § 1.164-3(j), providing a safe harbor for certain payments by individuals in exchange for State or local tax credits.

Reg. § 1.170A-1(h)(4), "Definitions," includes the following definitions for Reg. § 1.170A-1(h):

(i) *In consideration for*. A taxpayer receives goods or services in consideration for a taxpayer's payment or transfer to an entity described in section 170(c) if, at the time the taxpayer makes the payment to such entity, the taxpayer receives or expects to receive goods or services from that entity or any other party in return.

(ii) *Goods or services*. Goods or services means cash, property, services, benefits, and privileges.

(iii) *Applicability date*. The definitions provided in this paragraph (h)(4) are applicable for amounts paid or property transferred on or after December 17, 2019.

II.G.4.g.ii. Basis Limitations on Deducting Charitable Contributions Made by an S corporation or a Partnership

A partner may deduct charitable contributions without regard to the partner's basis.[1233] The basis of the partner's interest in the partnership is decreased (but not below zero) by the partner's share of the partnership's basis in the property contributed.[1234]

Until recently, the full fair market value of the contribution reduced basis, and triggering the regular basis limitations under part II.G.4.c Basis Limitations for Deducting Partnership and S Corporation Losses. However, for contributions made in tax years beginning after December 21, 2005,[1235] appreciation does not reduce basis and therefore is not subject to these basis limitations.[1236]

Trusts that are partners or S corporation shareholders may see their charitable contributions reduced due to certain rules relating to unrelated business income (which rules apply to all S corporation K-1 income even if the S corporation does not engage in a trade or business and does not have any debt-financed income). See part II.Q.7.c S Corporation Owned by a Trust Benefitting Charity (some of which applies to partnerships, even though the focus is S corporations). Although generally a trust cannot deduct contributions unless the trust agreement authorizes contributions to be made, trust deductions of partnership contributions are not so limited.[1237]

[1233] Letter Ruling 8405084; see fns. 1199-1200 in part II.G.4.e Basis Limitations for Partners in a Partnership. See discussion in McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 11.05[1][b] "Exclusion of Charitable Contributions From the Limitation."
[1234] Rev. Rul. 96-11; see Code § 705(a)(2)(B).
[1235] P.L. 109-280, section 1203(a).
[1236] Code § 1366(d)(4), 1367(a)(2).
[1237] Rev. Rul. 2004-5, which is discussed in fn. 4689, which is found in part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. Note that charitable contributions by trusts are more beneficial for net investment income tax purposes than charitable contributions by individuals. See fn. 2247.

II.G.4.h. Expenses Incurred by Owner-Officer

Under Code § 162(a), an S corporation shareholder could deduct losses arising from lawsuits against him personally relating to that person managing the business.[1238]

II.G.4.i. Passive Loss Limitations

See part II.K Passive Loss Rules for limitations on deductions and credits under the Code § 469 passive loss rules.

Although these limitations are significant, they are temporary, except when an individual dies or a trust terminates.[1239] More important than the timing of losses is the application of the passive loss rules in determining whether income is subject to the 3.8% tax on net investment income, which is why the detailed discussion is moved to the part describing that tax.[1240]

II.G.4.j. At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities)

Partners generally may deduct losses financed by bank loans to the partnership only to the extent permitted by the rules described in this part II.G.4.j.[1241]

An individual (as well as certain personal holding companies) may not deduct a loss to the extent not "at risk" with respect to the activity that generated the loss; any excess losses are suspended until they can be used.[1242]

[1238] Letter Ruling 201548011, which discussed the origin of the claim doctrine and mentioned:

> Generally, amounts paid in settlement of lawsuits are currently deductible if the acts which gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business. See, *e.g.*, *Federation Bank & Trust Co. v. Commissioner*, 27 T.C. 960, 973 (1957), *aff'd*, 256 F.2d 764 (2d Cir. 1958), *acq.*, 1969-2 C.B. xxiv (allowing petitioner to deduct amounts paid in settlement of legal proceedings charging petitioner with mismanagement in the liquidation of assets); *Butler v. Commissioner*, 17 T.C. 675, 679-81 (1951), *acq.*, 1952-1 C.B. 1 (settlement payment arising from shareholder suit for damages against principal officer for mismanagement of corporate affairs held deductible as an ordinary and necessary business expense directly connected to and proximately resulting from his business activity); Rev. Rul. 79-208, 1979-2 C.B. 79 (permitting taxpayer to deduct payments to settle lawsuit and obtain a release from breach of contract claims under a franchise agreement).
>
> Similarly, amounts paid for legal expenses in connection with litigation are allowed as business expenses where such litigation is directly connected to, or proximately results from, the conduct of a taxpayer's business. See, *e.g.*, *Howard v. Commissioner*, 22 B.T.A. 375, 378 (1931), *acq.*, 1945 C.B. 4 (holding that legal fees incurred by taxpayer to settle a shareholder's claim of misrepresentation in the conduct of business are deductible as business expenses); *D'Angelo v. Commissioner*, T.C. Memo. 2003-295 (petitioner entitled to a section 162 deduction for legal fees paid in defending suits alleging breach of fiduciary duty, mismanagement, and breach of contract in his capacity as an officer, partner, and shareholder of entities in which he had an ownership interest).
>
> In Rev. Rul. 80-211, 1980-2 C.B. 57, the taxpayer was sued civilly for breach of contract and fraud relating to the ordinary conduct of its trade or business. A judgment was rendered that included punitive damages. The ruling allowed the taxpayer to deduct amounts paid as punitive damages under section 162(a) as an ordinary and necessary business expense because the acts that gave rise to the civil suit were performed in the ordinary course of the taxpayer's business.

[1239] See part II.K.2.d Effect of Death of an Individual or Termination of Trust .

[1240] See part II.I.8 Application of 3.8% Tax to Business Income.

[1241] See Code § 465(b)(6), treating certain nonrecourse real estate loans as at-risk to partner. Also, compare Prop. Reg. § 1.465-24(a)(2) (which would treat partners as at-risk for loan guarantees) with Prop. Reg. § 1.465-24(a)(3) (contrary rule for S corporations). If a grantor trust borrows on a recourse basis but the lender's only recourse is against the trust's assets, its grantor is "at risk" for purposes of Code § 465(b) only to the extent of the trust's assets. Rev. Rul. 78-175.

[1242] Code § 465.

When a taxpayer transfers all of a business interest in a substituted basis transaction, any associated at risk losses are added to the basis of the transferred property[1243] and part or all of any at risk amount in excess of losses is added to the transferee's amount at risk.[1244] It has been suggested that, if less than the entire interest is transferred, it might be appropriate to allocate at risk amounts in proportion to what is transferred.[1245] For more discussion, see 550-4th T.M., At-Risk Rules, Detailed Analysis, VIII. Effect of Transfer/Disposition of Activity on Amount at Risk, C. Effect on Transferee with Carryover Basis. For the effect of a disposition on losses that were allowed under the at-risk rules but suspended under the Code § 469 passive loss rules, see part II.K.1.j Complete Disposition of Passive Activity.

AM 2014-003 addressed LLC Member guarantees of LLC debt and "qualified nonrecourse financing," taking the following positions:[1246]

- When a member of an LLC classified as a partnership or disregarded entity for federal tax purposes guarantees the LLC's debt, the member is at risk with respect to the amount of the guaranteed debt, without regard to whether such member waives any right to subrogation, reimbursement, or indemnification from the LLC, but only to the extent that the member has no right of contribution or reimbursement from persons other than the LLC, the member is not otherwise protected against

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[1243] Prop. Reg. § 1.465-67, "Transfers and dispositions; pass through of losses suspended under section 465(a)," provides:

(a) *Applicability*. This section shall apply to any transfer or disposition in which -

(1) The taxpayer transfers or disposes of such taxpayer's entire interest in the activity or the entity conducting the activity,

(2) The basis of the transferee is determined in whole or in part by reference to the basis of the transferor; and

(3) The transferor has suspended losses under section 465(a) at the time of the transfer or disposition.

For the treatment of any gain recognized by the transferor, see § 1.465-66.

(b) *Pass through of suspended losses*. If at the close of the taxable year in which the transfer or disposition occurs, the amount of the transferor's section 465(d) loss from the activity is in excess of the transferor's amount at risk in the activity, such excess shall be added to the transferor's basis in the activity. The preceding sentence is to be applied after the determination of any gain to the transferor and is to be used solely for the purpose of determining the basis of the property in the hands of the transferee.

[1244] Prop. Reg. § 1.465-68.

[1245] Willis, *Postlewaite & Alexander: Partnership Taxation*, ¶ 7.07. At Risk Aspects of Transfer of Partnership Interest Where Basis Carries Over and at Death of Partner, suggests possibly looking to Rev. Rul. 84-53. See part II.Q.8.e.ii.(a) Unitary Basis, citing Rev. Rul. 84-53. Also relevant in that treatise is ¶ 7.06 Adjustment to Basis of Partnership Interest for Loss Disallowed by Section 465; Tax Consequences of a Sale of That Interest.

[1246] AM 2014-003, authored by Curt G. Wilson, Associate Chief Counsel (Passthroughs & Special Industries) and sent to Division Counsel (Large Business & International) to the attention of a Senior Level Counsel (Domestic). In addition to the comments made below, the memo commented:

> This memorandum does not address the effect of a member guarantee of qualified nonrecourse financing in the context of a single member LLC taxed as a disregarded entity for federal tax purposes, because the member's at-risk amount generally will not be affected by the guarantee. As the sole owner of an LLC with qualified nonrecourse financing, the single member is at risk prior to guaranteeing the debt because the debt is qualified nonrecourse financing. After guaranteeing the debt, the debt no longer meets the definition of qualified nonrecourse financing, but as the guarantor, the single member is still at risk to the extent of the amount guaranteed and to the extent the single member is not otherwise protected against loss.

In addition to being concerned about using a disregarded entity LLC to avoid the at-risk rules, the IRS is also leery of using a QSST to avoid the at-risk rules. A QSST is a trust owning stock in an S corporation, which trust is taxed as a grantor trust deemed owned by the beneficiary; see part III.A.3.e.i QSSTs. CCA 201327009 allows the beneficiary to deduct the interest when the QSST buys from a third party using a promissory note; see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs. The IRS declined to rule on the loan's effect under the at-risk rules out of concern that taxpayers would set up a Code § 465(c)(4) device to limit liability. For how that interest is classified, see text accompanying fn 453 in part II.C.3.d Deducting Interest Expense on Debt Incurred by a Partnership.

loss within the meaning of Code § 465(b)(4), and the guarantee is bona fide and enforceable by creditors of the LLC under local law.[1247]

- When a member of an LLC classified as a partnership for federal tax purposes guarantees qualified nonrecourse financing of the LLC, the member's amount at risk is increased by the amount guaranteed, but only to the extent such debt was not previously taken into account by that member, the guaranteeing member has no right of contribution or reimbursement from persons other than the LLC, the guaranteeing member is not otherwise protected against loss within the meaning of Code § 465(b)(4), and the guarantee is bona fide and enforceable by creditors of the LLC under local law.

- When a member of an LLC guarantees qualified nonrecourse financing of the LLC, the amount of the guaranteed debt no longer meets the definition of "qualified nonrecourse financing" under Code § 465(b)(6)(B) if the guarantee is bona fide and enforceable by creditors of the LLC under local law, and the amount of the guaranteed debt will no longer be includible in the at-risk amount of the other non-guarantor members of the LLC.[1248]

[1247] Reasoning:

> In the case of an LLC, all members have limited liability with respect to LLC debt. In the absence of any co-guarantors or other similar arrangement, an LLC member who guarantees LLC debt becomes personally liable for the guaranteed debt and is in a position akin to the general partners in the example in Prop. [Reg.] § 1.465-24(a)(2)(ii) who had personally assumed the partnership's debt and who had no right of reimbursement for their $12,500 share. If called upon to pay under the guarantee, the guaranteeing member may seek recourse only against the LLC's assets, if any. As in the case of a general partner, a right to subrogation, reimbursement, or indemnification from the LLC (and only the LLC) does not protect the guaranteeing LLC member against loss within the meaning of § 465(b)(4).

Moreno v. U.S., 113 A.F.T.R.2d 2014-2149 (D. La. 5/19/2014), agreed with this principle and rebuffed government arguments looking to the individual guarantor's net worth or the practical matter of how the guaranty would be satisfied, instead counting only a legal right to contribution as reducing the amount at risk. *Moreno* said:

> With respect to rights of contribution and reimbursement, where a member of a limited liability company guarantees a liability of the limited liability company, he or she is at risk, except to the extent he or she has a right of contribution or reimbursement from the other guarantors. See e.g. IRS Field Service Advisory 2000-25-018 (June 23, 2000), 2000 WL 33116072 (each member of a limited liability company "who has guaranteed a liability of the limited liability company is at-risk, except to the extent the member has a right of reimbursement against the remaining members"); IRS Chief Counsel Advisory 20130828 (February 22, 2013), 2013 WL 653295 ("an LLC member is at risk with respect to LLC debt guaranteed by the member (where the LLC is treated as either a partnership or a disregarded entity for federal tax purposes), but only to the extent that the member has no right of contribution or reimbursement from the other guarantors..."; taxpayer is not at risk "for those amounts" for which he has a right of contribution against co-sureties); Susan Kalinka, *Limited Liability Companies and Partnerships: A Guide to Business and Tax Planning*, 9A LACIVL § 6.7 (3d ed.) (2012) (a member of an LLC who guarantees an obligation of the LLC will assume personal liability for the LLC's obligation, and that member should be entitled to include in his or her at risk amount the portion of the guaranteed liability for which the member may not seek reimbursement); S. Rep. 94-938, 49, 1976 U.S.C.C.A.N. 3438, 3485 ("a taxpayer's capital is not "at risk" in the business ... to the extent he is protected against economic loss of all or part of such capital by reason of an ... arrangement for compensation or reimbursement to him of any loss which he may suffer"). Here, all parties acknowledge that if either Dynamic or Moreno were to pay Aerodynamic's obligation, the paying entity would have right of contribution against the other for half the amount it paid, pursuant to La. Civ. Code arts. 3055 and 3056. Under such circumstances, the IRS has determined a guarantor is at risk for fifty percent of the amount guaranteed.

[1248] Reasoning:

> As a general rule, LLC members may not include liabilities of the LLC in their at-risk amounts unless the members are personally liable for the debt as provided by § 465(b)(2)(A). Further, under § 465(b)(4), taxpayers are not at risk with respect to amounts protected against loss through nonrecourse financing. Section 465(b)(6)(A) creates an exception to these rules when a nonrecourse liability meets the definition of qualified nonrecourse financing. Under § 465(b)(6)(B)(iii), a liability is qualified nonrecourse financing only if no person is personally liable for repayment.

The IRS has addressed whether a guarantor of debt of an LLC treated as either a partnership or a disregarded entity for federal tax purposes be "at risk" with respect to the guaranteed debt if the guarantor does not completely waive his rights of subrogation and reimbursement from the LLC with respect to that guaranteed debt. The IRS applied the following requirements (assuming certain exceptions[1249] do not already apply):[1250]

- The taxpayer must be personally liable for the debt,[1251] and

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When a member of an LLC treated as a partnership for federal tax purposes guarantees LLC qualified nonrecourse financing, the member becomes personally liable for that debt because the lender may seek to recover that amount of the debt from the personal assets of the guarantor. Because the guarantor is personally liable for that debt, that debt is no longer qualified nonrecourse financing as defined in § 465(b)(6)(B) and § 1.465-27(b)(1). Further, because the creditor may proceed against the property of the LLC securing the debt, or against any other property of the guarantor member, that debt also fails to satisfy the requirement in § 1.465-27(b)(2)(i) that qualified nonrecourse financing must be secured only by real property used in the activity of holding real property.

Because that debt is no longer qualified nonrecourse financing, the nonguaranteeing members of the LLC who previously included that portion of the qualified nonrecourse financing in their amount at risk and who have not guaranteed any portion of that debt may no longer include that amount of the debt in determining their amount at risk. Any reduction that causes an LLC member's at-risk amount to fall below zero will trigger recapture of losses under § 465(e). The at-risk amount of the LLC member that guarantees LLC debt is increased, but only to the extent such debt was not previously taken into account by that member, the guaranteeing member has no right of contribution or reimbursement from persons other than the LLC, the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts, and the guarantee is bona fide and enforceable by creditors of the LLC under local law.

The Field Office noted that non-guaranteeing LLC members may assert that a guarantee of qualified nonrecourse financing by another LLC member does not increase the guarantor's amount at risk and, therefore, should not reduce the at-risk amount of the non-guaranteeing members with respect to that financing. As discussed above, we do not adopt that reading of Prop. [Reg.] § 1.465-6(d). Even if it did apply in this situation, it would not aid the non-guaranteeing members because the financing would still cease to be qualified nonrecourse financing under Section 465(b)(6)(B). Section 465(b)(6)(B)(iii) defines qualified nonrecourse financing as financing for which no person is personally liable. Because a guarantor becomes personally liable for the amount guaranteed, any liability previously treated as qualified nonrecourse financing no longer meets the definition of qualified nonrecourse financing once it is guaranteed (whether or not the guarantor is at risk). As a result, the non-guaranteeing members may no longer avail themselves of the exception in § 465(b)(6)(A) to include any portion of the guaranteed liability in their at-risk amounts regardless of the impact of the guarantee on the guarantor's amount at risk. Whether Prop. [Reg.] § 1.465-6(d) applies to a guarantor of LLC debt is an inquiry that does not affect the analysis of whether a guaranteed liability constitutes qualified nonrecourse financing.

[1249] Code § 465(b)(2)(B).

[1250] CCA 201308028. The IRS noted:

It should be noted that the conclusions contained within this advice may be viewed as contrary to Prop. Treas. Reg. § 1.465-6(d) (1979), which provides that if a taxpayer guarantees repayment of an amount borrowed by another person (primary obligor) for use in an activity, the guaranty shall not increase the taxpayer's amount at risk. Prop. Reg. § 1.465-6(d) further provides that if the taxpayer repays to the creditor the amount borrowed by the primary obligor, the taxpayer's amount at risk shall be increased at such time as the taxpayer has no remaining legal rights against the primary obligor. However, Prop. Reg. § 1.465-6(d) was promulgated before the development of LLCs under various state laws, and at a time when entities treated as partnerships for federal tax purposes were usually state law general partnerships and limited partnerships.

….[W]e conclude that an LLC member is at risk with respect to LLC debt guaranteed by the member (where the LLC is treated as either a partnership or a disregarded entity for federal tax purposes), but only to the extent that the member has no right of contribution or reimbursement from other guarantors and is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts. Therefore, we conclude that Prop. Reg. § 1.465-6(d) is generally not applicable to situations involving bona fide guarantees of LLC debt by one or more members of the LLC that is enforceable by creditors of the LLC under local law, where the LLC is treated as either a partnership or a disregarded entity for federal tax purposes.

[1251] Based on whether the taxpayer is ultimately liable for repayment as the payor of last resort in the worst case scenario.

- The taxpayer is not otherwise protected from loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.[1252]

The IRS took the position that the mere fact that a taxpayer may be entitled to subrogation, reimbursement, or indemnification from an LLC (and only the LLC) under local law when payment is made on the guarantee does not mean that the taxpayer is "protected against loss." The IRS also stated that, to the extent that co-guarantors protect the taxpayer from loss under the economic realities existing at the end of a taxable year, to the taxpayer is not at risk for that year.

CCA 201606027[1253] addressed LLC Member guarantees of LLC debt and "qualified nonrecourse financing," taking the following positions regarding certain provisions that can trigger personal liability made the loans recourse (sometimes referred to as "bad boy guarantees"):

1. If a partner guarantees an obligation of the partnership and the guarantee is sufficient to cause the guaranteeing partner to bear the economic risk of loss for that obligation within the meaning of § 1.752-2(b)(1) of the Income Tax Regulations, the guaranteed debt is properly treated as recourse financing for purposes of applying the basis allocation rules of § 752. For this purpose, certain contingencies such as the partnership admitting in writing that it is insolvent or unable to pay its debts when due, its voluntary bankruptcy, or its acquiescence in an involuntary bankruptcy, after taking into account all the facts and circumstances, are not so remote a possibility that it is unlikely the obligation will ever be discharged within the meaning § 1.752-2(b)(4) that would cause the obligation to be disregarded under § 1.752-2(b)(3).[1254]

[1252] The IRS said that the majority view bases its determination on the "economic realities" present at the end of the taxable year and that the minority viewed bases its determination on whether the taxpayer is payor of last resort in a worst case scenario. The IRS concluded that the majority view is correct. If a taxpayer is insulated from loss with respect to a borrowed amount, based upon the facts and circumstances existing at the end of the taxable year, then the taxpayer is not at risk. However, if at some future time the taxpayer demonstrates that the taxpayer cannot recover under the loss limitation arrangement, the taxpayer will become at risk at that time.

[1253] Authored by James A. Quinn, Senior Counsel, Branch 3, Office of Associate Chief Counsel, (Passthroughs & Special Industries), to William D. Richard, Attorney (Seattle, Group 1) (Small Business/Self-Employed), October 23, 2015.

[1254] In support of this conclusion, the CCA reasoned:

> As a threshold matter, a bona fide guarantee that is enforceable by the lender under local law generally will be sufficient to cause the guaranteeing partner to be treated as bearing the economic risk of loss for the guaranteed partnership liability for purposes of § 1.752-2(a). For purposes of § 1.752-2, we believe it is reasonable to assume that a third-party lender will take all permissible affirmative steps to enforce its rights under a guarantee if the primary obligor defaults or threatens to default on its obligations. In this case, we view the "conditions" listed in section 1(b) of the First Guarantee as circumstances under which the lender may enforce the guarantee to collect the entire outstanding balance on the loan, beyond an actual default by X on its obligations. As such, we do not believe these "conditions" are properly viewed as conditions precedent that must occur before Y is entitled to seek repayment from C under the guarantee.[2] In addition, we believe it is reasonable to assume that one or more of these conditions, more likely than not, would be met upon a constructive liquidation of X under § 1.752-2(b)(1). Accordingly, we believe that these "conditions" do not fall within the definition of "contingencies" as intended by § 1.752-2(b)(4).
>
> > [2] According to the submission, it appears the taxpayer may assert that the various events listed in section 1(b) of the First Guarantee, upon the occurrence of which the First Guarantee will become immediately due and payable for the entire outstanding balance of the loan, are the only events under which the First Guarantee will become due and payable. It appears to us that a failure of X to repay the loan, by itself, likely would be sufficient to trigger the First Guarantee, as evidenced by the first sentence of section 1 of the First Guarantee. Assuming, arguendo, that the taxpayer's assertion is correct, we nevertheless believe that the likelihood that X or any other co-borrower will ever meet any one of these conditions, in the aggregate, is not so remote a possibility that would cause the obligation to be considered "likely to never be discharged" within the meaning of § 1.752-2(b)(4).
>
> For these reasons, we conclude that, for the purposes of §§ 704(d) and 752, and § 1.752-2(a), the promissory notes described above are recourse partnership liabilities allocable to the guaranteeing partner (C), and not to either A or B.

2. Where the partnership's sole business activity includes acquiring existing hotels, renovating them, installing personal property appropriate to improve the properties' utility as hotels, and holding and maintaining the premises, but does not include the hotels' day-to-day operations, the partnership is engaged in an "activity of holding real property" within the meaning of § 465(b)(6)(A).

3. When an individual partner guarantees a partnership obligation, the amount of the guaranteed debt no longer meets the definition of "qualified nonrecourse financing" under § 465(b)(6)(B), and the amount of the guaranteed debt will no longer be includible in the at-risk amount of the other non-guaranteeing partners, if the guarantee is bona fide and enforceable by creditors of the partnership under local law.[1255]

For regulations under Code § 752 that were changed in October 2016 and later, see part II.C.3 Allocating Liabilities (Including Debt).

[1255] After quoting from the statute and Reg. § 1.465-27(b), the CCA explained the at-risk rules as follows:

> Generally, a limited partner, in a limited partnership organized under state law, who guarantees partnership debt is not at risk with respect to the guaranteed debt, because the limited partner has a right to seek reimbursement from the partnership and the general partner for any amounts that the limited partner is called upon to pay under the guarantee. The limited partner is "protected against loss" within the meaning of § 465(b)(4) unless or until the limited partner has no remaining rights against the partnership or general partner for reimbursement of any amounts paid by the limited partner. To the extent that a general partner does not have a right of contribution or reimbursement under local law against any other partner for the debts of the partnership, the general partner is at risk for such debts under § 465(b)(2). The general partner's right to subrogation, reimbursement, or indemnification from the partnership's assets (and only the partnership's assets) does not protect the general partner against loss within the meaning of § 465(b)(4).
>
> In the case of an LLC, all members have limited liability with respect to LLC debt. In the absence of any co-guarantors or other similar arrangement, an LLC member who guarantees LLC debt becomes personally liable for the guaranteed debt and more closely resembles a general partner with respect to the guaranteed debt. If called upon to pay under the guarantee, the guaranteeing member may seek recourse only against the LLC's assets, if any. As in the case of a general partner, a right to subrogation, reimbursement, or indemnification from the LLC (and only the LLC) does not protect the guaranteeing LLC member against loss within the meaning of § 465(b)(4). Therefore, in the case of an LLC treated as a partnership or disregarded entity for federal tax purposes, we conclude that an LLC member is at risk with respect to LLC debt guaranteed by such member, but only to the extent that:
>
> (1) the guaranteeing member has no right of contribution or reimbursement from other guarantors,
> (2) the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts, and
> (3) the guarantee is bona fide and enforceable by creditors of the LLC under local law.
>
> As a general rule, LLC members may not include liabilities of the LLC in their at-risk amounts unless the members are personally liable for the debt as provided by § 465(b)(2)(A). Further, under § 465(b)(4), taxpayers are not at risk with respect to amounts protected against loss through nonrecourse financing. Section 465(b)(6)(A) creates an exception to these rules when a liability meets the definition of qualified nonrecourse financing. Under § 465(b)(6)(B)(iii), a liability is qualified nonrecourse financing only if no person is personally liable for repayment. When a member of an LLC treated as a partnership for federal tax purposes guarantees LLC qualified nonrecourse financing, the member becomes personally liable for that debt because the lender may seek to recover the amount of the debt from the personal assets of the guarantor. Because the guarantor is personally liable for the debt, the debt is no longer qualified nonrecourse financing as defined in § 465(b)(6)(B) and § 1.465-27(b)(1). Further, because the creditor may proceed against the property of the LLC securing the debt, or against any other property of the guarantor member, the debt also fails to satisfy the requirement in § 1.465-27(b)(2)(i) that qualified nonrecourse financing must be secured only by real property used in the activity of holding real property.
>
> It should be noted that this conclusion generally will not be affected by a determination that the guarantee is a "contingent" liability within the meaning of § 1.752- 2(b)(4). Instead, the question is simply whether the guarantee is sufficient to cause the guarantor to be considered personally liable for repayment of the debt, based on all the facts and circumstances, within the meaning of § 465(b)(6)(B)(iii). In this case, we believe the First Guarantee is sufficient for this purpose.

4. To the extent the guaranteeing partner has the right under the partnership operating agreement to call for the non-guaranteeing partners to make capital contributions and, if they fail to do so, treat ratable portions of the payment as loans to those partners, adjust their fractional interests in the partnership, or enter into a subsequent allocation agreement under which the risk of the guarantee would be shared among the partners, this right generally will not be sufficient to make the non-guaranteeing partners personally liable with respect to the guaranteed obligation for the purposes of §§ 752 and 465.[1256]

When the debt is no longer qualified nonrecourse financing due to a guarantee of that debt, the non-guaranteeing members of the LLC who previously included a portion of the qualified nonrecourse financing in their amount at risk and who have not guaranteed any portion of the debt may no longer include any amount of the debt in determining their amount at risk. Any reduction that causes an LLC member's at-risk amount to fall below zero will trigger recapture of losses under § 465(e). The at-risk amount of the LLC member that guarantees LLC debt is increased, but only to the extent such debt was not previously taken into account by that member, the guaranteeing member has no right of contribution or reimbursement from other guarantors, the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts, and the guarantee is bona fide and enforceable by creditors of the LLC under local law.

In this case, we conclude that, for the purposes of § 465(b)(6)(B)(iii) and § 1.465- 27(b)(1)(iii), the First Guarantee described above is sufficient to cause the guaranteeing partner, C, to be considered personally liable for the guaranteed debt obligations of X. Accordingly, the guaranteed debt obligations of X will no longer qualify as "Qualified Non-Recourse Financing" within the meaning of § 465(b)(6)(B) and § 1.465-27. A and B, as non-guaranteeing members of X, will not be considered at-risk with respect to any such amounts as a consequence of the First Guarantee.

[1256] The CCA first discussed some cases:

In *Pritchett v. Comm'r*, 85 T.C. 581 (1985), *rev'd and remanded*, 827 F.2d 644 (9th Cir. 1987), the taxpayers were limited partners in an oil and gas drilling operation, and they claimed deductions for losses in excess of their cash contributions to the partnership. The taxpayers argued that under the partnership agreement, they were "at risk" for partnership liabilities held by a drilling company that was responsible for developing the oil and gas fields. Under the contract the creditor would receive a portion of profits from the drilling operation. While general partners were the only parties personally liable, under the partnership agreement the general partners were given the right to call on the limited partners to make a capital contribution if the notes issued by the partnership remained unpaid upon their maturity date. The Service argued that the liability was contingent and that the taxpayers were only at risk once general partners called upon them to make a contribution. The Tax Court agreed with this analysis. Upon appeal, the Ninth Circuit held that the contractual obligations of the limited partners under the partnership agreement made them ultimately responsible for the debt. While the Commissioner argued that the liability was contingent simply because the general partners could elect to not make the cash calls, the Ninth Circuit did not agree. The Ninth Circuit determined that the cash calls were mandatory under the partnership agreements and that "economic reality" dictated that the general partners would make the calls.

In *Melvin v. Comm'r*, 88 T.C. 63 (1987), *aff'd*, 894 F.2d 1072 (9th Cir. 1990), the general partnership in which the taxpayer was a partner invested in a limited partnership. In payment for its limited partnership interest, the general partnership paid $35,000 cash and agreed to make additional capital contributions of $70,000. The obligation to make the additional capital contributions was evidenced by a $70,000 recourse promissory note. The taxpayer's share of the note was $50,000. The limited partnership obtained a $3,500,000 recourse loan from a bank and pledged partnership assets to the bank, including the $70,000 note along with other limited partner notes, as security. These notes were subsequently physically transferred to the bank. The court concluded that the taxpayer was at risk on the $3,500,000 loan to the extent of his pro rata share thereof. In reaching it conclusion the court reasoned that "a partner will be regarded as personally liable within the meaning of § 465(b)(2)(A) if he has the ultimate liability to repay the debt obligation of the partnership in the event funds from the partnership's assets are not available for that purpose. The relevant question is who, if anyone, will ultimately be obligated to pay the partnership's recourse obligations if the partnership is unable to do so. It is not relevant that the partnership MAY be able to do so. The scenario that controls is the worst-case scenario, not the best case." *Melvin*, 88 T.C. at 75 (citations omitted).

We believe that *Pritchett* and *Melvin* stand for the proposition that the relevant inquiries when dealing with guarantees of partnership debt, for purposes of § 465, are whether the guarantee causes the guaranteeing partner to become the "payor of last resort in a worst case scenario" for the partnership debt, given the "economic realities" of the particular situation, and whether the guarantor possesses any "mandatory" rights to contribution, reimbursement, or

The May 2016 meeting of the American Bar Association's Section on Taxation included the following unofficial comments by the IRS:[1257] The real estate tax community loudly protested CCA 201606027. The provisions that the CCA asserted turned the debt into recourse debt were typical provisions in nonrecourse arrangements. The CCA was mainly concerned with the seventh condition listed, triggered if the insolvency was admitted. Given that the lender required financial statements, the lender could force such an admission, making the loan essentially recourse. In fact, one state trial court had stated that the financial statements showing liabilities in excess of assets constituted such as admission. However, the appellate court pointed out that the lender's request for a formal admission of insolvency were repeatedly rejected, and the court reversed, saying that insolvency was never admitted and the financial statements did not constitute such an admission.[1258]

> subordination with respect to any other parties, as a result or consequence of paying on the guarantee, that would cause these other parties to be considered the "payors of last resort in a worst case scenario" with respect to that debt.

The CCA concluded:

> It appears that the taxpayer interprets X's Operating Agreement as giving an enforceable right to require A and B to make additional contributions to X, in addition to the specific remedies provided in paragraphs (i) and (ii) of section 7.5(e) of the Operating Agreement. As noted above, we do not agree with this interpretation of the Operating Agreement. Nevertheless, even if the taxpayer's interpretation of the Operating Agreement is ultimately determined to be correct, we still conclude that the taxpayer is not allocated basis under § 752 and is not at risk under § 465 with respect to the guaranteed debt.
>
> We reach this conclusion because we view the requirement for A and B to make additional capital contributions to X as a contingent liability within the meaning of § 1.752-2(b)(4). Because C may choose alternate remedies that would not cause A or B to be viewed as bearing the ultimate economic risk of loss for the guaranteed debt of X, we believe these alternate remedies are properly viewed as contingencies that make it unlikely that any payment obligations of A or B would ever be discharged. In addition, we believe these remedies may also be viewed as future events that cause the payment obligations of A and B to be "not determinable with reasonable certainty" and cause the obligations to be ignored until A and B are actually required to make payments to X, for purposes of § 1.752-2(b)(4).[3]
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> > [3] We believe that one or more arguments may also be made under § 1.752-2(j) in this case, depending on further factual development.
>
> In addition, for purposes of § 465, even if we view C as having an enforceable right to require A and B to make additional contributions to X in addition to the other remedies available in section 7.5(e) of X's Operating Agreement, we believe that the facts of this case would continue to be distinguishable from those in *Pritchett*. In this case, C has been provided with alternate remedies under section 7.5(e) of X's Operating Agreement if A and B choose not to make additional contributions to X under this provision. As a result, it appears that the requirement for A and B to make additional contributions under this provision is not a "mandatory" requirement, since C may elect to use these alternate remedies rather than have X enforce the Operating Agreement under the default provision of section 7.7. Therefore, it does not appear that "economic reality" would dictate that X or C must enforce the Operating Agreement under section 7.7 in a court proceeding against A and B in such circumstances. Accordingly, we conclude that A and B are not "payors of last resort in a worst case scenario", as discussed in *Pritchett* and *Melvin*, and therefore A and B are not currently at risk with respect to the guaranteed debt of X for purposes of § 465.
>
> We would further note that, to the extent that C may elect to use the remedy described in section 7.5(e)(i) of X's Operating Agreement, in which C may treat the amount of a Guaranty Contribution that a defaulting member failed to contribute as a loan to the defaulting member, such "loan" would appear to be subject to the related-party rule of § 465(b)(3)(A). Under the remedy of section 7.5(e)(i), A and B would be viewed as borrowing money from C with respect to the activity of X, at a time when C also possesses an ownership interest in the activity. Accordingly, A and B would not be considered at risk with respect to such amounts pursuant to § 465(b)(3)(A) under this scenario.
>
> Of course, if a payment obligation does arise in the future which requires A and B to make a payment to X, A and B would properly be viewed as making contributions to X at that time, for purposes of §§ 722, 704(d) and 465(b)(1)(A).
>
> In conclusion, because A and B do not have a mandatory obligation to make additional capital contributions to the [sic] X, regardless of which interpretation of X's Operating Agreement is ultimately determined to be correct, A and B do not bear the ultimate economic risk of loss for purposes of § 752, and A and B are not the payors of last resort in a worst case scenario for purposes of § 465.

For changes to regulations under Code § 752 in October 2016, see part II.C.3 Allocating Liabilities (Including Debt).

[1257] Recording ABATX1659.

[1258] *Zwirn*, fn. 1260.

In light of that case, AM 2016-001[1259] addresses the treatment under Code §§ 752 (allocation of liabilities) and 465 (at-risk rules of guarantee) of a partnership nonrecourse liability when the guarantee is conditioned on certain "nonrecourse carve-out" events, backing away from CCA 201606027. It concluded:

1. If a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the occurrence of certain "nonrecourse carve-out" events described below, the guarantee will not cause the obligation to fail to qualify as a nonrecourse liability of the partnership under section 752 and regulations promulgated thereunder until such time as one of those events actually occurs and causes the guarantor to become personally liable for the partnership debt under local law.[1260]

2. If a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the occurrence of certain "nonrecourse carve-out" events described below, the guarantee will not cause the obligation to fail to qualify as qualified nonrecourse financing for purposes of section 465(b)(6) and the regulations promulgated thereunder until such time as one of those events actually occurs and causes the guarantor to become personally liable for the partnership debt under local law.[1261]

At the ABA meeting, practitioner pointed out that the conditions in the CCA were only 7 out of about 20-30 triggers commonly found in nonrecourse financing and asked for guidance. The government spokesman unofficially provided the following bottom line: If the contingency that triggers the personal liability is within the control of the borrower or person who would be liable, then the loan is

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[1259] From Curt G. Wilson, Associate Chief Counsel (Passthroughs and Special Industries) (written by William Kostak), to Division Counsel (Small Business/Self-Employed), attn: Samuel Berman, Special Counsel, March 31, 2016.

[1260] The memorandum reviewed Code § 752(a), Reg. §§ 1.752-1(a), 1.752-2(a), 1.752-2(b)(1), 1.752-2(b)(3) and 1.752-2(b)(4), and *D.B. Zwirn Special Opportunities Fund, L.P. v. SCC Acquisitions, Inc.*, 902 N.Y.S.2d 93, 95 (App. Div. 2010), the latter which it characterized as a lender unsuccessfully enforcing a guarantee to be triggered by a "nonrecourse carve-out" event. In October 2016 and later, the regulations under Code § 752 changed; see part II.C.3 Allocating Liabilities (Including Debt). In arriving at the conclusion to which this footnote is appended, the memorandum reasoned:

> We think that the approach to interpreting the "nonrecourse carve-out" event relating to written admissions of insolvency that the court followed in *D.B. Zwirn* is appropriate not just for that type of carve-out, but for other typical carve-outs as well. In the commercial real estate finance industry, "nonrecourse carve-out" provisions are not intended to allow the lender to require an involuntary action by the borrower or guarantor, or to place borrowers or guarantors in circumstances that would require them to involuntarily commit a "bad act." Rather, the fundamental business purpose behind such carve-outs and the intent of the parties to such agreements is to prevent actions by the borrower or guarantor that could make recovery on the debt, or acquisition of the security underlying the debt upon default, more difficult. The "nonrecourse carve-out" provisions should be interpreted consistent with that purpose and intent in mind. Consequently, because it is not in the economic interest of the borrower or the guarantor to commit the bad acts described in the typical "nonrecourse carveout" provisions, it is unlikely that the contingency (the bad act) will occur and the contingent payment obligation should be disregarded under § 1.752-2(b)(4). Therefore, unless the facts and circumstances indicate otherwise, a typical "nonrecourse carve-out" provision that allows the borrower or the guarantor to avoid committing the enumerated bad act will not cause an otherwise nonrecourse liability to be treated as recourse for purposes of section 752 and § 1.752-2(a) until such time as the contingency actually occurs.

[1261] The memorandum reviewed Code §§ 465(c)(3), 465(b)(2)(A), 465(b)(4), and 465(b)(6) and Reg. §§ 1.465-27(b)(4), (5). In arriving at the conclusion to which this footnote is appended, the memorandum reasoned:

> Therefore, for the same reasons discussed above with respect to liability under section 752, we conclude that if a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the "nonrecourse carve-out" events enumerated above, the guarantee does not cause the guarantor to be treated as personally liable for the repayment of the partnership's liability, because the likelihood of any of the "nonrecourse carve-out" events occurring is such that the guarantor is effectively protected against loss until such time as one or more of the events actually occurs. Accordingly, we conclude that such guarantee will not cause the nonrecourse financing to fail to qualify as qualified nonrecourse financing under section 465(b)(6) and the regulations thereunder if such financing otherwise meets those requirements.

nonrecourse. On the other hand, if the lender controlled the triggers, then the loan is recourse. Court cases imposing recourse liability where the lender could force a trigger's occurrence would affect the government's view of that trigger. He also mentioned that the IRS does not revoke CCAs, so the CCA stands for that taxpayer, but AM 2016-001 represents the government's current thoroughly vetted position on triggers and is unlikely to change absent such court cases.

CCA 201805013 applied Code § 465(c)(3)(B) regarding aggregation of business activities, asserting that aggregation did not apply.[1262]

The Tax Court considers the "realistic possibility" that the guarantor would ultimately be subject to "economic loss" if the guaranty is called. *Bordelon v. Commissioner*, T.C. Memo. 2020-26 reasoned:[1263]

> Accordingly, when evaluating a guarantor's loss protections (including reimbursements from primary obligors), we look at the facts and circumstances to determine not only whether there is a right to the reimbursement but whether the substance of the right is meaningful. In other words, we must consider the "realistic possibility" that the guarantor would ultimately be subject to "economic loss" if called upon to make payments on account of the guarantee. See *Levien v. Commissioner*, 103 T.C. 120, 126 (1994), *aff'd without published opinion*, 77 F.3d. 497 (11th Cir. 1996); *Miller v. Commissioner*, T.C. Memo. 2006-125, 91 T.C.M. (CCH) 1267, 1276 (2006).
>
> We note that in these cases, the realistic-possibility analysis of protection against loss under section 465(b)(4) is not contrary to or divergent from the worst-case-scenario analysis we apply for purposes of determining personal liability under section 465(b)(2)(A).[10] Indeed, the tests may intuitively run together in a two-step at-risk analysis. For example, in facts involving an individual guaranteeing debts of his solely owned business, we would first apply the section 465(b)(2)(A) analysis presuming a worst-case scenario wherein the primary obligor defaults, becomes worthless, and is unable to make payments on the debt—thus triggering payments from the guarantor. See IRS Chief Counsel Advice 201308028 (Feb. 22, 2013).[11] Second, we would consider the realistic possibility of economic loss, in which case "it would be inappropriate … to then assume that the guaranteeing member will nevertheless be able to successfully seek subrogation, reimbursement, or indemnification from the primary obligor" who defaulted and became worthless in step 1. *Id.* Accordingly, we can apply both distinct analyses congruently in cases such as Mr. Bordelon's.
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> [10] Among the U.S. Courts of Appeals there has been a perceived split on the appropriate framework for analyzing section 465(b)(4) - *i.e.*, whether analyzing "realistic possibility", see, *e.g.*, *Waters v. Commissioner*, 978 F.2d 1310, 1316 (2d Cir. 1992), *aff'g* T.C. Memo. 1991-462; *Young v. Commissioner*, 926 F.2d 1083, 1089 (11th Cir. 1991), *aff'g* T.C. Memo. 1988-440 and T.C. Memo. 1988-525; *Moser v. Commissioner*, 914 F.2d 1040, 1048-1049 (8th Cir. 1990), *aff'g* T.C. Memo. 1989-142; *Am. Principals Leasing Corp. v. United States*, 904 F.2d 477, 483 (9th Cir. 1990), or else analyzing "obligor of last resort" under a "worst-case scenario", see, *e.g.*, *Emershaw v. Commissioner*, 949 F.2d 841, 845 (6th Cir. 1991), *aff'g* T.C. Memo. 1990-246. These cases would presumably be appealable to the Court of Appeals for the Fifth Circuit (absent a stipulation to the contrary, see sec. 7482(b)(1)(A), (2)), and we know of no opinion of that court addressing this issue. However,

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[1262] RIA Checkpoint summary:

> Business activities conducted through partnership and 3 separate S corps. couldn't be aggregated and treated as single activity for purposes of Code Sec. 465's at-risk rules when considering that those entities operated independently from each other in that they lacked identical ownership; sold products from different manufacturers; maintained separate franchise agreements, financing arrangements, and books and records; operated in different regions; and shared employees only in limited circumstances. And, even if partnership could show that it actively participated in managing each S corp. for Code Sec. 465(c)(3)(B)(i) purposes, Code Sec. 465(c)(3)(B)(i) didn't allow for aggregation because partnership didn't conduct such activities directly, but rather through separate partnership or S corp.

[1263] *Bordelon* is further discussed in part II.C.3.c.ii.(a) Permanent Rules Allocating Economic Risk of Loss to Recourse Liabilities in the text accompanying fn 401.

the split may not really be implicated in a situation like the one in these cases. Although we acknowledge that in factually complex cases, such as those involving multi-party sale-leaseback transactions or stop-loss agreements, choosing between the tests might lead to different results, see, *e.g.*, *Thornock v. Commissioner*, 94 T.C. 439, 450 (1990), we found little distinction between the two frameworks in *Wag-A-Bag, Inc. v. Commissioner*, T.C. Memo. 1992-581, 64 T.C.M. (CCH) 948, 952 (1992), and held that either would lead to the same result in that case. In these cases we follow Wag-A-Bag and find that in the circumstances before us, both approaches would lead to the same result.

[11] A memorandum of "Chief Counsel advice" is not precedent, sec. 6110(b)(1)(A), (k)(3), and we do not cite it as such. We use it simply as an illustration of one means of applying these two tests in tandem. We do not consider the Commissioner bound by this analysis or this method.

We determined above in part I.B. that Mr. Bordelon was personally liable for purposes of section 465(b)(2)(A). In that analysis we presumed that the primary obligors (Many LLC and AHM) were worthless and unable to pay the amount owed under the Many Loan. If we maintain that presumption as to the primary obligors and turn to the question of whether there is a realistic possibility of reimbursement, it is clear that Mr. Bordelon would not be protected against loss for purposes of section 465(b)(4) because his right to reimbursement would be against the worthless entities with no means to repay him for any amounts contributed.[12]

[12] The Commissioner's position in this case suggests we ignore the presumption that AHM would be worthless and instead hold that Mr. Bordelon is not at risk because if he were required to make a payment as guarantor to the debt, then Louisiana law provided him with a right of reimbursement from AHM. However, ignoring the presumption that an obligor is worthless would be a divergence from our jurisprudence on the at-risk rules, and we are not persuaded that such divergence would be appropriate in these cases.

Mr. Bordelon executed a personal guarantee in 2008 for Many Loan. Under that guarantee, he became directly liable to Union Bank for the full amount of the debt if the obligors defaulted. There was no other guarantor on the debt, nor was there a definite or fixed right to any contribution from other members of Many LLC or from AHM on account of the debt. Indeed, Mr. Bordelon was the sole owner of these entities and the only person with unlimited liability for the Many Loan. Even if we disregard a worthlessness determination when considering Mr. Bordelon's realistic possibility of economic loss, we cannot disregard that in substance Mr. Bordelon was the only one involved with respect to the liability for the Many Loan, the corresponding promissory note, and the personal guarantee. Accordingly, we are persuaded that Mr. Bordelon was personally liable, not protected against loss, and ultimately at risk under the Many Loan during 2008 so as to be entitled to deduct the losses related to Many LLC that he claimed on the Bordelons' 2008 return.

As to the taxpayer's at risk amount in another LLC, *Bordelon v. Commissioner*, T.C. Memo. 2020-26 held:

As for Mr. Bordelon's amount at risk, the foregoing basis analysis enables us to reach easily the conclusion that his guarantee of the Kilgore Loan increased his amount at risk in Kilgore LLC for 2011. We assume that there might be a scenario in which a partner's basis could increase on account of a guarantee but in which the guarantee would not result in his being considered at risk under section 465, but this is not such a case.

With respect to section 465(b)(2)(A), the personal guarantee in 2011 made Mr. Bordelon personally liable for the loan. He was directly liable to HFB for the underlying debt if a default occurred, and there was no right for a contribution or reimbursement from any other member of Kilgore LLC.

With respect to section 465(b)(4), there was no loss protection for Mr. Bordelon on the amount guaranteed. There were no other guarantors, and no other member of Kilgore LLC was personally liable for any portion of the debt. Therefore, we find that Mr. Bordelon was at risk in 2011 for the Kilgore Loan.

II.G.4.k. Be Sure to Use Suspended Losses as Soon as They Become Available

Finally, if one's losses are suspended due to basis limitations, be sure to deduct them as soon as basis becomes sufficient. Failure to do so causes the losses to become unusable when the statute of limitations, for the year in which they should have been taken, has run.[1264]

However, that does not necessarily translate into a desire to accelerate losses. For more thoughts on this idea, see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good.

II.G.4.l. Business Deductions and Losses

II.G.4.l.i. Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit

This part II.G.4.l.i discusses what is a "trade or business" under Code § 162, expenses from which generally would be deductible.[1265] Then it discusses what are activities for the production of income under Code § 212, expenses from which generally would be deductible.[1266] Because both provisions require a profit motive, it then discusses what Code § 183 says about profit motive.[1267]

II.G.4.l.i.(a). "Trade or Business" Under Code § 162

Subject to the various limitations provided in the preceding parts of part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner and subject to other limitations on what can be deducted, Code § 162(a) allows a taxpayer to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," even if the business sustains a loss.[1268]

Higgins v. Commissioner, 312 U.S. 212 (1941), held:[1269]

> To determine whether the activities of a taxpayer are "carrying on a business" requires an examination of the facts in each case…. The petitioner merely kept records and collected interest

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[1264] *Barnes v. Commissioner*, T.C. Memo 2012-80, *aff'd* 712 F.3d 581 (D.C. Cir. 2013) (imposing penalties on taxpayer for deducting 2003 S corporation losses against basis that had been used by previously suspended losses that taxpayer had failed to deduct in 1997).

[1265] See part II.G.4.l.i.(a) "Trade or Business" Under Code § 162.

[1266] See part II.G.4.l.i.(b) Requirements for Deduction Under Code § 212.

[1267] See part II.G.4.l.i.(c) Hobby Loss Benefits of Code § 183.

[1268] Reg. § 1.162-1(a) provides:

> Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162.... The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is deductible, even though such expenses exceed the gross income derived during the taxable year from such business.

[1269] *Higgins* dealt with the predecessor to Code § 162. Rev. Rul. 75-525 views the case as controlling in interpreting Code § 162. See fn. 3309 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax. *Commissioner v. Groetzinger*, 408 U.S. 23 (1987), commented on *Higgins* [footnote omitted]:

> The opinion, therefore,—although devoid of analysis and not setting forth what elements, if any, in addition to profit motive and regularity, were required to render an activity a trade or business—must stand for the propositions that full-time market activity in managing and preserving one's own estate is not embraced within the phrase "carrying on a business," and that salaries and other expenses incident to the operation are not deductible as having been paid or incurred in a trade or business.

After additional commentary on the case, *Groetzinger* continued:

and dividends from his securities, through managerial attention for his investments. No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board.

Commissioner v. Groetzinger, 408 U.S. 23 (1987), discussed various cases (footnotes in the quote below are mine):

> From these observations and decisions, we conclude (1) that, to be sure, the statutory words are broad and comprehensive (*Flint*);[1270] (2) that, however, expenses incident to caring for one's own investments, even though that endeavor is full-time, are not deductible as paid or incurred in carrying on a trade or business (*Higgins*; *City Bank*; *Pyne*);[1271] (3) that the opposite conclusion may follow for an active trader (*Snyder*)[1272].... One also must acknowledge that *Higgins*, with its stress on examining the facts in each case, affords no readily helpful standard, in the usual sense, with which to decide the present case and others similar to it. The Court's cases, thus, give us results, but little general guidance.

Pointing out that the cases provide little guidance, *Groetzinger* said they provided "some helpful indicators" and reasoned:

> If a taxpayer, as Groetzinger is stipulated to have done in 1978, devotes his full-time activity to gambling, and it is his intended livelihood source, it would seem that basic concepts of fairness (if there be much of that in the income tax law) demand that his activity be regarded as a trade or business just as any other readily accepted activity, such as being a retail store proprietor or, to come closer categorically, as being a casino operator or as being an active trader on the exchanges.
>
> It is argued, however, that a full-time gambler is not offering goods or his services.... One might well feel that a full-time gambler ought to qualify as much as a full-time trader,[12] as Justice Brandeis in Snyder implied and as courts have held.[13] The Commissioner, indeed, accepts the trader result. Tr. Of Oral Arg. 17. In any event, while the offering of goods and services usually would qualify the activity as a trade or business, this factor, it seems to us, is not an absolute prerequisite.

> Less than three months later, the Court considered the issue of the deductibility, as business expenses, of estate and trust fees. In unanimous opinions issued the same day and written by Justice Black, the Court ruled that the efforts of an estate or trust in asset conservation and maintenance did not constitute a trade or business. *City Bank Farmers Trust Co. v. Helvering*, 313 U.S. 121 (1941); *United States v. Pyne*, 313 U.S. 127 (1941). The *Higgins* case was deemed to be relevant and controlling.

[1270] *Groetzinger* referred to *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911), about which *Groetzinger* commented:

> It said: " 'Business' is a very comprehensive term and embraces everything about which a person can be employed." 220 U.S., at 171. It embraced the *Bouvier Dictionary* definition: "That which occupies the time, attention and labor of men for the purpose of a livelihood or profit." *Ibid*. See also *Helvering v. Horst*, 311 U.S. 112, 1181 (1940). And Justice Frankfurter has observed that "we assume that Congress uses common words in their popular meaning, as used in the common speech of men." Frankfurter, Some Reflections on the Reading of Statutes, 47 Colum. L. Rev. 527, 536 (1947).

[1271] See fn. 1269 for the Court's discussion of these cases.

[1272] *Groetzinger* commented:

> *Snyder v. Commissioner*, 295 U.S. 134 (1935), had to do with margin trading and capital gains, and held, in that context, that an investor, seeking merely to increase his holdings, was not engaged in a trade or business. Justice Brandeis, in his opinion for the Court, noted that the Board of Tax Appeals theretofore had ruled that a taxpayer who devoted the major portion of his time to transactions on the stock exchange for the purpose of making a livelihood could treat losses incurred as having been sustained in the course of a trade or business. He went on to observe that no facts were adduced in Snyder to show that the taxpayer "might properly be characterized as a 'trader on an exchange who makes a living in buying and selling securities.' " *Id.*, at 139. These observations, thus, are dicta, but, by their use, the Court appears to have drawn a distinction between an active trader and an investor.

[12] "It takes a buyer to make a seller and it takes an opposing gambler to make a bet." Boyle, What is a Trade or Business?, 39 Tax Lawyer 737, 763 (1986).

[13] *Levin v. United States*, 597 F.2d 760, 765 (Ct. Cl. 1979); *Commissioner v. Nubar*, 185 F.2d 584, 588 (CA4 1950), *cert. denied*, 341 U.S. 925 (1961); *Fuld v. Commissioner*, 139 F.2d 465, 468-469 (CA2 1943). See also *Moller v. United States*, 721 F.2d 810 (CA Fed. 1983), *cert. denied*, 467 U.S. 1251 (1984); *Purvis v. Commissioner*, 580 F.2d 1332, 1334 (CA9 1976).

After specifically rejecting the idea that offering goods or services is a prerequisite for engaging in a "trade or business," *Groetzinger* concluded (highlighting added):

> Of course, not every income-producing and profit-making endeavor constitutes a trade or business. The income tax law, almost from the beginning, has distinguished between a business or trade, on the one hand, and "transactions entered into for profit but not connected with ... business or trade," on the other. See Revenue Act of 1916, § 5(a) Fifth, 39 Stat. 759. Congress "distinguished the broad range of income or profit producing activities from those satisfying the narrow category of trade or business." *Whipple v. Commissioner*, 373 U.S. 193, 197 (1963). We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.
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> It is suggested that we should defer to the position taken by the Commissioner and by the Solicitor General, but, in the absence of guidance, for over several decades now, through the medium of definitive statutes or regulations, we see little reason to do so. We would defer, instead, to the Code's normal focus on what we regard as a common-sense concept of what is a trade or business. Otherwise, as here, in the context of a minimum tax, it is not too extreme to say that the taxpayer is being taxed on his gambling losses,[15] a result distinctly out of line with the Code's focus on income.
>
> We do not overrule or cut back on the Court's holding in *Higgins* when we conclude that if one's gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business within the meaning of the statutes with which we are here concerned. Respondent Groetzinger satisfied that test in 1978. Constant and large-scale effort on his part was made. Skill was required and was applied. He did what he did for a livelihood, though with a less than successful result. This was not a hobby or a passing fancy or an occasional bet for amusement.
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> We therefore adhere to the general position of the *Higgins* Court, taken 45 years ago, that resolution of this issue "requires an examination of the facts in each case." 312 U.S., at 217. This may be thought by some to be a less-than-satisfactory solution, for facts vary. See Boyle, What is a Trade or Business?, 39 Tax Lawyer 737, 767 (1986); Note, The Business of Betting: Proposals for Reforming the Taxation of Business Gamblers, 38 Tax Lawyer 759 (1985); Lopez, Defining "Trade of Business" under the Internal Revenue Code: A Survey of Relevant Cases, 11 Fla. St. L. Rev. 949 (1984). *Cf.* Comment, Continuing Vitality of the "Goods or Services" Test, 15 U. Balt. L. Rev. 108 (1985). But the difficulty rests in the Code's wide utilization in various contexts of the term "trade or business," in the absence of an all-purpose definition by statute or regulation, and in our concern that an attempt judicially to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code. We leave repair or revision, if any be needed, which we doubt, to the Congress where we

feel, at this late date, the ultimate responsibility rests. *Cf. Flood v. Kuhn*, 407 U.S. 258, 269-285 (1972).[16]

[15] "The more he lost, the more minimum tax he has to pay." Boyle, 39 Tax Lawyer, at 754. The Commissioner concedes that application of the goods-or-services-test here "visits somewhat harsh consequences" on taxpayer Groetzinger, Brief for Petitioner 36, and "points to ... perhaps unfortunate draftsmanship." *Ibid*. See also Reply Brief for Petitioner 11.

[16] It is possible, of course, that our conclusion here may subject the gambler to self-employment tax, see §§ 1401-1403 of the Code, and therefore may not be an unmixed blessing for him. Federal taxes, however, rest where Congress has placed them.

Let's look at the requirement that "the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit." *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision) (footnote reproducing Code § 162(a) omitted below), seems to impose a higher standard:

> It is well settled, that in order to constitute the carrying on of a trade or business under section 162(a), the activity must "be entered into, in good faith, with the dominant hope and intent of realizing a profit, i.e., taxable income, therefrom." *Hirsch v. Commissioner*, 315 F.2d 731, 736 (9th Cir. 1963), *affg*. a Memorandum Opinion of this Court. See also *Hager v. Commissioner*, 76 T.C. 759, 784 (1981); *Golanty v. Commissioner*, 72 T.C. 411, 425 (1979), *affd*. without published opinion 647 F.2d 170 (9th Cir. 1981).

However, *Brannen* was decided before *Groetzinger* and *Groetzinger* is a higher court), so *Groetzinger* would control.

"The expectation of profit need not be reasonable, but the taxpayer must conduct the activity with the actual and honest objective of making a profit."[1273]

Brannen suggests that the regulations reproduced in part II.G.4.l.i.(c) Hobby Loss Benefits of Code § 183 are a good summary of the cases on this issue; see fn. 1287 in that part. However, no inference is to be drawn from the provisions of Code § 183 and the regulations thereunder that any activity of a C corporation is or is not a business or engaged in for profit.[1274]

[1273] *Robison v. Commissioner*, T.C. Memo. 2018-88, citing then reasoning further:

> *Hildebrand v. Commissioner*, 28 F.3d 1024, 1026-1027 (10th Cir. 1994), *aff'g Krause v. Commissioner*, 99 T.C. 132 (1992); *Keanini v. Commissioner*, 94 T.C. 41, 46 (1990). Because petitioners were the only partners in Robison Ranch, we need not separately determine the intent at the partnership level. Greater weight is given to objective facts than to a taxpayer's self-serving statement of intent. *King v. Commissioner*, 116 T.C. 198, 205 (2001); sec. 1.183-2(a) and (b), Income Tax Regs. Evidence from years subsequent to the years in issue is relevant to the extent it creates inferences regarding a taxpayer's requisite profit objective in earlier years. See *Hoyle v. Commissioner*, T.C. Memo. 1994-592; *Smith v. Commissioner*, T.C. Memo. 1993-140.

Barker v. Commissioner, T.C. Memo. 2018-67, stated:

> To be entitled to deductions under section 162, SoBe must have entered into the music business with the "actual and honest objective of making a profit." *Osteen v. Commissioner*, 62 F.3d 356, 358 (11th Cir. 1995), *aff'g* in part, *rev'g* in part T.C. Memo. 1993-519; *Dreicer v. Commissioner*, 78 T.C. at 645; see also sec. 183(c).

[1274] Reg. § 1.183-1(a).

Losses for 12 years, when the taxpayer was 65 years of age when starting the activity, did not disqualify the activity, in which he engaged full time, from constituting a business.[1275]

[1275] *Ellsworth v. Commissioner*, T.C. Memo. 1962-32, allowed the taxpayer to deduct losses. The taxpayer's testimony and corroborating expert testimony held persuade the court:

> Petitioner testified that he would not have reentered the breeding of dairy cattle in 1948 unless he "felt sure" he could make a profit, although, based on his past experience in breeding livestock, he realized that initial losses were inevitable since it would require about 10 to 15 years to develop superior strains in his Sybil cattle so that they would have substantial commercial value. Petitioner also ascribed his continuous losses from his farm enterprise in part to various causes such as climatic conditions, adverse effects on breeding establishments of artificial insemination, and economic depressions in the milk industry. Notwithstanding these latter factors, which were beyond his control, petitioner had more than a vain hope that a profit would result from his venture in the near future which would justify his expenditures.
>
> The record shows that petitioner's operation was conducted on an efficient, economical and sound scientific basis when compared to other breeding establishments; that the blood lines of his herd have been constantly improving; and that the prospects of making a profit from the sale of his cattle are considerably improved. Petitioner's expectation of realizing a profit in the very near future was corroborated by three experts in the breeding of livestock who testified, in general, as to the potential profit represented by petitioner's foundation herd, particularly in the "bull stud" market for use in artificial insemination establishments. J.F. Cavanaugh testified that petitioner's cattle "have arrived at a point where we think they would sell to good advantage." Likewise, Parodneck, another expert, testified that an individual who had a breeding herd during the taxable years involved, had "a reasonable expectancy of making a profit." We found their testimony in this respect convincing.

Although he had independent sources of income, he worked hard to minimize losses and set himself up for potential future profits:

> Admittedly, petitioner possessed an independent income and was not dependent on the success of the farm for a livelihood. He also may well have had pleasure from residing in a country home, but these facts alone do not negate his intent to operate the farm for profit. *Wilson v. Eisner*, 282 Fed. 38 (C.A. 2, 1922); *DuPont v: United States*, 28 F.Supp. 122, 124 (D. Delaware, 1939) (C.A. 2). Nor is such intent vitiated by the fact that petitioner received an annual income from dividends sufficient to offset substantial losses from his farm enterprise. No evidence was adduced that petitioner was indifferent to whether there was a loss or gain, or that the farm was an incident to the social or domestic aspects of his life. A substantial income from sources other than farming, or substantial sources of capital, was necessary as a basis for embarking on the farming project because of anticipated losses in the earlier years. We have no doubt upon the record that petitioner devoted himself assiduously to the economical operation of the farm with the reasonable hope of substantial future profits from the breeding operation. We further note that petitioner took affirmative steps to minimize losses derived in1958 by reducing his herd, terminating his lease of a neighboring farm and reducing his working area further by renting some of his acreage. We are satisfied that all of his activities at the farm were influenced by the ambition to produce a valuable strain of dairy livestock which would be commercially acceptable.
>
> That petitioner was about 65 years of age in 1948 when he commenced his selective breeding enterprise and would be 75 or 80 before he could make a profit, in our opinion, is not determinative of the issue. More significant, we believe, is the fact that he gave such attention to the farm as is usually given to a business enterprise. Apart from his annual vacation, petitioner devoted virtually all of his personal attention to supervising the farm operations, including a staff of several full time employees who assisted him. Petitioner, whose average working day on the farm was in excess of eight hours, performed all of the functions of a farm manager. During the taxable years involved, detailed records were kept of daily milk production, of statistics relating to the breeding activities of his livestock, and of income and expenses attributable to the operation of the farm. The farm was a well equipped establishment and was operated in a businesslike manner. We find, on the whole picture, that the farm operation was not carried on for the purpose of display, social diversion, or for the gratification of a personal whim. *Samuel Riker, Jr., Executor*, 6 B.T.A. 890, 893 (1927).

The court concluded:

> Considering all of the evidence we hold that petitioner carried on his farm activities, and particularly his breeding operations, on a commercial basis with the reasonable hope of making it profitable and not for his recreation, pleasure or other personal reason. Accordingly, the expenses in question are deductible under section 162(a), *supra*.

An individual who earns a living working 40 hours per week may also have a trade or business working another 30 hours per week, even if the other activity has not yet produced a product.[1276]

When a taxpayer invests in a partnership, the partnership's profit motive is determinative.[1277]

[1276] *Snyder v. U.S.*, 674 F.2d 1359 (10th Cir. 1982), stated that the taxpayer's profit motive is only significant under Code § 162 insofar as it affords a means of *distinguishing* between an enterprise carried on in good faith as a "trade or business" and an enterprise merely carried on as a hobby. It pointed out:

> A taxpayer is clearly not engaged in a trade or business if his predominant purpose is recreation or a hobby. See, *e.g.*, *Carkhuff v. Commissioner*, 425 F.2d 1400, 1404 (6th Cir. 1970); *Schley v. Commissioner*, 375 F.2d 747, 750 (2d Cir. 1967). On the other hand, an author may be in a trade or business within the meaning of section 162 if he "participated in that endeavor with a good faith expectation of making a profit." *Stern v. United States*, No. 70-782-HP (C.D. Cal. Mar. 26, 1971), 71-1 U.S. Tax. Cas. (CCH) ¶ 9375. The business need not yield an immediate profit. *Id*.

It also pointed out that it is more difficult to prove a business when activity is not the taxpayer's principal means of livelihood and is of a sporting or recreational nature, citing *Imbesi v. Commissioner*, 361 F.2d 640, 645 (3d Cir. 1966). It held:

> On remand, if the trial court finds taxpayer was primarily motivated by profit, the court must then determine whether taxpayer devoted sufficient time over a substantial enough period to be in a trade or business under section 162. If the trial court finds that taxpayer was not engaged in a trade or business in the relevant years, it must then determine whether the expenses were deductible under section 212 as ordinary and necessary expenses for the production of income.

[1277] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), stated:

> In order for a partnership to be entitled to a deduction for expenses attributable to a trade or business in computing its taxable income (or loss) under section 703(a), it must be established that the partnership engaged in the activity with the primary purpose and intent[14] of making a profit. *Hirsch v. Commissioner*, *supra* at 736; *Golanty v. Commissioner*, *supra* at 425; *Hager v. Commissioner*, *supra* at 784. Britton Properties need not have a reasonable expectation of profit, but the partnership must have the intent and objective of realizing a profit.[15] *Hirsch v. Commissioner*, *supra*; *Hager v. Commissioner*, *supra*; *Jasionowski v. Commissioner*, 66 T.C. 312, 321 (1976); *Bessenyey v. Commissioner*, 45 T.C. 261, 274 (1965), *affd*. 379 F.2d 252 (2d Cir. 1967).
>
> [14] While it may at first appear difficult to ascribe an "intent" to an entity such as the limited partnership herein, we have previously held that "It is the intent of the partnership and not that of any specific partner which is determinative in characterizing the income for purposes of taxation." *Podell v. Commissioner*, 55 T.C. 429, 433 (1970). See also *Miller v. Commissioner*, 70 T.C. 448, 456 (1978), where we looked to the "partnership's motives." In this same context, the taxpayer in *Estate of Freeland v. Commissioner*, 393 F.2d 573, 584 (9th Cir. 1968), *affg*. a Memorandum Opinion of this Court, argued that as a limited partner, the intent of the operating partners in the partnership should not be attributed to her. In rejecting this contention, the Second Circuit stated that while the limited partnership may have been an "investment" to her, the intent of the partnership controlled in determining whether the land owned by the partnership was property described in sec. 1221(1).
>
> [15] We recognize that the standard we have used was recently reviewed in *Dreicer v. Commissioner*, 665 F.2d 1292 (D.C. Cir. 1982), *revg. and remanding* a Memorandum Opinion of this Court. In *Dreicer*, the Circuit Court, after a review of the legislative history, concluded that the applicable standard is not whether the taxpayer had "a bona fide expectation" of profit but, rather, whether he engaged in the activity with the "objective" of making a profit. The Court correctly stated that sec. 1.183-2(a), Income Tax Regs., provides that the facts must indicate that the taxpayer entered into the activity with "the objective of making a profit." The difference in the standard of "objective of making a profit" and a "bona fide expectation" of making a profit might be merely one of semantics. In any event, the Circuit Court in the *Dreicer* case recognized, as this Court has in many cases, that an activity is not engaged in for profit if the taxpayer does not have the "objective" or "intent" of making a profit, and that the "objective" or "intent" of the taxpayer is a question of fact to be decided in each case from all the evidence of record.

Barker v. Commissioner, T.C. Memo. 2018-67, stated:

> We determine the existence of such an objective at the partnership level, *Brannen v. Commissioner*, 722 F.2d 695, 703-704 (11th Cir. 1984), *aff'g* 79 T.C. 471 (1992), and "we focus on the intent of the general partner … since it is [this] individual[] who actually controlled the partnership's activities", *Fuchs v. Commissioner*, 83 T.C. 79, 98 (1984).

However, if the taxpayers are the only partners, one can look directly to their situation. See fn 1273.

Although an individual holding property for the production of income must look to Code § 212 rather than Code § 162,[1278] a corporation appears able to use Code § 162 to deduct expenses related to the production of income, as illustrated by Rev. Rul. 78-195:

> A corporation that was formed for the express purpose of investing in real property purchased a tract of unimproved, non-income-producing real property, which it held for two years and sold without having made any substantial improvements. The corporation did not make any significant efforts to sell the property and did not engage in any other transactions in real or personal property or in other commercial activities. During the period that it held the property, the corporation incurred expenses for interest, real property taxes, accounting fees, and general office costs.
>
> *Held*, the accounting fees and general office costs are expenses related to investment property of the corporation and are deductible by the corporation under section 162 of the Internal Revenue Code of 1954 in the year in which paid or incurred. The interest and real property taxes are deductible by the corporation under sections 163 and 164 of the Code, respectively. See section 266 and the Income Tax Regulations thereunder regarding amounts which may be charged to capital account.

II.G.4.l.i.(b). Requirements for Deduction Under Code § 212

Subject to the various limitations provided in the preceding parts of part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner and subject to other limitations on what can be deducted, Code § 212 allows an individual to deduct:

> all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or
>
> (3) in connection with the determination, collection, or refund of any tax.

However, the activity need not produce a profit for the deductions to be allowable under Code § 212.[1279]

[1278] See part II.G.4.l.i.(d) Whether Managing Investments Constitutes a Trade or Business, especially fns 1313-1314.

[1279] Reg. § 1.212-1(b) provides:

> The term "income" for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter paid or incurred in connection with such bonds are deductible. Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.

On the other hand, Reg. § 1.212-1(c) provides that:

> In the case of taxable years beginning before January 1, 1970, expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case. For example, consideration will be given to the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer. For provisions relating to activities not engaged in for profit applicable to taxable years beginning after December 31, 1969, see section 183 and the regulations thereunder.

Another issue is whether fees are "ordinary and necessary" expenses for investment advice allowable under Code § 212 or are nondeductible capital expenses. In resolving this issue, *Honodel v. Commissioner*, 76 T.C. 351 (1981), held:[1280]

> … we "look to the nature of the services performed" by the investment adviser rather than "their designation or treatment" by the taxpayer.[5] *Cagle v. Commissioner*, 63 T.C. 86, 96 (1974), *affd*. 539 F.2d 409 (5th Cir. 1976), and the cases cited therein. Our inquiry focuses on whether the services were performed in the process of acquisition or for investment advice. See generally *Woodward v. Commissioner*, *supra* at 577.
>
> [5] Petitioners urge us to apply the origin-of-the-claim test first specifically propounded by the Supreme Court in *United States v. Gilmore*, *supra* at 49. See *Reed v. Commissioner*, 55 T.C. 32, 39-40 (1970), and the cases cited therein. The Supreme Court in *Woodward v. Commissioner*, 397 U.S. 572, 577-578, applied the "origin" test in holding that litigation expenses incurred in connection with appraisal proceedings had their origin in the "process of acquisition" and were therefore nondeductible capital expenditures. The Court stressed that the taxpayer's motive or purpose would not be considered. Therefore, in the case at issue herein, we follow the Supreme Court's guidance in ignoring each petitioner's "motive or purpose." We adopt an inquiry consistent with that of the Supreme Court by looking at the nature of the services performed (the origin of the fee) in determining whether such services are rendered in the process of acquisition.

The court summarized the facts and applied this rule:

> The "nature of the services performed" by FMS for its clientele, including petitioners, may be summarized quite simply. In periodic planning sessions, FMS evaluated and analyzed each petitioner's personal, financial, and tax status, elicited objectives and proposed investment programs in light of those objectives. Further, FMS analyzed numerous investment opportunities presented to it by outside brokers in the process of selecting the projects under our consideration. In evaluating these investments, FMS utilized the services of outside counsel for legal and tax advice. FMS, through its agents and outside contractors, negotiated the purchase of these investments and prepared the legal documentation, including the limited partnership agreement,

[1280] The quote below refers to *Woodward v. Commissioner*, 397 U.S. 572, 575 (1970), *affg*. 410 F.2d 313 (8th Cir. 1969), which *affd*. 49 T.C. 377 (1968).

necessary to consummate the transaction. The potential investments that met with the approval of FMS were recommended to petitioners who had the option to invest if they so desired.

The complexity, or should we say perplexity, resulting from this factual web arises because of the dual nature of FMS's function: (1) An advisory function and (2) an acquisition function. Respondent contends that the acquisition function was all encompassing in arguing as follows:

> the evidence shows that Clark [FMS] identifies suitable investment projects, forms limited partnerships which he then causes to purchase the projects, and finally sells the units of limited partnership to his clients at a fixed price per unit… Accordingly, viewed from the end result and the manner in which the fees are charged, it appears they represent nothing more than part of the cost of acquiring partnership interests, or represent commissions for Clark's services in putting the project together….

We disagree with respondent because he fails to focus on the "nature of the services performed" by FMS, as required in *Cagle v. Commissioner*, *supra*. Instead, respondent incorrectly points to the end result or consequence of such services.

We find that those services provided by FMS relating to (1) periodic planning sessions and (2) the evaluation of potential investments to the extent needed to formulate an opinion regarding such investments were investment advice. In addition, those services performed by FMS in communicating its recommendations to petitioners were investment advice. Conversely, those services rendered in the "process of acquisition" including, but not limited to, negotiating the purchase and creating the investment vehicle were capital in nature. See *Kimmelman v. Commissioner*, 72 T.C. 294, 304-305 (1979); section 741.

FMS adopted a two-tier fee schedule: (1) A monthly retainer fee and (2) an investment fee. We now must examine the nature of each of these fees to determine if they are allocable to currently deductible investment advice or to capitalizable acquisition costs. Generally, petitioners paid a monthly retainer fee whether or not they invested in a project recommended to them by FMS. Spence Clark testified that FMS "had doctor clients pay us for two or three years, without receiving an investment and they may have … paid \$5,000.00, \$10,000.00, \$20,000.00, \$30,000.00 in fees, and still not invested." Only those clients who decided to invest in a recommended project an took advantage of FMS's acquisition function paid the investment fees. Those clients who chose not to invest and hence were not required to pay the investment fee received the exact same investment services as those who chose to invest. Conversely, petitioners could only participate in an investment if they paid the investment fee. Each petitioner voluntarily could choose to invest in the projects. Each was cognizant of the fact that a decision to invest resulted in the imposition of this investment fee. This investment fee was a cost of acquiring an interest in the limited partnership projects herein.

Based upon this reasoning, we hold that the monthly retainer fees paid by petitioners are allocable to investment advice and are therefore deductible under section 212(2). Further, we find that the investment fees paid by petitioners are nondeductible capital expenditures incurred in connection with the acquisition of partnership interests and are includable in their bases.[6] See sec. 742. Our holding is consistent with that of the Court of Claims in *Picker v. United States*, 178 Ct.Cl. 445, 371 F.2d 486, 499 (1967). In *Picker*, the Court of Claims found that fees were paid for a recommendation that was not utilized in the acquisition of a capital asset. The court held that such fees were paid for investment counsel and therefore were deductible under section 212(2).

[6] We are assuming that the cattle investment and the Glendale Shopping Center investment (see table at pp. 359-360) were in partnership form. The fees paid for these investments are therefore treated consistently with the fees paid for the apartment projects. In any case, the form of the investment will not affect our result.

II.G.4.l.i.(c). Hobby Loss Benefits of Code § 183

Code § 183(a) provides:

> *General rule*. In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

Code § 183 also applies to deductions passing through a partnership.[1281]

Where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may constitute one activity.[1282] Income and deductions would be allocated between activities.[1283] Reporting activities on separate schedules (for example, one on Schedule C and another on

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[1281] Rev. Rul. 77-320 concluded:

> *Held*, section 183 of the Code applies to the activities of a partnership, and the provisions of section 183 are applied at the partnership level and reflected in the partners' distributive shares.

See *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), quoted in fn. 1310. But the Fifth Circuit may have a different view, having stated in *Copeland v. Commissioner*, 290 F.3d 326 (2002) (but correctly pointing out how Code § 183 is sometimes incorrectly referred to as disallowing deductions):

> The Tax Court's wording to the contrary notwithstanding, however, the deductions were not actually disallowed under I.R.C. § 183, but under I.R.C. §§ 162 and 174, neither of which are limited — as is § 183 — to activities engaged in by individuals and S corporations, to the exclusion of partnerships.[26] I.R.C. § 183 provided the *Krause* court with only the factors for analysis, not statutory authority to allow or disallow deductions themselves. To say that the deductions are disallowed "under section 183" impermissibly conflates the I.R.C. sections in question and thereby glosses over this crucial distinction.
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> [26] Even the Commissioner recognizes this limitation in his appellate brief when he states (emphasis ours): "The regulations under § 183 list a number of factors relevant to the determination of profit motive, and those factors have frequently been applied by the courts in determining whether a profit motive exists for all sorts of entities, including partnerships and corporations, *to which the limitations on deductibility of § 183 do not apply*."

[1282] Reg. § 1.183-1(d)(1), which provides further:

> In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account. Generally, the most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various undertakings. Generally, the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities. The taxpayer's characterization will not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case. If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying section 183. Where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value. Thus, the farming and holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land).

[1283] Reg. § 1.183-1(d)(2) provides:

Schedule F) is an admission that the taxpayer views the activities as separate, requiring the taxpayer to overcome a high hurdle to establish that the undertakings were a single activity.[1284]

Code § 183(c) provides:[1285]

> *Activity not engaged in for profit defined*. For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

Thus, Code § 183 "is not a disallowance provision, but rather an allowance provision which operates only when the taxpayer's expenses are not allowable as deductions under section 162(a) or 212(1) and (2)," and "the profit motive analysis must be resolved *before* turning to section 183."[1286] However, courts often conflate Code §§ 162 and 183 and jump directly to whether a profit motive exists under Code § 183, presumably because a finding of profit motive under Code § 183 means that one does not need to consider a profit motive under Code § 162.

Code § 183(d) presumes an activity is engaged in for profit if it is profitable for a particular number of years. If the presumption does not apply, then Reg. § 1.183-2(b) kicks in [footnotes in the long quote below are mine, elaborating on each factor]:[1287]

> *Relevant factors*. In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account.[1288] No one factor is

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> *Rules for allocation of expenses*. If the taxpayer is engaged in more than one activity, an item of deduction or income may be allocated between two or more of these activities. Where property is used in several activities, and one or more of such activities is determined not to be engaged in for profit, deductions relating to such property must be allocated between the various activities on a reasonable and consistently applied basis.

[1284] *Den Besten v. Commissioner*, T.C. Memo. 2019-154, citing for the admission issue *Topping v. Commissioner*, T.C. Memo. 2007-92, 2007 WL 1135339, at *9 (citing *Mendes v. Commissioner*, 121 T.C. 308, 312 (2003), and *Estate of Hall v. Commissioner*, 92 T.C. 312, 337-338 (1989)).

[1285] Reg. § 1.183-1(a) reinforces this predicate by including:

> Whether an activity is engaged in for profit is determined under section 162 and section 212(1) and (2) except insofar as section 183(d) creates a presumption that the activity is engaged in for profit.

[1286] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision) (emphasis in original), quoted in fn. 1310. However, courts often fail to consider Code § 162 before turning to a Code § 183 analysis; for example, *Boneparte v. Commissioner*, T.C. Memo. 2017-193, correctly contrasted the consequences of being a professional gambler with being a casual gambler and dove right into Code § 183 with even mentioning Code § 162 (but the taxpayer, who was a toll bridge operator, prepared his own returns and represented himself in Tax Court, so the lack of rigor is not surprising).

[1287] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), held that:

> since the regulation is not unreasonable and plainly inconsistent as it deals with a specific issue raised in section 183 which requires a determination before that section is applicable, it should be given full force and effect. See *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 (1948). In addition, since many of the statements in the regulation, including the relevant factors listed, were derived from case law decided prior to the enactment of section 183, it is clear that the standards used in determining whether a profit motive exists for purposes of section 162 or 212 have remained the same. See *Jasionowski v. Commissioner*, *supra* at 321-322; *Benz v. Commissioner*, 63 T.C. 375, 383 (1974).

[1288] *Robison v. Commissioner*, T.C. Memo. 2018-88, stated:

> All facts and circumstances are to be taken into account, and no single factor or mathematical preponderance of factors is determinative. *Westbrook v. Commissioner*, 68 F.3d at 876; *Hildebrand v. Commissioner*, 28 F.3d at 1027. We address the most relevant factors in determining petitioners' intent.

After considering the factors in fns 1289, 1290, 1291, 1294, 1297, and 1300, the court concluded:

> This is a very close case, and our determination for the years in issue is limited to the facts found for those years. After weighing all the facts and circumstances in the light of the relevant factors, we conclude that petitioners engaged in their ranching activity for the years in issue with the requisite profit objective. Petitioners' activities cannot be

determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:

(1) *Manner in which the taxpayer carries on the activity*. The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit.[1289] Similarly, where an activity is carried on

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characterized as a "hobby" during those years. Petitioners' efforts to reduce Robison Ranch's expenses and the resulting decrease in petitioners' net losses during the years in issue are most persuasive. Accordingly, we reject respondent's disallowance of the loss deductions relating to the ranching activity under section 183.

[1289] *Robison v. Commissioner*, T.C. Memo. 2018-88, included the following reasoning:

Carrying on an activity in a businesslike manner, such as by maintaining complete and accurate books and records, conducting the activity in a manner similar to other activities of the same nature that are profitable, and making changes in operations to adopt new techniques or abandon unprofitable methods, is a factor that may indicate a profit objective. Sec. 1.183-2(b)(1), Income Tax Regs. Businesslike conduct is characterized by careful and thorough investigation of the profitability of a proposed venture, monitoring of a venture in progress, and attention to problems that arise over time. See *Ronnen v. Commissioner*, 90 T.C. 74, 93 (1988); *Taube v. Commissioner*, 88 T.C. 464, 481-482 (1987).

While a taxpayer need not maintain a sophisticated cost accounting system, the taxpayer should keep records that enable the taxpayer to make informed business decisions. See *Burger v. Commissioner*, 809 F.2d 355, 359 (7th Cir. 1987), *aff'g* T.C. Memo. 1985-523. For a taxpayer's books and records to indicate a profit motive, the books and records should enable a taxpayer to cut expenses, increase profits, or evaluate the overall performance of the operation. See *Abbene v. Commissioner*, T.C. Memo. 1998-330. Petitioners kept many financial and administrative records, such as weekly meeting minutes, employment contracts, payroll tax returns, insurance policies and payments, and formal leases for employees who lived on Robison Ranch.

Although petitioners' records were voluminous, respondent argues that petitioners' administrative and financial recordkeeping was more akin to a conscious attention to detail than to something used to analyze expenses or improve profitability. See *Golanty v. Commissioner*, 72 T.C. 411, 430 (1979), *aff'd*, 647 F.2d 170 (9th Cir. 1981). Petitioners contend that R. Robison used QuickBooks' profit and loss statements to monitor the ranch's finances and cut costs. We believe petitioners used them for the important purposes of cutting expenses, increasing profits, and evaluating the overall performance of the operation. See *id*. However, there is no evidence that they used them to create budgets or make income projections, which would have been advantageous and further indicative of operating in a businesslike manner. *See Keating v. Commissioner*, 544 F.3d 900, 904 (8th Cir. 2008), *aff'g* T.C. Memo. 2007-309; *Foster v. Commissioner*, T.C. Memo. 2012-207, slip op. at 14….

Respondent also argued that petitioners had no written business plan for Robison Ranch. Numerous court opinions mention that a businesslike operation often would involve a business plan. *See*, *e.g.*, *Wesinger v. Commissioner*, T.C. Memo. 1999-372. Petitioners retroactively created business plans for the years in issue, which were largely narratives of the actions petitioners took during those years. The fact that petitioners had no written business plan does not negate a profit motive, as a business plan can be evidenced by actions. *See Annuzzi v. Commissioner*, T.C. Memo. 2014-233, at *16; *Phillips v. Commissioner*, T.C. Memo. 1997-128 (stating that written financial plan not required for 32-horse farm where business plan was evidenced by action). Nevertheless, a business plan likely would have aided petitioners in creating analyses for the future financial management or planning of the activity. *See Foster v. Commissioner*, T.C. Memo. 2012-207, slip op. at 14.

Maintaining an additional bank account for the activity separate from a taxpayer's personal finances is indicative of an activity being carried on in a businesslike manner. *See Wayts v. Commissioner*, T.C. Memo. 1992-82 (finding horse racing and breeding activity was carried on in a businesslike manner because it had a separate bank account) (citing *Pryor v. Commissioner*, T.C. Memo. 1991-109). Petitioners' separate maintenance of their personal finances and Robison Ranch's are indicative of operating in a businesslike manner.

Perhaps the most important indication of whether an activity is being performed in a businesslike manner is whether the taxpayer implements methods for controlling losses, including efforts to reduce expenses and generate income. *See Dodge v. Com missioner*, T.C. Memo. 1998-89, *aff'd* without published opinion, 188 F.3d 507 (6th Cir. 1999). Petitioners contend that they made changes to their operating methods, adopted new techniques, and abandoned unprofitable methods that contributed to their losses. The record supports this contention. Petitioners made changes in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.[1290]

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in their ranching activity when they realized that certain operations would not be profitable, changing Robison Ranch's operation two times - from Paint Horses, to Quarter Horses, to a registered cattle herd. *Cf. Williams v. Commissioner*, T.C. Memo. 2018-48, at *24-*25 (finding cattle operation was not carried on in a businesslike manner because taxpayer did not make changes or transition his operation for 10 years despite continued losses).

Similarly, *Den Besten v. Commissioner*, T.C. Memo. 2019-154, held that the taxpayer had a qualified business plan:

> While petitioner's plan was not formally written, it can be inferred, from his deliberate actions to achieve a narrowly focused goal, that he did have a plan.

Den Besten also held that the taxpayer's failure to maintain formal accounting records was not fatal, when the taxpayer kept sufficient receipts to substantiate his income and deductions:

> The records petitioner maintained were consistent with his business profit objective and enabled him to make educated business decisions about his cutting horse activity.

The taxpayer's advertising efforts and results also impressed the *Den Besten* court:

> A taxpayer may further exhibit his profit objective by the manner in which he advertises his business. A single form of substantial advertisement itself may not establish that a taxpayer has carried on his activity in a businesslike manner. See *McKeever v. Commissioner*, T.C. Memo. 2000-288; *Cohn v. Commissioner*, T.C. Memo. 1983-301, 1983 Tax Ct. Memo LEXIS 486, *aff'd*, 742 F.2d 1432 (2d Cir. 1984). Different kinds of advertising media may allow the taxpayer "[t]o expand … [his] potential market and to attract new individuals". *Cohn v. Commissioner*, 1983 Tax Ct. Memo LEXIS 486, at *22. Horse shows may be an effective advertising method. See *Engdahl v. Commissioner*, 72 T.C. at 662-663; *Dodge v. Commissioner*, T.C. Memo. 1998-89.
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> Petitioner displayed banners at competition events advertising both his seed business and his cutting horse activity, and he had advertisements in printed programs and sales catalogs. Petitioner sold advertisement items such as blankets and belt buckles marked with his brand name and talked with people across the nation regarding his horses, all of which resulted in sales, breeding, and training opportunities. Petitioner marked his operation with his own unique brand. He used his brand on advertisement items, in production sales catalogs, and even on some of the horses he bred.

[1290] *Robison v. Commissioner*, T.C. Memo. 2018-88, included the following reasoning:

> Petitioners hired professionals to manage Robison Ranch, employing a full-time ranch manager and a ranch hand during the years in issue, both of whom lived on site. Petitioners also conducted weekly meetings with Robison Ranch employees. While Dahl was not an expert in registered Angus cattle ranching, nor had he managed a ranch previously, he was experienced in cattle ranching, having been raised on an unregistered cattle ranch. Further, petitioners made use of a local veterinarian who was an expert regarding brisket disease and the effects of high altitudes on cattle. This factor favors petitioners.

A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Hendricks v. CIR*, 32 F3d 94, 98 (4th Cir. 1994) (physician's farm sustained losses in 20 of 21 years of operation; lack of profit motive evidenced by taxpayer's knowledge "of steps he might have taken, but failed to take, to improve the farm's profitability"); *Holmes v. CIR*, 74 TCM (CCH) 494 (1997) (farm found not to be carried on for profit because, among other things, taxpayers failed to keep records in businesslike way; negligence penalty sustained; extensive analysis); *Elliott v. CIR*, 90 TC 960, 973 (1988), *aff'd* without opinion, 899 F2d 18 (9th Cir. 1990) (Amway distributors not engaged in business for profit where they "made some small modifications in their routine social life [on entering the business], kept cursory notes about their activities, and claimed deductions for the cost of nearly everything they owned or did"; negligence penalty imposed); *Allen v. CIR*, 72 TC 28 (1979) (taxpayers operated ski lodge in businesslike manner, experimenting with different modes of operating it in hope of making profit); *Lyon v. CIR*, 36 TCM (CCH) 979 (1977) (failure to maintain records and unbusinesslike approach; activity not "engaged in for profit"); Lee, *supra* note 8, at 397–407. Compare *Rozzano v. CIR*, 94 TCM (CCH) 29 (2007) (holding horse farm was run for profit, notwithstanding large losses annually for eight years, largely because operation was carried on in business-like manner).

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974).

Den Besten v. Commissioner, T.C. Memo. 2019-154, held that the taxpayer's change of operating methods indicated a profit objective:

(2) *The expertise of the taxpayer or his advisors*. Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices.[1291] Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.[1292]

After his championships in 1997 and 1998, petitioner acquired and remodeled the Yellow Rose, expanding his operation. This significant acquisition enabled him to expand into hosting cutting horse competitions and production sales. It also increased his boarding and training capacities. He sold his seed business in order to increase the effort and time he needed to coordinate these efforts and to train potential foals. The Court concludes these actions are strongly indicative of petitioner's having a profit motive during this timeframe preceding the years in issue. The actions are consistent with an intent to improve profitability through new operating methods.

Even though petitioner owned and operated the Yellow Rose outside the years in issue, he recognized he had to sell it to generate time and capital to save the seed business. Petitioner reduced his operation on the basis of economic realities and entered into a winding-down period with respect to the cutting horse activity. Petitioner's realization he needed to scale down his operation is also indicative of a profit motive.

[1291] *Robison v. Commissioner*, T.C. Memo. 2018-88, included the following reasoning:

S. Robison has a family background in ranching and farming although he had never previously operated a ranch. Petitioners consulted with persons who were knowledgeable about ranching, including a ranch attorney, other ranch owners, trainers and breeders, and their veterinarian. *See Givens v. Commissioner*, T.C. Memo. 1989-529 (a profit objective was indicated where the taxpayer sought and acquired advice in all aspects of Tennessee Walking Horse breeding from experienced owners, trainers, and a veterinarian). Petitioners also sought advice regarding the business elements of starting Robison Ranch from their accountant. In the face of mounting losses, it would have been prudent to seek further business advice; however, we believe this factor favors petitioners.

Den Besten v. Commissioner, T.C. Memo. 2019-154, recognized the taxpayer's demonstrated expertise:

Petitioner has a high level of expertise in the care, training, and competing of cutting horses, including their feeding, breeding, foaling, training, competing, and selling. His efforts resulted in two champion cutting horses and at least eight futurity prospects. His production sales attracted national attention. He offered purchases by telephone, and consignors traveled to list their horses in his production sales. In addition, he had a network of trainers to assist him. Petitioner had been a respected businessman in a related business for years.

However, *Whatley v. Commissioner*, T.C. Memo. 2021-11 required expertise to be relevant and substantial: Whatley also has no experience operating a timber farm like the one at Sheepdog Farms. We do acknowledge his argument that his foray into the business at the age of 27 should weigh in his favor. But we don't think it should weigh very much—it was over 35 years ago, and his business was different. Sheepdog Farms is reportedly a timber farm. The business Whatley ran as a young man bought and logged timber that was ready to harvest. These businesses may be in the same general field, but timber harvesting and timber growing are not similar enough for us to find that Whatley had experience in the business.[13]

[13] Whatley also argues that he has experience in the field because he lends money to timber farmers through his bank. We are unconvinced. People don't go to a mechanic's banker to fix their cars - they go to a mechanic.

[1292] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

See *DeMattia v. CIR*, 75 TCM (CCH) 1903, 1906 (1998) (retired dentist's sponsorship of son's professional golf career not conducted in businesslike manner; no "goals or financial conditions," no prior investigation of profit potential, and no separate records); *Taras v. CIR*, 74 TCM (CCH) 1388, 1395 (1997) ("Petitioners initiated their activity [horse racing] without developing a business plan commensurate with that which would be expected from someone who was motivated primarily by a profit objective"); *Lucid v. CIR*, 73 TCM (CCH) 2892 (1997) (no profit motive for business of selling yachts; no business plan or training or experience in business; negligence penalty sustained); *Benz v. CIR*, 63 TC 375 (1974) (taxpayer was "relative novice"; breeding activity was hobby); Lee, *supra* note 8, at 407–412. *Taras* has been affirmed by an unpublished opinion, 187 F3d 627 (3d Cir. 1999) .

The citation to Lee is to Lee, "A Blend of Old Wines in a New Wineskin: Section 183 and Beyond," 29 Tax L. Rev. 347 (1974). *Ford v. Commissioner*, T.C. Memo. 2018-18, found no profit motive, starting its criticism of the taxpayer:

She had no expertise in club ownership, maintained inadequate records, disregarded expert business advice, nonchalantly accepted Bell Cove's perpetual losses, and made no attempt to reduce expenses, increase revenue, or improve Bell Cove's overall performance.

(3) *The time and effort expended by the taxpayer in carrying on the activity*. The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.[1293]

(4) *Expectation that assets used in activity may appreciate in value*. The term "profit" encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity

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[1293] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Hawkins v. CIR*, 38 TCM (CCH) 469 (1979) (publication of book of poetry not for profit; no evidence of continuous or repeated activity in literary field or intent to write with substantial regularity); Lee, *supra* note 8, at 412–416. But see *Cornfeld v. CIR*, 797 F2d 1049, 1052 (DC Cir. 1986) ("to have an honest profit objective a taxpayer need not run the business himself or have expertise in it; it suffices that he engage those who do"); *Nickerson v. CIR*, 700 F2d 402, 407 (7th Cir. 1983) (taxpayer engaged in farming for profit even though he had another full-time job and spent only spare time on farm; taxpayer's efforts were "prodigious" and farm did not provide recreation); *Perry v. CIR*, 74 TCM (CCH) 616 (1997) (taxpayers' horse breeding operation was for profit, even though taxpayers were both employed full-time in other jobs, because they had knowledge and experience needed for success).

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974). *Ford v. Commissioner*, T.C. Memo. 2018-18, found no profit motive, concluding its criticism of the taxpayer:

> Owning Bell Cove elevated petitioner's status in the country music community, allowed her to further the careers of young performers, offered her weekly opportunities to interact with country music fans, and satiated her love promoting country music. Petitioner earnestly devoted time and energy to Bell Cove but was primarily motivated by personal pleasure, not profit, and simply used the club's losses to offset her trust and capital gain income. See *Bessenyey v. Commissioner*, 45 T.C. 261, 275 (1965), *aff'd*, 379 F.2d 252 (2d Cir. 1967); sec. 1.183-2(b)(3), (8), (9), Income Tax Regs.

Den Besten v. Commissioner, T.C. Memo. 2019-154, held that the taxpayer's efforts were ample:

> ... When evaluating the time and effort a taxpayer dedicated to horse activities, the relevant inquiry is the amount of time and effort contributed above and beyond the amount generally required to sustain a hobby. *Betts v. Commissioner*, T.C. Memo. 2010-164.
>
> During the years in issue petitioner spent a considerable amount of time breeding approximately 12 mares per season, delivering the foals, and performing veterinary work on his horses as needed. Petitioner had engaged in an extensive stallion service contracts for live cover breeding program, which required vigilance through the mares' breeding cycles and careful physical control of the stallions during mating. Petitioner's dedication to the oversight of the successful breeding program extend well beyond that of a mere hobbyist.
>
> While unforeseen events forced petitioner to scale back his activities, the Court cannot overlook the size and depth of his cutting horse activity leading up to the years in issue.

together with the appreciation of land will exceed expenses of operation.[1294] See, however, paragraph (d) of § 1.183-1 for definition of an activity in this connection.[1295]

(5) *The success of the taxpayer in carrying on other similar or dissimilar activities*. The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.[1296]

[1294] *Robison v. Commissioner*, T.C. Memo. 2018-88, included the following reasoning:

> However, a profit objective may be inferred from such expected appreciation of the activity's assets only where the appreciation exceeds operating expenses and is sufficient to recoup the accumulated losses of prior years. *See Golanty v. Commissioner*, 72 T.C. at 427-428; *Hillman v. Commissioner*, T.C. Memo. 1999-255.
>
> Respondent argues that petitioners' objective must include recoupment of all of Robison Ranch's past losses. This expectation is too high. *See Welch v. Commissioner*, at *35. "An overall profit is present if net earnings and appreciation are sufficient to recoup the losses sustained in the "intervening years: between a given tax year and the time at which future profits were expected." *Helmick v. Commissioner*, T.C. Memo. 2009-220, slip op. at 27 (citing *Bessenyey v. Commissioner*, 45 T.C. 261, 274 (1965), *aff'd*, 379 F.2d 252 (2d Cir. 1967)). Therefore, the question is not whether petitioners would recoup all of Robison Ranch's losses but whether they would recoup the losses between the years in issue and the "hoped-for profitable future." *See id.* at 28.
>
> Petitioners did not provide a valuation of Robison Ranch. There is not enough evidence in the record to determine the current value of or petitioners' adjusted basis in the ranch property, and we are therefore unable to determine the amount of appreciation, if any. Accordingly, this factor is neutral.

[1295] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Bolaris v. CIR*, 776 F2d 1428 (9th Cir. 1985) (depreciation and operating expense deductions allowed for former principal residence that was rented pending sale; profit motive can exist even if gain on sale qualifies for nonrecognition); *Thompson v. US*, 90-1 USTC ¶ 50,043 (D. Conn. 1989) (in determining whether horse breeding operation was carried on for profit, jury could consider possibility of appreciation in value of land used in operation); *Dickson v. CIR*, 47 TCM (CCH) 509 (1983) (expectation of profit from appreciation in value of sailboat was major factor in finding boat chartering activity was for profit); Lee, *supra* note 8, at 416–418. But see *Jasionowski v. CIR*, 66 TC 312 (1976) (taxpayer's expectation of capital gains upon eventual sale of property not sufficient to supply profit motive for current lease of the property).

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974). Another footnote in Bittker & Lokken says:

> See *Landry v. CIR*, 86 TC 1284, 1306 (1986) (rejecting IRS's argument that § 183 applies where, notwithstanding conceded expectation of profit in the long run, intention to profit during the taxable year was lacking; § 183 inapplicable if taxpayer "intended to make a profit within a reasonable time"); *Lemmen v. CIR*, 77 TC 1326 (1981) (*acq*.) (expectation of profit from herd of breeding cattle over long range established).

Ford v. Commissioner, T.C. Memo. 2018-8, at fn 7 cited this regulation to add weight to its conclusion of no profit motive, pointing out:

> Further, Bell Cove's $420,253 of accumulated losses exceeded its $383,900 of appreciation.

[1296] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), cites Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347, 418-420 (1974).

After reciting the factors in Reg. § 1.183-2(b), *Barker v. Commissioner*, T.C. Memo. 2018-67, held:

> The totality of the facts and circumstances indicate that petitioner- SoBe's CEO and managing member—operated SoBe as a trade or business with the "actual and honest objective of making a profit." See *Osteen v. Commissioner*, 62 F.3d at 358. Petitioner had prior business successes in the music industry - he founded Peaches & Herb and co-produced a Grammy-winning song for Gladys Knight & the Pips - and he ran successful defense contracting businesses, having helped to turn one of them around after several years without a profit. Petitioner leveraged his prior experience and contacts in the music industry as he prepared for SoBe's formation and he ran SoBe in a businesslike manner, working there full time. He also devoted significant capital to make it a profitable business. While SoBe was not profitable from its founding in 2002 through 2011 - nor, indeed, through the time of trial - petitioner testified that SoBe positioned itself well to make a profit by amassing a catalog of songs that it has been

(6) *The taxpayer's history of income or losses with respect to the activity*. A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit.[1297] If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.[1298]

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able to monetize. Petitioner also convincingly testified about the turmoil in the music industry and the difficulties faced by artists and producers over the years in issue.

The fact that petitioner's son, Yannique, was one of SoBe's signed artists and that SoBe had advanced him the costs of recording, producing, and promoting his music does not mean that SoBe was merely a vehicle to fund Yannique's musical aspirations or that SoBe had no profit objective. SoBe had other artists; it did not devote most of its resources to Yannique. We also conclude that the other facts favoring characterization as a hobby, such as the fact that petitioner enjoyed the creative aspects of the music industry and had income from other sources and that SoBe had yet to make a profit as of trial, are outweighed by the facts indicating a profit motive.

Thus, we conclude for years 2003 through 2011 that SoBe is a trade or business and is eligible to claim deductions under section 162.

Den Besten v. Commissioner, T.C. Memo. 2019-154, discussed how experience in one business informed his conduct of the activity in question:

A taxpayer's success in other business ventures may indicate that the taxpayer has the entrepreneurial skills and determination to succeed in subsequent endeavors. This in turn may help demonstrate that his present objective is profit. Sec. 1.183-2(b)(5), Income Tax Regs.; see also *Rabinowitz v. Commissioner*, T.C. Memo. 2005-188; *Daugherty v. Commissioner*, T.C. Memo. 1983-188. A court can infer that a taxpayer's diligence, initiative, foresight, and other qualities will generally lead to success in other business activities if he has demonstrated those qualities by starting his own business and turning that business into a relatively large and profitable enterprise. See *Daugherty v. Commissioner*, T.C. Memo. 1983-188.

Petitioner successfully operated his seed business. In 2002 he sold the business to his son for approximately $4.3 million. After his son encountered financial difficulties, petitioner returned to the seed business once again, turning it into a profitable business.

The cutting horse activity is altogether different from the seed business, but the potential consumer audience in the agricultural setting is substantially similar. Petitioner advertised both businesses to a joint audience at horse competitions. He was using the business acumen acquired from operating the seed business to grow his brand and cutting horse activity. Because petitioner was successful in the seed business, the Court finds this factor favors his having a profit objective.

[1297] *Robison v. Commissioner*, T.C. Memo. 2018-88, included the following reasoning:

Petitioners realized no profits whatsoever in 16 years of engaging in their ranching activity…. the years in issue are beyond the startup stage.

Further, despite reduced expenses and increased profits during the years in issue, petitioners produced no detailed or concrete plans as to how to further reduce their losses or as to when they expect to make a profit. The possibility of a speculative profit is insufficient to outweigh the absence of profits for a sustained period of years. *See Chandler v. Commissioner*, T.C. Memo. 2010-92 (the possibility of a speculative profit did not outweigh more than 20 years of losses reported for the taxpayer's horse activity). This factor strongly favors respondent.

[1298] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

See *Taras v. CIR*, 74 TCM (CCH) 1388, 1395 (1997) ("Throughout all the years of continuous losses, petitioners did not materially alter their mode of operation"); *Allen v. CIR*, 72 TC 28 (1979) (ski lodge's losses explained by market saturation, low snowfall, and gasoline shortages); Lee, *supra* note 8, at 420–428; infra ¶ 22.5.5 (presumption arising from two successful years). Taras has been affirmed by an unpublished opinion, 99-1 USTC ¶ 50,489 (3d Cir. 1999). But see *Rabinowitz v. CIR*, 90 TCM (CCH) 113, 121 (2005) (finding charter aircraft business was carried on for profit,

(7) *The amount of occasional profits, if any, which are earned*. The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.[1299]

(8) *The financial status of the taxpayer*. The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit[1300] especially if there are personal or recreational elements involved.[1301]

(9) *Elements of personal pleasure or recreation*. The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which

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notwithstanding 12 successive years of losses, because taxpayers "used their considerable business skills to attempt to make the business profitable" and losses for later periods resulted from unforeseen factors); *Burrus v. CIR*, 86 TCM (CCH) 429, 439 (2003) (finding "actual and honest intent to profit from" cattle raising, even though activity generated losses exceeding revenues for all of six years before court and four succeeding years; "such losses are consistent with a startup period inherent in herd building and therefore do not necessarily indicate a lack of profit motive").

The citation to Lee is to Lee, "A Blend of Old Wines in a New Wineskin: Section 183 and Beyond," 29 Tax L. Rev. 347 (1974).

[1299] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), cites Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347, 428-431 (1974).

[1300] *Robison v. Commissioner*, T.C. Memo. 2018-88, included the following reasoning:

> A taxpayer with substantial income unrelated to the activity can more readily afford a hobby . *See Wesley v. Commissioner*, T.C. Memo. 2007-78. Petitioners' substantial income from S. Robison's career has allowed them to continue their ranching activity in spite of 16 years of losses. Further, the activity has also generated tax savings in the form of net losses that offset that income, resulting in much smaller after-tax burden for the years in issue. This factor favors respondent.

[1301] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Hendricks v. CIR*, 32 F3d 94 (4th Cir. 1994) (physician's substantial income from medical practice was evidence that farm, which consistently operated at loss, was not for profit); *Jasionowski v. CIR*, 66 TC 312 (1976) (taxpayer's substantial income from other sources and other rental experience indicated that lease under which substantial losses, as distinguished from usual start-up losses, would be incurred for several years was not for profit); *Hurd v. CIR*, 37 TCM (CCH) 499 (1978) (substantial outside income enabled taxpayers to absorb large losses from ranch; held, not for profit); Lee, *supra* note 8, at 431–436. Compare *Ranciato v. CIR*, 52 F3d 23, 26 (2d Cir. 1995) (Tax Court's finding of lack of profit motive reversed because court failed to consider all relevant factors, including that taxpayer was "a solid middle-class wage earner, not an individual of wealth whose unprofitable extracurricular activities would suggest an effort to shelter unrelated income through deliberate losses").

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974). Being a trust fund baby is not helpful; see *Ford* in fn 1293.

> would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.[1302]

Reg. § 1.183-2(c) provides:

> *Example (1)*. The taxpayer inherited a farm from her husband in an area which was becoming largely residential, and is now nearly all so. The farm had never made a profit before the taxpayer inherited it, and the farm has since had substantial losses in each year. The decedent from whom the taxpayer inherited the farm was a stockbroker, and he also left the taxpayer substantial stock holdings which yield large income from dividends. The taxpayer lives on an area of the farm which is set aside exclusively for living purposes. A farm manager is employed to operate the farm, but modern methods are not used in operating the farm. The taxpayer was born and raised on a farm, and expresses a strong preference for living on a farm. The taxpayer's activity of farming, based on all the facts and circumstances, could be found not to be engaged in for profit.
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> *Example (2)*. The taxpayer is a wealthy individual who is greatly interested in philosophy. During the past 30 years he has written and published at his own expense several pamphlets, and he has engaged in extensive lecturing activity, advocating and disseminating his ideas. He has made a profit from these activities in only occasional years, and the profits in those years were small in relation to the amount of the losses in all other years. The taxpayer has very sizable income from securities (dividends and capital gains) which constitutes the principal source of his livelihood. The activity of lecturing, publishing pamphlets, and disseminating his ideas is not an activity engaged in by the taxpayer for profit.
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> *Example (3)*. The taxpayer, very successful in the business of retailing soft drinks, raise dogs and horses. He began raising a particular breed of dog many years ago in the belief that the breed was in danger of declining, and he has raised and sold the dogs in each year since. The taxpayer recently began raising and racing thoroughbred horses. The losses from the taxpayer's dog and horse activities have increased in magnitude over the years, and he has not made a profit on these operations during any of the last 15 years. The taxpayer generally sells the dogs only to friends, does not advertise the dogs for sale, and shows the dogs only infrequently. The taxpayer races his horses only at the "prestige" tracks at which he combines his racing activities with social and recreational activities. The horse and dog operations are conducted at a large residential property on which the taxpayer also lives, which includes substantial living quarters and attractive recreational facilities for the taxpayer and his family. Since (i) the activity of raising dogs and horses and racing the horses is of a sporting and recreational nature, (ii) the taxpayer has substantial income from his business activities of retailing soft drinks, (iii) the horse and dog operations are not conducted in a businesslike manner, and (iv) such operations have a continuous record of

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[1302] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Allen v. CIR*, 72 TC 28 (1979) (taxpayers never used ski lodge for personal recreation); Lee, *supra* note 8, at 436–444. See *McCarthy v. CIR*, 79 TCM (CCH) 1912, 1916 (2000) ("motorcross racing activity was inherently recreational and was conducted as an activity to be shared by father and son").

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974). For an example of activity that elevated the taxpayer's social profile, see *Ford* in fn 1293.

losses, it could be determined that the horse and dog activities of the taxpayer are not engaged in for profit.

Example (4). The taxpayer inherited a farm of 65 acres from his parents when they died 6 years ago. The taxpayer moved to the farm from his house in a small nearby town, and he operates it in the same manner as his parents operated the farm before they died. The taxpayer is employed as a skilled machine operator in a nearby factory, for which he is paid approximately $8,500 per year. The farm has not been profitable for the past 15 years because of rising costs of operating farms in general, and because of the decline in the price of the produce of this farm in particular. The taxpayer consults the local agent of the State agricultural service from time-to-time, and the suggestions of the agent have generally been followed. The manner in which the farm is operated by the taxpayer is substantially similar to the manner in which farms of similar size, and which grow similar crops in the area are operated. Many of these other farms do not make profits. The taxpayer does much of the required labor around the farm himself, such as fixing fences, planting, crops, etc. The activity of farming could be found, based on all the facts and circumstances, to be engaged in by the taxpayer for profit.

Example (5). A, an independent oil and gas operator, frequently engages in the activity of searching for oil on undeveloped and unexplored land which is not near proven fields. He does so in a manner substantially similar to that of others who engage in the same activity. The changes, based on the experience of A and others who engaged in this activity, are strong that A will not find a commercially profitable oil deposit when he drills on land not established geologically to be proven oil bearing land. However, on the rare occasions that these activities do result in discovering a well, the operator generally realizes a very large return from such activity. Thus, there is a small chance that A will make a large profit from his oil exploration activity. Under these circumstances, A is engaged in the activity of oil drilling for profit.

Example (6). C, a chemist, is employed by a large chemical company and is engaged in a wide variety of basic research projects for his employer. Although he does no work for his employer with respect to the development of new plastics, he has always been interested in such development and has outfitted a workshop in his home at his own expense which he uses to experiment in the field. He has patented several developments at his own expense but as yet has realized no income from his inventions or from such patents. C conducts his research on a regular, systematic basis, incurs fees to secure consultation on his projects from time to time, and makes extensive efforts to "market" his developments. C has devoted substantial time and expense in an effort to develop a plastic sufficiently hard, durable, and malleable that it could be used in lieu of sheet steel in many major applications, such as automobile bodies. Although there may be only a small chance that C will invent new plastics, the return from any such development would be so large that it induces C to incur the costs of his experimental work. C is sufficiently qualified by his background that there is some reasonable basis for his experimental activities. C's experimental work does not involve substantial personal or recreational aspects and is conducted in an effort to find practical applications for his work. Under these circumstances, C may be found to be engaged in the experimental activities for profit.

Den Besten v. Commissioner, T.C. Memo. 2019-154, summarized the profit motive inquiry (citations moved to footnote):[1303]

> Breeding, raising, training, and showing horses may be an activity entered into for profit pursuant to section 162. Such a determination will depend upon whether the taxpayer engaged in the activity with the primary purpose of making a profit. A reasonable expectation of profit is not required, but the facts and circumstances must indicate that the taxpayer entered into the activity or continued the activity with the actual and honest objective of making a profit. Evidence from years outside the years in issue can be relevant if it provides context to evaluate the taxpayer's overall requisite profit motive.

If a taxpayer conducts business through many entities and also conducts related business outside of those entities, the Court of Claims has held that the taxpayer may establish a "unified business enterprise" that supports finding that the outside related business has the requisite profit motive.[1304] CCA 201747006, by Brad Poston, asserts that the Court of Claims' decision undermines the separateness of S corporations from their owners and should not be followed.[1305] I do not view that to be the case; I view the "unified business enterprise" theory as merely helping establish motive. However, expect the IRS to strongly challenge the "unified business enterprise," as it did successfully in a taxpayer's very weak case decided in 2016.[1306]

Code § 183(b) allows:

> (1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and
>
> (2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(References above and below to "this chapter" or "chapter 1" are to Code §§ 1-1400U-3.)

1303 Citing *Engdahl v. Commissioner*, 72 T.C. 659, 665-666 (1979); *Dunn v. Commissioner*, 70 T.C. 715, 720 (1978), *aff'd*, 615 F.2d 578 (2d Cir. 1980); *Jasionowski v. Commissioner*, 66 T.C. 312, 319 (1976); Reg. § 1.183-2(a); *Dreicer v. Commissioner*, 78 T.C. 642, 645 (1982), *aff'd* without published opinion, 702 F.2d 1205 (D.C. Cir. 1983); *Feldman v. Commissioner*, T.C. Memo. 1986-287, 1986 Tax Ct. Memo LEXIS 321, at *16; *Donoghue v. Commissioner*, T.C. Memo. 2019-71, at *23; and *Smith v. Commissioner*, T.C. Memo. 1993-140 (considering profits and losses in subsequent years to have probative, although not determinative, significance).

1304 *Morton v. United States*, 98 Fed. Cl. 596 (2011). The court did not seem aware that regulations addressed how to find a profit motive under Code § 183.

1305 The CCA opens with:

> In conference calls on 7/20/17 and 8/28/17, we discussed with your office the holding of *Peter Morton v. U.S.*, 98 Fed. Cl. 596 (2011), and its effect of excluding wholly-owned or majority owned S corporations from precedent set by *Moline Properties v. Commissioner*, 63 S.Ct. 1132 (1943). Based upon the authorities and analysis below, we conclude the Service should reject the *Morton* holding and continue to assert that *Moline Properties* is applicable to S corporations, regardless of degree of ownership.

Of course, both *Moline* and another case the CCA cited, *Deputy v. DuPont*, 308 U.S. 488 (1940), long predate the idea of an S election. However, the CCA is quite correct that one cannot simply disregard an S corporation; for example, see parts II.G.25 Taxing Entity or Individual Performing Services and II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker.

1306 *Steinberger v. Commissioner*, T.C. Memo. 2016-104, rejecting a doctor's alleged business use of an airplane to travel in his business when his flying the airplane did not save the doctor any significant time over driving.

Reg. § 1.183-1(b)(1) elaborates on allowing deductions:

> *Manner and extent*. If an activity is not engaged in for profit, deductions are allowable under section 183(b) in the following order and only to the following extent:
>
> (i) Amounts allowable as deductions during the taxable year under chapter 1 of the Code without regard to whether the activity giving rise to such amounts was engaged in for profit are allowable to the full extent allowed by the relevant sections of the Code, determined after taking into account any limitations or exceptions with respect to the allowability of such amounts. For example, the allowability-of-interest expenses incurred with respect to activities not engaged in for profit is limited by the rules contained in section 163(d).
>
> (ii) Amounts otherwise allowable as deductions during the taxable year under chapter 1 of the Code, but only if such allowance does not result in an adjustment to the basis of property, determined as if the activity giving rise to such amounts was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivision (i) of this subparagraph.
>
> (iii) Amounts otherwise allowable as deductions for the taxable year under chapter 1 of the Code which result in (or if otherwise allowed would have resulted in) an adjustment to the basis of property, determined as if the activity giving rise to such deductions was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivisions (i) and (ii) of this subparagraph. Deductions falling within this subdivision include such items as depreciation, partial losses with respect to property, partially worthless debts, amortization, and amortizable bond premium.

Special rules apply to basis adjustments for deductions allowed under Reg. § 1.183-1(b)(1)(iii).[1307]

Code § 183(b)(2) and Reg. § 1.183-1(b)(1)(ii) provide a benefit to individuals that is not available to C corporations – deducting expenses that would be business expenses if the activity had been engaged in for profit. On the other hand, all expenses under Code § 183(b)(1) and Reg. § 1.183-1(b)(1)(i) would have been allowable to a corporation anyway, and all expenses allowable to an individual under Code § 183(b) and Reg. § 1.183-1(b)(1) would be subject to the limitations described in part II.G.4.n Itemized Deductions, which might very well eliminate their benefit. Comparing the choice between C corporation and an individual (including through a partnership or S corporation):

[1307] Reg. § 1.183-1(b)(2), "Rule for deductions involving basis adjustments," provides:

(i) *In general*. If deductions are allowed under subparagraph (1)(iii) of this paragraph, and such deductions are allowed with respect to more than one asset, the deduction allowed with respect to each asset shall be determined separately in accordance with the computation set forth in subdivision (ii) of this subparagraph.

(ii) *Basis adjustment fraction*. The deduction allowed under subparagraph (1)(iii) of this paragraph is computed by multiplying the amount which would have been allowed, had the activity been engaged in for profit, as a deduction with respect to each particular asset which involves a basis adjustment, by the basis adjustment fraction—

(a) The numerator of which is the total of deductions allowable under subparagraph (1)(iii) of this paragraph, and

(b) The denominator of which is the total of deductions which involve basis adjustments which would have been allowed with respect to the activity had the activity been engaged in for profit. The amount resulting from this computation is the deduction allowed under subparagraph (1)(iii) of this paragraph with respect to the particular asset. The basis of such asset is adjusted only to the extent of such deduction.

- Both require the same profit motive to qualify under Code § 162 as a threshold inquiry.

- Code § 183 provides an additional chance for an individual to prove profit motive, which opportunity is not available to a C corporation. Whether this additional opportunity makes a difference depends on the facts and circumstances.

- Would being an entity make a difference? When testing business purpose, one would test the entity's intent[1308] rather than the individual's. When looking at an individual's business purpose, one would compare that activity to the individual's other activities. An individual who is establishing a side business may consider interposing an entity that is not disregarded between the business and the individual, so that profit motive can be tested solely by reference to the entity's activities. My sense is that C corporations are tested for profit motive only when using a side deal to shelter income from their core activity and that they are not scrutinized for profit motive for their core activity; however, Code § 162 does not draw such a distinction, so one cannot rely on that distinction as a matter of law.

- If a profit motive cannot be established:

    - Code § 183(b)(1) and Reg. § 1.183-1(b)(1)(i) allows individuals to deduct whatever they could have deducted absent a profit motive, and C corporations have the same benefit. However, limitations on using itemized deductions may prevent these deduction from generating a tax benefit, whereas a C corporation does not have the same limits.

    - Code § 183(b)(2) and Reg. § 1.183-1(b)(1)(ii) provide a benefit to individuals that is not available to C corporations – deducting expenses that would be business expenses if the activity had been engaged in for profit. However, limitations on using itemized deductions may prevent these deduction from generating a tax benefit.

In applying Code § 183, gross income derived from an activity not engaged in for profit includes the total of all gains from the sale, exchange, or other disposition of property, and all other gross receipts derived from such activity.[1309]

[1308] For testing a partnership's intent, see fn. 1277 in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162; note that adding a service partner might complicate funding any losses. For testing an S corporation's intent, see fn. 1311; I have not looked to see the rule for Code § 162 absent Code § 183.

[1309] Reg. § 1.183-1(e), which further provides:

> Such gross income shall include, for instance, capital gains, and rents received for the use of property which is held in connection with the activity. The taxpayer may determine gross income from any activity by subtracting the cost of goods sold from the gross receipts so long as he consistently does so and follows generally accepted methods of accounting in determining such gross income.

In the case of a partnership, Code § 183(b) is applied at the partnership level and can be a helpful relief valve.[1310] Also, Code § 183 is applied at the corporate level in determining the allowable deductions of an S corporation.[1311]

II.G.4.l.i.(d). Whether Managing Investments Constitutes a Trade or Business

This part II.G.4.l.i.(d) reviews whether managing one's own investments and whether managing others' investments constitutes a trade or business, expenses of which are deductible under Code § 162. However, C corporations do not appear to be subjected to these standards,[1312] so this discussion appears to apply only to other taxpayers.

"No matter how large the estate or how continuous or extended the work required may be," managing one's own portfolio of marketable securities does not constitute a trade or business. *Higgins v. Commissioner*, 312 U.S. 212 (1941).[1313]

Congress enacted Code § 212 to provide relief for taxpayers caught by *Higgins*.[1314] In denying the taxpayer a business bad debt for loans to corporations in which the taxpayer worked full-time, *Whipple v. Commissioner*, 373 U.S. 193 (1963), stated:

> Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer though substantially the product of his services, legally arises not from his own trade or business but from

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[1310] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), held:

> Since the partnership is not entitled to any deductions under section 162, the activity of the partnership constitutes one "not engaged in for profit" as defined in section 183(c). We therefore turn to section 183 to determine the amount, if any, of deductions which are otherwise allowable under section 183(b). We are again faced with the question of whether the allowance provision, section 183(b), is to be applied at the partnership or partner level. For the many reasons stated above, we conclude that section 183(b) should be applied at the partnership level. See sec. 703(a); sec. 1.703-1(a), Income Tax Regs.; *Hager v. Commissioner*, *supra* at 788. Accordingly, as the partnership did not report any deductions in 1975 which are otherwise allowed without regard to whether the activity is engaged in for profit, the partnership is entitled to the deductions claimed, without inclusion in basis of the nonrecourse note in the amount of $1,400,000, but only to the extent of the gross income derived from the activity in 1975 in the amount of $679. Sec. 183(b)(2). The result of applying section 183(b)(2) is that the partnership in 1975 had income of zero; that is, it had no profit and it had no loss. Therefore, petitioner had no distributive share of income or loss from Britton Properties.[17]
>
> [17] Since petitioner's pro rata share of the partnership's income of $679 was included by respondent in his 1975 income, the result of our holding is that respondent erred in increasing petitioner's income, as reported, by $34 of partnership income but did not err in disallowing petitioner's claimed partnership loss of $15,751.

[1311] Reg. § 1.183-1(f).

[1312] See text accompanying fn 1278 in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162.

[1313] See part II.G.4.l.i.(a) "Trade or Business" Under Code § 162, in which fn 1269 discusses the case's weight and continued validity.

[1314] *Whipple v. Commissioner*, 373 U.S. 193 (1963), stated:

> In response to the *Higgins* case and to give relief to *Higgins*-type taxpayers, see H.R. Rep. No. 2333, 77th Cong., 2d Sess. 46, § 23(a) was amended not by disturbing the Court's definition of "trade or business" but by following the pattern that had been established since 1916 of "[enlarging] the categories of incomes with reference to which expenses were deductible," *McDonald v. Commissioner*, 323 U.S. 57, 62; *United States v. Gilmore*, 372 U.S. 39, 45, to include expenses incurred in the production of income.

that of the corporation. Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debts losses arising from his own business and those actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business.

Managing investments for one's self, wife, and three children without compensation did not constitute a trade or business in *Beals v. Commissioner*, T.C. Memo. 1987-171. Although *Beals* acknowledged that being a day-trader may be a trade or business,[1315] the taxpayer's full-time efforts towards managing investments did not constitute day trading and therefore did not constitute a trade or business.[1316]

Whether trading commodities was a trade or business has been the subject of attempts to tax nonresident aliens, who were taxed when the trading rose to the level of a trade or business[1317] and were not taxed when it didn't. *Liang v. Commissioner*, 23 T.C. 1040 (1955), stated in its Official Tax Court Syllabus:

[1315] The court noted:

> On the other hand, the Court has recognized that a full-time trader of securities may be in a trade or business. *Snyder v. Commissioner*, 295 U.S. 134, 139 (1935).
>
> In *Liang v. Commissioner*, 23 T.C. 1040 (1955), we had to distinguish between an investor and a trader; we observed:
>
> > The distinction between an investment account and a trading account is that in the former, securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of the securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis. [23 T.C. at 1043.]
>
> The taxpayer's agent "never acquired any hedges; never made short sales; and never purchased any 'puts' or 'calls'." 23 T.C. at 1044. We held that the primary objective of the activity in question "was that of an investment account established to provide a reliable source of income." 23 T.C. at 1045.
>
> More recently, in *Purvis v. Commissioner*, 530 F.2d 1332 (9th Cir. 1976), *affg.* a Memorandum Opinion of this Court, the Court of Appeals for the Ninth Circuit applied the test of *Liang v. Commissioner*, *supra*, and concluded that the taxpayer was investing, not trading. The court noted:
>
> > From 1963 to 1968 petitioner engaged in only 75 sales of securities and ten short-term commodities sales. Of these, 31 involved stock which had been held for more than six months. A substantial number involved shares which petitioner admits were held as investments, or which were held for periods exceeding three years, indicating that they were investments. [530 F.2d at 1334.]

[1316] The court held:

> In the case before us, the petitioner makes no claim that he was a trader, and the evidence does not reveal any pattern of trading: his investments changed very little from year to year, and he reported only small capital transactions each year. To support his position, he relies on his investment activities. It appears that the petitioner was not a mere passive investor; he actively investigated and followed the investments made by him and his family. Nevertheless, it is well settled that the management of investments, despite the extent and scope of such activities, is not a trade or business for tax purposes. *Whipple v. Commissioner*, *supra*; *Higgins v. Commissioner*, *supra*. Consequently, we hold that the petitioner was not engaged in a trade or business during the years at issue.

[1317] *Adda v. Commissioner*, 10 T.C. 273, 277 (1948), the Official Tax Court Syllabus to which said:

> Petitioner, a nonresident alien, empowered his brother, who resided in the United States, to deal in commodity futures at his own discretion through resident brokers in the United States for petitioner's account. Petitioner's brother exercised this authority in 1940 and 1941, trading in substantial amounts. *Held*, petitioner was engaged in trade or business in the United States and is taxable as a nonresident alien so engaged; *held*, further, that the petitioner is entitled to a net short term capital loss carry-over from 1940 to 1941.

The court reasoned:

> Trading in commodities for one's own account for profit may be a "trade or business" if sufficiently extensive. *Fuld v. Commissioner*, 139 Fed.(2d) 465; *Norbert H. Wiesler*, 6 T.C. 1148; *affirmed* without discussion of this point, 161 Fed.(2d) 997. The respondent determined that the petitioner was engaged in trade or business in the United States. While the number of transactions or the total amount of money involved in them has not been stated, it is apparent that many transactions were effected through different brokers, several accounts were maintained, and gains and losses in substantial amounts were realized. This evidence shows that the trading was extensive enough to amount to a trade or business, and the petitioner does not contend, nor has he shown, that the transactions were so infrequent or inconsequential as not to amount to a trade or business.

> Petitioner, a nonresident alien whose securities were managed primarily for investment purposes by a resident commission agent, held, on facts, not subject to tax on capital gains as not being engaged in a trade or business within the United States under section 211(b), Internal Revenue Code of 1939.

The court began its description of the case:

> Petitioner, a nonresident alien, was not present in this country in 1946 nor, apparently, at any other time after he entered into the agency agreement in 1932. He left the management of his considerable account entirely to the discretion of his agent. The latter invested petitioner's funds in stocks and securities. He never acquired any hedges; never made short sales; and never purchased "puts" or "calls." His commission in excess of a fixed salary was based on total earnings of the account, regardless of source.
>
> Purchase and sale activity in the account during 1946, the year in controversy, and during 1940, which far exceeded such activity in other years, is adequately explained by transitional changes in the industries represented by the securities immediately before and after American participation in World War II, when increased trading activity was not unusual in the routine conservation and management of investment portfolios. And, in spite of increased activity, even during the year in controversy the average holding period of the securities sold was 5.8 years. More than 90 per cent of the gross gain was derived from the sale of securities held for more than 2 years; and more than 40 per cent of the gross gain was realized from the sale of securities held for more than 5 years. The absence of frequent short-term turnover in petitioner's portfolio negatives the conclusion that these securities were sold as part of a trading operation rather than as investment activity.

In finding for the taxpayer that the taxpayer had not engaged in a trade or business, the court reasoned:

> Whether activities undertaken in connection with investments are sufficiently extensive to constitute a trade or business is a question to be decided on the particular facts. *Higgins v. Commissioner*, 312 U.S. 212. In *Fernand C. A. Adda*, 10 T.C. 273, *affirmed* per curiam (C.A. 4) 171 F.2d 457, certiorari denied 336 U.S. 952, extensive transactions in commodities which do not pay dividends and could have resulted in profit only by means of the gains on the purchases and sales were found to constitute a trade or business. For similar reasons *Commissioner v. Nubar*, (C.A. 4) 185 F.2d 584, reversing 13 T.C. 566, certiorari denied 341 U.S. 925, held that transactions in commodities and securities where the taxpayer was himself present in the United States throughout the period were sufficient to constitute the conduct of a trade or business.

The present situation is quite different. Petitioner never having been present in the United States, it is only through the activity of his agent that he could be held to have conducted a business. For the solution of this problem we look not solely to the year in controversy but to the entire agency and particularly to the 7 years shown by the record. These figures appearing in our findings satisfy us that the primary, if not the sole objective, was that of an investment account established to provide a reliable source of income. In fact in 4 of the 7 years the capital transactions resulted in losses rather than gains and only in the year for which respondent has determined the deficiency were the gains of any considerable consequence.

Day-trading on margin, with annual transaction volume of more than half of the taxpayer's net worth,[1318] was held to be a trade or business for purposes of the Code § 166 bad debt rules.[1319] Averaging 15 trades per year, of which a substantial portion were long-term investments, was not a trade or business.[1320] A

[1318] *Levin v. U.S.*, 597 F.2d 760 (Ct. Cl. 1979), found that the taxpayer:

> … devoted virtually all his working time to the purchase and sale of securities. His initial investments made during and immediately following World War II brought him substantial profits. Although he frequently purchased heavily in the stock of one company or another, he was generally active in purchases and sales of stocks of various corporations. For instance, in 1961, the year of the indebtedness note in question, he conducted 332 transactions which represented the transfer of 112,400 shares with a total value of $3,452,125.
>
> Routinely taxpayer visited the corporations in which he was interested and talked to company officers, traveling out of town for these visits when necessary. His days were frequently spent in the brokerage houses on Wall Street; he ate lunch with brokers at the Stock Exchange Club; and he attended lectures sponsored by securities analysts when the topics were of interest. He maintained ledger sheets of all his stock transactions, attended stockholders' meetings, and generally spent his time purchasing and selling securities on his own account.
>
> It was taxpayer's practice to purchase to the extent of allowable margin. He traded with four to six brokerage houses in order to disperse his large number of shares in any one corporation, as many brokers prohibited concentrated holdings in their margin accounts. In addition, this practice avoided pressure to liquidate his entire investment in a particular company to meet a single broker's margin call. Prior to the market decline in late 969 and early 1970, taxpayer was exceedingly successful in his stock transactions. In 1968, for instance, he held stock valued at nearly $8 million with a margin debt of approximately $3 million, leaving him a net worth of about $5 million. His only other source of income was $5,000 in salary for sitting on the board of directors of a small oil-producing company.

[1319] The court held:

> Although the Supreme Court has yet to find a taxpayer properly characterized as a securities "trader," it is clear such a section 166 "businessman" exists, given the proper facts. *Higgins v. Commissioner*, 312 U.S. 212 (1941); *Snyder v. Commissioner*, 295 U.S. 134 (1935); *Commissioner v. Nubar*, 185 F.2d 584 (4th Cir. 1950). By contrast the activity of a mere "invest[or] is not a trade or business." *Whipple v. Commissioner*, 373 U.S. 193, 202 (1963). Neither the code, the regulations, nor the courts have yet provided a precise definition as to when an individual taxpayer's behavior is that of a trader rather than an investor in corporate stocks. According to *Higgins*, a factual analysis in each case is required to determine if a particular taxpayer's securities activities rise to the level of "carrying on a business." 312 U.S. at 217.
>
> It has been ruled, however, that:
>
> > … [A] taxpayer who, for the purpose of making a livelihood, devotes the major portion of his time to speculating on the stock exchange may treat losses thus incurred as having been sustained in the course of a trade or business.… [*Snyder*, 295 U.S. at 139.]
>
> Establishing continuity of investment activity is not enough. The taxpayer must do more than "merely [keep] records and [collect] interest and dividends from his securities, through managerial attention for his investments." *Higgins*, 312 U.S. at 218; *Wilson v. United States*, 179 Ct.Cl. 725, 746, 376 F.2d 280, 293 (1967). In effect, a "trader" is an active investor in that he does not passively accumulate earnings, nor merely oversee his accounts, but manipulates his holdings in an attempt to produce the best possible yield. That is, the trader's profits are derived through the very acts of trading—direct management of purchasing and selling. *Purvis v. Commissioner*, 530 F.2d 1332 (9th Cir. 1976); *Chiang Hsiao Liang*, 23 T.C. 1040 (1955).
>
> Even absent a clear judicial demarcation between trader and investor, it is apparent that plaintiff taxpayer's securities activities place him close to the trader end of the spectrum. Aside from a small annual salary for sitting on the board of an oil-producing company, his entire and substantial income was derived from his trading. He devoted virtually his whole working day to his stock transactions, unlike the taxpayers in *Snyder* and *Wilson*. In contrast to the distant management of a portfolio portrayed in Higgins, judgments regarding purchases and sales were made directly by taxpayer, based on his personal investigation of the assets, operation and management of various corporations. In addition, the sheer quantity of transactions he conducted also supports a reasonable conclusion that this taxpayer's business was trading on his own account.
>
> Defendant urges a narrowing of this issue to consideration of whether taxpayer's activities in regard to the particular stock he held in Central Railroad alone amounted to a "trade or business." While the courts do acknowledge that a trader (and even a "dealer") may hold simultaneously certain shares for investment purposes and others to trade, *e.g.*, *Bradford v. United States*, 195 Ct.Cl. 500, 444 F.2d 1133 (1971), the question here is whether taxpayer was generally "carrying on the business" of trading for his own account. It is concluded that he was.

[1320] *Purvis v. Commissioner*, 530 F.2d 1332 (9th Cir. 1976), noted:

"taxpayer may be a dealer as to some securities and at the same time hold other securities as a trader or investor on his own account and not for resale to customers."[1321]

Moller v. U.S., 721 F.2d 810 (Fed. Cir 1983), explained:[1322]

> … in order to be a trader, a taxpayer's activities must be directed to short-term trading, not the long-term holding of investments, and income must be principally derived from the sale of securities rather than from dividends and interest paid on those securities. In determining whether a taxpayer who manages his own investments is a trader, and thus engaged in a trade or business, relevant considerations are the taxpayer's investment intent, the nature of the income to be derived from the activity, and the frequency, extent, and regularity of the taxpayer's securities transactions. See *Purvis*, 530 F.2d at 1334.

King v. Commissioner, 89 T.C. 445, 458-459 (1987), explained the differences between traders, dealers, and investors:

> … a primary distinction for Federal tax purposes between a trader and a dealer in securities or commodities is that a dealer does not hold securities or commodities as capital assets if held in connection with his trade or business, where as a trader holds securities or commodities as capital assets whether or not such assets are held in connection with his trade or business.[5] A dealer falls within an exception to capital asset treatment because he deals in property held primarily for sale to customers in the ordinary course of his trade or business. A trader, on the other hand, does not have customers and is therefore not considered to fall within an exception to capital asset treatment.
>
> [5] The same capital treatment to which traders in securities are subject has also been held applicable to traders of commodity futures. *Commissioner v. Covington*, 120 F.2d 768 (5th Cir. 1941), *affg.* on this issue 42 B.T.A. 601 (1940); *Vickers v. Commissioner*, 80 T.C. 394, 405 (1983).
> The distinction between a "trader" and an "investor" also turns on the nature of the activity in which the taxpayer is involved. A trader seeks profit from short-term market swings and receives income principally from selling on an exchange rather than from dividends, interest, or long-term

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From 1963 to 1968 petitioner engaged in only 75 sales of securities and ten short-term commodities sales. Of these, 31 involved stock which had been held for more than six months. A substantial number involved shares which petitioner admits were held as investments, or which were held for periods exceeding three years, indicating that they were investments.

[1321] *Bradford v. U.S.*, 444 F.2d 1133 (Ct. Cl. 1971).

[1322] The court analyzed the taxpayers' activity:

The Claims Court concluded that taxpayers were investors and not traders because they were primarily interested in the long-term growth potential of their stocks. We agree. Mr. Moller testified that he was looking for long-term growth and the payment of dividends. In addition, the taxpayers did not derive their income from the relatively short-term turnover of stocks, nor did they derive any significant profits through the act of trading. Interest and dividend income was over 98% of taxpayers' gross income for 1976 and 1977, and in 1976 their profit from the sale of securities was only $612, while in 1977 their sales resulted in a loss of $233.

The number of sales transactions made by the taxpayers also leads to the conclusion that they were not traders in securities. In the cases in which taxpayers have been held to be in the business of trading in securities for their own account, the number of their transactions indicated that they were engaged in market transactions on an almost daily basis. See *Levin*, 597 F.2d at 765; *Fuld v. Commissioner*, 139 F.2d 465 (2d Cir. 1943). At most, the Mollers engaged in 83 security purchase transactions and 41 sales transactions in 1976 and 76 purchase and 30 sales transactions in 1977. [footnote omitted]

Moreover, taxpayers did not "endeavor to catch the swings in the daily market movements and profit thereby on a short term basis." *Purvis*, 530 F.2d at 1334. The stocks owned by taxpayers, which they sold during 1976 and 1977, had been held for an average of over 3-1/2 and 8 years, respectively.

The Mollers were investors and not traders.

appreciation. *Groetzinger v. Commissioner*, 771 F.2d 269, 274-275 (7th Cir. 1985), *affd.* 480 U.S. __ (1987); *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983). Further, a trader will be deemed to be engaged in a trade or business if his trading is frequent and substantial. *Groetzinger v. Commissioner*, *supra* at 275; *Fuld v. Commissioner*, 139 F.2d 465 (2d Cir. 1943), *affg.* 44 B.T.A. 1268 (1941). An investor, on the other hand, makes purchases for capital appreciation and income, usually without regard to short-term developments that would influence prices on the daily market. *Groetzinger v. Commissioner*, 82 T.C. 793, 801 (1984), *affd.* 771 F.2d 269 (7th Cir. 1985), *affd.* 480 U.S. __ (1987); *Liang v. Commissioner*, 23 T.C. 1040, 1043 (1955). No matter how extensive his activities might be, an investor is never considered to be engaged in a trade or business with respect to his investment activities. *Higgins v. Commissioner*, 312 U.S. 212, 216, 218 (1941); *Groetzinger v. Commissioner*, 771 F.2d at 275.

The issue in *King* was whether interest expense relating to the taxpayer's trading was subject to the investment interest limitations of Code § 163(d) or was business interest. The court reasoned (at 459-460) [footnotes referred to below are in fn [1323]]:

> Petitioner clearly was in the trade or business of trading commodity futures during the years in issue.[6] Petitioner's trading was frequent and substantial but he traded solely for his own account during the years in issue and neither had customers nor performed services analogous to those performed by a merchant.[7] The parties appear to agree that petitioner was in the trade or business of trading commodities futures.[8]
>
> Based on the foregoing, we determined in our earlier opinion that certain short-term capital losses claimed by petitioner were allowable. Such losses were incurred by a commodities dealer within the meaning of sec. 108(f) (see note 6 supra), in the trading of commodities and were therefore to be

[1323] Here are the footnotes that accompanied the text above:

[6] We note that in our earlier opinion, relating to petitioner's motion for partial summary judgment, we stated that the parties were in agreement that "petitioner was a dealer in commodities within the meaning of Section 108(f)" of the Tax Reform Act of 1984 (Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630), as amended by sec. 1808(d) of the Tax Reform Act of 1986. Section 108(f), as amended, provides in relevant part "For purposes of this section, the term 'commodities dealer' means any taxpayer who - (1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B)." Sec. 1402(i)(2)(B) defines, for purposes of sec. 1402(i) a commodities dealer as "a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission." A sec. 1256 contract is defined as including "any regulated futures contract." Sec. 1256(b)(1).

Petitioner was a registered member of the CME, a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, and was actively engaged in trading regulated futures contracts. Therefore, pursuant to sec. 108(f), petitioner was a commodities dealer for purposes of sec. 108 of the Tax Reform Act of 1984, as amended by sec. 1808(d) of the Tax Reform Act of 1986. This status as a commodities dealer, however, applies solely for purposes of section 108 and does not, for any other purpose, affect petitioner's status as a trader who is not a dealer. See H. Rept. 99-426, at 911 (1985).

[7] Until 1968, petitioner acted as a broker as well as trading for his own account. At that time, petitioner may have been a dealer with respect to futures contracts, but this is not relevant to the years in issue.

[8] We also note that sec. 108(a) and (b) of the Tax Reform Act of 1984, 98 Stat. 630, as amended by sec. 1808(d) of the Tax Reform Act of 1986, 100 Stat. 2817-2818, provides,

> SEC. 108(a). *General Rule*. For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions—
>
> (1) which are entered into before 1982 and form part of a straddle, and
>
> (2) to which the amendments made by title V of such Act do not apply, any loss from such disposition shall be allowed for the taxable year of the disposition if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business.
>
> (b) *Loss Incurred in a Trade or Business*. For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.

treated as incurred in a trade or business for purposes of sec. 108(a). The character of such losses as capital losses, however, is not affected by their treatment as losses incurred in a trade or business for purposes of sec. 108.

King also held that the purchase of gold was part of his trade or business of trading commodities futures, rejecting the IRS' contention that *Higgins* (fns 1313-1314) applied to segregate the purchase of gold from other activity.[1324]

After reviewing precedent,[1325] *Holsinger v. Commissioner*, T.C. Memo. 2008-191, reasoned and held:

> Petitioners argue that they were traders, trading as agents of Alpha. With the incorporation of Alpha, petitioners argue they became traders. In determining whether a taxpayer's trading activity constituted a trade or business, courts have distinguished between "traders" and "investors". *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983); see also *Levin v. United States*, 220 Ct. Cl. 197, 597 F.2d 760, 765 (1979).
>
> In determining whether a taxpayer is a trader, nonexclusive factors to consider are: (1) The taxpayer's intent, (2) the nature of the income to be derived from the activity, and (3) the frequency, extent, and regularity of the taxpayer's securities transactions. *Moller v. United States*, *supra* at 813. For a taxpayer to be a trader the trading activity must be substantial, which means "frequent, regular, and continuous enough to constitute a trade or business" as opposed to sporadic trading. *Ball v. Commissioner*, T.C. Memo. 2000-245 (quoting *Hart v. Commissioner*, T.C. Memo. 1997-11). A taxpayer's activities constitute a trade or business where both of the following requirements are met: (1) The taxpayer's trading is substantial, and (2) the taxpayer seeks to catch the swings in the daily market movements and to profit from these short-term changes rather than to profit from the long-term holding of investments. *Mayer v. Commissioner*, *supra*.
>
> As to the first requirement, we find petitioners' trading was not substantial. Courts consider the number of executed trades in a year and the amount of money involved in those trades when evaluating whether a taxpayer's trading activities were substantial. See, *e.g.*, *Mayer v.*

[1324] 89 T.C. at 464-465:

> As we have stated, petitioner herein was clearly in the trade or business of trading commodities futures. Petitioner acquired the gold in issue pursuant to delivery on long gold futures contracts which he acquired in the regular course of his business. Petitioner also disposed of the gold pursuant to short gold futures contracts. While petitioner had not regularly held physical commodities for extended periods of time, petitioner did periodically, in the course of his business, take delivery of physical commodities. Further, petitioner took no affirmative action to set apart or distinguish this transaction from other transactions which were entered into in the normal course of his business. These factors strongly suggest that petitioner's gold transaction was part of his trade or business of trading commodity futures.
>
> This case is not factually similar to *Higgins* in that the transaction here in issue was integrally related to transactions which were indisputably part of petitioner's trade or business, *i.e.*, the closing of the futures contracts by which the gold was acquired and disposed. In *Higgins*, the only relationship between the taxpayer's investment activities and real estate activities was that they were directed through the same office. *Higgins* does not lead us to the conclusion that the transaction here in issue should be separated out from petitioner's trade or business.
>
> We are not aware of any case which has held that a taxpayer may hold property both as a trader of commodity futures and as an investor in commodities. Past cases have held that a taxpayer may be both a trader and a dealer with respect to securities, but these cases have not dealt with the issue of whether the taxpayer therein was a trader or investor. *Kemon v. Commissioner*, *supra* at 1033; *Carl Marks & Co. v. Commissioner*, 12 T.C. 1196 (1949).

[1325] Before addressing that the taxpayers bore the burden of proof, the court stated:

> The Internal Revenue Code does not define the term "trade or business" for purposes of section 162. *Commissioner v. Groetzinger*, 480 U.S. 23, 27 (1987); *Estate of Yaeger v. Commissioner*, 889 F.2d 29, 33 (2d Cir. 1989), affg. T.C. Memo. 1988-264. Whether activities constitute a trade or business is a question of fact. See *Higgins v. Commissioner*, 312 U.S. 212, 217 (1941); *Estate of Yaeger v. Commissioner*, *supra* at 33; *Mayer v. Commissioner*, T.C. Memo. 1994-209; *Paoli v. Commissioner*, T.C. Memo. 1991-351.

Commissioner, *supra*; *Paoli v. Commissioner*, *supra*. In Paoli, the Court held trading activities were substantial when the taxpayers traded stocks or options worth approximately $9 million. In *Mayer*, the Court considered over 1,100 executed sales and purchases in each of the years at issue therein to be substantial trading activity. Trading activity was found to be insubstantial when a taxpayer executed at most 83 purchases and 41 sales in one year and 76 purchases and 30 sales in the second year. *Moller v. United States*, *supra* at 813. In 2001 petitioners executed approximately 289 trades. An analysis of petitioners' trading activity reveals that in 2001 they traded on 63 days. This total represents less than 40 percent of the trading days from April 19, 2001, the day petitioners incorporated Alpha, until December 31, 2001. In 2002 petitioners traded on 110 days and executed approximately 372 trades. This total represents less than 45 percent of the trading days in 2002. We find it doubtful whether the trades were conducted with the frequency, continuity, and regularity indicative of a business.

As to the second requirement, petitioners have failed to prove that they sought to catch the swings in the daily market movements and to profit from these short-term changes rather than to profit from the long-term holding of investments. Petitioner testified that his goal in forming Alpha was to profit from short-term swings in the market. Additionally, petitioner testified that he usually closed his account at the end of the day and tried to avoid holding stocks and options overnight. The documentary evidence, however, paints a different picture. A list of petitioners' trades shows they rarely bought and sold on the same day. Furthermore, a significant amount of petitioners' holdings was held for more than 31 days. As a result, we find that petitioners have not demonstrated that they sought to capture the daily swings in the market. We find that they were not traders, but investors. Petitioners' trading pattern is consistent with that of an investor, not of a trader.

A bad debt case, *Dagres v. Commissioner*, 136 T.C. 263, 281 (2011),[1326] noted that:[1327]

Selling one's investment expertise to others is as much a business as selling one's legal expertise or medical expertise.

In cases where business promotion activities are found to rise to the level of a trade or business, a common factor for distinguishing mere investment from conduct of a trade or business has been compensation other than the normal investor's return: "income received directly for his own services rather than indirectly through the corporate enterprise". *Id.* That is, if the taxpayer receives not just a return on his own investment but compensation attributable to his services, then that fact tends to show that he is in a trade or business. Although fee, commission, or other non-investor compensation is a common element, it is not a necessary element, provided the facts support the

[1326] For more details about the case, see fn 1146 in part II.G.4.a.iii Character of Bad Debt.

[1327] This quote followed a discussion contrasting the case from *Whipple* (see fn 1314 and accompanying text):

However, an activity that would otherwise be a business does not necessarily lose that status because it includes an investment function. Rather, the activity of "promoting, organizing, financing, and/or dealing in corporations

… for a fee or commission or with the immediate purpose of selling the corporations at a profit in the ordinary course of that business" is a business, *Deely v. Commissioner*, 73 T.C. 1081, 1093 (1980) (citing *Whipple v. Commissioner*, 373 U.S. at 202-203), supplemented by T.C. Memo. 1981-229 [¶81,229 PH Memo TC], as is "developing …

corporations as going businesses for sale to customers", *Whipple v. Commissioner*, 373 U.S. at 203. Bankers, investment bankers, financial planners, and stockbrokers all earn fees and commissions for work that includes investing or facilitating the investing of their clients' funds.[22]

[22] *Cf. InverWorld, Inc. v. Commissioner*, T.C. Memo. 1996-301 (holding that the taxpayer was in a trade or business pursuant to section 864(b); distinguishing "cases [that] did not address taxpayers who managed the investments of others").

conclusion that the taxpayer is more than a passive investor. *Farrar v. Commissioner*, T.C. Memo. 1988-385; see also *Deely v. Commissioner*, 73 T.C. at 1093. Notably, in such business promotion cases, the trade-or-business characterization applies even though the taxpayer invests his own funds in, lends funds to, or guarantees the debts of the businesses he promotes. See *Farrar v. Commissioner*, *supra*.

Lender Management, LLC v. Commissioner, T.C. Memo. 2017-246, held that Lender Management, LLC ("Lender Management") carried on a trade or business under Code § 162. Tax years 2010-2012 were at issue. Lender Management reported net losses of $462,505 and $307,760 for tax years 2010 and 2011 and net income of $376,238 and $808,302 for tax years 2012 and 2013, respectively.

The court described certain relationships:

> During the tax years in issue Lender Management provided direct management services to three limited liability companies: Murray & Marvin Lender Investments, LLC (M&M), Lenco Investments, LLC (Lenco), and Lotis Equity, LLC (Lotis) (collectively, investment LLCs). Each of the investment LLCs elected to be treated as a partnership for Federal income tax purposes. Lender Management directed the investment and management of assets held by the investment LLCs for the benefit of their owners. The end-level owners with respect to M&M, Lenco, and Lotis were, in each case, all children, grandchildren, or great-grandchildren of Harry.

The court described certain arrangements:

> 1. ***Structure and Purpose***
>
> The investment LLCs were created in 2005 as part of a reorganization of Lender Management. The goals of the 2005 reorganization were to accommodate greater diversification of the managed investments and more flexible asset allocation at the individual investor level. As part of the restructuring Lender Management shifted from a cost-based office model to a profit-based model.
>
> Lender Management engaged a hedge fund specialist to help it restructure its affairs and its managed portfolio using a hedge fund, or "fund of funds", manager model. Pursuant to the restructuring strategy, Lender Management divided its managed portfolio into the three investment LLCs, each formed for the purpose of holding investments in a different class of assets. M&M invested in private equities, Lenco in hedge funds, and Lotis in public equities.[4] From 2005 forward, over one-half of the assets under management were invested in private equity.
>
> [4] Lotis merged into Lenco in 2010 because Lender Management determined that Lenco's hedge fund investments held enough public equities to meet the company's asset diversification goals.
>
> 2. ***Operating Agreements***
>
> Lender Management's operating agreement permitted it, without limitation, to engage in the business of managing the "Lender Family Office" and to provide management services to Lender family members, related entities, and "other third-party nonfamily members." The operating agreements for the investment LLCs designated Lender Management as the sole manager for each entity. Lender Management held the exclusive rights to direct the business and affairs of the investment LLCs.
>
> Lender Management also managed downstream entities in which M&M held a controlling interest. Investors in some of these downstream entities included persons who were not members of the

Lender family. It received fees for managing these entities. For the tax years in issue between 12% and 15% of M&M's net investment portfolio consisted of these downstream entities.

Members understood that they could withdraw their investments in the investment LLCs at any time, subject to liquidity constraints, if they became dissatisfied with how the investments were being managed. The operating agreements for Lenco and Lotis provided that members could withdraw all or a portion of their capital accounts on specified dates of each year or on any other date approved by the manager. The operating agreement for M&M provided that members could withdraw all or a portion of their capital accounts with the consent of the manager in the exercise of the manager's discretion.

B. ***Compensation***

Lender Management received a profits interest in each of the investment LLCs in exchange for the services it provided to the investment LLCs and their members. These profits interests were designated "Class A" interests under the operating agreements for the investment LLCs. The class A interests were structured concurrent with Lender Management's reorganization and its shift to a profit-based office model.

Under the initial terms of the operating agreements, effective August 1, 2005, Lender Management was entitled to receive for its class A interests the following percentages: (1) from Lenco, 1% of net asset value annually, plus 5% of any increase in net asset value from the prior fiscal period; (2) from M&M, 5% of gross receipts annually, plus 2% of any increase in net asset value from the prior fiscal period; and (3) from Lotis, 2% of net asset value annually, plus 5% of net trading profits.[5] Lender Management received income from the class A interests only to the extent that the investment LLCs generated profits. Net asset value was defined as the amount by which the fair market value of the investment LLC's assets exceeded its liabilities.

[5] For Lotis, class A interests were entitled to a share of the adjusted profit as defined in the operating agreement.

As of December 31, 2010, the operating agreements for M&M and Lenco were amended to provide Lender Management with increased profits interests. The class A interests for M&M and Lenco were increased to equal the aggregate of 2.5% of net asset value, plus 25% of the increase in net asset value, annually. Similar to the initial terms of the operating agreements, Lender Management received payments for its class A interests only to the extent that M&M and Lenco generated net profits. The increased profits interests were intended to more closely align Lender Management's goal of maximizing profits with that of its clients and to create greater incentive for Lender Management and its employees to perform successfully as managers of the invested portfolios. During the tax years in issue any payments that Lender Management earned from its profits interests were to be paid separately from the payments that it would otherwise receive as a minority member of each of the investment LLCs.

C. ***Lender Management Services***

During the tax years in issue Lender Management made investment decisions and executed transactions on behalf of the investment LLCs. It operated for the purpose of earning a profit, and its main objective was to earn the highest possible return on assets under management. Lender Management provided individual investors in the investment LLCs with one-on-one investment advisory and financial planning services.

> Lender Management employed five employees during each of the tax years in issue. It had a total payroll for its employees of $333,200, $311,233, and $390,554 during the tax years in issue, respectively. For tax year 2011 the payroll included a $123,249 guaranteed payment to Keith. For tax year 2012 the payroll included a $206,417 guaranteed payment to Keith.

Lender Management's chief investment officer worked about 50 hours a week. The court described his activities:

> As CIO, Keith retained the ultimate authority to make all investment decisions on behalf of Lender Management and the investment LLCs. Most of his time was dedicated to researching and pursuing new investment opportunities and monitoring and managing existing positions. For example, he discovered a company in Israel, and Lender Management owned an interest in and participated in the management of this company.
>
> He reviewed personally approximately 150 private equity and hedge fund proposals per year on behalf of the investment LLCs. He met with and attended presentations of hedge fund managers, private equity managers, and investment bankers. Lender Management is not an active trader, but in a typical year the firm would enter into multiple new private equity deals and make one or two hedge fund trades.
>
> Lender Management arranged annual business meetings, which were for all clients in the investment LLCs. These group meetings were held so that Lender Management could review face-to-face with all of its clients the performance of their investments at least once per year. The location of the annual meeting changed each year so that no single investor was repeatedly inconvenienced by having to travel a long distance. Because of conflicts Keith had difficulty getting all of Lender Management's clients to attend these meetings. He would conduct additional face-to-face meetings with clients who were more interested in the status of their financial investments at times and locations that were convenient for them.
>
> Keith interacted directly with Lender Management's clients. He collected information from and worked with these individuals to understand their cashflow needs and their risk tolerances for investment, and Lender Management engaged in asset allocation based on these and other factors. Lender Management devised and implemented special ventures known as eligible investment options (EIOs), which allowed clients to participate in investments more directly suited to their age and risk tolerance. Keith developed and maintained a number of computer models, including a model that projected the cash needs of individual investors and a model that tracked and forecasted the cashflows associated with M&M's private equity investments.

Lender Management had other employees and outsourced certain management services:

> Lender Management interviewed accounting and investment firms to provide outsourced management services beginning in 2006. It hired Harris myCFO, a division of Harris Bank, which provided both accounting and investment advice. In 2010 two of the principals of Harris myCFO formed their own firm, Pathstone Family Office, LLC (Pathstone), and Lender Management engaged Pathstone on May 6, 2010.[7] During the tax years in issue Pathstone provided Lender Management with accounting and investment advisory services.
>
> [7] Lender Management began the process of terminating its relationship with Harris myCFO in 2009 in anticipation of its move to Pathstone. When discussing outsourced management services received by Lender Management during the tax years in issue we refer hereinafter to

Pathstone, although the record is unclear as to whether Lender Management still engaged Harris myCFO in the early months of 2010.

Pathstone's accounting professionals were based in Atlanta, Georgia. Ms. Flament spoke with the accounting professionals over the phone between three and five times per week, and they exchanged between 50 and 100 emails per week. During the tax years in issue Pathstone prepared Lender Management's partnership tax returns. Pathstone also prepared quarterly financial reports for the investment LLCs.

Keith worked at the same office buildings as Pathstone's investment professionals in Englewood Cliffs, and later Fort Lee, New Jersey. He collaborated with Pathstone's principal investment adviser in selecting new investments for the investment LLCs. He presented Pathstone's advisers with his own research on investment opportunities, and he often received their advice before acting on prospective deals. Pathstone's advisers also presented him with investment opportunities. Keith exercised ultimate authority over the investment LLCs' investments and did not always follow Pathstone's advice. Pathstone did not have the authority to move cash on behalf of Lender Management or the investment LLCs.

The court reviewed the cases discussed above:

Certain activities are not considered trades or businesses. An investor is not, by virtue of his activities undertaken to manage and monitor his own investments, engaged in a trade or business. *Whipple v. Commissioner*, 373 U.S. 193 (1963); *Higgins v. Commissioner*, 312 U.S. at 218. "No matter how large the estate or how continuous or extended the work required may be", overseeing the management of one's own investments is generally[9] regarded as the work of a mere investor. *Higgins v. Commissioner*, 312 U.S. at 218. Expenses incurred by the taxpayer in trading securities or performing other investment-related activities strictly for his own account generally may not be deducted under section 162 as expenses incurred in carrying on a trade or business. See *id.*; *Beals v. Commissioner*, T.C. Memo. 1987-171. The taxpayer's activities as an investor may produce income or profit, but profit from investment is not taken as evidence that the taxpayer is engaged in a trade or business. Any profit so derived arises from the successful conduct of the trade or business of the corporation or other venture in which the taxpayer has taken a stake, rather than from the taxpayer's own activities. *Whipple v. Commissioner*, 373 U.S. at 202.

[9] An exception to the general rule applies when the taxpayer is also an active trader of securities. See *Moller v. United States*, 721 F.2d 810 (Fed. Cir. 1983); *Liang v. Commissioner*, 23 T.C. 1040 (1955). Petitioners do not contend that Lender Management operated as a trader during the tax years in issue.

A common factor distinguishing the conduct of a trade or business from mere investment has been the receipt by the taxpayer of compensation other than the normal investor's return. *Whipple v. Commissioner*, 373 U.S. at 202-203. Compensation other than the normal investor's return is income received by the taxpayer directly for his or her services rather than indirectly through the corporate enterprise. *Id.* At 203. If the taxpayer receives not just a return on his or her own investment but compensation attributable to his or her services provided to others, then that fact tends to show that he or she is in a trade or business. *Dagres v. Commissioner*, 136 T.C. at 281-282. The trade-or-business designation may apply even though the taxpayer invests his or her own funds alongside those that are managed for others, provided the facts otherwise support the conclusion that the taxpayer is actively engaged in providing services to others and is not just a passive investor. *Id.* at 282, 285-286.

> An activity that would otherwise be a business does not necessarily lose that status because it includes an investment function. *Id.* at 281. Work that includes investing or facilitating the investing of others' funds may qualify as a trade or business. *Id.* In *Dagres* we held that "[s]elling one's investment expertise to others is as much a business as selling one's legal expertise or medical expertise." Id. Investment advisory, financial planning, and other asset management services provided to others may constitute a trade or business. See *id.*

The court discussed the heightened scrutiny of this being a family business:[1328]

> Generally transactions within a family group are subjected to heightened scrutiny. *Estate of Bongard v. Commissioner*, 124 T.C. 95, 119 (2005); *Cirelli v. Commissioner*, 82 T.C. 335, 343 (1984). Where a payment is made in the context of a family relationship, we carefully scrutinize the facts to determine whether there was a bona fide business relationship and whether the payment was not made because of the familial relationship. See *Commissioner v. Culbertson*, 337 U.S. 733, 746 (1949); *Martens v. Commissioner*, T.C Memo. 1990-42, *aff'd* without published opinion, 934 F.2d 319 (4th Cir. 1991). In *DiDonato v. Commissioner*, T.C. Memo. 2013-11, we concluded that certain payments between cousin-owned businesses were not deductible. The payments were not deductible because the record did not establish that services were actually rendered.
>
> We find that Lender Management satisfies a review under heightened scrutiny. The end-level investors in the investment LLCs during the tax years in issue were all members of the Lender family. Lender Management's CIO, Keith, is a member of the Lender family. His father Marvin was managing member and 99%-owner of Lender Management in 2010, and Keith occupied the same position in 2011 and 2012. At all relevant times only two members of the Lender family were owners of Lender Management.
>
> Separate from Lender Management, Marvin owned 11.47% of Lenco and 5.84% of M&M in 2010. Keith owned indirectly less than 4% of Lenco and 10% of M&M during the years he served as managing member.
>
> There was no requirement or understanding among members of the Lender family that Lender Management would remain manager of the assets held by the investment LLCs indefinitely. Lender Management's investment choices and related activities were driven by the needs of clients, and its clients were able to withdraw their investments if they became dissatisfied with its services. Investors in Lenco and Lotis were entitled to withdraw their capital interests for any reason at least annually. Although a complete withdrawal from M&M required the manager's approval, we are satisfied on the facts before us that there was a common understanding that Lender Management would grant such approval if any investor became unhappy with how his or her funds were being managed.
>
> Apart from what they received as returns on their respective investments, Lender Management's clients generally earned employment income. For example, Carl worked in sales for a cable communications company. Keith, like Carl, would have benefited from his membership in the investment LLCs during the tax years in issue regardless of whether he chose to work for Lender Management. Keith's position compensated him for the services that he provided to Lender Management, and it was his only full-time job during the tax years in issue. As managing member

[1328] For *Bongard* and related cases regarding scrutiny of a family business entity for estate tax purposes, see part III.C.1 Whether Code § 2036 Applies.

> he was highly motivated to excel and to see Lender Management receive the benefit of the class A interests.
>
> Although each investor in the investment LLCs was in some way a member of the Lender family, Lender Management's clients did not act collectively or with a single mindset. Lender Management's clients were geographically dispersed, many did not know each other, and some were in such conflict with others that they refused to attend the same business meetings. Their needs as investors did not necessarily coincide. Lender Management did not simply make investments on behalf of the Lender family group. It provided investment advisory services and managed investments for each of its clients individually, regardless of the clients' relationship to each other or to the managing member of Lender Management.

Contrasting *Higgins*,[1329] the court said:

> Lender Management was not managing its own money. Most of the assets under management were owned by members of the Lender family that had no ownership interest in Lender Management. Lender Management managed investments and did substantially more than keeping records and collecting interest and dividends.

Contrasting *Beals*,[1330] in which the taxpayer managed investments for himself, his wife, and their children, the court noted:

> In that case there was no business relationship. By contrast Lender Management had an obligation to its clients, and it tailored its investment strategy, allocated assets, and performed other related financial services specifically to meet the needs of its clients.

The court concluded:

> There is no dispute that Lender Management provided services. The profits interests were provided in exchange for services and not because Marvin and Keith were part of the Lender family. The Lender family members that participated in the investment LLCs expected Lender Management to provide them with services similar to those of a hedge fund manager. The relationship between Lender Management and the investment LLCs was a business relationship.
>
> Respondent cites no applicable attribution rules that would require us to treat Lender Management or its managing member as owning all of the interests in the investment LLCs. Lender Management carried on its operations in a continuous and businesslike manner for the purpose of earning a profit, and it provided valuable services to clients for compensation. For the tax years in issue Lender Management was carrying on a trade or business for the purpose of section 162.

II.G.4.l.i.(e). Family Office As a Trade or Business

This part II.G.4.l.i.(e) discusses tax issues. Part II.G.4.l.i.(f) Family Office – Securities Law Issues discusses certain regulation of family offices.

Part II.G.4.l.i.(d) Whether Managing Investments Constitutes a Trade or Business teaches:

[1329] See fn 1269 in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162 and text accompanying fn 1314.
[1330] See text accompanying fn 1315.

- Managing one's own investments[1331] (or the investments of one's spouse and children)[1332] does not constitute a trade or business, unless one is a day trader or something similar.[1333]

- Managing another person's investments may constitute a trade or business, whether one's compensation is expressed as a fixed payment or a profits interest.[1334]

- However, a C corporation may deduct expenses of managing investments.[1335]

- Giving a C corporation that incurs investment management expenses a profits interest in an investment partnership allows the investors to deflect profits to the C corporation instead of trying to deduct investment fees themselves. However, a conservative approach of complying with proposed regulations regarding service partners adds significant complexity, making this planning complex from a financial and tax viewpoint, as described in this part II.G.4.l.i.(e). Before including a QTIP trust in such a partnership, consider parts II.H.2.c QTIP Trusts - Code § 2519 Trap and II.O.2.c Effect of Buy-Sell Agreement on Marital Deduction.

Concerned with the unfairness of disallowing deductions for activities designed to generate profit that did not rise to the level of a trade or business,[1336] Congress enacted Code § 212 to provide individuals with an itemized deduction for investment expenses.[1337] Congress even relaxed the rules if the individual could prove that the activity generated a profit in enough years or had sufficient profit motive.[1338]

However, 2017 tax reform disallowed investment expenses through December 31, 2025.[1339] Even when deductible for regular tax, they would not be deductible for alternative minimum tax purposes.[1340] Running expenses through a partnership or S corporation does not change this treatment.[1341]

Taxpayers may try to avoid these limitations by giving the investment manager a profits interest in a partnership through which they invest their taxable assets instead of paying an advisory fee. (The emphasis is on taxable investments, because one cannot deduct expenses incurred in managing tax-exempt investments.)[1342] Favorable precedent includes *Dagres*[1343] and *Lender Management*,[1344] both of which are described (*Lender Management* extensively) in part II.G.4.l.i.(d) Whether Managing Investments Constitutes a Trade or Business.

Deflecting the income to the investment management firm solves the investment partnership's owners' problem, but then one needs to consider the consequences of the investment management firm's expenses. To prevent the investment management firm from having the same problem regarding miscellaneous

[1331] See fns 1313-1316, as well as part II.G.4.l.i.(a) "Trade or Business" Under Code § 162, especially fn 1269.
[1332] See text accompanying fns 1315-1316.
[1333] See fns 1317-1327 and the accompanying text.
[1334] See fns 1326-1330 and the accompanying text.
[1335] See text accompanying fn 1278 in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162.
[1336] See fn 1314 in part II.G.4.l.i.(d) Whether Managing Investments Constitutes a Trade or Business.
[1337] See part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax, fn 1397 and part II.G.4.l.i.(b) Requirements for Deduction Under Code § 212.
[1338] See part II.G.4.l.i.(c) Hobby Loss Benefits of Code § 183. Despite its pejorative name, Code § 183 is a favorable provision that benefits individuals.
[1339] See Code § 67(g), cited in part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.
[1340] See part II.G.4.n Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.
[1341] Reg. § 1.67-2T(b)(1).
[1342] Code § 265.
[1343] See fns 1326-1327 and the accompanying text.
[1344] See fns 1329-1330 and the accompanying and preceding text, which started shortly after fn 1327.

itemized deductions, the investment management firm needs to be engaged in a trade or business. As described in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162, this inquiry depends on a variety of circumstances, and whether the investment management firm will be able to deduct the expenses is unpredictable, unless it is owned by an unrelated third party that provides services to a variety of clients. Of course, if the investment management firm is owned by third parties and one errs on the side of a higher profits interest (so that the firm can pay its expenses), then one risks overpaying for the services.

In *Hellman v. Commissioner*, a case that was later settled with substantial income tax payments,[1345] the Tax Court's October 1, 2018 order included the following:

> These cases involve expense deductions claimed by GF Family Management, LLC (GFM), an investment management firm owned and operated by petitioners. Petitioners are members of the same family, and GFM is a "family office" as defined by the Federal securities laws. See 17 C.F.R 275.202(a)(11)(G)-1(b)(1) and (d)(4). Each petitioner held a 25% profits interest in GFM, and the assets managed by GFM were held by six investment partnerships. GFM held a 1% interest in each partnership, and trusts of which petitioners are the beneficiaries held (individually or collectively) the remaining 99% of each partnership….
>
> These cases appear to resemble *Lender Management* in some respects, but not in others. GFM is a family office that managed investment assets for four family members. All four family members resided in the Atlanta metropolitan area and appear to have been on good terms. GFM received performance-based compensation keyed to the success of the investments it made. One investor, Mark Graham, appears to have had authority over day-to-day investment decisions. But here, unlike in Lender Management, all of the other investors were also owners of the management company, with each investor holding a 25% profits interest in GFM.
>
> Each party contends that summary judgment may be granted in his favor on the basis of the Court's legal rulings and factual findings in *Lender Management*. From our review of the facts currently contained in the record, we do not think that opinion dictates a ruling in favor of either side as a matter of law. In *Lender Management* we relied on a variety of factors tending to prove (or disprove) the existence of a "trade or business." Besides the manner in which the family office was compensated for its services, relevant factors may include but are not necessarily limited to: (1) the nature and extent of the services provided by the family office employees; (2) the relative amounts of expertise possessed and time devoted by family office employees versus outside investment managers and consultants; (3) the individualization of investment strategies for different family members with differing investment preferences and needs; and (4) the proportionality (or lack thereof) between the share of profits inuring to each family member in his or her capacity as an owner of the family office and the share of profits inuring to that same individual in his or her capacity as an investor in the managed funds.
>
> In cases such as these, an important question is whether the owners of the family office are "actively engaged in providing services to others," *Lender Management*, at *26, or are simply providing services to themselves. *See Dagres*, 136 T.C. at 281 ("Selling one's investment expertise to others is as much a business as selling one's legal expertise."). Here, each family member had a 25% profits interest in GFM. If each family member (for example) also had an aggregate 25% interest in the assets under management, there would be perfect proportionality between the

[1345] On November 9, 2018, Judge Lauber entered a decision in docket no. 8486-17, confirming agreed-upon "deficiencies in income tax due from petitioners for the taxable years 2012, 2013, and 2014 in the amounts of $98,074.00, $138,055.00, and $132,459.00, respectively."

two streams of income. In that event, it would not matter how GFM was compensated, because that compensation, once distributed ratably to the four owners, would simply replace investment income that each person would otherwise have derived from the investment portfolios. That was not the case in *Lender Management*, where one family member had a 99% profits interest in the management company, but held only minority interests in the assets under management. The facts currently in the record do not enable the Court to assess the degree or proportionality (or lack thereof) here.

We conclude that further factual development is necessary to shed light on this and other questions. Relevant facts may include the following:

- The education and professional background of each investor-employee.

- The work schedules of each investor-employee, with descriptions of the general work performed. Ideally, this information would include approximate hours worked weekly or monthly.

- Any details pertaining to the decision process by which GFM was selected as the management company, the decision process by which Mark Graham was chosen as GFM's manager, and the identities of any other candidates considered for these two roles.

- The net asset value of each investment partnership, on a quarterly, semiannual, and/or annual basis, during the 2012-2014 tax years in question and also during 2011 and 2015.

- The aggregate percentage ownership interest that each of the four family members had in the total assets held by all the investment partnerships. Such percentage figures might be provided on a quarterly, semi-annual, and/or annual basis, for the 2012-2014 tax years in question and also for 2011 and 2015.

- Information concerning the major investments held by each investment partnership and the estimated dollar value of those investments.

- The similarities and distinctions between the investment strategies and objectives of each investment partnership. Relevant distinguishing factors might include average asset turnover, relative investment horizons, and the relative risk and nature of the investments made.

- How (if at all) the investment strategies and objectives of the partnerships were tailored to the individual needs and preferences of the four family members.

- Any additional facts the parties believe would be relevant to the "trade or business" analysis as undertaken in *Lender Management*.

The IRS attacks may seek to recharacterize the profits interest, which deflects income, as a nondeductible guaranteed payment; to defend against this attack, the investment management firm's profits interest should have real entrepreneurial risk.[1346] Here are some guidelines under the rules described in fn 1346:

[1346] See fns 511-531 in part II.C.8.a Code § 707 - Compensating a Partner for Services Performed. The paragraphs preceding and encompassing the text accompanying fns 528-531 focus on entrepreneurial risk and make structuring the profits interest somewhat tricky.

- The budgeted annual profits interest should be reasonable. Consider weighing the possibility of making a gift in granting a vested interest that might exceed annual reasonable compensation[1347] against what might seem like a third party at-will relationship if the profits interest is terminable at will or is constantly being tinkered with. Ultimately, I favor allowing termination or periodic adjustments, so long as the partnership has a business reason for the investment management company's continued involvement, such as wanting a management company with a stable leadership team invested in the partnership's ongoing success, and the adjustments do not happen too frequently.

- Although a preferred profits interest is consistent with the partnership income tax rules generally, such an interest in a marketable securities partnership might be perceived to reduce entrepreneurial risk, and a cap on a profits interest might be perceived to resemble a fee. Therefore, a straight pro rata percentage of all partnership items seems safer.

- The government is concerned about a service partner being able to manipulate the annual profits to generate a steady fee. How this might play out in an investment partnership might be the service partner deciding how to time capital gains and losses. Accordingly, consider making distributions (other than tax distributions) be based on the lesser of cumulative realized net income or cumulative combined realized and unrealized net income. This introduces some complexity, in that distributions of income earned and taxed in one year might be suspended due to unrealized losses and need to be made up in a future year when any unrealized losses are reversed (through being recognized or through growth in value).

- Suppose the partnership starts off well and the investment management company receives significant distributions, then the partnership doesn't do so well but the management company keeps the money. The IRS suggested that such an arrangement would seem like a fee, rather than the management company facing an entrepreneurial risk of loss. Therefore, the preamble and proposed regulations introduced the idea of clawback – the investment management company must repay the distributions. This clawback idea does envision the investment management company keeping tax distributions, which would be only fair considering that it cannot get a refund by carrying back a net operating loss[1348] and generally a capital loss is not deducible in excess of capital gains.[1349] The preamble and proposed regulations do not specify when the repayment of distributions must occur; perhaps it could occur when the partnership terminates, but query whether it should occur much sooner to feel more "real."

Issuing a pure profits interest is a nontaxable event for income tax purposes,[1350] presumably because the holder will be earning income each year as profits are received. The structure described above distributes profits to all parties out of the same pool. However, it may be desirable to distribute profits in tiers, each of which has different allocations; this is called a preferred profits interest.[1351]

If there is risk that the investment management firm may not be able to deduct its expenses, consider using a C corporation for its choice of entity. A C corporation's federal tax rate is 21%, compared to 23.8% for qualified dividends and long-term capital gains and 40.8% for other ordinary income paid to an individual in the highest federal income tax bracket. Its deductions for state income tax are not limited. Furthermore,

[1347] See fn 1353 and the accompanying text.
[1348] See part II.G.4.l.ii Net Operating Loss Deduction.
[1349] The rule and exceptions are described in the text accompanying fns 1507-1509 in part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy and fn 1390 in part II.G.4.m.i Code § 1341 Claim of Right Deduction.
[1350] See part II.M.4.f Issuing a Profits Interest to a Service Provider.
[1351] See generally part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

when a C corporation receives dividends from a domestic corporation, it can exclude at least 50% of them from income. For details, see part II.E.1.g Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation. A C corporation is also more likely than an individual to be able to deduct investment expenses under Code § 162.[1352]

I'm not a fan of C corporations, because double tax generally will apply, when the earnings come out, sooner or later, making them more expensive in the long-run (depending on the time value of money) than pass-through entities. See part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities. However, if the investment management firm is spending its income on providing investment management services, then it might not accumulate much income to distribute.

Thus, a C corporation offers reduced income tax rates on investment income and deduction of none, part, or all of the investment management expenses. A corporation that does not pay dividends may become subject to the 20% accumulated earnings tax or personal holding company income tax. See part 0 No distributions under Biden's plan:

Biden Plan	
Distributing 50% of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-36,800
Net Income after Income Tax	$63,200

So, effective tax rates under current law are 55.8% distributing all earnings, 42.8% distributing half of the earnings, and 29.8% distributing none of the earnings.

Effective tax rates under the Biden plan are 72.6% distributing all earnings, 54.7% distributing half of the earnings, and 36.8% distributing none of the earnings.

Incentives to Declare Dividends.

Now for some additional caveats:

If the investment management firm is owned by family members who also own the investment partnership but is not owned in the same proportion as the investment partnership, an unexpected gift may be deemed to have been made.[1353] I expect this gift to be minimal, because the profits interest is annually renewable, but calculations under the regulations under Code § 2701 may generate gifts beyond reasonable expectations.

[1352] See text accompanying fn 1278 in part II.G.4.l.i.(a) "Trade or Business" Under Code § 162.

[1353] See part III.B.7.c.ii Profits Interest in a Partnership in Which Transferor and Applicable Family Members Initially Hold Only a Profits Interest, which is part of part III.B.7.c Code § 2701 Interaction with Income Tax Planning and informed by part III.B.7.b Code § 2701 Overview.

If the corporation provides personal services that do not relate to managing investments, be sure to charge for them. Failure to charge can constitute a constructive dividend, cause the expenses to be disallowed at the corporate level and incur a taxable dividend to the shareholder.[1354]

Furthermore, accounting for investment partnerships can be complex. A partnership needs to account for built-in gain and loss not only with respect to assets contributed to the partnership but also for assets that the partnership owns when partners come and go. See part II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships. Also, contributions of cash within two years before or after a distribution of property raises issues described in part II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner, and contributions of property within two years before or after a distributions of cash raises issues described in part II.M.3.e Exception: Disguised Sale Rules.

Given all of the issues described in this part II.G.4.l.i.(e), one might not even consider this structure unless annual investment management fees exceed $200,000.

II.G.4.l.i.(f). Family Office – Securities Law Issues

I am not a securities law expert. Below is a description of the "family office" exemption from registration under the Investment Advisers Act of 1940. The Securities & Exchange Commission (SEC) explained:[1355]

> The failure of a family office to be able to meet the conditions of the rule will not preclude the office from providing advisory services to family members either collectively or individually. Rather, the family office will need to register under the Advisers Act (unless another exemption is available) or seek an exemptive order from the Commission. A number of family offices currently are registered under the Advisers Act.

A "family office," as defined in 17 C.F.R. § 275.202(a)(11)(G)-1, is not considered an "investment adviser" for purpose of the Investment Advisers Act of 1940.[1356] Certain pre-2010 persons are automatically considered "family offices" under this rule.[1357] Being excluded from the definition of an "investment adviser" for purpose of the Investment Advisers Act of 1940 precludes state regulation.[1358]

[1354] See fn 4596 in part II.Q.7.a.iv Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303.

[1355] Part II of RIN 3235-AK66, which is SEC Release No. IA-3220; File No. S7-25-10.

[1356] 17 C.F.R. § 275.202(a)(11)(G)-1(a).

[1357] 17 C.F.R. § 275.202(a)(11)(G)-1(c) provides:

> *Grandfathering*. A family office as defined in paragraph (a) of this section shall not exclude any person, who was not registered or required to be registered under the Act on January 1, 2010, solely because such person provides investment advice to, and was engaged before January 1, 2010 in providing investment advice to:
>
> (1) Natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who have invested with the family office before January 1, 2010 and are accredited investors, as defined in Regulation D under the Securities Act of 1933;
>
> (2) Any company owned exclusively and controlled by one or more family members; or
>
> (3) Any investment adviser registered under the Act that provides investment advice to the family office and who identifies investment opportunities to the family office, and invests in such transactions on substantially the same terms as the family office invests, but does not invest in other funds advised by the family office, and whose assets as to which the family office directly or indirectly provides investment advice represents, in the aggregate, not more than 5 percent of the value of the total assets as to which the family office provides investment advice; provided that a family office that would not be a family office but for this paragraph (c) shall be deemed to be an investment adviser for purposes of paragraphs (1), (2) and (4) of section 206 of the Act.

[1358] 15 U.S.C. § 80b-3a(b) provides:

Otherwise, for purposes of the family office exclusion:[1359]

> A family office is a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) that:
>
> (1) Has no clients other than family clients;[1360] provided that if a person that is not a family client becomes a client of the family office as a result of the death of a family member[1361] or key employee[1362] or other involuntary transfer from a family member or key employee, that person shall be deemed to be a family client for purposes of this section for one year following the completion of the transfer of legal title to the assets resulting from the involuntary event;

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(1) *In general*. No law of any State or political subdivision thereof requiring the registration, licensing, or qualification as an investment adviser or supervised person of an investment adviser shall apply to any person--
   (A) that is registered under section 80b-3 of this title as an investment adviser, or that is a supervised person of such person, except that a State may license, register, or otherwise qualify any investment adviser representative who has a place of business located within that State;
   (B) that is not registered under section 80b-3 of this title because that person is excepted from the definition of an investment adviser under section 80b-2(a)(11) of this title; or
   (C) that is not registered under section 80b-3 of this title because that person is exempt from registration as provided in subsection (b)(7) of such section, or is a supervised person of such person.
(2) *Limitation*. Nothing in this subsection shall prohibit the securities commission (or any agency or office performing like functions) of any State from investigating and bringing enforcement actions with respect to fraud or deceit against an investment adviser or person associated with an investment adviser.

15 U.S.C. § 80b-2(a)(11) provides:

> "Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include … (G) any family office, as defined by rule, regulation, or order of the Commission, in accordance with the purposes of this subchapter; or (H) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

[1359] 17 C.F.R. § 275.202(a)(11)(G)-1(b).

[1360] [This footnote is not from the quoted material.] For the definition of a "family client," see text accompanying fn 1365.

[1361] [This footnote is not from the quoted material.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(6) provides:

> Family member means all lineal descendants (including by adoption, stepchildren, foster children, and individuals that were a minor when another family member became a legal guardian of that individual) of a common ancestor (who may be living or deceased), and such lineal descendants' spouses or spousal equivalents; provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members.

[1362] [This footnote is not from the quoted material.] For the definition of a "key employee," see text accompanying fn 1370.

(2) Is wholly owned by family clients and is exclusively controlled[1363] (directly or indirectly) by one or more family members and/or family entities;[1364] and

(3) Does not hold itself out to the public as an investment adviser.

The rule does not explain what a "client" is, but it does define "family client" as:[1365]

(i) Any family member;[1366]

(ii) Any former family member;[1367]

(iii) Any key employee;[1368]

(iv) Any former key employee, provided that upon the end of such individual's employment by the family office, the former key employee shall not receive investment advice from the family office (or invest additional assets with a family office-advised trust, foundation or entity) other than with respect to assets advised (directly or indirectly) by the family office immediately prior to the end of such individual's employment, except that a former key employee shall be permitted to receive investment advice from the family office with respect to additional investments that the former key employee was contractually obligated to make, and that relate to a family-office advised investment existing, in each case prior to the time the person became a former key employee.

[1363] [This footnote is not from the quoted material.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(2) provides:

> Control means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company.

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> Commenters persuaded us to expand who may own the family office from "family members" to "family clients." This change is consistent with the intent behind our proposed language (which contemplated that the family could own the family office indirectly) and more clearly allows family members to structure their ownership of the family office for tax or other reasons. We also agree with suggestions that the rule permit key employees to own a non-controlling stake in the family office to serve as part of an incentive compensation package for key employees. We remain convinced, however, that for our core policy rationale to be fulfilled - that a family office is essentially a family managing its own wealth - the family, directly or indirectly, should control the family office. Accordingly, the final rule provides that while family clients may own the family office, family members and family entities (*i.e.*, their wholly owned companies or family trusts) must control the family office.[109]
>
> [109] We note that, as proposed, we are not limiting the exclusion to a family office that is not operated for the purpose of generating a profit. We also note that some family offices may be structured such that all or a portion of family client investment gains are distributed as dividends from the family office (when family clients own the family office) and that a not-for-profit requirement would preclude this family office structure. We were persuaded by several commenters who cautioned against limiting the exclusion for family offices to those that operate on a not-for-profit basis, arguing that it would be difficult to administer and is unnecessary given the limited clientele that a family office may advise and rely on the exclusion. *See, e.g.*, AICPA Letter; Davis Polk Letter; Kozusko Letter.

[1364] [This footnote is not from the quoted material.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(5) provides:

> Family entity means any of the trusts, estates, companies or other entities set forth in paragraphs (d)(4)(v), (vi), (vii), (viii), (ix), or (xi) of this section, but excluding key employees and their trusts from the definition of family client solely for purposes of this definition.

[1365] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(4).

[1366] [This footnote is not from the quoted material.] For the definition of a "family member," see text accompanying fn 1361.

[1367] [This footnote is not from the quoted material.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(7) provides:

> Former family member means a spouse, spousal equivalent, or stepchild that was a family member but is no longer a family member due to a divorce or other similar event.

[1368] [This footnote is not from the quoted material.] For the definition of a "key employee," see text accompanying fn 1370.

(v) Any non-profit organization, charitable foundation, charitable trust (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries[1369] are other family clients and charitable or non-profit organizations), or other charitable organization, in each case for which all the funding such foundation, trust or organization holds came exclusively from one or more other family clients;

(vi) Any estate of a family member, former family member, key employee, or, subject to the condition contained in paragraph (d)(4)(iv) of this section, former key employee;

(vii) Any irrevocable trust in which one or more other family clients are the only current beneficiaries;

(viii) Any irrevocable trust funded exclusively by one or more other family clients in which other family clients and non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations are the only current beneficiaries;

(ix) Any revocable trust of which one or more other family clients are the sole grantor;

(x) Any trust of which: Each trustee or other person authorized to make decisions with respect to the trust is a key employee; and each settlor or other person who has contributed assets to the trust is a key employee or the key employee's current and/or former spouse or spousal equivalent who, at the time of contribution, holds a joint, community property, or other similar shared ownership interest with the key employee; or

(xi) Any company wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more other family clients; provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of "investment company" under the Investment Company Act of 1940.

The definition of "key employee" has a few components:[1370]

- A "natural person," including "any key employee's spouse or spouse equivalent[1371] who holds a joint, community property, or other similar shared ownership interest with that key employee."
- Who either:[1372]

[1369] [This footnote is not from the quoted material.] Part II.A.1.c of RIN 3235-AK66, which is SEC Release No. IA-3220; File No. S7-25-10, explains:

> As suggested by commenters, the final rule disregards contingent beneficiaries of trusts, which commenters explained are often named in the event that all family members are deceased to prevent the trust from distributing assets to distant relatives or escheating to the state.[51] If the contingent beneficiary later becomes an actual beneficiary and is not a permitted current beneficiary of a family trust under the exclusion (such as a family friend), the rule's provisions concerning involuntary transfers allow for an orderly transition of investment advice regarding those assets away from the family office.
>
> [51] *See, e.g.*, Comment Letter of Arnold & Porter LLP (Nov. 11, 2010); Bessemer Letter.

[1370] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(8).

[1371] [This footnote was not in the quote.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(9) provides:

> Spousal equivalent means a cohabitant occupying a relationship generally equivalent to that of a spouse.

[1372] I wasn't quite sure of this breakdown the way that 17 C.F.R. § 275.202(a)(11)(G)-1(d)(8) reads. However, part II.A.1.f of RIN 3235-AK66, which is SEC Release No. IA-3220; File No. S7-25-10, provides:

- Is "an executive officer,[1373] director, trustee, general partner, or person serving in a similar capacity of the family office or its affiliated family office,"[1374] or
- Is an "employee of the family office or its affiliated family office[1375] (other than an employee performing solely clerical, secretarial, or administrative functions with regard to the family office) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office or affiliated family office, provided that such employee has been performing such functions and duties for or on behalf of the family office or affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months."

II.G.4.l.ii. Net Operating Loss Deduction (Code § 172)

If net losses from business activities cause a taxpayer to have a negative taxable income, Code § 172 may allow a taxpayer to deduct a net operating loss (NOL).[1376] Note that one does not generate an NOL until

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The final rule treats certain key employees of the family office, their estates, and certain entities through which key employees may invest as family clients so that they may receive investment advice from, and participate in investment opportunities provided by, the family office. More specifically, the final rule permits the family office to provide investment advice to any natural person (including any key employee's spouse or spousal equivalent who holds a joint, community property or other similar shared ownership interest with that key employee) who is (i) an executive officer, director, trustee, general partner, or person serving in a similar capacity at the family office or its affiliated family office or (ii) any other employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial, or administrative functions) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office or affiliated family office, provided that such employee has been performing such functions or duties for or on behalf of the family office or affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least twelve months.[79] The final rule also permits the family office to advise certain trusts of key employees, as further described below. Finally, in addition to receiving direct advice from the family office, key employees (because they are "family clients") may indirectly receive investment advice through the family office by their investment in family office-advised private funds, charitable organizations, and other family entities, as described in previous sections of this Release.

[79] Rule 202(a)(11)(G)-1(d)(8).

[1373] [This footnote was not in the quote.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(3) provides:

Executive officer means the president, any vice president in charge of a principal business unit, division or function (such as administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the family office.

[1374] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(1) provides:

Affiliated family office means a family office wholly owned by family clients of another family office and that is controlled (directly or indirectly) by one or more family members of such other family office and/or family entities affiliated with such other family office and has no clients other than family clients of such other family office.

For the definition of a "family entity," see fn 1364.

[1375] See fn 1374.

[1376] Code § 172(d)(4), "Nonbusiness deductions of taxpayers other than corporations," excludes the following from computing a net operating loss:

In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence -

(A) any gain or loss from the sale or other disposition of -
   (i) property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or
   (ii) real property used in the trade or business,
   shall be treated as attributable to the trade or business;
(B) the modifications specified in paragraphs (1), (2)(B), and (3) shall be taken into account;
(C) any deduction for casualty or theft losses allowable under paragraph (2) or (3) of section 165(c) shall be treated as attributable to the trade or business; and

after applying limitations relating to debt-financed or other losses described in parts II.G.4.c Basis Limitations for Deducting Partnership and S Corporation Losses and II.G.4.j At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities).

This part II.G.4.l.ii is intended only to provide a broad overview of how NOLs fit into the overall scheme of loss deductions; it is not intended to teach one how to compute or efficiently use NOLs.

2017 tax reform eliminated the NOL carryback and now provides an unlimited NOL carryforward.[1377] However, the 2020 CARES Act temporarily reinstated the carryback. The Senate Finance Committee Report explained:

> **Section 2303. Modifications for net operating losses**
>
> The provision relaxes the limitations on a company's use of losses. Net operating losses (NOL) are currently subject to a taxable-income limitation, and they cannot be carried back to reduce income in a prior tax year. The provision provides that an NOL arising in a tax year beginning in 2018, 2019, or 2020 can be carried back five years. The provision also temporarily removes the taxable income limitation to allow an NOL to fully offset income. These changes will allow companies to utilize losses and amend prior year returns, which will provide critical cash flow and liquidity during the COVID-19 emergency.
>
> **Section 2304. Modification of limitation on losses for taxpayers other than corporations**
>
> The provision modifies the loss limitation applicable to pass-through businesses and sole proprietors, so they can utilize excess business losses and access critical cash flow to maintain operations and payroll for their employees.

Note that the 2020 CARES Act provision described above and effectuated below does not provide immediate relief for 2020 losses, because 2020 NOLs will not be determined until taxpayers file their 2020 returns in the spring of 2021. However, a taxpayer owing 2019 tax might be able to get an installment agreement with the IRS and then use the NOL towards payments deferred until 2021 and future years. If an owner of a pass-through entity pledges his anticipated NOL carryback refund (offsetting income from that entity reported on prior years' returns) to secure a loan to the entity while entity is in bankruptcy, the bankruptcy court may enforce that pledge;[1378] furthermore, a refund of taxes paid with respect to one spouse's income is not tenancy-by-the-entirety property.[1379] The IRS has posted unofficial guidance as Frequently Asked Questions: Temporary procedures to fax certain Forms 1139 and 1045 due to COVID-19; if that link does not work or to get information on this and other topics regarding the 2020 CARES Act, go to Coronavirus Tax Relief and Economic Impact Payments.

> (D) any deduction allowed under section 404 to the extent attributable to contributions which are made on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall not be treated as attributable to the trade or business of such individual.

See also parts II.G.27.b Real Estate as a Trade or Business and II.G.4.l.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit.

[1377] Code § 172(a), (b).

[1378] *In re: Somerset Regional Water Resources, LLC*, 949 F.3d 837 (3rd Cir. 2020), interpreting an ambiguous pledge agreement in favor of providing the security the lender reasonably expected.

[1379] *In re: Somerset Regional Water Resources, LLC*, 949 F.3d 837 (3rd Cir. 2020), with an extensive quote on this subject in the text accompanying fn 1116 in part II.F.7 Tenancy by the Entirety.

Accordingly, Code § 172(a) allows "a deduction for the taxable year an amount equal to"

(1) in the case of a taxable year beginning before January 1, 2021, the aggregate of the net operating loss carryovers to such year, plus the net operating loss carrybacks to such year, and

(2) in the case of a taxable year beginning after December 31, 2020, the sum of -

(A) the aggregate amount of net operating losses arising in taxable years beginning before January 1, 2018, carried to such taxable year, plus

(B) the lesser of -

(i) the aggregate amount of net operating losses arising in taxable years beginning after December 31, 2017, carried to such taxable year, or

(ii) 80 percent of the excess (if any) of –[1380]

(I) taxable income computed without regard to the deductions under this section and sections 199A and 250, over

(II) the amount determined under subparagraph (A).

Code § 172(b), "Net operating loss carrybacks and carryovers," includes:

- (1) "Years to which loss may be carried,"
- (2) "Amount of carrybacks and carryovers," and
- (3) "Election to waive carryback."

Code § 172(b)(1)(D), "Special Rule For Losses Arising in 2018, 2019, and 2020," provides:

(i) *In General.* In the case of any net operating loss arising in a taxable year beginning after December 31, 2017, and before January 1, 2021 -

(I) such loss shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss, and

(II) subparagraphs (B) and (C)(i) shall not apply.

P.L. 116-260, § 281(a), Div. N, added § 2303(e) to P.L. 116-136, retroactively, so that P.L. 116-136, § 2303(e), "Special rules with respect to farming losses," provides:

[1380] [My footnote:] The 2020 CARES Act also amended Code § 172(b)(2)(C) to provide that, "For purposes of the preceding sentence, the taxable income for any such prior taxable year shall" …

(C) for taxable years beginning after December 31, 2020, be reduced by 20 percent of the excess (if any) described in subsection (a)(2)(B)(ii) for such taxable year.

(1) *Election to disregard application of amendments made by subsections (a) and (b).*

(A) *In general*. If a taxpayer who has a farming loss (within the meaning of section 172(b)(1)(B)(ii) of the Internal Revenue Code of 1986) for any taxable year beginning in 2018, 2019, or 2020 makes an election under this paragraph, then -

(i) the amendments made by subsection (a) shall not apply to any taxable year beginning in 2018, 2019, or 2020, and

(ii) the amendments made by subsection (b) shall not apply to any net operating loss arising in any taxable year beginning in 2018, 2019, or 2020.

(B) *Election*.

(i) *In general*. Except as provided in clause (ii)(II), an election under this paragraph shall be made in such manner as may be prescribed by the Secretary. Such election, once made, shall be irrevocable.

(ii) *Time for making election*.

(I) *In general*. An election under this paragraph shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxpayer's first taxable year ending after the date of the enactment of the COVID-related Tax Relief Act of 2020.

(II) *Previously filed returns*. In the case of any taxable year for which the taxpayer has filed a return of Federal income tax before the date of the enactment of the COVID-related Tax Relief Act of 2020 which disregards the amendments made by subsections (a) and (b), such taxpayer shall be treated as having made an election under this paragraph unless the taxpayer amends such return to reflect such amendments by the due date (including extensions of time) for filing the taxpayer's return for the first taxable year ending after the date of the enactment of the COVID-related Tax Relief Act of 2020.

(C) *Regulations*. The Secretary of the Treasury (or the Secretary's delegate) shall issue such regulations and other guidance as may be necessary to carry out the purposes of this paragraph, including regulations and guidance relating to the application of the rules of section 172(a) of the Internal Revenue Code of 1986 (as in effect before the date of the enactment of the CARES Act) to taxpayers making an election under this paragraph.

(2) *Revocation of election to waive carryback*. The last sentence of section 172(b)(3) of the Internal Revenue Code of 1986 and the last sentence of section 172(b)(1)(B) of such Code shall not apply to any election -

(A) which was made before the date of the enactment of the COVID-related Tax Relief Act of 2020, and

(B) which relates to the carryback period provided under section 172(b)(1)(B) of such Code with respect to any net operating loss arising in taxable years beginning in 2018 or 2019."

Rev. Proc. 2021-14, Section 1.02 provides:

> Specifically, this revenue procedure prescribes when and how to make an election with regard to all NOLs of the taxpayer, regardless of whether the NOL is a Farming Loss NOL. This revenue procedure also provides that a taxpayer is treated as having made a deemed election under § 2303(e)(1) of the CARES Act if the taxpayer, before December 27, 2020, filed one or more original or amended Federal income tax returns, or applications for tentative refund, that disregard the CARES Act Amendments with regard to a Farming Loss NOL. This revenue procedure further prescribes when and how to revoke an election made under § 172(b)(1)(B)(iv) or § 172(b)(3) of the Code to waive the two-year carryback period for the farming loss portion of a Farming Loss NOL incurred in a taxable year beginning in 2018 or 2019.

More about NOL carryback procedures under Code § 172 follows after discussing the limits Code § 461(*l*) places on individuals.

IRS training on 2017 changes, "Modification of Net Operating Loss Deduction," is at https://www.irs.gov/pub/newsroom/tcja-training-provision-13302-modified-nol.pdf. The Internal Revenue Manual procedural update, "Carryback CARES Act Guidance," amended IRM subsection 21.5.9, at https://www.irs.gov/pub/foia/ig/wi/wi-21-0520-0589_redacted.pdf.

Code § 461(*l*), "Limitation on Excess Business Losses of Noncorporate Taxpayers," provides:

(1) *Limitation*. In the case of taxable year of a taxpayer other than a corporation -

(A) for any taxable year beginning after December 31, 2017, and before January 1, 2026, subsection (j) (relating to limitation on excess farm losses of certain taxpayers) shall not apply, and

(B) for any taxable year beginning after December 31, 2020, and before January 1, 2026, any excess business loss of the taxpayer for the taxable year shall not be allowed.

(2) *Disallowed Loss Carryover*. Any loss which is disallowed under paragraph (1) shall be treated as net operating loss for the taxable year for purposes of determining any net operating loss carryover under section 172(b) for subsequent taxable years.

(3) *Excess Business Loss*. For purposes of this subsection -

(A) *In General*. The term "excess business loss" means the excess (if any) of –

(i) the aggregate deductions of the taxpayer for the taxable year which are attributable to trades or businesses of such taxpayer (determined without regard to whether or not such deductions are disallowed for such taxable year under paragraph (1) and without regard to any deduction allowable under section 172 or 199A),[1381] over

(ii) the sum of –

[1381] [My footnote:] See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income, especially fn 749 in part II.E.1.c.i.(b) Other Federal Effects of Code § 199A Deduction.

(I) the aggregate gross income or gain of such taxpayer for the taxable year which is attributable to such trades or businesses, plus

(II) $250,000 (200 percent of such amount in the case of a joint return).

Such excess shall be determined without regard to any deductions, gross income, or gains attributable to any trade or business of performing services as an employee.

(B) *Treatment Of Capital Gains And Losses*.

(i) *Losses*. Deductions for losses from sales or exchanges of capital assets shall not be taken into account under subparagraph (A)(i).

(ii) *Gains*. The amount of gains from sales or exchanges of capital assets taken into account under subparagraph (A)(ii) shall not exceed the lesser of -

(I) the capital gain net income determined by taking into account only gains and losses attributable to a trade or business, or

(II) the capital gain net income.

(C) *Adjustment for Inflation*. In the case of any taxable year beginning after December 31, 2018, the $250,000 amount in subparagraph (A)(ii)(II) shall be increased by an amount equal to -

(i) such dollar amount, multiplied by

(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting "2017" for "2016" in subparagraph (A)(ii) thereof.

If any amount as increased under the preceding sentence is not a multiple of $1,000, such amount shall be rounded to the nearest multiple of $1,000.

(4) *Application of Subsection in Case of Partnerships and S Corporations*. In the case of a partnership or S corporation -

(A) this subsection shall be applied at the partner or shareholder level, and

(B) each partner's or shareholder's allocable share of the items of income, gain, deduction, or loss of the partnership or S corporation for any taxable year from trades or businesses attributable to the partnership or S corporation shall be taken into account by the partner or shareholder in applying this subsection to the taxable year of such partner or shareholder with or within which the taxable year of the partnership or S corporation ends.

For purposes of this paragraph, in the case of an S corporation, an allocable share shall be the shareholder's pro rata share of an item.

(5) *Additional Reporting*. The Secretary shall prescribe such additional reporting requirements as the Secretary determines necessary to carry out the purposes of this subsection.

(6) *Coordination with Section 469*. This subsection shall be applied after the application of section 469.[1382]

As to Code § 461(*l*), IRS training, "Limitation on Losses for Taxpayers other than Corporations," is at https://www.irs.gov/pub/newsroom/tcja-training-provision-11012-limits-on-losses.pdf.

I have heard uncertainty expressed regarding how alternative minimum tax (AMT) carrybacks work for C corporations, given that AMT income is no longer calculated because 2017 tax reform repealed AMT for 2018 and future years.

Guidance under the 2020 CARES Act helps taxpayers expedite their tentative NOL carryback refunds. Such a tentative refund generally pays the taxpayer the claimed refund (generally within 90 days of making the claim) and is subject to review, etc. after the refund. Notice 2020-26 "extends the deadline for filing an application for a tentative carryback adjustment … with respect to the carryback of an NOL that arose in any taxable year that began during calendar year 2018 and that ended on or before June 30, 2019."[1383] Rev. Proc. 2020-24 provides guidance regarding elections relating to NOL carrybacks from 2018, 2019, or 2020.[1384]

CCA 201928014 explained how its author believed a corporation computes its charitable deduction[1385] in conjunction with net operating losses:

<u>ISSUES</u>

(1) Taxpayer has both charitable contribution and net operating loss carryovers from multiple tax years available in the year at issue. Section 170(d)(2)(B) requires a reduction to a taxpayer's charitable contribution carryover to the extent an excess charitable contribution reduces

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[1382] [My footnote:] For Code § 469, see part II.K Passive Loss Rules.

[1383] Notice 2020-26, Section 3, "Extension of Time to File," begins with:

The Department of the Treasury and the IRS grant a six-month extension of time to file Form 1045 or Form 1139, as applicable, to taxpayers that have an NOL that arose in a taxable year that began during calendar year 2018 and that ended on or before June 30, 2019. This extension of time is limited to requesting a tentative refund to carry back an NOL and does not extend the time to carry back any other item.

For example, in the case of an NOL that arose in a taxable year ending on December 31, 2018, a taxpayer normally would have until December 31, 2019, to file the Form 1045 or Form 1139, as applicable, but due to this relief, will now have until June 30, 2020, to file the Form 1045 or Form 1139, as applicable. For this same taxpayer, if the taxpayer is a corporation, the deadline to claim a minimum tax credit described in § 53(e)(5) is December 30, 2020, but in order to file one application for a tentative refund and claim both the NOL carryback and the minimum tax credit at the same time, the taxpayer must do so by the earlier of the two deadlines.

[1384] Rev. Proc. 2020-24, Section 1.02 provides:

This revenue procedure prescribes when and how to file the following elections.

(1) *Election to waive NOL carryback*. Section 4.01(1) of this revenue procedure provides guidance regarding an election under § 172(b)(3) to waive the carryback period for an NOL arising in a taxable year beginning after December 31, 2017, and before January 1, 2020.

(2) *Election to exclude section 965 years*. Section 4.01(2) of this revenue procedure provides guidance regarding an election under § 172(b)(1)(D)(v)(I) to exclude from the carryback period for an NOL arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, any taxable year in which the taxpayer has a section 965(a) inclusion, as defined in § 1.965-1(f)(37) (a section 965 year).

(3) *Elections under the CARES Act special rule concerning taxable years beginning before January 1, 2018, and ending after December 31, 2017*. Section 4.04(1) of this revenue procedure provides guidance regarding elections under the special rule set forth in § 2303(d) of the CARES Act to waive any carryback period, to reduce any carryback period, or to revoke any election made under § 172(b) to waive any carryback period for a taxable year that began before January 1, 2018, and ended after December 31, 2017.

[1385] See part II.G.4.g Limitations on Deducting Charitable Contributions, especially fn 1210.

modified taxable income (as computed under § 172(b)(2)) and increases an NOL carryover, so as to eliminate a double tax benefit. Is Taxpayer required to calculate the charitable contribution carryover adjustment using a year-by-year or an aggregate NOL computation under § 172(b)(2)?

(2) Taxpayer has a charitable contribution carryover set to expire in the year at issue pursuant to the five-year carryover period provided in § 170(d)(2). Section 170(d)(2)(B) requires a reduction to a taxpayer's charitable contribution carryover to the extent an excess charitable contribution reduces modified taxable income (as computed under § 172(b)(2)) and increases an NOL carryover. Is Taxpayer required to reduce its current year charitable contributions first or can it choose to reduce a prior year's charitable contribution carryover to prevent its expiration?

<u>CONCLUSIONS</u>

(1) Section 172(b)(2) requires Taxpayer to use a year-by-year NOL absorption computation to determine the charitable contribution carryover adjustment under § 170(d)(2)(B).

(2) Taxpayer must first reduce its current year charitable contributions by the adjustment under § 170(d)(2)(B) before reducing its earliest year's charitable contribution carryover.

CCA 201928014 provided an example:

X Corp had $1,000 of taxable income in 2017 before considering its NOL carryovers or charitable contribution deduction. X Corp had NOL carryovers of $5,000 available to use in 2017, which included $100 from 2012 and $1,500 from 2013. X Corp also had charitable carryovers available to use in 2017 of $300, which included $150 from 2012. In 2017, X Corp made charitable contributions of $120.

In this example, like in Taxpayer's case, X Corp cannot deduct any charitable contributions in 2017 because the NOL carryovers reduce taxable income for 2017 to $0. But, like Taxpayer, X Corp still must compute the 10% limit for purposes of determining modified taxable income and the amount of the NOL carryovers that are absorbed.

First, X Corp must subtract its 2012 NOL from its 2017 taxable income to determine the § 170 taxable income ($1,000-$100=$900). X Corp must then multiply its § 170 taxable income by the 10% limitation ($900x10=$90). The $90 represents the amount of the 2017 charitable contribution that is allowed for purposes of calculating modified taxable income under § 172(b)(2).

Second, because X Corp cannot deduct any charitable contributions in 2017 and it has NOL and charitable carryovers, it must determine how much of the 2017 charitable contributions it can carry over to 2018 after applying the § 170(d)(2)(B) adjustment. X Corp must reduce its 2017 charitable contributions by $90 because that amount was allowed in the modified taxable income calculation ($900-$90=$810), resulting in an increased NOL carryover to 2018 and the charitable contributions not actually being deducted. The result is that only $30 ($120-$90) of the 2017 charitable contributions is allowed to be carried over to 2018.

Lastly, X Corp must calculate the amount of the 2013 NOL carryover that is absorbed under § 172(b)(2) and the amount carried over to 2018. The 2013 NOL carryover is reduced by the amount absorbed, which is the 2017 modified taxable income, and the remainder is carried over to 2018 ($1,500-$810=$690).

II.G.4.l.iii. Code § 267 Disallowance of Related-Party Deductions or Losses

Code § 267(a) disallows certain related-party deductions or losses.[1386]

Code § 267(b) applies the following relationships for subsection (a):

(1) Members of a family, as defined in subsection (c)(4);

(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(3) Two corporations which are members of the same controlled group (as defined in subsection (f));

(4) A grantor and a fiduciary of any trust;

(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

(6) A fiduciary of a trust and a beneficiary of such trust;

[1386] Code § 267(a) provides:

(1) *Deduction for losses disallowed*. No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). The preceding sentence shall not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.

(2) *Matching of deduction and payee income item in the case of expenses and interest*. If—

(A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and

(B) at the close of the taxable year of the taxpayer for which (but for this paragraph) the amount would be deductible under this chapter, both the taxpayer and the person to whom the payment is to be made are persons specified in any of the paragraphs of subsection (b),

then any deduction allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made (or, if later, as of the day on which it would be so allowable but for this paragraph). For purposes of this paragraph, in the case of a personal service corporation (within the meaning of section 441(i)(2)), such corporation and any employee-owner (within the meaning of section 269A(b)(2), as modified by section 441(i)(2)) shall be treated as persons specified in subsection (b).

(3) *Payments to foreign persons*.

(A) *In general*. The Secretary shall by regulations apply the matching principle of paragraph (2) in cases in which the person to whom the payment is to be made is not a United States person.

(B) *Special rule for certain foreign entities*.

(i) *In general*. Notwithstanding subparagraph (A), in the case of any item payable to a controlled foreign corporation (as defined in section 957) or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the payor with respect to such amount for any taxable year before the taxable year in which paid only to the extent that an amount attributable to such item is includible (determined without regard to properly allocable deductions and qualified deficits under section 952(c)(1)(B)) during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.

(ii) *Secretarial authority*. The Secretary may by regulation exempt transactions from the application of clause (i), including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged and in which the payment of the accrued amounts occurs within 8½ months after accrual or within such other period as the Secretary may prescribe.

(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;

(10) A corporation and a partnership if the same persons own—

(A) more than 50 percent in value of the outstanding stock of the corporation, and

(B) more than 50 percent of the capital interest, or the profits interest, in the partnership;

(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;

(12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

Grantor trusts are disregarded from their deemed owners for this purpose. See CCA 201343021.[1387]

Reg. § 1.267(b)-1, "Relationships," provides:

(a) *In general*.

(1) The persons referred to in section 267(a) and § 1.267(a)-1 are specified in section 267(b).

(2) Under section 267(b)(3), it is not necessary that either of the two corporations be a personal holding company or a foreign personal holding company for the taxable year in which the sale or exchange occurs or in which the expenses or interest are properly accruable, but either one of them must be such a company for the taxable year next preceding the taxable year in which the sale or exchange occurs or in which the expenses or interest are accrued.

(3) Under section 267(b)(9), the control of certain educational and charitable organizations exempt from tax under section 501 includes any kind of control, direct or indirect, by means of which a person in fact controls such an organization, whether or not the control is legally enforceable and regardless of the method by which the control is exercised or exercisable. In the case of an individual, control possessed by the individual's family, as

[1387] See fn 6333 in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation.

defined in section 267(c)(4) and paragraph (a)(4) of § 1.267(c)-1, shall be taken into account.

(b) *Partnerships*.

(1) Since section 267 does not include members of a partnership and the partnership as related persons, transactions between partners and partnerships do not come within the scope of section 267. Such transactions are governed by section 707 for the purposes of which the partnership is considered to be an entity separate from the partners. See section 707 and § 1.707-1. Any transaction described in section 267(a) between a partnership and a person other than a partner shall be considered as occurring between the other person and the members of the partnership separately. Therefore, if the other person and a partner are within any one of the relationships specified in section 267(b), no deductions with respect to such transactions between the other person and the partnership shall be allowed—

(i) To the related partner to the extent of his distributive share of partnership deductions for losses or unpaid expenses or interest resulting from such transactions, and

(ii) To the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by such other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of such transaction.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example (1). A, an equal partner in the ABC partnership, personally owns all the stock of M Corporation. B and C are not related to A. The partnership and all the partners use an accrual method of accounting, and are on a calendar year. M Corporation uses the cash receipts and disbursements method of accounting and is also on a calendar year. During 1956 the partnership borrowed money from M Corporation and also sold property to M Corporation, sustaining a loss on the sale. On December 31, 1956, the partnership accrued its interest liability to the M Corporation and on April 1, 1957 (more than 2½ months after the close of its taxable year), it paid the M Corporation the amount of such accrued interest. Applying the rules of this paragraph, the transactions are considered as occurring between M Corporation and the partners separately. The sale and interest transactions considered as occurring between A and the M Corporation fall within the scope of section 267(a) and (b), but the transactions considered as occurring between partners B and C and the M Corporation do not. The latter two partners may, therefore, deduct their distributive shares of partnership deductions for the loss and the accrued interest. However, no deduction shall be allowed to A for his distributive shares of these partnership deductions. Furthermore, A's adjusted basis for his partnership interest must be decreased by the amount of his distributive share of such deductions. See section 705(a)(2).

Example (2). Assume the same facts as in example (1) of this subparagraph except that the partnership and all the partners use the cash receipts and disbursements method of accounting, and that M Corporation uses an accrual method. Assume further, that during 1956 M Corporation borrowed money from the partnership and that on a sale of property to the partnership during that year M Corporation sustained a loss. On December 31, 1956, the M Corporation accrued its interest liability on the borrowed money and on April 1, 1957 (more than 2½ months after the close of its taxable year) it paid the accrued interest to the partnership. The corporation's deduction for the accrued interest it not allowed to the extent of A's distributive share (one-third) of such interest income. M Corporation's deduction for the loss on the sale of the property to the partnership is not allowed to the extent of A's one-third interest in the purchased property.

Code § 267(c) applies the following rules in determining the ownership of stock subsection (b):[1388]

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

Reg. § 1.267(c)-1, "Constructive ownership of stock," provides:

(a) *In general*.

(1) The determination of stock ownership for purposes of section 267(b) shall be in accordance with the rules in section 267(c).

(2) For an individual to be considered under section 267(c)(2) as constructively owning the stock of a corporation which is owned, directly or indirectly, by or for members of his family it is not necessary that he own stock in the corporation either directly or indirectly. On the other hand, for an individual to be considered under section 267(c)(3) as owning the stock of a corporation owned either actually, or constructively under section 267(c)(1), by or for his partner, such individual must himself actually own, or constructively own under section 267(c)(1), stock of such corporation.

(3) An individual's constructive ownership, under section 267(c)(2) or (3), of stock owned directly or indirectly by or for a member of his family, or by or for his partner, is not to be considered as actual ownership of such stock, and the individual's constructive ownership of the stock is not to be attributed to another member of his family or to another partner. However, an individual's constructive ownership, under section 267(c)(1), of stock owned directly or indirectly by or for a corporation, partnership, estate, or trust shall be considered

[1388] Code § 267(c) also applies for attribution in certain partnership related-party transactions. See fn 5328 in part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

as actual ownership of the stock, and the individual's ownership may be attributed to a member of his family or to his partner.

(4) The family of an individual shall include only his brothers and sisters, spouse, ancestors, and lineal descendants. In determining whether any of these relationships exist, full effect shall be given to a legal adoption. The term "ancestors" includes parents and grandparents, and the term "lineal descendants" includes children and grandchildren.

(b) *Examples*. The application of section 267(c) may be illustrated by the following examples:

Example (1). On July 1, 1957, A owned 75 percent, and AW, his wife, owned 25 percent, of the outstanding stock of the M Corporation. The M Corporation in turn owned 80 percent of the outstanding stock of the O Corporation. Under section 267(c)(1), A and AW are each considered as owning an amount of the O Corporation stock actually owned by M Corporation in proportion to their respective ownership of M Corporation stock. Therefore, A constructively owns 60 percent (75 percent of 80 percent) of the O Corporation stock and AW constructively owns 20 percent (25 percent of 80 percent) of such stock. Under the family ownership rule of section 267(c)(2), an individual is considered as constructively owning the stock actually owned by his spouse. A and AW, therefore, are each considered as constructively owning the M Corporation stock actually owned by the other. For the purpose of applying this family ownership rule, A's and AW's constructive ownership of O Corporation stock is considered as actual ownership under section 267(c)(5). Thus, A constructively owns the 20 percent of the O Corporation stock constructively owned by AW, and AW constructively owns the 60 percent of the O Corporation stock constructively owned by A. In addition, the family ownership rule may be applied to make AWF, AW's father, the constructive owner of the 25 percent of the M Corporation stock actually owned by AW. As noted above, AW's constructive ownership of 20 percent of the O Corporation stock is considered as actual ownership for purposes of applying the family ownership rule, and AWF is thereby considered the constructive owner of this stock also. However, AW's constructive ownership of the stock constructively and actually owned by A may not be considered as actual ownership for the purpose of again applying the family ownership rule to make AWF the constructive owner of these shares. The ownership of the stock in the M and O Corporations may be tabulated as follows:

[chart omitted because I'm too lazy]

Assuming that the M Corporation and the O Corporation make their income tax returns for calendar years, and that there was no distribution in liquidation of the M or O Corporation, and further assuming that either corporation was a personal holding company under section 542 for the calendar year 1956, no deduction is allowable with respect to losses from sales or exchanges of property made on July 1, 1957, between the two corporations. Moreover, whether or not either corporation was a personal holding company, no loss would be allowable on a sale or exchange between A or AW and either corporation. A deduction would be allowed, however, for a loss sustained in an arm's length sale or exchange between A and AWF, and between AWF and the M or O Corporation.

Example (2). On June 15, 1957, all of the stock of the N Corporation was owned in equal proportions by A and his partner, AP. Except in the case of distributions in liquidation by the N Corporation, no deduction is allowable with respect to losses from sales or exchanges of property made on June 15, 1957, between A and the N Corporation or AP and the N Corporation since each partner is considered as owning the stock owned by the other; therefore, each is considered as owning more than 50 percent in value of the outstanding stock of the N Corporation.

Example (3). On June 7, 1957, A owned no stock in X Corporation, but his wife, AW, owned 20 percent in value of the outstanding stock of X, and A's partner, AP, owned 60 percent in value of the outstanding stock of X. The partnership firm of A and AP owned no stock in X Corporation. The ownership of AW's stock is attributed to A, but not that of AP since A does not own any X Corporation stock either actually, or constructively under section 267(c)(1). A's constructive ownership of AW's stock is not the ownership required for the attribution of AP's stock. Therefore, deductions for losses from sales or exchanges of property made on June 7, 1957, between X Corporation and A or AW are allowable since neither person owned more than 50 percent in value of the outstanding stock of X, but deductions for losses from sales or exchanges between X Corporation and AP would not be allowable by section 267(a) (except for distributions in liquidation of X Corporation).

An irrevocable trust paying mandatory income to the grantor's surviving spouse, remainder to the grantor's children is not related under Code § 267(b) or 707(b)(1) with respect to grantor trusts deemed owned by the grantor's two siblings, respectively.[1389]

II.G.4.m. Fixing Unfair Income Tax Results

II.G.4.m.i. Code § 1341 Claim of Right Deduction

Our income tax system tends to accelerate income recognition and defer deductions, absent specific provisions to the contrary (of which there are very notable provisions). If a taxpayer recognizes income that ultimately not something the taxpayer can keep, writing off that income in a future year might not do justice to the taxpayer, depending on the taxpayer's future tax posture. Accordingly, Code § 1341(a), "General rule," provides:

If -

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amount of such deduction exceeds $3,000,

then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to -

[1389] Letter Ruling 200920032.

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

For purposes of paragraph (5)(B), the corresponding provisions of the Internal Revenue Code of 1939 shall be chapter 1 of such code (other than subchapter E, relating to self-employment income) and subchapter E of chapter 2 of such code.

As to the Code § 1341(a)(1) requirement that "an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item," *Mihelick v. U.S.*, 927 F.3d 1138 (11th Cir. 2019), described what "appeared" implies:

> What matters is whether Mihelick sincerely believed she had a right to Bluso's income, not the correctness of her belief. *McKinney v. United States*, 574 F.2d 1240, 1243 (5th Cir. 1978)[2] ("The language of [§] 1341(a)(1), *i.e.*[,] `because it appeared that the taxpayer had an unrestricted right to such item,' must necessarily mean `because it appeared (*to the taxpayer*) that (he) had an unrestricted right to such item.'" (emphasis added)). After all, if a taxpayer had to correctly believe that she had an unrestricted right to income to qualify for § 1341, then the taxpayer would have correctly paid her income taxes in the first place, and § 1341 would never come into play, since the second element of § 1341 requires a showing that the taxpayer did not, in fact, have an unrestricted right to the income. So Mihelick did not need to be right that she had an unrestricted right to Bluso's income; she just needed to sincerely believe it.[3]
>
> [2] Decisions handed down by the Fifth Circuit by the close of business on September 30, 1981, are binding on this Court.
>
> [3] The taxpayer need only subjectively believe that she was entitled to an item of income - even if some may consider her belief to be unreasonable. As stated, the object of § 1341 is "to put the taxpayer in the same position he would have been in had he not included the item as gross income in the first place." *Fla. Progress*, 348 F.3d at 957. The section does not discriminate between those who reasonably or unreasonably paid excess taxes - its aim is to return to the taxpayer excess taxes paid. And this makes good sense: no one would report and pay taxes on income to which she does not believe herself to be entitled, only to take the trouble of going through § 1341 to return herself to her starting position.

As to the Code § 1341(a)(2) requirement that "it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item," *Mihelick v. U.S.*, 927 F.3d 1138 (11th Cir. 2019), described this element:

> To make this showing, the taxpayer must demonstrate that she involuntarily gave away the relevant income because of some obligation, and the obligation had a substantive nexus to the original receipt of the income. See *Batchelor-Robjohns v. United States*, 788 F.3d 1280, 1293-94 (11th Cir. 2015). Mihelick satisfies both requirements.
>
> Mihelick involuntarily gave away $300,000 of the relevant income to which she previously believed she had an unrestricted right. We have explained that "payments made to settle a lawsuit" may constitute an involuntary obligation for § 1341 purposes. *Batchelor-Robjohns*, 788 F.3d at 1293-94 (citing *Barrett v. Commissioner*, 96 T.C. 713 (1991)).[4] In *Barrett*, two groups of

securities brokers sued Barrett and several other shareholders at his brokerage firm after the Securities and Exchange Commission instituted administrative proceedings against the brokers for suspected insider-trading violations. *Barrett*, 96 T.C. at 715. At a hearing, the magistrate judge advised Barrett and his co-defendants to settle the suits to "avoid the hazards of litigation," "substantial legal fees," and "adverse trial publicity," all of which would be harmful for Barrett and his brokerage business. *Id.* Barrett heeded the magistrate judge's advice and without admitting wrongdoing, settled the civil suits for $54,000. *Id.* He then sought a tax credit through § 1341. *Id.* At 716.

> [4] In *Batchelor-Robjohns*, we adopted *Barrett*'s reasoning as to what constitutes an involuntary obligation, but we did not adopt all aspects of *Barrett*. Part of *Barrett*'s reasoning rested on the distinction between taking a tax credit and a deduction under § 1341. See *Barrett*, 96 T.C. at 718. But in *Batchelor-Robjohns*, we ruled that the "deduction/credit distinction merely determines how to account for a § 1341 repayment on one's return, nothing more." *Batchelor-Robjohns*, 788 F.3d at 1297.

The government fought Barrett's attempt to obtain the § 1341 credit. It argued that Barrett's payment was voluntary, so he failed to establish that he did not have an unrestricted right to the $54,000 he paid to settle the suits. *Id.* at 718. In particular, the government complained that Barrett "merely settled the lawsuits" while continuing to deny his liability and "was not compelled to pay out $54,000 by a judicial decree after a trial on the merits." *Id.*

The *Barrett* Court was unmoved by the government's arguments. It would be "ludicrous," the *Barrett* Court explained, "[t]o conclude that [Barrett] restored the $54,000 voluntarily without regard to any legal obligation." *Id.* At 719. Pointing out the risks that Barrett faced – losing his license, facing up to $10 million in liability, not knowing the type of evidence the plaintiffs wielded - and the fact that "[t]he policy of the law is to foster the peaceful settlement of disputes without litigation," *Barrett* held that the settlement was "made in good faith and at arm's length." *Id.* at 719-20. That good-faith settlement, "whether or not embodied in a judgment, established the fact and the amount of [Barrett's] legal obligation" and showed that Barrett did not have an unrestricted right to the $54,000 for § 1341 purposes. *Id.*

Mihelick's situation is materially indistinguishable. As with Barrett, Mihelick's obligation to pay arose not from a final judgment, but from an agreement she entered in good-faith to avoid litigation. And it would be equally as "ludicrous" - as it was in *Barrett* to say that Barrett voluntarily paid his $54,000 - to conclude that Mihelick voluntarily paid $300,000 of her income without regard to any legal obligation.

Indeed, Mihelick initially opposed paying Bluso for any liability arising from the Barnes lawsuit. Only after Bluso threatened her with litigation did she agree to be bound to do so and enter into Article 5 of her separation agreement. And even that did not occur without a battle: the parties actually negotiated Article 5 of the separation agreement - Bluso asked Mihelick to simply give him $150,000, but Mihelick turned down that offer because she judged that Barnes's lawsuit would not produce that much liability. Then, even after Bluso settled the Barnes lawsuit for $600,000 and attempted to collect $300,000 from Mihelick, she resisted paying, prompting Bluso to withhold alimony for a month.

In *Mihelick v. U.S.*, 927 F.3d 1138 (11th Cir. 2019), the taxpayer and her husband divorced, and she was forced to repay him half of the income he had returned to settle a dispute over his prior compensation that was included in a joint return. The court explained:

The government next suggests a new requirement that the taxpayer must meet. According to the government, a taxpayer lacks an unrestricted right to an item of income only if she returned the income to the "actual owner." Although the government cites no caselaw for support, its contention is not unprecedented. See *Alcoa, Inc. v. United States*, 509 F.3d 173, 180-82 (3d Cir. 2007). Nevertheless, we decline to adopt a new requirement for this Circuit that lacks a basis in the statutory text and is inconsistent with § 1341's purpose—namely, returning the taxpayer who unnecessarily pays taxes on income she did not have to "the same position [s]he would have been in had [s]he not included the item as gross income in the first place." *Fla. Progress*, 348 F.3d at 957. It is sufficient on this record that Barnes effectively and reasonably claimed to be the rightful owner of the $300,000, and Bluso and Mihelick - who otherwise had a claim to be the rightful owners of the $300,000 - agreed in a legally binding way not to challenge that.

Code § 1341(b), "Special rules," provides:

(1) If the decrease in tax ascertained under subsection (a)(5)(B) exceeds the tax imposed by this chapter for the taxable year (computed without the deduction) such excess shall be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year, and shall be refunded or credited in the same manner as if it were an overpayment for such taxable year.

(2) Subsection (a) does not apply to any deduction allowable with respect to an item which was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. This paragraph shall not apply if the deduction arises out of refunds or repayments with respect to rates made by a regulated public utility (as defined in section 7701(a)(33) without regard to the limitation contained in the last two sentences thereof) if such refunds or repayments are required to be made by the Government, political subdivision, agency, or instrumentality referred to in such section, or by an order of a court, or are made in settlement of litigation or under threat or imminence of litigation.

(3) If the tax imposed by this chapter for the taxable year is the amount determined under subsection (a)(5) , then the deduction referred to in subsection (a)(2)shall not be taken into account for any purpose of this subtitle other than this section .

(4) For purposes of determining whether paragraph (4) or paragraph (5) of subsection (a) applies -

(A) in any case where the deduction referred to in paragraph (4) of subsection (a) results in a net operating loss, such loss shall, for purposes of computing the tax for the taxable year under such paragraph (4), be carried back to the same extent and in the same manner as is provided under section 172 ; and

(B) in any case where the exclusion referred to in paragraph (5)(B) of subsection (a) results in a net operating loss or capital loss for the prior taxable year (or years), such loss shall, for purposes of computing the decrease in tax for the prior taxable year (or years) under such paragraph (5)(B), be carried back and carried over to the same extent and in the same manner as is provided under section 172 or section 1212, except that no carryover beyond the taxable year shall be taken into account.

(5) For purposes of this chapter, the net operating loss described in paragraph (4)(A) of this subsection, or the net operating loss or capital loss described in paragraph (4)(B) of this subsection, as the case may be, shall (after the application of paragraph (4) or (5)(B) of subsection (a) for the taxable year) be taken into account under section 172 or 1212 for taxable years after the taxable year to the same extent and in the same manner as -

(A) a net operating loss sustained for the taxable year, if paragraph (4) of subsection (a) applied, or

(B) a net operating loss or capital loss sustained for the prior taxable year (or years), if paragraph (5)(B) of subsection (a)applied.

In response to limitations in deducting capital losses,[1390] Reg. § 1.1341-1(c), "Application to deductions which are capital in nature," provides:

> Section 1341 and this section shall also apply to a deduction which is capital in nature otherwise allowable in the taxable year. If the deduction otherwise allowable is capital in nature, the determination of whether the taxpayer is entitled to the benefits of section 1341 and this section shall be made without regard to the net capital loss limitation imposed by section 1211. For example, if a taxpayer restores $4,000 in the taxable year and such amount is a long-term capital loss, the taxpayer will, nevertheless, be considered to have met the $3,000 deduction requirement for purposes of applying this section, although the full amount of the loss might not be allowable as a deduction for the taxable year. However, if the tax for the taxable year is computed with the deduction taken into account, the deduction allowable will be subject to the limitation on capital losses provided in section 1211, and the capital loss carryover provided in section 1212.

II.G.4.m.ii. Equitable Recoupment

Code § 6214(b), "Jurisdiction over other years and quarters," provides:[1391]

> The Tax Court in redetermining a deficiency of income tax for any taxable year or of gift tax for any calendar year or calendar quarter shall consider such facts with relation to the taxes for other years or calendar quarters as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other year or calendar quarter has been overpaid or underpaid. Notwithstanding the preceding sentence, the Tax Court may apply the doctrine of equitable recoupment to the same extent that it is available in civil tax cases before the district courts of the United States and the United States Court of Federal Claims.

Estate of Jorgensen v. Commissioner, T.C. Memo. 2009-66, quoted *Menard, Inc. v. Commissioner*, 130 T.C. 54, 62-63 (2008):

> The doctrine of equitable recoupment is a judicially created doctrine that, under certain circumstances, allows a litigant to avoid the bar of an expired statutory limitation period. The

[1390] See fns 1507-1509 and accompanying text in part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy.

[1391] In footnote 14, *Estate of Jorgensen v. Commissioner*, T.C. Memo. 2009-66, explained:

> Before the amendment to sec. 6214(b), the Courts of Appeals that considered whether we may entertain an equitable recoupment claim split on the question. Compare *Estate of Mueller v. Commissioner*, 153 F.3d 302 (6th Cir. 1998), *affg.* on other grounds 107 T.C. 189 (1996), with *Estate of Branson v. Commissioner*, 264 F.3d 904 (9th Cir. 2001), *affg.* 113 T.C. 6, 15 (1999).

Estate of Branson was a reviewed Tax Court decision, with a 12-3 vote.

doctrine prevents an inequitable windfall to a taxpayer or to the Government that would otherwise result from the inconsistent tax treatment of a single transaction, item, or event affecting the same taxpayer or a sufficiently related taxpayer. Equitable recoupment operates as a defense that may be asserted by a taxpayer to reduce the Commissioner's timely claim of a deficiency, or by the Commissioner to reduce the taxpayer's timely claim for a refund. When applied for the benefit of a taxpayer, the equitable recoupment doctrine allows a taxpayer to recoup the amount of a time-barred tax overpayment by allowing the overpayment to be applied as an offset against a deficiency if certain requirements are met.

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

As to factor (2), *Estate of Jorgensen v. Commissioner*, T.C. Memo. 2009-66, explained:

A claim of equitable recoupment will lie only where the Government has taxed a single transaction, item, or taxable event under two inconsistent theories. *Estate of Branson v. Commissioner*, 113 T.C. 6, 15 (1999), *affd.* 264 F.3d 904 (9th Cir. 2001). In *Estate of Branson*, the decedent's estate included stock in two closely held corporations. To pay applicable estate taxes, the estate sold a portion of the stock. The stock was sold for considerably more than its value reported on the estate. Under section 1014(a)(1),[16] the value of the stock tax return, as declared on the estate tax return was used as its basis for determining gain from the sale. The estate did not pay the tax on the sale but distributed the gain to the estate's residuary beneficiary, who paid the tax due. The Commissioner determined a deficiency in estate tax on the ground that the closely held corporation stock was worth substantially more than declared. In *Estate of Branson v. Commissioner*, T.C. Memo. 1999-231, we agreed with the Commissioner. Our revaluation of the stock resulted in an estate tax deficiency. Since pursuant to section 1014(a) the same valuation was used to determine the residuary beneficiary's gain on the sale of the stock, it followed that the residuary beneficiary had overpaid her income tax. *Estate of Branson v. Commissioner*, 264 F.3d at 907.

[16] Sec. 1014 generally provides a basis for property acquired from a decedent that is equal to the value placed upon the property for purposes of the Federal estate tax. See *Estate of Branson v. Commissioner*, 113 T.C. at 34-35; sec. 1.1014-1(a), Income Tax Regs.

When the same four individuals owned a law firm operated as a PC and another as an LLP and a payroll tax error caused the wrong entity to pay payroll taxes, a recovery of taxes against the correct entity generated equitable recoupment for taxes paid by the wrong entity. *Emery Celli Cuti Brinckerhoff & Abady v. Commissioner*, T.C. Memo. 2018-55.

II.G.4.m.iii. Tax Benefit Rule

Code § 111, "Recovery of tax benefit items," provides:

(a) *Deductions*. Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter.

(b) *Credits*.

(1) *In general*. If-

(A) a credit was allowable with respect to any amount for any prior taxable year, and

(B) during the taxable year there is a downward price adjustment or similar adjustment,

the tax imposed by this chapter for the taxable year shall be increased by the amount of the credit attributable to the adjustment.

(2) *Exception where credit did not reduce tax*. Paragraph (1) shall not apply to the extent that the credit allowable for the recovered amount did not reduce the amount of tax imposed by this chapter.

(3) *Exception for investment tax credit and foreign tax credit*. This subsection shall not apply with respect to the credit determined under section 46 and the foreign tax credit.

(c) *Treatment of carryovers*. For purposes of this section, an increase in a carryover which has not expired before the beginning of the taxable year in which the recovery or adjustment takes place shall be treated as reducing tax imposed by this chapter.

(d) *Special rules for accumulated earnings tax and for personal holding company tax*. In applying subsection (a) for the purpose of determining the accumulated earnings tax under section 531 or the tax under section 541 (relating to personal holding companies)-

(1) any excluded amount under subsection (a) allowed for the purposes of this subtitle (other than section 531 or section 541) shall be allowed whether or not such amount resulted in a reduction of the tax under section 531 or the tax under section 541 for the prior taxable year; and

(2) where any excluded amount under subsection (a) was not allowable as a deduction for the prior taxable year for purposes of this subtitle other than of section 531 or section 541 but was allowable for the same taxable year under section 531 or section 541, then such excluded amount shall be allowable if it did not result in a reduction of the tax under section 531 or the tax under section 541.

The companion cases of *Hillsboro Nat'l Bank v. Commissioner* and *Bliss Dairy, Inc. v. United States*, 460 U.S. 370 (1983), describe the tax benefit rule in part II of their opinion:

> The Government[7] in each case relies solely on the tax benefit rule - a judicially developed principle[8] that allays some of the inflexibilities of the annual accounting system. An annual accounting system is a practical necessity if the federal income tax is to produce revenue ascertainable and payable at regular intervals. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365

(1931). Nevertheless, strict adherence to an annual accounting system would create transactional inequities. Often an apparently completed transaction will reopen unexpectedly in a subsequent tax year, rendering the initial reporting improper. For instance, if a taxpayer held a note that became apparently uncollectible early in the taxable year, but the debtor made an unexpected financial recovery before the close of the year and paid the debt, the transaction would have no tax consequences for the taxpayer, for the repayment of the principal would be recovery of capital. If, however, the debtor's financial recovery and the resulting repayment took place after the close of the taxable year, the taxpayer would have a deduction for the apparently bad debt in the first year under § 166(a) of the Code, 26 U.S.C. § 166(a). Without the tax benefit rule, the repayment in the second year, representing a return of capital, would not be taxable. The second transaction, then, although economically identical to the first, could, because of the differences in accounting, yield drastically different tax consequences. The Government, by allowing a deduction that it could not have known to be improper at the time, would be foreclosed[9] from recouping any of the tax saved because of the improper deduction.[10] Recognizing and seeking to avoid the possible distortions of income,[11] the courts have long required the taxpayer to recognize the repayment in the second year as income. See, *e.g.*, *Estate of Block v. Commissioner*, 39 B.T.A. 338 (1939), *aff'd sub nom. Union Trust Co. v. Commissioner*, 111 F.2d 60 (CA7), *cert. denied*, 311 U.S. 658 (1940); *South Dakota Concrete Products Co. v. Commissioner*, 26 B.T.A. 1429 (1932); Plumb, *The Tax Benefit Rule Today*, 57 Harv. L. Rev., 129, 176, 178 and n. 172 (1943) (hereinafter Plumb).[12]

[7] In No. 81-485, the Solicitor General represents the Commissioner of Internal Revenue, while in No. 81-930, he represents the United States. We refer to the Commissioner and the United States collectively as "the Government."

[8] Although the rule originated in the courts, it has the implicit approval of Congress, which enacted § 111 as a limitation on the rule. See note 12, *infra*.

[9] A rule analogous to the tax benefit rule protects the taxpayer who is required to report income received in one year under claim of right that he later ends up repaying. Under that rule, he is allowed a deduction in the subsequent year. See generally § 1341, 26 U.S.C. § 1341; 1 B. Bittker Federal Taxation of Income, Estates and Gifts § 6.3 (1981).

[10] When the event proving the deduction improper occurs after the close of the taxable year, even if the statute of limitations has not run, the Commissioner's proper remedy is to invoke the tax benefit rule and require inclusion in the later year rather than to re-open the earlier year. See *Lexmont Corp. v. Commissioner*, 20 T.C. 185 (1953); *South Dakota Concrete Products Co. v. Commissioner*, 26 B.T.A. 1429, 1432 (1932); 1 J. Mertens, Law of Federal Income Taxation § 7.34 (J. Doheny rev. ed. 1981); Bittker & Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L. Rev. 265, 266 (1978).

Much of Justice Blackmun's dissent takes issue with this well-settled rule. The inclusion of the income in the year of the deductions by amending the returns for that year is not before us in these cases, for none of the parties has suggested such a result, no doubt because the rule is so settled. It is not at all clear what would happen on the remand that Justice Blackmun desires. Neither taxpayer has ever sought to file an amended return. The statute of limitations has now run on the years to which the dissent would attribute the income, § 6501(a), and we have no indication in the record that the Government has held those years open for any other reason.

Even if the question were before us, we could not accept the view of Justice Blackmun's dissent. It is, of course, true that the tax benefit rule is not a precise way of dealing with the transactional inequities that occur as a result of the annual accounting system, *post*, at 3, 5. See note 12, *infra*. Justice Blackmun's approach, however, does not eliminate the problem; it only multiplies the number of rules. If the statute of limitations has run on the earlier year, the dissent recognizes that the rule that we now apply must apply. *Post*, at 5. Thus, under the proposed scheme, the only difference is that, if the inconsistent event fortuitously occurs between the end of the year of the deduction and the running of the statute of limitations, the Commissioner must reopen the earlier year or permit an amended return even though it is settled that the acceptance of such a return after the date for filing a return is not covered by statute but within the discretion of the Commissioner. See, *e.g.*, *Koch v. Alexander*, 561 F.2d 1115 (CA4 1977) (*per curiam*); *Miskovsky v. United States*, 414 F.2d 954 (CA3 1969). In any other situation, the income must be recognized in the later year. Surely a single rule covering all situations would be preferable to several rules that do not alleviate any of the disadvantages of the single rule.

A second flaw in Justice Blackmun's approach lies in his assertion that the practice he proposes is like any correction made after audit. Changes on audit reflect the proper tax treatment of items under the facts as they were known at the end of the taxable year. The tax benefit rule is addressed to a different problem—that of events that occur after the close of the taxable year.

In any event, whatever the merits of amending the return of the year of the improper deduction might originally have been, we think it too late in the day to change the rule. Neither the judicial origins of the rule nor the subsequent codification permit the approach suggested by Justice Blackmun.

The dissent suggests that the reason that the early cases expounding the tax benefit rule required inclusion in the later year was that the statute of limitations barred adjustment in the earlier year. *Post*, at 3, n. *. That suggestion simply does not reflect the cases cited. In *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931), the judgment of the Court of Appeals reflected Justice Blackmun's approach, holding that the amount *recovered* in the later year was not income in that year but that the taxpayer had to amend its returns for the years of the deductions. *Id*., at 362. This Court reversed, stating, "That the recovery made by respondent in 1920 was gross income *for that year* ... cannot, we think, be doubted." *Id*., at 363. (Emphasis added). Neither does *Healy v. Commissioner*, 345 U.S. 278 (1953), a case dealing with income received under claim of right, provide any support for this novel theory. On the contrary, the Court's discussion of the statute of limitations, cited by the dissent, in context, is as follows:

"A rule which required that the adjustment be made in the earlier year of receipt instead of the later year of repayment would generally be unfavorable to taxpayers, for the statute of limitations would frequently bar any adjustment of the tax liability for the earlier year. Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the accounting is made, and would violate the spirit of the annual accounting system." *Id.*, at 284-285 (footnote omitted). Even the earliest cases, then, reflect the currently accepted view of the tax benefit rule.

Further, § 111, the partial codification of the tax benefit rule, see note 8, *supra*, contradicts Justice Blackmun's view. It provides that gross income for a year does not include a specified portion of a recovery of amounts earlier deducted, implying that the remainder of the recovery is to be included in gross income for that year. See, *e.g.*, S. Rep. No. 830, 88th Cong., 2d Sess. 100 (1964); S. Rep. 1631, 77th Cong., 2d Sess. 79 (1942). Even if the judicial origins of the rule supported Justice Blackmun, we would still be obliged to bow to the will of Congress.

[11] As the rule developed, a number of theories supported taxation in the later year. One explained that the taxpayer who had taken the deduction "consented" to "return" it if events proved him not entitled to it, *e.g.*, *Philadelphia National Bank v. Rothensies*, 43 F.Supp. 923, 925 (E. D. Pa. 1942), while another explained that the deduction offset income in the earlier year, which became "latent" income that might be recaptured, *e.g.*, *National Bank of Commerce v. Commissioner*, 115 F.2d 875, 876-877 (1940); Lassen, *The Tax Benefit Rule and Related Problems*, 20 Taxes 473, 476 (1942). Still a third view maintained that the later recognition of income was a balancing entry. *E.g.*, *South Dakota Concrete Products Co. v. Commissioner*, 26 B.T.A. 1429, 1431 (1932). All these views reflected that the initial accounting for the item must be corrected to present a true picture of income. While annual accounting precludes reopening the earlier year, it does not prevent a less precise correction - far superior to none - in the current year, analogous to the practice of financial accountants. See W. Meigs, A. Mosich, C. Johnson and T. Keller, *Intermediate Accounting* 109 (3d ed. 1974). This concern with more accurate measurement of income underlies the tax benefit rule and always has.

[12] Even this rule did not create complete transactional equivalence. In the second version of the transaction discussed in the text, the taxpayer might have realized no benefit from the deduction, if, for instance, he had no taxable income for that year. Application of the tax benefit rule as originally developed would require the taxpayer to recognize income on the repayment, so that the net result of the collection of the principal amount of the debt would be recognition of income. Similarly, the tax rates might change between the two years, so that a deduction and an inclusion, though equal in amount, would not produce exactly offsetting tax consequences. Congress enacted § 111 to deal with part of this problem. Although a change in the rates may still lead to differences in taxes due, see *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct.Cl. 1967), § 111 provides that the taxpayer can exclude from income the amount that did not give rise to some tax benefit. See *Dobson v. Commissioner*, 320 U.S. 489, 505-506 (1943). This exclusionary rule and the inclusionary rule described in the text are generally known together as the tax benefit rule. It is the inclusionary aspect of the rule with which we are currently concerned.

The taxpayers and the Government in these cases propose different formulations of the tax benefit rule. The taxpayers contend that the rule requires the inclusion of amounts recovered in later years, and they do not view the events in these cases as "recoveries." The Government, on the other hand, urges that the tax benefit rule requires the inclusion of amounts previously deducted if later events are inconsistent with the deductions; it insists that no "recovery" is necessary to the application of the rule. Further, it asserts that the events in these cases are inconsistent with the deductions taken by the taxpayers. We are not in complete agreement with either view.

An examination of the purpose and accepted applications of the tax benefit rule reveals that a "recovery" will not always be necessary to invoke the tax benefit rule. The purpose of the rule is not simply to tax "recoveries." On the contrary, it is to approximate the results produced by a tax system based on transactional rather than annual accounting. See generally Bittker and Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. Rev. 265, 270 (1978); Byrne, *The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments*, 56 Notre Dame Law. 215, 221, 232, (1980); Tye, *The Tax Benefit Doctrine Reexamined*, 3 Tax. L. Rev. 329 (1948) (hereinafter Tye). It has long been accepted that a taxpayer using accrual accounting who accrues and deducts an expense in a tax year before it becomes payable and who for some reason eventually does not have to pay the liability must then take into income the amount of the expense earlier deducted. See, *e.g.*, *Mayfair Minerals, Inc. v. Commissioner*, 456 F.2d 622 (CA5 1972) (per curiam); *Bear Manufacturing Co. v. United States*, 430 F.2d 152 (CA7 1970), *cert. denied*, 400 U.S. 1021 (1971); *Haynsworth v. Commissioner*, 68 T.C. 703 (1977), *aff'd without op.*, 609 F.2d 1007 (CA5 1979); *G.M. Standifer Construction Corp. v. Commissioner*, 30 B.T.A. 184, 186-187 (1934), *petition for review dism'd*, 78 F.2d 285 (CA9 1935). The bookkeeping entry cancelling the liability, though it increases the balance sheet net worth of the taxpayer, does not fit within any ordinary definition of "recovery."[13] Thus, the taxpayers' formulation of the rule neither serves the purposes of the rule nor accurately reflects the cases that establish the rule. Further, the taxpayers' proposal would introduce an undesirable formalism into the application of the tax benefit rule. Lower courts have been able to stretch the definition of "recovery" to include a great variety of events. For instance, in cases of corporate liquidations, courts have viewed the corporation's receipt of its own stock as a "recovery," reasoning that, even though the instant that the corporation receives the stock it becomes worthless, the stock has value as it is turned over to the corporation, and that ephemeral value represents a recovery for the corporation. See, *e.g.*, *Tennessee-Carolina Transportation, Inc. v. Commissioner*, 582 F.2d 378, 382 (CA6 1978), *cert. denied*, 440 U.S. 909 (1979) (alternative holding). Or, payment to another party may be imputed to the taxpayer, giving rise to a recovery. See *First Trust and Savings Bank v. United States*, 614 F.2d 1142, 1146 (CA7 1980) (alternative holding). Imposition of a requirement that there be a recovery would, in many cases, simply require the Government to cast its argument in different and unnatural terminology, without adding anything to the analysis.[14]

[13] See, *e.g.*, Bittker and Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L.Rev. 265, 267 (1978); *cf.* Zysman, *Income Derived from Recovery of Deductions*, 19 Taxes 29, 30 (1941) (We are "not concerned with a theoretical or pure economic concept of income, but with gross income within the meaning of the statute.")

Although Justice Stevens insists that this situation falls within the standard meaning of "recovery," it does so only in the sense that an increase in balance sheet net worth is to be considered a recovery. *Post*, at 15, n. 26. But in Bliss, Justice Stevens asserts that there is no recovery. There, the corporation's balance sheet shows zero as the historic cost of the grain on hand, because the corporation expensed the asset upon acquisition. At the date of liquidation, the historic cost of the grain on hand was in fact greater than zero, and an accurate balance sheet would have reflected an asset account balance greater than zero. The necessary adjustment thus reflects an increase in balance sheet net worth.

[14] Despite Justice Stevens' assertion that *Tennessee-Carolina* was wrong, *post*, at 15, n. 26, the case fits what seems to be his definition of a recovery - an enhancement of the taxpayer's wealth - for the corporation in Tennessee-Carolina received stock worth more than the balance sheet book value of its assets. See note 13, supra. Thus we disagree with the assertion that the recovery rule is a bright-line rule easily applied.

The basic purpose of the tax benefit rule is to achieve rough transactional parity in tax, see note 12, supra, and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous. Such an event, unforeseen at the time of an earlier deduction, may in many cases require the application of the tax benefit rule. We do not, however, agree that this consequence invariably follows. Not every unforeseen event will require the taxpayer to report income in the amount of his earlier deduction. On the contrary, the tax benefit rule will "cancel out" an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based.[15] That is, if that event had occurred within the same taxable year, it would have foreclosed the deduction.[16] In some cases, a subsequent recovery by the taxpayer will be the only event that would be fundamentally inconsistent with the provision granting the deduction. In such a case, only actual recovery by the taxpayer would justify application of the tax benefit rule. For example, if a calendar-year taxpayer made a rental payment on December 15 for a 30-day lease deductible in the current year under § 162(a)(3), see Treas. Reg. § 1.461-1(a)(1), 26 CFR § 1.461-1(a)(1)(1982); *e.g.*, *Zaninovich v. Commissioner*, 616 F.2d 429 (CA9 1980),[17] the tax benefit rule would not require the recognition of income if the leased premises were destroyed by fire on January 10. The resulting inability of the taxpayer to occupy the building would be an event not fundamentally inconsistent with his prior deduction as an ordinary and necessary business expense under § 162(a). The loss is attributable to the business[18] and therefore is consistent with the deduction of the rental payment as an ordinary and necessary business expense. On the other hand, had the premises not burned and, in January, the taxpayer decided to use them to house his family rather than to continue the operation of his business, he would have converted the leasehold to personal use. This would be an event fundamentally inconsistent with the business use on which the deduction was based.[19] In the case of the fire, only if the lessor—by virtue of some provision in the lease—had refunded the rental payment would the taxpayer be required under the tax benefit rule to recognize income on the subsequent destruction of the building. In other words, the subsequent recovery of the previously deducted rental payment would be the only event inconsistent with the provision allowing the deduction. It therefore is evident that the tax benefit rule must be applied on a case-by-case basis. A court must consider the facts and circumstances of each case in the light of the purpose and function of the provisions granting the deductions.

[15] Justice Stevens accuses us of creating confusion at this point in the analysis by requiring the courts to distinguish "inconsistent events" from "fundamentally inconsistent events." *Post*, at 16. That line is not the line we draw; rather, we draw the line between merely unexpected events and inconsistent events.

This approach differs from that proposed by the Government in that the Government has not attempted to explain why two events are inconsistent. Apparently, in the Government's view, any unexpected event is inconsistent with an earlier deduction. That view we cannot accept.

[16] Justice Stevens apparently disagrees with this rule, for, although he concurs in the result in *Hillsboro*, he asserts that the events there would have resulted in denial of the deduction had they all occurred in one year. *Post*, at 16. We find it difficult to believe that Congress placed such a premium on having a transaction straddle two tax years.

[17] Justice Stevens questions whether this amount was properly deductible under § 162(a)(3) and seems to suggest that if it was, Congress meant the deduction to be irrevocable. *Post*, at 13, n. 25. It is clear that § 162(a)(3) permits the deduction of prepaid expenses that will benefit the taxpayer for a short time into the next taxable year, as in our example, rather than benefitting the taxpayer substantially beyond the taxable year. See generally 1 B. Bittker, *supra* n. 1, at ¶ 20.4.1.

The dissent's view that the preferable approach is to scrutinize the deduction more carefully in the year it is taken ignores two basic problems. First, reasons unrelated to the certainty that the taxpayer will eventually consume the asset as expected often enter into the decision when to allow the deduction. For instance, the desire to save taxpayers the burden of careful allocation of relatively small expenditures favors the allowance of the entire deduction in a single year of some business expenditures attributable to operations after the close of the taxable year. See generally *ibid*. Second, we simply cannot predict the future, no matter how carefully we scrutinize the deduction in the earlier year. For instance, in the case of the bad debt that is eventually repaid, we already require that the debt be apparently worthless in the year of deduction, see § 166(a)(1), but we often find that the future does not conform to earlier perceptions, and the taxpayer collects the debt. Then, "the deductions are practical necessities due to our inability to read the future, and the inclusion of the recovery in income is necessary to offset the deduction." *South Dakota Concrete Products Co. v. Commissioner*, 26 B.T.A. 1429, 1432 (1932).

[18] The loss is properly attributable to the business because the acceptance of the risk of loss is a reasonable business judgment that the courts ordinarily will not question. See *Welch v. Helvering*, 290 U.S. 111, 113 (1933); 1 B. Bittker, supra, n. 11, at ¶ 20.3.2.

[19] See 1 B. Bittker, supra, n. 11, ¶ 20.2.2 ("[F]ood and shelter are quintessential nondeductible personal expenses"). See also p. 25-26, *infra*.

When the later event takes place in the context of a nonrecognition provision of the Code, there will be an inherent tension between the tax benefit rule and the nonrecognition provision. See *Putoma Corp. v. Commissioner*, 601 F.2d 734, 742 (CA5 1979); *id.*, at 751 (Rubin, J., dissenting); *cf. Helvering v. American Dental Co.*, 318 U.S. 322 (1943) (tension between exclusion of gifts from income and treatment of cancellation of indebtedness as income). We cannot resolve that tension with a blanket rule that the tax benefit rule will always prevail. Instead, we must focus on the particular provisions of the Code at issue in any case.[20]

[20] An unreserved endorsement of the Government's formulation might dictate the results in a broad range of cases not before us. See, *e.g.*, Brief for the United States in No. 81-830 and the Commissioner in No. 81-485 at 20; Reply Brief for the Petitioner in No. 81-485 at 12; Tr. of Oral Arg. At 33. For instance, the Government's position implies that an individual proprietor who makes a gift of an expensed asset must recognize the amount of the expense as income, but *cf. Campbell v. Prothro*, 209 F.2d 331, 335 (CA5 1954). See generally 2A J. Rabkin & M. Johnson, Federal Income Gift and Estate Taxation § 6.01(3) (1982) (discussing Commissioner's treatment of gifts of expensed assets). Similarly, the Government's view suggests the conclusion that one who dies and leaves an expensed asset to his heirs would, in his last return, recognize income in the amount of the earlier deduction. Our decision in the cases before us now, however, will not determine the outcome in these other situations; it will only demonstrate the proper analysis. Those cases will require consideration of the treatment of gifts and legacies as well as §§ 1245(b)(1), (2), and 1250(d)(1), (2), which are a partial codification of the tax benefit rule, see O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders*, 27 Tax L. Rev. 215, 216 (1972), and which exempt dispositions by gift and transfers at death from the operation of the general depreciation recapture rules. Although there may be an inconsistent event in the personal use of an expensed asset, that event occurs in the context of a nonrecognition rule, see, *e.g.*, *Campbell v. Prothro*, *supra*, at 336; 1 B. Bittker, Federal Taxation of Income, Estates, and Gifts ¶ 5.21 (1981), and resolution of these cases would require a determination whether the nonrecognition rule or the tax benefit rule prevails.

The formulation that we endorse today follows clearly from the long development of the tax benefit rule. JUSTICE STEVENS' assertion that there is no suggestion in the early cases or from the early commentators that the rule could ever be applied in any case that did not involve a physical recovery, *post*, at 5 is incorrect. The early cases frequently framed the rule in terms consistent with our view and irreconcilable with that of the dissent. See *Barnett v. Commissioner*, 39 B.T.A. 864, 867 (1939) ("Finally, the present case is analogous to a number of others, where ... [w]hen some event occurs which is *inconsistent* with a deduction taken in a prior year, adjustment may have to be made by reporting a balancing item in income for the year in which the change occurs.") (emphasis added); *Estate of Block v. Commissioner*, 39 B.T.A. 338 (1939) ("When recovery or *some other event which is inconsistent* with what has been done in the past occurs, adjustment must be made in reporting income for the year in which the change occurs.") (emphasis added); *South Dakota Concrete Products Co. v. Commissioner*, 26 B.T.A. 1429, 1432 (1932) ("[W]hen an *adjustment* occurs which is inconsistent with what has been done in the past in the determination of tax liability, the adjustment should be reflected in reporting income for the year in which it occurs.") (emphasis added).[21] The reliance of the dissent on the early commentators is equally misplaced, for the articles cited in the dissent, like the early cases, often stated the rule in terms of inconsistent events.[22]

> [21] Justice Stevens' attempt to discount the explicit statement in *Estate of Block* that inconsistent events would trigger the recognition of income, *post*, at 6, n. 9, is singularly unpersuasive. The Board of Tax Appeals used the word "recovery" later in the opinion because it was faced with a recovery in that case, not because it meant to repudiate hastily its discussion in the same opinion of the general rule. Similarly, the mere assertion that the broad formulation in *Barnett* followed a discussion of a Treasury regulation, *post*, at 6, n. 10, does not support the view of the dissent that the concept of inconsistent events represents a break with the early cases.
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> [22] "The rule requiring taxation of income from the recovery or cancellation of items previously deducted is a remedial expedient, designed to prevent the unjust enrichment of a taxpayer and to offset the benefit derived from a deduction to which, *in the light of subsequent events*, the taxpayer was not entitled." Plumb 176 (1943) (emphasis added). See also id., at 131, 178.
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> "In a few words, the basic idea of the Tax Benefit Rule is this: If a taxpayer has derived a benefit from a deduction by reducing his taxable income in the year of deduction, he must declare as taxable income any recovery *or other change of his status* which - *ex nunc* - makes the original deduction seem unjustified." Lassen, The Tax Benefit Rule and Related Problems, 20 Taxes 473, 473 (1942) (emphasis added).
>
> One author saw his subject - the recovery of deductions - as an example of the broader rule: "Sometimes a subsequent event reveals the income or deductions as reported by the taxpayer to be erroneous. Thus the unexpected recovery of a portion of an amount lost and already deducted reduces the loss as originally determined. There are even cases in which items apparently finally and accurately determined have to be adjusted *on account of a subsequent event*." Zysman, Income Derived from the Recovery of Deductions, 19 Taxes 29, 29 (1941) (emphasis added).

Finally, Justice Stevens' dissent relies heavily on the codification in § 111 of the exclusionary aspect of the tax benefit rule, which requires the taxpayer to include in income only the amount of the deduction that gave rise to a tax benefit, see note 12, *supra*. That provision does, as the dissent observes, speak of a "recovery." By its terms, it only applies to bad debts, taxes, and delinquency amounts. Yet this Court has held, *Dobson v. Commissioner*, 320 U.S. 489, 505-506 (1943), and it has always been accepted since,[23] that § 111 does not limit the application of the exclusionary aspect of the tax benefit rule. On the contrary, it lists a few applications and represents a general endorsement of the exclusionary aspect of the tax benefit rule to other situations within the inclusionary part of the rule. The failure to mention inconsistent events in § 111 no more suggests that they do not trigger the application of the tax benefit rule than the failure to mention the recovery of a capital loss suggests that it does not, see *Dobson*, *supra*.

[23] See, *e.g.*, Bittker and Kanner, The Tax Benefit Rule, 26 U.C.L.A. L. Rev. 265, 266 (1978); Tye 330; Plumb 144-145.

Justice Stevens also suggests that we err in recognizing transactional equity as the reason for the tax benefit rule. It is difficult to understand why even the clearest recovery should be taxed if not for the concern with transactional equity, see *supra*, at 6-7. Nor does the concern with transactional equity entail a change in our approach to the annual accounting system. Although the tax system relies basically on annual accounting, see *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931), the tax benefit rule eliminates some of the distortions that would otherwise arise from such a system. See, *e.g.*, Bittker and Kanner, The Tax Benefit Rule, 26 U.C.L.A.L. Rev. 265, 268-270 (1978); Tye 350; Plumb 178 and n. 172. The limited nature of the rule and its effect on the annual accounting principle bears repetition: only if the occurrence of the event in the earlier year would have resulted in the disallowance of the deduction can the Commissioner require a compensating recognition of income when the event occurs in the later year.[24]

[24] Justice Stevens seems to fear that our approach to the annual accounting system is inconsistent with Sanford & Brooks in a way that will vest new power in the tax collector to ignore the annual accounting system. The fear is unfounded. In *Sanford & Brooks*, a taxpayer who had incurred a net loss on a long-term contract managed to recoup the loss in a lawsuit in a later year. The earlier net losses on the contract contributed to net losses for the business in most of the tax years during the performance of the contract. The Court rejected the taxpayer's contention that it should be able to exclude the award on the theory that the award offset the earlier net losses. This adherence to the annual accounting system is perfectly consistent with the approach we follow in the cases now before us. In situations implicating the tax benefit rule or the analogous doctrine permitting the taxpayer to take a deduction when income recognized earlier under a claim of right must be repaid, see note 9, *supra*, the problem is that the taxpayer has mischaracterized some event. Either he has recognized income that eventually turns out not to be income, or he has taken a deduction that eventually turns out not to be a deduction. Neither of these problems arose in *Sanford & Brooks*. Instead, the problem there was that the taxpayer had properly deducted expenditures and was properly recognizing income but thought that the two should have been matched in the same year. The tax benefit rule does not permit the Commissioner or the taxpayer to rematch properly recognized income with properly deducted expenses; it merely permits a balancing entry when an apparently proper expense turns out to be improper.

Our approach today is consistent with our decision in *Nash v. United States*, 398 U.S. 1 (1970). There, we rejected the Government's argument that the tax benefit rule required a taxpayer who incorporated a partnership under § 351 to include in income the amount of the bad debt reserve of the partnership. The Government's theory was that, although § 351 provides that there will be no gain or loss on the transfer of assets to a controlled corporation in such a situation, the partnership had taken bad debt deductions to create the reserve, see § 166(c), and when the partnership terminated, it no longer needed the bad debt reserve. We noted that the receivables were transferred to the corporation along with the bad debt reserve. *Id.*, at 5 and n. 5. Not only was there no "recovery," *id.*, at 4, but there was no inconsistent event of any kind. That the fair market value of the receivables was equal to the face amount less the bad debt reserve, *id.*, at 4, reflected that the reserve, and the deductions that constituted it, were still an accurate estimate of the debts that would ultimately prove uncollectible, and the deduction was therefore completely consistent with the later transfer of the receivables to the incorporated business. See *Citizens' Acceptance Corp v. United States*, 320 F. Supp. 798 (D. Del. 1971), *rev'd* on other grounds, 462 F.2d 751 (CA3 1972); Rev. Rul. 78-279, 1978-2 Cum. Bull. 135; Rev. Rul. 78-278, 1978-2 Cum. Bull. 134; see generally O'Hare, Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders, 27 Tax L. Rev. 215, 219-221 (1972).[25]

[25] Justice Stevens attempts to read our prior cases as somehow inconsistent with our approach here. Nash is the only case in which we have dealt with the inclusionary aspect of the tax benefit rule, and, as we have established, there was neither a recovery nor an inconsistent event in that case. In *Dobson v. Commissioner*, 320 U.S. 489 (1943), we considered the exclusionary aspect of the rule. That case involved a recovery that was clearly inconsistent with the deduction, and the only question was whether the deduction had created a benefit. The references to "recovery" in the opinion describe the case before the Court. They do not in any way impose general requirements for inclusion, as the dissent seems to suggest.

In the cases currently before us, then, we must undertake an examination of the particular provisions of the Code that govern these transactions to determine whether the deductions taken by the taxpayers were actually inconsistent with later events and whether specific nonrecognition provisions prevail over the principle of the tax benefit rule.[26]

[26] It is worth noting that a holding requiring no recognition of income is not, as Justice BLACKMUN's dissent suggests, a conclusion that the tax benefit rule "has no application to the situation presented." *Post*, at 1. As a general principle of tax law, the rule of course applies; it simply does not require the recognition of income.

Part III of the Court's opinion discussed a provision granting a corporation a deduction for taxes imposed on its shareholders but paid by the corporation:

In *Hillsboro*, the key provision is § 164(e).[27] That section grants the corporation a deduction for taxes imposed on its shareholders but paid by the corporation. It also denies the shareholders any deduction for the tax. In this case, the Commissioner has argued that the refund of the taxes by the state to the shareholders is the equivalent of the payment of a dividend from Hillsboro to its shareholders. If Hillsboro does not recognize income in the amount of the earlier deduction, it will have deducted a dividend. Since the general structure of the corporate tax provisions does not permit deduction of dividends, the Commissioner concludes that the payment to the shareholders must be inconsistent with the original deduction and therefore requires the inclusion of the amount of the taxes as income under the tax benefit rule.

[27] The Commissioner asserts also that Hillsboro deducted the taxes as a contested liability under § 461(f), and that the legislative history of § 461(f) shows that Congress intended that the tax benefit rule apply if a taxpayer successfully contested a liability deducted under § 461(f). We do not view this argument as in any way separate from the Commissioner's argument under § 164(e). Section 461(f) does not grant deductions of its own force; the expenditure must qualify as deductible in character under some other section. See Treas. Reg. § 1.461-2(a)(1)(iv), 26 CFR § 1.461-2(a)(1)(iv) (1982). If the expenditure does qualify independently as deductible, but, because it is contested, it lacks the certainty otherwise required for deduction, § 461(f) grants the deduction, on the condition that the tax benefit rule will apply. But for the tax benefit rule to apply, there must be some event that is inconsistent with the provision granting the deduction. The question here then remains whether the deduction is appropriate under § 164(e) or whether later events are inconsistent with that deduction.

In evaluating this argument, it is instructive to consider what the tax consequences of the payment of a shareholder tax by the corporation would be without § 164(e) and compare them to the consequences under § 164(e). Without § 164(e), the corporation would not be entitled to a deduction, for the tax is not imposed on it. See Treas. Reg. § 1.164-1(a), 26 CFR § 1.164-1(a) (1982); *Wisconsin Gas & Electric v. United States*, 322 U.S. 526, 527-530 (1944). If the corporation has earnings and profits, the shareholder would have to recognize income in the amount of the taxes, because a payment by a corporation for the benefit of its shareholders is a constructive dividend. See §§ 301(c), 316(a); *e.g. Ireland v. United States*, 621 F.2d 731, 735 (CA5 1980); B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 7.05 (4th ed. 1979). The shareholder, however, would be entitled to a deduction since the constructive dividend is used to satisfy his tax liability. Section 164(a)(2). Thus, for the shareholder, the transaction would be a wash: he would recognize the amount of tax as income,[28] but he would have an offsetting deduction for the tax. For the corporation, there would be no tax consequences, for the payment of a dividend gives rise to neither income nor a deduction. Section 311(a).

[28] There would be an exception for a shareholder who had not yet earned $200 in interest and dividend income from his stock holdings in this and other corporations during the taxable year. He would be able to exclude up to $200 received in dividend and interest income for the year. See § 116(a)(1), (b), 26 U.S.C. § 116(a)(1), (b) (Supp. 1980). At the time of the Hillsboro transaction, the exclusion was $100. See 26 U.S.C. § 116(a).

Under § 164(e), the economics of the transaction of course remain unchanged: the corporation is still satisfying a liability of the shareholder and therefore paying a constructive dividend. The tax consequences are, however, significantly different, at least for the corporation. The transaction is still a wash for the shareholder; although § 164(e) denies him the deduction to which he would otherwise be entitled, he need not recognize income on the constructive dividend, Treas. Reg. § 1.164-7, 26 CFR § 1.164-7 (1982). But the corporation is entitled to a deduction that would not otherwise be available. In other words, the only effect of § 164(e) is to permit the corporation to deduct a dividend. Thus, we cannot agree with the Commissioner that, simply because the events here give rise to a deductible dividend, they cannot be consistent with the deduction. In at least some circumstances, a deductible dividend is within the contemplation of the Code. The question we must answer is whether § 164(e) permits a deductible dividend in these circumstances - when, the money, though initially paid into the state treasury, ultimately reaches the shareholder - or whether the deductible dividend is available, as the Commissioner urges, only when the money remains in the state treasury, as properly assessed and collected tax revenue.

Rephrased, our question now is whether Congress, in granting this special favor to corporations that paid dividends by satisfying the liability of their shareholders, was concerned with the reason the money was paid out by the corporation or with the use to which it was ultimately put. Since § 164(e) represents a break with the usual rules governing corporate distributions, the structure of the Code does not provide any guidance on the reach of the provision. This Court has described the provisions as "prompted by the plight of various banking corporations which paid and voluntarily absorbed the burden of certain local taxes imposed upon their shareholders, but were not permitted to deduct those payments from gross income." *Wisconsin Gas & Electric Co. v. United States*, 322 U.S., at 531 (footnote omitted). The section, in substantially similar form, has been part of the Code since the Revenue Act of 1921, 42 Stat. 227. The provision was added by the Senate, but its Committee Report merely mentions the deduction without discussing it, see S. Rep. No. 275, 67th Cong., 1st Sess. 19 (1921). The only discussion of the provision appears to be that between Dr. T. S. Adams and Senator Smoot at the Senate Hearings. Dr. Adams's statement explains why the states imposed the property tax on the shareholders and collected it from the banks, but it does not cast much light on the reason for the deduction. Hearings on H. R. 8245 before the Comm. on Finance, 67th Cong., 1st Sess. 250-251 (1921) (statement of Dr. T. S. Adams, tax advisor, Treasury Department). Senator Smoot's response, however, is more revealing:

> I have been a director of a bank ... for over 20 years. They have paid that tax ever since I have owned a share of stock in the bank ... I know nothing about it. I do not take 1 cent of credit for deductions, and the banks are entitled to it. *They pay it out*. *Id*., at 251 (emphasis added).

The *payment* by the corporations of a liability that Congress knew was not a tax imposed on them[29] gave rise to the entitlement to a deduction; Congress was unconcerned that the corporations took a deduction for amounts that did not satisfy their tax liability. It apparently perceived the shareholders and the corporations as independent of one another, each "know [ing] nothing about" the payments by the other. In those circumstances, it is difficult to conclude that the Congress intended that the corporation have no deduction if the state turned the tax revenues over to these independent parties. We conclude that the purpose of § 164(e) was to provide relief for the corporations making these payments, and the focus of Congress was on the act of payment rather than on the ultimate use of the funds by the state. As long as the payment itself was not negated by a refund to the corporation, the change in character of the funds in the hands of the state does not require the corporation to recognize income, and we reverse the judgment below.[30]

[29] Dr. Adams testified repeatedly that the banks paid the tax "voluntarily." Hearings on H. R. 8245 before the Comm. on Finance, 67th Cong., 1st Sess. 250 (1921) (statement of Dr. T. S. Adams, tax advisor, Treasury Department).

[30] Our examination of the legislative history thus leads us to reject Justice Blackmun's unsupported suggestion that Congress focused on the payment of a tax. Post, at 2. The theory he suggests leads to the conclusion that, even if the state had not refunded the taxes, the bank would not have been entitled to the deduction, because it had not paid a "tax." It is difficult to believe that the Congress that acted to alleviate "the plight of various banking corporations which paid and voluntarily absorbed the burden," Wisconsin Gas & Electric Co. v. United States, 322 U.S. 526, 531 [32 AFTR 368] (1944), intended the result suggested by the dissent.

Part IV discussed how the tax benefit rule interacted with a statutory tax-free liquidation of a corporation:

The problem in *Bliss* is more complicated. *Bliss* took a deduction under § 162(a), so we must begin by examining that provision. Section 162(a) permits a deduction for the "ordinary and necessary expenses" of carrying on a trade or business. The deduction is predicated on the consumption of the asset in the trade or business. See Treas. Reg. § 1.162-3, 26 CFR § 1.162-3 (1982) ("Taxpayers ... should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation in the taxable year ....") (emphasis added). If the taxpayer later sells the asset rather than consuming it in furtherance of his trade or business, it is quite clear that he would lose his deduction, for the basis of the asset would be zero, see, *e.g.*, *Spitalny v. United States*, 430 F.2d 195 (CA9 1970), so he would recognize the full amount of the proceeds on sale as gain. See § 1001(a), (c). In general, if the taxpayer converts the expensed asset to some other, non-business use, that action is inconsistent with his earlier deduction, and the tax benefit rule would require inclusion in income of the amount of the unwarranted deduction. That non-business use is inconsistent with a deduction for an ordinary and necessary business expense is clear from an examination of the Code. While § 162(a) permits a deduction for ordinary and necessary business expenses, § 262 explicitly denies a deduction for personal expenses. In the 1916 Act, the two provisions were a single section. See § 5(a)(1st), 39 Stat. 756. The provision has been uniformly interpreted as providing a deduction only for those expenses attributable to the business of the taxpayer. See, *e.g.*, *Kornhauser v. United States*, 267 [276] U.S. 145 (1928); H. Rep., 75th Cong., 3d Sess. 46 (January 14, 1938) ("a taxpayer should be granted a reasonable deduction for the direct expenses he has incurred in connection with his income") (emphasis added); see generally, 1 B. Bittker, Federal Taxation of Income, Estates and Gifts § 20.2 (1981). Thus, if a corporation turns expensed assets to the analog of personal consumption, as Bliss did here—distribution to shareholders[31] - it would seem that it should take into income the amount of the earlier deduction.[32]

[31] "Paying the dividend was the enjoyment of [the corporate] income. A body corporate can be said to enjoy its income in no other way." *Williamson v. United States*, 292 F.2d 524, 530 (Ct.Cl. 1961).

[32] Justice Stevens' dissent takes issue with this conclusion, characterizing the situation as identical to that in Nash, which he explains as a case in which we held that, although "a business asset matching a prior deduction ... would not be used up ... until it had passed to a different taxpayer," the transfer did not require the recognition of income. *Post*, at 13. What is misleading in this description is its failure to recognize that in Nash the prior deduction was reflected in the asset transferred because of the contra-asset account: uncollectible accounts. That contra-asset diminished the asset, see generally W. Meigs, A. Mosich, C. Johnson and T. Keller, Intermediate Accounting 140-141 (3d ed. 1974), and was inseparable from it. Therefore, the transfer of the notes did not establish that they were worth their face value, and there was no inconsistent event.

In *Bliss*, the taxpayers took a deduction for an expense and credited the asset account. Unlike the debit to the expense account in *Nash*, the debit to the expense account did not reflect any economic decrease in the value of the asset. When the taxpayers transferred the asset, it became clear that the economic decrease would not take place in the hands of Bliss - and possibly never would occur.

To see the difference more clearly, consider the views of a third party contemplating purchasing the asset on hand in *Nash* and one contemplating purchasing the asset on hand in *Bliss*. In *Nash*, the purchaser would be willing to pay only the face amount of the receivables less the amount in the contra-asset account—the amount earlier deducted by the taxpayer—because that is all the purchaser could expect to realize on them. In other words, the deduction reflected a real decrease in the value of the asset. In *Bliss*, on the other hand, the purchaser would be happy to pay the value of the grain, undiminished by the expense deducted by the taxpayer. The deduction and the asset remain separable, and the taxpayer can transfer one without netting out the other.

That conclusion, however, does not resolve this case, for the distribution by Bliss to its shareholders is governed by a provision of the Code that specifically shields the taxpayer from recognition of gain - § 336. We must therefore proceed to inquire whether this is the sort of gain that goes unrecognized under § 336. Our examination of the background of § 336 and its place within the framework of tax law convinces us that it does not prevent the application of the tax benefit rule.[33]

[33] We are aware that Congress considered but failed to enact a bill amending §§ 1245 and 1250 to cover any deduction of the purchase price of property. H. R. 10936, 94th Cong., 1st Sess. (1975). That bill would have settled the question here, since it is clear that § 1245 overrides

§ 336. Section 1245(a)(1); Treas. Reg. § 1.1245-6(b), 26 CFR § 1.1245-6(b) (1982). The failure to enact the bill does not suggest that Congress intended that deductions under § 162 not be subject to recapture. Both the House and Senate committees reported favorably on the bill, S. Rep. No. 94-1346, 94th Cong., 2d Sess. (1976); H. R. No. 94-1350, 94th Cong., 2d Sess. (1976), the House passed it, and Congress adjourned without any action by the Senate. See Government Printing Office, Calendars of the United States House of Representatives and History of Legislation 174 (Final ed. 1977). The reports suggest that Congress focused on disposition by sale and thought the income subject to recapture in any event, but possibly at capital gains rather than ordinary income rates. S. Rep. No. 94-1346, *supra*, at 2; H. R. No. 94-1350, *supra*, at 2. Given this background, we cannot draw any inference from the failure to enact the amendment.

Section 336 was enacted as part of the 1954 Code. It codified the doctrine of *General Utilities Co. v. Helvering*, 296 U.S. 200, 206 (1935), that a corporation does not recognize gain on the distribution of appreciated property to its shareholders. Before the enactment of the statutory provision, the rule was expressed in the regulations, which provided that the corporation would not recognize gain or loss, "however [the assets] may have *appreciated or depreciated* in value since their acquisition." Income Tax Regulations 118, § 39.22(a)-20 (1953) (emphasis added). The Senate Report recognized this regulation as the source of the new § 336, S. Rep. No. 1622, 83d Cong., 2d Sess. 258 (1954). The House Report explained its version of the provision, "Thus, the fact that the property distributed has *appreciated or depreciated* in value over its adjusted basis to the distributing corporation will in no way alter the application of subsection (a) [providing nonrecognition]." H. R. No. 1337, 83d Cong., 2d Sess. at A90 (1954) (emphasis added). This background indicates that the real concern of the provision is to prevent recognition of market appreciation that has not been realized by an arm's-length transfer to an unrelated party rather than to shield all types of income that might arise from the disposition of an asset.

Despite the breadth of the nonrecognition language in § 336, the rule of nonrecognition clearly is not without exception. For instance, § 336 does not bar the recapture under §§ 1245 and 1250 of excessive depreciation taken on distributed assets. Sections 1245(a), 1250(a); Treas. Reg. §2.1245-6(b), 1.1250-1(c)(2), 26 CFR §§ 1.1245-6(b), 1.1250-1(c)(2) (1982). Even in the absence of countervailing statutory provisions, courts have never read the command of nonrecognition in § 336 as absolute. The "assignment of income" doctrine has always applied to distributions in liquidation. See, *e.g.*, *Siegel v. United States*, 464 F.2d 891 (CA9 1972), *cert. dism'd*, 410 U.S. 918 (1973); *Williamson v. United States*, 292 F.2d 524 (Ct.Cl. 1961); see also *Idaho First National Bank v. United States*, 265 F.2d 6 (CA9 1959) (decided before *General Utilities* codified in § 336). That judicial doctrine prevents taxpayers from avoiding taxation by shifting income from the person or entity that earns it to someone who pays taxes at a lower rate.[34] Since income recognized by the corporation is subject to the corporate tax and is again taxed at the individual level upon distribution to the shareholder, shifting of income from a corporation to a shareholder can be particularly attractive: it eliminates one level of taxation. Responding to that incentive, corporations have attempted to distribute to shareholders fully performed contracts or accounts receivable and then to invoke § 336 to avoid taxation on the income. In spite of the language of nonrecognition, the courts have applied the assignment of income doctrine and required the corporation to recognize the income.[35] Section 336, then clearly does not shield the taxpayer from recognition of all income on the distribution.

[34] For instance, a taxpayer cannot avoid recognizing the interest income on bonds that he owns by clipping the coupons and giving them to another party. See, *e.g.*, *Helvering v. Horst*, 311 U.S. 112 (1940); *Lucas v. Earl*, 281 U.S. 111 (1930).

[35] Indeed, the legislative history of § 336 compels such a result. Section 336 arose out of the same provision in the House bill as did § 311, which provides for nonrecognition of gain on nonliquidating distributions of appreciated property, and the Senate comment on § 311 explicitly provides for the application of the assignment of income doctrine. S. Rep. No. 1622, *supra*, at 247.

Next, we look to a companion provision - § 337, which governs sales of assets followed by distribution of the proceeds in liquidation.[36] It uses essentially the same broad language to shield the corporation from the recognition of gain on the sale of the assets. The similarity in language alone would make the construction of § 337 relevant in interpreting § 336. In addition, the function of the two provisions reveals that they should be construed in tandem. Section 337 was enacted in response to the distinction created by *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950), and *Commissioner v. Court Holding*, 324 U.S. 331 (1945). Under those cases, a corporation that liquidated by distributing appreciated assets to its shareholders recognized no income, as now provided in § 336, even though its shareholders might sell the assets shortly after the distribution. See *Cumberland*. If the corporation sold the assets, though, it would recognize income on the sale, and a sale by the shareholders after distribution in kind might be attributed to the corporation. See *Court Holding*. To eliminate the necessarily formalistic distinctions and the uncertainties created by *Court Holding* and *Cumberland*, Congress enacted § 337, permitting the corporation to adopt a plan of liquidation, sell its assets without recognizing gain or loss at the corporate level, and distribute the proceeds to the shareholders. The very purpose of § 337 was to create the same consequences as § 336. See *Midland-Ross Corp. v. United States*, 485 F.2d 110 (CA6 1973); S. Rep. No. 1622, *supra*, at 258.

[36] In relevant part, § 337 provides:

> ("(a)) If within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.
>
> ("(b)) (1) For purposes of subsection (a), the term "property" does not include-
>
> ("(A)) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year, and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business,
>
> ("(B)) installment obligations acquired in respect of the sale or exchange (without regard to whether such sale or exchange occurred before, on, or after the date of the adoption of the plan referred to in subsection (a)) of stock in trade or other property described in subparagraph (A) of this paragraph, and
>
> ("(C)) installment obligations acquired in respect of property (other than property described in subparagraph (A)) sold or exchanged before the date of the adoption of such plan of liquidation.
>
> "(2) Notwithstanding paragraph (1) of this subsection, if substantially all of the property described in subparagraph (A) of such paragraph (1) which is attributable to a trade or

business of the corporation is, in accordance with this section, sold or exchanged to one person in one transaction, then for purposes of subsection (a) the term "property" includes-

("(A)) such property so sold or exchanged, and

("(B)) installment obligations acquired in respect of such sale or exchange.

("(c)) (1) This section shall not apply to any sale or exchange -

("(A)) made by a collapsible corporation (as defined in section 341(b)), or

("(B)) following the adoption of a plan of complete liquidation, if section 333 applies with respect to such liquidation."

There are some specific differences between the two provisions, largely aimed at governing the period during which the liquidating corporation sells its assets, a problem that does not arise when the corporation distributes its assets to its shareholders. For instance, § 337 does not shield the income produced by the sale of inventory in the ordinary course of business; that income will be taxed at the corporate level before distribution of the proceeds to the shareholders. See § 337(b). These differences indicate that Congress did not intend to allow corporations to escape taxation on business income earned while carrying on business in the corporate form; what it did intend to shield was market appreciation.

The question whether § 337 protects the corporation from recognizing income because of unwarranted deductions has arisen frequently, and the rule is now well established that the tax benefit rule overrides the nonrecognition provision. *Connery v. United States*, 460 F.2d 1130 (CA3 1972); *Commissioner v. Anders*, 414 F.2d 1283 (CA10), *cert. denied*, 396 U.S. 958 (1969); *Krajeck v. United States*, 75-1 USTC ¶ 9492 (D. ND 1975); *S. E. Evans, Inc. v. United States*, 317 F.Supp. 423 (D. Ark. 1970), *Anders v. United States*, 462 F.2d 1147 (Ct.Cl.), *cert. denied*, 409 U.S. 1064 (1972); *Estate of Munter v. Commissioner*, 63 T.C. 663 (1975); Rev. Rul. 61-214, 1961-2 Cum. Bull. 60; Byrne, The Tax Benefit Rule as Applied to Corporate Liquidations: Recent Developments, 56 Notre Dame Law 215, 221 (1980); Note, Tax Treatment of Previously Expensed Assets in Corporate Liquidations, 80 Mich. L. Rev. 1636, 1638-39 (1982); *cf. Spitalny v. United States*, *supra*, 430 F.2d 195 (when deduction and liquidation occur within a single year, though tax benefit rule does not apply, principle does). Congress has recently undertaken major revisions of the Code, see Economic Tax Recovery Act of 1981, Pub. 97-34, 95 Stat. 172, and has made changes in the liquidation provisions, *e.g.*, Pub. 95-600, 92 Stat. 2904 (amending § 337); Pub. 95-628, 92 Stat. 3628 (same), but it did not act to change this long-standing, universally accepted rule. If the construction of the language in section 337 as permitting recognition in these circumstances has the acquiescence of Congress, *Lorillard v. Pons*, 434 U.S. 575, 580 (1978), we must conclude that Congress intended the same construction of the same language in the parallel provision in § 336.

Thus, the legislative history of § 336, the application of other general rules of tax law, and the construction of the identical language in § 337 all indicate that § 336 does not permit a liquidating corporation to avoid the tax benefit rule. Consequently, we reverse the judgment of the Court of Appeals and hold that, on liquidation, Bliss must include in income the amount of the unwarranted deduction.[37]

[37] Some commentators have argued that the correct measure of the income that Bliss should include is the lesser of the amount it deducted or the basis that the shareholders will take in the asset. See Feld, The Tax Benefit of Bliss, 62 B. U. L. Rev. 443, 463-464 (1982); see also Rev. Rul. 74-396, 1974-2 Cum. Bull. 106. Since Bliss has not suggested that, if there is an amount taken into income, it should be less than the amount previously deducted, we need not address the point.

As Justice Stevens observes, *post*, at 17 and n. 26, we do not resolve this question. His perception of ambiguities elsewhere in our discussion of the amount recognized as income is simply inaccurate. Our discussion of the tax consequences on the sale of an expensed asset, *supra*, at 25, does not suggest that the entire amount of proceeds on sale is attributable to the tax benefit rule. Instead, we illustrated that the basis rules automatically lead to inclusion of the amount attributable to the operation of the tax benefit rule. That is, the proceeds will equal the cost plus any appreciation (or less any decrease in value). The appreciation would be recognized as gain (or the decrease as loss) in the ordinary sale, regardless of whether the taxpayer had expensed the asset upon acquisition. The reduction of the basis to zero when the item is expensed ensures that if it is sold rather than consumed the unwarranted deduction will be included in income along with any appreciation, and it is this amount that the tax benefit rule requires to be recognized as income.

II.G.4.n. Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax

For "itemized deductions," various limitations apply for regular tax and for alternative minimum tax. "Itemized deductions" are those not allowed in determining an adjusted gross income.[1392]

Deductions allowed in determining adjusted gross income that might be business expenses or incurred for the production of income include the following:

- "Deductions … attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee."[1393]

- Certain deductions that are reimbursed by an employer or are incurred by certain performing artists, governmental officials, elementary and secondary school teachers, or military reservists.[1394]

- Losses from the sale or exchange of property under Code §§ 161-199.[1395]

- The deductions allowed by Code §§ 161-199, by Code § 212,[1396] and by Code § 611 (relating to depletion) which are attributable to property held for the production of rents or royalties.[1397]

[1392] Code § 63(b).
[1393] Code § 62(a)(1). This includes unreimbursed business expenses as a partner. *Cristo v. Commissioner*, T.C. Memo. 2017-239 (managing member who owned 95% of an LLC.) It also includes expenses incurred by an individual taxpayer in preparing that portion of the taxpayer's return that relates to the taxpayer's business as a sole proprietor (such as profit or loss from business (Schedule C), income or loss from rentals or royalties (Part I of Schedule E, Supplemental Income and Loss), or farm income and expenses (Schedule F)), and expenses incurred in resolving asserted tax deficiencies relating to the taxpayer's business as a sole proprietor. Rev. Rul. 92-29.
[1394] Code § 62(a)(2).
[1395] Code § 62(a)(3).
[1396] See part II.G.4.l.i.(b) Requirements for Deduction Under Code § 212.
[1397] Code § 62(a)(4).

- In the case of a life tenant of property, or an income beneficiary of property held in trust, or an heir, legatee, or devisee of an estate, the deduction for depreciation allowed by Code § 167 and the deduction allowed by Code § 611 (depletion).[1398]

- Certain contributions to qualified retirement plans[1399] or IRAs.[1400]

Code § 63(b), (e)(1) disallows an individual's itemized deductions if the individual takes the "standard deduction."

Code § 67(a) reduces an individual's "miscellaneous itemized deductions" by 2% of the adjusted gross income, but Code § 67(g) disallows these deductions entirely for an individual for any taxable year beginning after December 31, 2017 and before January 1, 2026. Code § 67(b) defines "miscellaneous itemized deductions" as itemized deductions other than:

(1) the deduction under section 163 (relating to interest),

(2) the deduction under section 164 (relating to taxes),

(3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),

(4) the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose),

(5) the deduction under section 213 (relating to medical, dental, etc., expenses),

(6) any deduction allowable for impairment-related work expenses,

(7) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),

(8) any deduction allowable in connection with personal property used in a short sale,

(9) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),

(10) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),[1401]

(11) the deduction under section 171 (relating to deduction for amortizable bond premium), and

(12) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

Rev. Proc. 2019-46 discusses the interaction between this disallowance of miscellaneous itemized deductions and rules for using optional standard mileage rates in computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes.

[1398] Code § 62(a)(5).
[1399] Code § 62(a)(6), referring to the Code § 404 deduction allowed to self-employed individuals under Code § 401(c)(1).
[1400] Code § 62(a)(7), referring to Code § 219 IRA deductions.
[1401] [my footnote:] See text accompanying fn 2923 in part II.J.19.a.vii Loss on Sale of Annuity.

For any taxable year beginning after December 31, 2017 and before January 1, 2026, Code § 164(b)(6) limits an individual's deductions for state taxes to $10,000 ($5,000 for individuals who are married filing separately), but it does not apply this limit to property taxes attributable to Code § 212 trade or business (which generally would be rental real estate, if it is a trade or business).[1402] Revenue Ruling 2019-11 provides guidance to taxpayers regarding the inclusion in income of recovered state and local taxes in the current year when the taxpayer deducted state and local taxes paid in a prior year, subject to the Code § 164(b)(6) limitation.

Originally, charitable contributions that generate state tax credits were not reduced by the state tax credits that are awarded[1403] and were very helpful to those who are charitably inclined and receive a better deduction than the state income tax deduction. However, regulations may reduce the charitable deduction to account for state tax credits to be awarded; this reduction may generate a state income tax deduction relating to that credit. Reg. § 1.170A-1(h)(3), "Payments resulting in state or local tax benefits," provides:

(i) *State or local tax credits*. Except as provided in paragraph (h)(3)(vi) of this section, if a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), the amount of the taxpayer's charitable contribution deduction under section 170(a) is reduced by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer.

(ii) *State or local tax deductions*.

(A) *In general*. If a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), and the taxpayer receives or expects to receive state or local tax deductions that do not exceed the amount of the taxpayer's payment or the fair market value of the property transferred by the taxpayer to the entity, the taxpayer is not required to reduce its charitable contribution deduction under section 170(a) on account of the state or local tax deductions.

(B) *Excess state or local tax deductions*. If the taxpayer receives or expects to receive a state or local tax deduction that exceeds the amount of the taxpayer's payment or the fair market value of the property transferred, the taxpayer's charitable contribution deduction under section 170(a) is reduced.

(iii) *In consideration for*. For purposes of paragraph (h)(3)(i) of this section, the term in consideration for shall have the meaning set forth in § 1.170A-13(f)(6), except that the state or local tax credit need not be provided by the donee organization.

(iv) *Amount of reduction*. For purposes of paragraph (h)(3)(i) of this section, the amount of any state or local tax credit is the maximum credit allowable that corresponds to the amount of the taxpayer's payment or transfer to the entity described in section 170(c).

(v) *State or local tax*. For purposes of paragraph (h)(3) of this section, the term state or local tax means a tax imposed by a State, a possession of the United States, or by a political subdivision of any of the foregoing, or by the District of Columbia.

(vi) *Exception*. Paragraph (h)(3)(i) of this section shall not apply to any payment or transfer of property if the total amount of the state and local tax credits received or expected to be received by the taxpayer

[1402] For more details about my comment on real estate as trade or business, see part II.E.1.e Whether Real Estate Qualifies As a Trade or Business.
[1403] CCA 201105010.

is 15 percent or less of the taxpayer's payment, or 15 percent or less of the fair market value of the property transferred by the taxpayer.

(vii) *Examples*. The following examples illustrate the provisions of this paragraph (h)(3). The examples in paragraph (h)(6) of this section are not illustrative for purposes of this paragraph (h)(3).

(A) *Example 1*. A, an individual, makes a payment of $1,000 to X, an entity described in section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70 percent of the amount of A's payment to X. Under paragraph (h)(3)(i) of this section, A's charitable contribution deduction is reduced by $700 (0.70 x $1,000). This reduction occurs regardless of whether A is able to claim the state tax credit in that year. Thus, A's charitable contribution deduction for the $1,000 payment to X may not exceed $300.

(B) *Example 2*. B, an individual, transfers a painting to Y, an entity described in section 170(c). At the time of the transfer, the painting has a fair market value of $100,000. In exchange for the painting, B receives or expects to receive a state tax credit equal to 10 percent of the fair market value of the painting. Under paragraph (h)(3)(vi) of this section, B is not required to apply the general rule of paragraph (h)(3)(i) of this section because the amount of the tax credit received or expected to be received by B does not exceed 15 percent of the fair market value of the property transferred to Y. Accordingly, the amount of B's charitable contribution deduction for the transfer of the painting is not reduced under paragraph (h)(3)(i) of this section.

(C) *Example 3*. C, an individual, makes a payment of $1,000 to Z, an entity described in section 170(c). In exchange for the payment, under state M law, C is entitled to receive a state tax deduction equal to the amount paid by C to Z. Under paragraph (h)(3)(ii)(A) of this section, C's charitable contribution deduction under section 170(a) is not required to be reduced on account of C's state tax deduction for C's payment to Z.

(viii) *Effective/applicability date*. This paragraph (h)(3) applies to amounts paid or property transferred by a taxpayer after August 27, 2018.

Notice 2019-12, § 3, "Safe Harbor For Individuals," provides for post-August 27, 2018 contributions:

The Treasury Department and the IRS take seriously the concern that the proposed regulations could create unfair consequences for individuals who (i) itemize deductions for federal income tax purposes, (ii) make a payment to a section 170(c) entity in return for a state or local tax credit, and (iii) would have been able to deduct a payment of tax to the state or local government in the amount of the credit. A safe harbor is appropriate to mitigate the consequences of the proposed regulations in the situation described above.

Accordingly, the Treasury Department and the IRS intend to publish a proposed regulation amending Treasury Regulation § 1.164-3 to provide a safe harbor for certain individuals who make a payment to or for the use of an entity described in section 170(c) in return for a state or local tax credit. Under this safe harbor, an individual who itemizes deductions and who makes a payment to a section 170(c) entity in return for a state or local tax credit may treat as a payment of state or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is or will be disallowed under final regulations. This treatment as a payment of state or local tax under section 164 is allowed in the taxable year in which the payment is made to the extent the resulting credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability for such taxable year or the preceding taxable year.[1] To the extent the resulting credit is not applied to offset the individual's state or local tax liability for the taxable year of the payment or the preceding taxable year, any excess credit permitted to be carried forward may be treated as a payment of state or local tax under section 164 in the taxable year or years for which the carryover credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability. This safe harbor shall not apply to a transfer of property.

[1] Some state or local tax credit programs allow an individual to apply the state or local tax credit to offset a prior year's state or local tax liability.

> Nothing in this notice may be construed as permitting a taxpayer who applies this safe harbor to treat the amount of any payment as deductible under more than one provision of the Code or Treasury regulations.
>
> Nothing in this notice may be construed as permitting a taxpayer who applies this safe harbor to avoid the limitations of section 164(b)(6) for any amount paid as a tax or treated under this notice as a payment of tax.

Notice 2019-12, § 4, "Examples," provides:

> In the examples below, assume that the taxpayer's application of the state or local tax credit is consistent with applicable state or local law and that the taxpayer is an individual who itemizes deductions for federal income tax purposes.
>
> *Example 1*. In year 1, Taxpayer A makes a payment of $500 to an entity described in section 170(c). In return for the payment, A receives a dollar-for-dollar state income tax credit. Prior to application of the credit, A's state income tax liability for year 1 was $500 or more; A applies the $500 credit to A's year 1 state income tax liability. Under section 3 of this notice, A treats the $500 payment as a payment of state income tax in year 1 for purposes of section 164. To determine A's deduction amount, A must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).
>
> *Example 2*. In year 1, Taxpayer B makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, B receives a dollar-for-dollar state income tax credit, which under state law may be carried forward for three taxable years. Prior to application of the credit, B's state income tax liability for year 1 was $5,000; B applies $5,000 of the $7,000 credit to B's year 1 state income tax liability. Under section 3 of this notice, B treats $5,000 of the $7,000 payment as a payment of state income tax in year 1 for purposes of section 164. Prior to application of the remaining credit, B's state income tax liability for year 2 exceeds $2,000; B applies the excess credit of $2,000 to B's year 2 state income tax liability. For year 2, B treats the $2,000 as a payment of state income tax for purposes of section 164. To determine B's deduction amounts in years 1 and 2, B must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).
>
> *Example 3*. In year 1, Taxpayer C makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, C receives a local real property tax credit equal to 25 percent of the amount of this payment ($1,750). Prior to application of the credit, C's local real property tax liability in year 1 was $3,500; C applies the $1,750 credit to C's year 1 local real property tax liability. Under section 3 of this notice, for year 1, C treats $1,750 as a payment of local real property tax for purposes of section 164. To determine C's deduction amount, C must apply the provisions of section 164 applicable to payments of state and local taxes, including the limitation under section 164(b)(6).

This recharacterization of charitable contributions that generate tax credits as state tax payments extends to tax credit contributions that generate credit against business owners' individual income tax but does not disallow recharacterize contributions when the credits are against entity level taxation.[1404] Similarly, if a partnership pays an entity-level income tax, Rev. Rul. 58-25 allows the partnership to deduct the tax against its income instead of separately stating the tax on the partner's K-1s. Notice 2020-75, § 3.01, discusses how this applies in light of the Code § 164(b)(6) limitations:

[1404] Reg. § 1.162-15(a)(3)(iv), Examples (3), which is reproduced in part II.G.4.g.i Charitable Deduction vs. Business Expense.

Purpose and scope. The Treasury Department and the IRS intend to issue proposed regulations to provide certainty to individual owners of partnerships and S corporations in calculating their SALT deduction limitations. Based on the statutory and administrative authorities described in section 2 of this notice, the forthcoming proposed regulations will clarify that Specified Income Tax Payments (as defined in section 3.02(1) of this notice) are deductible by partnerships and S corporations in computing their non-separately stated income or loss.

Notice 2020-75, § 3.02, "Forthcoming regulations," describes the proposed regulations' expected concepts:

(1) *Definition of Specified Income Tax Payment*. For purposes of section 3.02 of this notice, the term "Specified Income Tax Payment" means any amount paid by a partnership or an S corporation to a State, a political subdivision of a State, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corporation. This definition does not include income taxes imposed by U.S. territories or their political subdivisions. Thus, this definition solely includes income taxes described in section 164(b)(2) for which a deduction by a partnership is not disallowed under section 703(a)(2)(B), and such income taxes for which a deduction by an S corporation is not disallowed under section 1363(b)(2). For this purpose, a Specified Income Tax Payment includes any amount paid by a partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the partnership or S corporation, without regard to whether the imposition of and liability for the income tax is the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction's tax law and which reduces the partners' or shareholders' own individual income tax liabilities under the Domestic Jurisdiction's tax law.

(2) *Deductibility of Specified Income Tax Payments*. If a partnership or an S corporation makes a Specified Income Tax Payment during a taxable year, the partnership or S corporation is allowed a deduction for the Specified Income Tax Payment in computing its taxable income for the taxable year in which the payment is made.

(3) *Specified Income Tax Payments not separately taken into account*. Any Specified Income Tax Payment made by a partnership or an S corporation during a taxable year does not constitute an item of deduction that a partner or an S corporation shareholder takes into account separately under section 702 or section 1366 in determining the partner's or S corporation shareholder's own Federal income tax liability for the taxable year. Instead, Specified Income Tax Payments will be reflected in a partner's or an S corporation shareholder's distributive or pro-rata share of nonseparately stated income or loss reported on a Schedule K-1 (or similar form).

(4) *Specified Income Tax Payments not taken into account for SALT deduction limitation*. Any Specified Income Tax Payment made by a partnership or an S corporation is not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or a shareholder of the S corporation.

Notice 2020-75, § 4, "*Applicability Date*," provides:

The proposed regulations described in this notice will apply to Specified Income Tax Payments made on or after November 9, 2020. The proposed regulations will also permit taxpayers described

> in section 3.02 of this notice to apply the rules described in this notice to Specified Income Tax Payments made in a taxable year of the partnership or S corporation ending after December 31, 2017, and made before November 9, 2020, provided that the Specified Income Tax Payment is made to satisfy the liability for income tax imposed on the partnership or S corporation pursuant to a law enacted prior to November 9, 2020. Prior to the issuance of the proposed regulations, taxpayers may rely on the provisions of this notice with respect to Specified Income Tax Payments as described in this section 4.

In response to owners of pass-through entities not being able to deduct state and local taxes imposed on their owners' distributive share of income, some states have imposed entity-level taxes; the Multistate Tax Commission is looking into entity-level taxation to combat the complexity of tiered pass-through entities (especially partnerships).[1405] EY prepared a study on the different C corporation and S corporation effective tax rates.[1406] AICPA issued its own reports.[1407]

Certain trust administrative expenses are not itemized deductions and instead are deducted in arriving at adjusted gross income (often called "above the line"); therefore, they are fully deductible for regular tax and alternative minimum tax.[1408] Thus, nongrantor trusts treat these items more favorably than individuals and grantor trusts.

Among the items the alternative minimum tax disallows for noncorporate taxpayers are deductions for the following under Code § 56(b)(1)(A):

> (i) for any miscellaneous itemized deduction (as defined in section 67(b)), or
>
> (ii) for any taxes described in paragraph (1), (2), or (3) of section 164(a) or clause (ii) of section 164(b)(5)(A).

To work around the Code § 67(g) suspension of the deduction for investment expenses characterized as miscellaneous itemized deductions and the unfavorable AMT treatment after the suspension ends, see part II.G.4.l.i.(e) Family Office As a Trade or Business.

[1405] https://www.mtc.gov/Uniformity/Standing-Subcommittee.

[1406] http://mainstreetemployers.org/wp-content/uploads/2016/03/EY-S-Corp-Association-Tax-Treatment-of-S-and-C-Corporations-2018.pdf.

[1407] 15-page position paper on state pass through entity level tax implementation issues is at https://www.aicpa.org/content/dam/aicpa/advocacy/downloadabledocuments/aicpa-paper-on-state-pass-through-entity-level-tax-issues-10-4-18.pdf, and 2-page paper is at https://www.aicpa.org/content/dam/aicpa/advocacy/downloadabledocuments/one-pager-on-aicpa-paper-on-state-pass-through-entity-level-tax-issues-10-4.pdf.

[1408] See fn 2429 and accompanying text in part II.J.3.d Who Benefits Most from Deductions.

II.I.8. Application of 3.8% Tax to Business Income

II.I.8.a. General Application of 3.8% Tax to Business Income

Gross income from interest,[2255] dividends, annuities, royalties,[2256] and rents is excluded from NII if it is derived in the ordinary course of a trade or business that is not a passive activity;[2257] however, any item of gross income from the investment of working capital will be treated as not derived in the ordinary course of a trade or business.[2258] Gain from the sale of an asset is excluded from NII if it is derived in the

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[2255] Self-charged interest is treated as business income. Reg. § 1.1411-4(g)(5) provides:

> Gross income from interest (within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section) that is received by the taxpayer from a nonpassive activity of such taxpayer, solely for purposes of section 1411, is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5. The amount of interest income that is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5, and thus excluded from the calculation of net investment income, under this paragraph (g)(5) is limited to the amount that would have been considered passive activity gross income under the rules of § 1.469-7 if the payor was a passive activity of the taxpayer. For purposes of this rule, the term nonpassive activity does not include a trade or business described in § 1.1411-5(a)(2). However, this rule does not apply to the extent the corresponding deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

As described in fn. 2258, other than self-charged interest described above, interest income generally will constitute NII, even if it is fully business-related, unless the business is in the nature of a bank, etc.

[2256] See part II.K.1.f Royalty as a Trade or Business. If licensing royalties does not rise to the level of a trade or business, consider obtaining a preferred profits interest in lieu of royalty income (if the owner of the property being provided is active in the business) or a structure such as described in part II.E Recommended Structure for Entities (with some extra share of profits allocated to the person who contributed the property).

[2257] Reg. § 1.1411-4(b), which provides:

> Gross income described in paragraph (a)(1)(i) of this section is excluded from net investment income if it is derived in the ordinary course of a trade or business not described in § 1.1411-5….

CCA 202118009 correctly asserted:

> As discussed above, § 1.1411-4(b) does not provide any rules for determining whether gross income derived by a shareholder of a C corporation (including a closely held C corporation) may be properly treated as derived in the ordinary course of a trade or business. C corporations, including closely held C corporations, are not passthrough entities. This analysis and conclusion do not change simply because a shareholder may be treated as materially participating, for purposes of § 469, in a trade or business activity conducted through a closely held C corporation. Accordingly, any dividend income received by a shareholder from a C corporation will be subject to tax under § 1411, irrespective of whether the C corporation is a closely held C corporation within the meaning of § 469(h)(1) or whether the shareholder is treated as materially participating in the trade or business activity of the C corporation.

[2258] Reg. § 1.1411-6(a), which also provides:

> In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See § 1.1411-4(f) for rules regarding properly allocable deductions with respect to an investment of working capital…

Reg. § 1.469-2T(c)(3)(ii) treats only the following as gross income derived in the ordinary course of a trade or business:

> (A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;
> (B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;
> (C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;
> (D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);
> (E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);
> (F) Amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and
> (G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

ordinary course of a trade or business that is not a passive activity;[2259] however, any net gain that is attributable to the investment of working capital will be treated as not derived in the ordinary course of a trade or business.[2260] Other gross income from a trade or business is NII if it a passive activity.[2261]

Passive income is subject to the NII tax, and Code § 469 and the regulations thereunder determine whether a trade or business is passive.[2262]

Income from a trade or business of trading in financial instruments[2263] or commodities[2264] is also subject to NII tax.[2265] This rule applies to traders – not to dealers or investors.[2266]

[2259] Reg. § 1.1411-4(a)(1)(iii).

[2260] Reg. § 1.1411-6(a), which also provides:

> In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See ... § 1.1411-7 for rules relating to the adjustment to net gain on the disposition of interests in a partnership or S corporation.

It also provides an example showing how strict this rule is: The taxpayer uses an interest-bearing checking account at a local bank to make daily deposits of the restaurant's cash receipts and to pay the restaurant's recurring ordinary and necessary business expenses. The account's average daily balance is approximately $2,500, but at any given time the balance may be significantly more or less than this amount, depending on the business' short-term cash flow needs. Any interest the account generates constitutes NII.

[2261] Reg. § 1.1411-4(c).

[2262] Reg. § 1.1411-5(b)(1)(ii).

[2263] Reg. § 1.1411-5(c)(1) provides:

> *Definition of financial instruments*. For purposes of section 1411 and the regulations thereunder, the term financial instruments includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives, or any evidence of an interest in any of the items described in this paragraph (c)(1). An evidence of an interest in any of the items described in this paragraph (c)(1) includes, but is not limited to, short positions or partial units in any of the items described in this paragraph (c)(1).

[2264] Reg. § 1.1411-5(c)(2) provides:

> *Definition of commodities*. For purposes of section 1411 and the regulations thereunder, the term commodities refers to items described in section 475(e)(2).

[2265] Code § 1411(c)(2)(B); Reg. § 1.1411-5(a)(2).

[2266] The final regulations adopted the proposed regulations. The preamble to the latter, REG-130507-11, provides:

> **C. Trading in Financial Instruments or Commodities**
>
> **i. Distinguishing Between Dealers, Traders, and Investors**
>
> Determining whether trading in financial instruments or commodities rises to the level of a section 162 trade or business is a question of fact. *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941); *Estate of Yaeger v. Comm'r*, 889 F.2d 29, 33 (2d Cir. 1989). In general, section 475(c)(1) provides that the term dealer in securities means a taxpayer who (A) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (B) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. In contrast, a trader seeks profit from short-term market swings and receives income principally from selling on an exchange rather than from dividends, interest, or long-term appreciation. *Groetzinger v. Comm'r*, 771 F.2d 269, 274-275 (7th Cir. 1985), *aff'd* 480 U.S. 23 (1987); *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983). A person will be a trader, and therefore engaged in a section 162 trade or business, if his or her trading is frequent and substantial, which has been rephrased as "frequent, regular, and continuous." *Boatner v. Comm'r*, T.C. Memo. 1997-379, *aff'd* in unpublished opinion 164 F.3d 629 (9th Cir. 1998). An investor is a person who purchases and sells securities with the principal purpose of realizing investment income in the form of interest, dividends, and gains from appreciation in value over a relatively long period of time (that is, long-term appreciation). The management of one's own investments is not considered a section 162 trade or business no matter how extensive or substantial the investments might be. See *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941); *King v. Comm'r*, 89 T.C. 445 (1987). Therefore, an investor is not considered to be engaged in a section 162 trade or business of investing.
>
> For purposes of section 1411(c)(2)(B), in order to determine whether gross income is derived from a section 162 trade or business of trading in financial instruments or commodities, the gross income must be derived from an activity that

This tax favors (by excluding) trade or business income from partnerships and S corporations in which the taxpayer significantly or materially participates, which for many taxpayers simply means work for more than 100 hours in a year.[2267] Although a partnership's income from a trade or business generally would be subject to self-employment tax, whereas an S corporation income from a trade or business is not,[2268] one should consider that exit strategies[2269] and basis step-up issues[2270] tend to favor partnerships over S corporations. One might consider combining a partnership for the business operations themselves with an S corporation to block self-employment income from passing through to the ultimate owners.[2271]

II.I.8.a.i. Passive Activity Recharacterization Rules

Various passive activity recharacterization rules also provide NII exclusions for trade or business activity:

- Significant participation activities (more than 100 hours of participation).[2272]

- Certain rental activities.[2273]

- To the extent that any gain from a trade or business is recharacterized as "not from a passive activity" by reason of certain rules relating to the disposition of substantially appreciated property formerly used in nonpassive activity[2274] and is not from the disposition of an interest in property that was held for investment for more than 50% of the period during which the taxpayer held that interest in property in nonpassive activities,[2275] such trade or business is a nonpassive activity solely with respect to such recharacterized gain.[2276]

- To the extent that any income or gain from a trade or business is recharacterized as a nonpassive activity and is further characterized as portfolio income under certain provisions, then such trade or

would constitute trading for purposes of chapter 1. Therefore, a person that is a trader in commodities or a trader in financial instruments is engaged in a trade or business for purposes of section 1411(c)(2)(B). The Treasury Department and the IRS emphasize that the proposed regulations do not change the state of the law with respect to classification of traders, dealers, or investors for purposes of chapter 1.

2267 See part II.K.1.a Counting Work as Participation, being careful to consider part II.K.1.a.v What Does Not Count as Participation. Other than work as a mere investor, almost any type of work appears to qualify towards material participation for purposes of the Code § 1411. For the more-than-100 hours rule, see fn. 2272.

2268 See part II.L.1 FICA: Corporation.

2269 See part II.Q Exiting from or Dividing a Business. However, when considering a Code § 736 redemption, see part II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411. Also see part II.G.16 Limitations on the Use of Installment Sales, but note that the suggestion in that part about forming a partnership to hold property that is to be sold would not work with an S corporation, because a partnership is not eligible to hold stock in an S corporation.

2270 See part II.H.2 Basis Step-Up Issues.

2271 See part II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker.

2272 Reg. § 1.1411-5(b)(2)(i), referring to Reg. § 1.469-2T(f)(2), which is described in fn. 3148 of part II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

2273 Reg. § 1.1411-5(b)(2)(i), referring to Reg. § 1.469-2(f)(5) or 1.469-2(f)(6), which are described in fns. 3132 and 3089, respectively, within part II.K.1.e Rental Activities.

2274 Reg. § 1.469-2(c)(2)(iii), which provides, generally:

> If an interest in property used in an activity is substantially appreciated at the time of its disposition, any gain from the disposition shall be treated as not from a passive activity unless the interest in property was used in a passive activity for either:
>
> (1) 20 percent of the period during which the taxpayer held the interest in property; or
>
> (2) The entire 24-month period ending on the date of the disposition.

An interest in property is substantially appreciated if the fair market value of the interest in property exceeds 120% of the adjusted basis of the interest. Reg. § 1.469-2(c)(2)(iii)(C).

2275 Reg. § 1.469-2(c)(2)(iii)(F).

2276 Reg. § 1.1411-5(b)(2)(i).

business constitutes a passive activity solely with respect to such recharacterized income or gain.[2277] The relevant portfolio income provision is either:

- o the rental of nondepreciable property, equity-financed lending activities, and royalty income from passthrough entities,[2278] or
- o the disposition of an interest in property that was held for investment for more than 50% of the period during which the taxpayer held that interest in property in nonpassive activities.[2279]

II.I.8.a.ii. Passive Activity Grouping Rules

Regarding how the Code § 469 grouping rules interact with classifying income under Code § 469, the preamble explains:[2280]

> Section 1.469-4 provides rules for defining an activity for purposes of applying the passive activity loss rules of section 469 (grouping rules). The grouping rules will apply in determining the scope of a taxpayer's trade or business in order to determine whether such trade or business is a passive activity for purposes of section 1411(c)(2)(A). However, a proper grouping under § 1.469-4(d)(1) (grouping rental activities with other trade or business activities) will not convert gross income from rents into other gross income derived from a trade or business described in proposed § 1.1411-5(a)(1).

For example, if a partner in a partnership participates in one trade or business for more than 500 hours and another trade or business for only 50 hours and the individual groups both activities as one activity in a way that qualifies both trades or businesses as nonpassive, business income from both trades or businesses is excluded from NII.[2281]

For more information about the Code § 469 grouping rules, including regrouping as a result of the NII tax, see part II.K.1.b Grouping Activities.

[2277] Reg. § 1.1411-5(b)(2)(iii).
[2278] Reg. § 1.1411-5(b)(2)(iii) refers to Reg. § 1.469-2T(f)(10), which refers to Reg. § 1.469-2(f)(10). Sutton & Howell-Smith, *Federal Income Taxation of Passive Activities* (WG&L), ¶ 7.01[2][b] Recharacterized Items, refers to Reg. § 1.469-2(f)(10) as the rental of nondepreciable property (¶ 10.05 of the treatise), equity-financed lending activities (¶ 7.03 of the treatise), and royalty income from passthrough entities (¶ 13.05 of the treatise).
[2279] Reg. § 1.469-2(c)(2)(iii)(F).
[2280] Part 6.B.1.(b)(4) of the preamble.
[2281] Reg. § 1.1411-5(b)(3), Example (2).

II.I.8.a.iii. Qualifying Self-Charged Interest or Rent Is Not NII

Certain self-charged interest[2282] or rent[2283] received from a business are automatically deemed nonpassive trade or business income if the borrower/tenant is a nonpassive trade or business; however, self-charged interest is excluded only to the extent it is self-charged.[2284]

Note that the taxpayer must materially participate, satisfying the more-than-500-hours or similar rules,[2285] to satisfy the self-rental exception of footnote 2283:

- Although significant participation (more than 100 hours) suffices for other business income,[2286] it does not for the self-rental exception. If this contrast in treatment (between material participation and significant participation) is significant (particularly if the property is about be sold)[2287] and avoiding the NII tax on the rental income becomes important, consider using the structure depicted in part II.E.6 Recommended Partnership Structure – Flowchart,[2288] perhaps migrating as depicted in part II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

- Material participation requires ownership.[2289]

[2282] Reg. § 1.1411-4(g)(5) provides:

> Treatment of self-charged interest income. Gross income from interest (within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section) that is received by the taxpayer from a nonpassive activity of such taxpayer, solely for purposes of section 1411, is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5. The amount of interest income that is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5, and thus excluded from the calculation of net investment income, under this paragraph (g)(5) is limited to the amount that would have been considered passive activity gross income under the rules of § 1.469-7 if the payor was a passive activity of the taxpayer. For purposes of this rule, the term nonpassive activity does not include a trade or business described in § 1.1411-5(a)(2). However, this rule does not apply to the extent the corresponding deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

[2283] Reg. § 1.1411-4(f)(6)(i) provides:

> Gross income from rents. To the extent that gross rental income described in paragraph (a)(1)(i) of this section is treated as not derived from a passive activity by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), such gross rental income is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section.

See fn. 2324 regarding the interaction of Reg. § 1.469-2(f)(6) with the 3.8% tax on net investment income. See part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity for an explanation of Reg. § 1.469-2(f)(6).
See fn. 3089 for the text of Reg. § 1.469-2(f)(6).

[2284] Reg. § 1.469-7 (treatment of self-charged items of interest income and deduction), which applies "in the case of a lending transaction (including guaranteed payments for the use of capital under section 707(c)) between a taxpayer and a passthrough entity in which the taxpayer owns a direct or indirect interest, or between certain passthrough entities." Reg. § 1.469-7(a)(1). See parts II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation, II.I.8.d Partnership Structuring in Light of the 3.8% Tax on Net Investment Income, and II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736 regarding the interaction of partnership tax rules with the passive loss rules and rules governing NII.

[2285] See part II.K.1.a.ii Material Participation.

[2286] See part II.I.8.a.i Passive Activity Recharacterization Rules. If at all practical, an owner should materially participate instead of significantly participate. See part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

[2287] See fn. 2290

[2288] This structure often is ideal; see part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons. However, it might need to be unwound by subjecting the real estate to a long-term business lease and distributing the real estate to the client's beneficiaries not active in the business, to try to disentangle the active from the inactive beneficiaries. Note, however, that splitting up an entity taxed as a partnership generally can be done on a tax-free basis; see part II.Q.8 Exiting From or Dividing a Partnership, especially part II.Q.8.b.i Distribution of Property by a Partnership.

[2289] See fn. 3088 and part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

If self-charged rental is excluded from NII, gain on the sale of the rental property is also excluded.[2290]

II.I.8.a.iv. Determination of Trade or Business Status, Passive Activity Status, or Trading Status of Pass-Through Entities

If an individual, estate, or trust owns or engages in a trade or business,[2291] the determination of whether such gross income is derived in a trade or business is made at the owner's level.[2292]

If an individual, estate, or trust owns an interest in a trade or business through a partnership or S corporation:[2293]

- whether gross income is a passive trade or business activity is determined at the owner level; and
- whether gross income is derived in trade or business of a trader trading in financial instruments or commodities[2294] is determined at the entity level.

II.I.8.a.v. Working Capital Is NII

II.I.8.a.v.(a). Policy of Working Capital as NII

The tax applies to interest, dividends, etc. whether inside or outside an entity, and arguments that such income was derived from working capital used to generate active business income will not help any.[2295] The preamble to the proposed regulations explains:[2296]

> Section 1411(c)(3) provides that a rule similar to the rule of section 469(e)(1)(B) applies for purposes of section 1411 (the working capital rule). Section 469(e)(1)(B) provides that, for purposes of determining whether income is treated as from a passive activity, any income or gain attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business.
>
> The term working capital is not defined in either section 469 or section 1411, but it generally refers to capital set aside for use in and the future needs of a trade or business. Because the capital may not be necessary for the immediate conduct of the trade or business, the amounts are often invested by businesses in income-producing liquid assets such as savings accounts, certificates of deposit, money market accounts, short-term government and commercial bonds, and other similar investments. These investment assets will usually produce portfolio-type income, such as interest. Under section 469(e)(1)(B), portfolio-type income generated by working capital is not derived in the ordinary course of a trade or business, and therefore, it is not treated as passive income. Under

[2290] Reg. § 1.1411-4(f)(6)(ii) provides:

> Gain or loss from the disposition of property. To the extent that gain or loss resulting from the disposition of property is treated as nonpassive gain or loss by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), then such gain or loss is deemed to be derived from property used in the ordinary course of a trade or business within the meaning of paragraph (d)(4)(i) of this section.

See fns. 2324 and 3091 regarding Reg. § 1.469-2(f)(6).

[2291] Directly or indirectly through ownership of an interest in an entity that is disregarded as an entity separate from its owner under the check-the-box rules of Reg. § 301.7701-3.

[2292] Reg. § 1.1411-4(b)(1).

[2293] Reg. § 1.1411-4(b)(2).

[2294] Reg. § 1.1411-5(c) discusses financial instruments and commodities.

[2295] Code § 1411(c)(3) provides that any income, gain, or loss which is attributable to an investment of working capital is deemed not to be derived in the ordinary course of a trade or business in applying this rule.

[2296] Part 7 of the preamble.

> section 1411(c)(3), gross income from and net gain attributable to the investment of working capital is not derived in the ordinary course of a trade or business, and therefore such gross income and net gain is subject to section 1411.
>
> A taxpayer may take into account the properly allocable deductions (related to losses or deductions properly allocable to the investment of such working capital) in determining net investment income. See part 5.E of this preamble regarding properly allocable deductions.

The preamble to the final regulations simply mentions:[2297]

> Section 1411(c)(3) provides that income on the investment of working capital is not treated as derived from a trade or business for purposes of section 1411(c)(1) and is subject to tax under section 1411. Section 1.1411-6 of the final regulations provides guidance on working capital under section 1411(c)(3).

Of course, if the taxpayer does not materially participate in the business, generally all of the business' income will be NII, so the working capital exception would be moot.[2298]

II.I.8.a.v.(b). What Is Working Capital

Reg. § 1.1411-6(a) provides:[2299]

> *General rule*. For purposes of section 1411, any item of gross income from the investment of working capital will be treated as not derived in the ordinary course of a trade or business, and any net gain that is attributable to the investment of working capital will be treated as not derived in the ordinary course of a trade or business. In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See § 1.1411- 4(f) for rules regarding properly allocable deductions with respect to an investment of working capital and § 1.1411-7 for rules relating to the adjustment to net gain on the disposition of interests in a partnership or S corporation.

Reg. § 1.1411-6(b) provides an example holding that cash used in daily operations constitute

> working capital under § 1.469-2T(c)(3)(ii) and, pursuant to paragraph (a) of this section, the interest generated by this working capital will not be treated as derived in the ordinary course of S's restaurant business. Accordingly, the interest income derived by S from its checking and savings accounts … constitutes gross income from interest under § 1.1411-4(a)(1)(i).

To place context on this reference to Reg. § 1.469-2T(c)(3)(ii), Reg. § 1.469-2T(c)(3)(i) excludes from passive activity gross income items of portfolio income and further provides:

[2297] T.D. 9644.

[2298] Reg. § 1.1411-5(b)(3), Example (5).

[2299] Reg. § 1.1411-6(b) provides an example holding that cash used in daily operations constitute

> working capital under § 1.469-2T(c)(3)(ii) and, pursuant to paragraph (a) of this section, the interest generated by this working capital will not be treated as derived in the ordinary course of S's restaurant business. Accordingly, the interest income derived by S from its checking and savings accounts … constitutes gross income from interest under § 1.1411-4(a)(1)(i).

For purposes of the preceding sentence, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of paragraph (c)(3)(ii) of this section), that is attributable to—

(A) Interest (including amounts treated as interest under paragraph (e)(2)(ii) of this section, relating to certain payments to partners for the use of capital); annuities; royalties (including fees and other payments for the use of intangible property); dividends on C corporation stock; and income (including dividends) from a real estate investment trust (within the meaning of section 856), regulated investment company (within the meaning of section 851), real estate mortgage investment conduit (within the meaning of section 860D), common trust fund (within the meaning of section 584), controlled foreign corporation (within the meaning of section 957), qualified electing fund (within the meaning of section 1295(a)), or cooperative (within the meaning of section 1381(a));

(B) Dividends on S corporation stock (within the meaning of section 1368(c)(2));

(C) The disposition of property that produces income of a type described in paragraph (c)(3)(i)(A) of this section; and

(D) The disposition of property held for investment (within the meaning of section 163(d)).

Reg. § 1.469-2T(c)(3)(ii) provides:

Gross income derived in the ordinary course of a trade or business. Solely for purposes of paragraph (c)(3)(i) of this section, gross income derived in the ordinary course of a trade or business includes only—

(A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;

(B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;

(C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;

(D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);

(E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);

(F) Amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and

(G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

As to (G) above, it has been suggested that the IRS has informally indicated its intention to broaden the definition of mineral royalty income derived in a trade or business, but taxpayers should request a ruling to receive a proper determination.[2300] The same author said that several private letter rulings held that "float revenue, as a substitute for service fees, is derived in the ordinary course of a trade or business."[2301]

II.I.8.a.vi. What is a "Trade or Business"?

The preamble to the final regulations discuss what is a "trade or business" for purposes of the 3.8% tax:[2302]

> Several commentators requested guidance concerning the meaning of "trade or business." Commentators suggested that the regulations include references to relevant case law and administrative guidance. A commentator requested that the regulations expand upon existing guidance by including bright-line examples of what constitutes a trade or business to aid taxpayers in determining if income is derived in the ordinary course of a trade or business and thus is excluded from net investment income.
>
> As noted in part 6.A. of the preamble to the proposed regulations, the rules under section 162 have long existed as guidance for determining the existence of a trade or business and are applied in many circumstances. Whether an activity constitutes a trade or business for purposes of section 162 is generally a factual question. For example, in Higgins v. Commissioner, 312 U.S. 212 (1941), the Supreme Court stated that the determination of "whether the activities of a taxpayer are 'carrying on a trade or business' requires an examination of the facts in each case." 312 U.S. at 217. Except for certain clarifications made in response to the proposed regulations, further guidance concerning the definition of trade or business is beyond the scope of these regulations.
>
> In response to these commentators, § 1.1411-1(d) of the final regulations provides that the term trade or business, when used in section 1411 and the final regulations, describes a trade or business within the meaning of section 162. The section 162 reference incorporates case law and administrative guidance applicable to section 162.
>
> One commentator noted that determining whether income is earned in a section 162 trade or business under a separate entity approach, as reflected in proposed § 1.1411-4(b), will yield unexpected results that are inconsistent with section 162. For purposes of determining whether income is earned under section 162, the commentator noted that § 1.183-1(d) provides that activities are determined and their section 162 trade or business status is evaluated by aggregating undertakings in any reasonable manner determined by the taxpayer.
>
> The Treasury Department and the IRS do not believe that the determination of a trade or business under section 162 mandates the use of the definition of "activity" within the meaning of § 1.183-1(d). Section 183 disallows expenses in excess of income attributable to activities not engaged in for profit. Section 1.183-1(a) provides that section 162 and section 212 activities are not subject to section 183 limitations. The definition of activity within § 1.183-1(d) allows taxpayers latitude to combine different activities into a single activity to establish that the taxpayer is engaged in an activity for profit, and thus is not subject to the section 183 limitation. However, once the taxpayer determines that section 183 is not applicable, the taxpayer then must determine whether the activity

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[2300] Sutton & Howell-Smith, ¶ 12.03[3][a] Royalties, *Federal Income Taxation of Passive Activities* (WG&L).
[2301] Sutton & Howell-Smith, ¶ 2.02[1][f][vii] Other income identified by the Commissioner, *Federal Income Taxation of Passive Activities* (WG&L), pointing to Letter Rulings 199924020, 199924022, and 199924023.
[2302] T.D. 9644.

> is a section 162 trade or business or a section 212 for-profit activity. Furthermore, different definitions of "activity" can be found in sections 465 and 469. Therefore, the Treasury Department and the IRS do not believe that determining whether a trade or business exists using the activity determinations of Code provisions unrelated to section 162 is appropriate.

For further analysis, see part II.G.4.l.i.(a) "Trade or Business" Under Code § 162.

II.I.8.a.vii. Former Passive Activities – NII Implications

The preamble to the final regulations addressed former passive activities:[2303]

> The final regulations clarify, for section 1411 purposes, the treatment of income, deductions, gains, losses, and the use of suspended losses from former passive activities. The Treasury Department and the IRS considered three alternatives. One approach is the complete disallowance of all suspended losses once the activity is no longer a passive activity (in other words, becomes a former passive activity or a nonpassive activity). The rationale behind this approach is that the income from the activity would not be includable in net investment income, thus the suspended losses become irrelevant. Another approach is the unrestricted allowance of all suspended losses in the year in which they are allowed by section 469(f), regardless of whether the nonpassive income is included in net investment income. The rationale behind this approach is that the losses were generated during a period when the activity was a passive activity, and if such losses were allowed in full, they would have potentially reduced net investment income, and therefore the losses should continue to retain their character as net investment income deductions. The third approach is a hybrid approach that allows suspended losses from former passive activities in calculation of net investment income (as properly allocable deductions under section 1411(c)(1)(B) or in section 1411(c)(1)(A)(iii) in the case of losses) but only to the extent of the nonpassive income from such former passive activity that is included in net investment income in that year. The final regulations adopt this hybrid approach.
>
> For example, in the case of a former passive trade or business activity with suspended losses of $10,000 that generates $3,000 of net nonpassive income, section 469(c)(1)(A) allows $3,000 of the $10,000 suspended loss to offset the nonpassive income in the current year. Since the gross nonpassive income is not included in section 1411(c)(1)(A)(ii) (or in section 1411(c)(1)(A)(iii) in the case of gains from the disposition of property in such trade or business), none of the deductions and losses associated with such income are properly allocable deductions under

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[2303] T.D. 9644. For general issues regarding former passive activities, see part II.K.1.k Former Passive Activities. The preamble describes the interaction of these rules with Code § 1411:

> If a taxpayer materially participates in a former passive trade or business activity, the gross income produced by that activity (and associated section 1411(c)(1)(B) properly allocable deductions) in the current year generally would not be net investment income because the activity is no longer a trade or business that is a passive activity within the meaning of section 469. However, in the case of rental income not derived in the ordinary course of a trade or business, a classification of the rental income as nonpassive for purposes of section 469 will not result automatically in the exclusion of such rental income and associated deductions from net investment income. Furthermore, it is possible that a section 469 former passive activity may still generate net investment income on its disposition to the extent the gain is included in section 1411(c)(1)(A)(iii) and not entirely excluded by, for example, section 1411(c)(4).
>
> Suspended losses that are allowed by reason of section 469(f)(1)(A) or (C) may constitute properly allocable deductions under section 1411(c)(1)(B) and § 1.1411-4(f)(2) (to the extent those losses would be described in section 62(a)(1) or 62(a)(4)) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) and § 1.1411-4(d) (to the extent those losses would be described in section 62(a)(3) in the year they are allowed, depending on the underlying character and origin of such losses). The treatment of excess suspended losses of a former passive activity upon a fully taxable disposition is discussed in the next section of this preamble.

section 1411(c)(1)(B) (or in section 1411(c)(1)(A)(iii) in the case of losses from the disposition of property in such trade or business). Thus, under the facts of this example, the final regulations provide that the $3,000 is not a properly allocable deduction (or a loss included in section 1411(c)(1)(A)(iii)). However, to the extent that the remaining suspended passive loss deduction of $7,000 is allowed by section 469(f)(1)(C) to offset other net passive activity income (which is included in net investment income by reason of section 1411(c)(1)(A) less deductions allowed by section 1411(c)(1)(B)), such amounts are considered properly allocable deductions under section 1411(c)(1)(B), or as a loss included in section 1411(c)(1)(A)(iii), as appropriate.

Reg. § 1.1411-4(g)(8) provides the details described above. For more information on former passive activities, see part II.K.1.k Former Passive Activities.

II.I.8.b. 3.8% Tax Does Not Apply to Gain on Sale of Active Business Assets

Net gain from the disposition of property does not include gain or loss attributable to property held in a nonpassive[2304] trade or business.[2305]

However, this exception does not apply to the gain or loss attributable to the disposition of investments of working capital.[2306]

Although a partnership interest or S corporation stock generally is not property held in a trade or business qualifying for the exclusion,[2307] the portion of the sale proceeds attributable to business assets does qualify.[2308]

If an individual, estate, or trust owns or engages in a trade or business directly (or indirectly through a disregarded entity), the determination of whether net gain is attributable to property held in a trade or business is made at the individual, estate, or trust level.[2309] If an individual, estate, or trust that owns an interest in a passthrough entity such as a partnership or S corporation and that entity is engaged in a trade or business, the determination of whether net gain is attributable to (i) a passive activity is made at the owner level; and (ii) the trade or business of a trader trading in financial instruments or commodities is made at the entity level.[2310]

II.I.8.c. Application of 3.8% Tax to Rental Income

As mentioned above, rental income is NII unless it is self-rental[2311] or not only is from a trade or business but also nonpassive.[2312]

[2304] By "nonpassive" I mean not described in Reg. § 1.1411-5. See part II.I.8 Application of 3.8% Tax to Business Income, especially fn. 2262.
[2305] Reg. §§ 1.1411-4(a)(1)(iii), 1.1411-4(d)(4)(i)(A).
[2306] Reg. § 1.1411-4(d)(4)(i)(A). See Reg. § 1.1411-6 regarding working capital, which is described in part II.I.8.a.v Working Capital Is NII.
[2307] Reg. § 1.1411-4(d)(4)(i)(B)(1).
[2308] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[2309] Reg. § 1.1411-4(d)(4)(i)(B)(2).
[2310] Reg. § 1.1411-4(d)(4)(i)(B)(3).
[2311] See fn. 2283.
[2312] See fn. 2257. Note that *Erbs v. Commissioner*, T.C. Summary Opinion 2001-85, held that the material participation rules "govern whether a trade or business is passive and do not address the more fundamental question of whether an activity constitutes a trade or business." See generally "¶L-1103, Regular activity in business is required for being engaged in a trade or business—trade or business expenses," Fed. Tax. Coord.2d. See also Bittker & Lokken, "¶47.3, Property Used in a Trade

Because the self-rental exception is relatively straightforward, this part II.I.8.c focuses on whether the rental not only is from a trade or business but also is nonpassive.

II.I.8.c.i. If Not Self-Rental, Most Rental Income Is *Per Se* Passive Income and Therefore NII

Generally, rental constitutes passive income, even if it constitutes a trade or business in which the taxpayer materially participates.[2313] The NII rules elaborate on exceptions to this general rule. For example, short-term equipment leasing income is not NII,[2314] if the taxpayer materially participates.[2315]

II.I.8.c.ii. Real Estate Classified as Nonpassive for Real Estate Professionals

The general rule that rental is per se passive does not apply to certain real estate professionals.[2316] Therefore, if a real estate professional who meets this exceptions engages in a real estate trade or business, the rental income would not constitute NII.

Although the final regulations declined to provide broad relief for real estate professionals, the preamble informs us:[2317]

> The final regulations do, however, provide a safe harbor test for certain real estate professionals in § 1.1411-4(g)(7). The safe harbor test provides that, if a real estate professional (within the

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or Business," *Federal Taxation of Income, Estates, and Gifts*; "¶L-1115, Renting and/or managing rental real estate as a trade or business," *Fed. Tax. Coord.2d*.

2313 See part II.K.1.e Rental Activities.

2314 Reg. § 1.1411-5(b)(3), Example (3) provides:

> *Application of the rental activity exceptions*. B, an unmarried individual, is a partner in PRS, which is engaged in an equipment leasing activity. The average period of customer use of the equipment is seven days or less (and therefore meets the exception in § 1.469-1T(e)(3)(ii)(A)). B materially participates in the equipment leasing activity (within the meaning of § 1.469-5T(a)). The equipment leasing activity constitutes a trade or business. In Year 1, B has modified adjusted gross income (as defined in § 1.1411-2(c)) of $300,000, all of which is derived from PRS. All of the income from PRS is derived in the ordinary course of the equipment leasing activity, and all of PRS's property is held in the equipment leasing activity. Of B's allocable share of income from PRS, $275,000 constitutes gross income from rents (within the meaning of § 1.1411-4(a)(1)(i)). While $275,000 of the gross income from the equipment leasing activity meets the definition of rents in § 1.1411-4(a)(1)(i), the activity meets one of the exceptions to rental activity in § 1.469-1T(e)(3)(ii) and B materially participates in the activity. Therefore, the trade or business is not a passive activity with respect to B for purposes of paragraph (b)(1)(ii) of this section. Because the rents are derived in the ordinary course of a trade or business not described in paragraph (a) of this section, the ordinary course of a trade or business exception in § 1.1411-4(b) applies, and the rents are not described in § 1.1411-4(a)(1)(i). Furthermore, because the equipment leasing trade or business is not a trade or business described in paragraph (a)(1) or (a)(2) of this section, the $25,000 of other gross income is not net investment income under § 1.1411-4(a)(1)(ii). However, the $25,000 of other gross income may be net investment income by reason of section 1411(c)(3) and § 1.1411-6 if it is attributable to PRS's working capital. Finally, gain or loss from the sale of the property held in the equipment leasing activity will not be subject to § 1.1411-4(a)(1)(iii) because, although it is attributable to a trade or business, it is not a trade or business to which the section 1411 tax applies.

2315 Reg. § 1.1411-5(b)(3), Example (4) provides:

> Application of section 469 and other gross income under § 1.1411-4(a)(1)(ii). Same facts as Example 3, except B does not materially participate in the equipment leasing trade or business and therefore the trade or business is a passive activity with respect to B for purposes of paragraph (b)(1)(ii) of this section. Accordingly, the $275,000 of gross income from rents is described in § 1.1411-4(a)(1)(i) because the rents are derived from a trade or business that is a passive activity with respect to B. Furthermore, the $25,000 of other gross income from the equipment leasing trade or business is described in § 1.1411-4(a)(1)(ii) because the gross income is derived from a trade or business described in paragraph (a)(1) of this section. Finally, gain or loss from the sale of the property used in the equipment leasing trade or business is subject to § 1.1411-4(a)(1)(iii) because the trade or business is a passive activity with respect to B, as described in paragraph (b)(1)(ii) of this section.

2316 See fns. 3080-3097.

2317 T.D. 9655.

meaning of section 469(c)(7)) participates in a rental real estate activity for more than 500 hours per year, the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. Alternatively, if the taxpayer has participated in a rental real estate activity for more than 500 hours per year in five of the last ten taxable years (one or more of which may be taxable years prior to the effective date of section 1411), then the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. The safe harbor test also provides that, if the hour requirements are met, the real property is considered as used in a trade or business for purposes of calculating net gain under section 1411(c)(1)(A)(iii). The Treasury Department and the IRS recognize that some real estate professionals with substantial rental activities may derive such rental income in the ordinary course of a trade or business, even though they fail to satisfy the 500 hour requirement in the safe harbor test. As a result, the final regulations specifically provide that such failure will not preclude a taxpayer from establishing that such gross rental income and gain or loss from the disposition of real property, as applicable, is not included in net investment income.

Thus, the annual threshold is reduced from more than 750 hours under the passive loss rules to more than 500 hours.[2318]

Also, Reg. § 1.1411-4(g)(7)(ii)(B) does not require that each rental activity owned by the real estate professional be a trade or business. On June 16, 2014, I informally confirmed with a drafter of the regulation that, if a real estate professional groups activities so that real estate trade or business undertakings are grouped with real estate undertakings that are not trade or business undertakings, the latter nevertheless receive treatment as not constituting NII. For example, suppose a real estate professional actively manages several real estate properties that are trade or business undertakings and also owns several properties rented using triple-net leases. If the professional groups all of those undertakings as a single activity, income from the triple-net leases does not constitute NII.

See also part II.G.27 Real Estate Special Issues.

[2318] Reg. § 1.1411-4(g)(7) provides:

(7) *Treatment of certain real estate professionals*

(i) *Safe Harbor*. In the case of a real estate professional (as defined in section 469(c)(7)(B)) that participates in a rental real estate activity for more than 500 hours during such year, or has participated in such real estate activities for more than 500 hours in any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year, then—

(A) Such gross rental income from that rental activity is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section; and

(B) Gain or loss resulting from the disposition of property used in such rental real estate activity is deemed to be derived from property used in the ordinary course of a trade or business within the meaning of paragraph (d)(4)(i) of this section.

(ii) *Definitions*—

(A) *Participation*. For purposes of establishing participation under this paragraph (g)(7), any participation in the activity that would count towards establishing material participation under section 469 shall be considered.

(B) *Rental real estate activity*. The term rental real estate activity used in this paragraph (g)(7) is a rental activity within the meaning of § 1.469-1T(e)(3). An election to treat all rental real estate as a single rental activity under §1.469-9(g) also applies for purposes of this paragraph (g)(7). However, any rental real estate that the taxpayer grouped with a trade or business activity under § 1.469-4(d)(1)(i)(A) or (d)(1)(i)(C) is not a rental real estate activity.

(iii) *Effect of safe harbor*. The inability of a real estate professional to satisfy the safe harbor in this paragraph (g)(7) does not preclude such taxpayer from establishing that such gross rental income and gain or loss from the disposition of property, as applicable, is not included in net investment income under any other provision of section 1411.

II.I.8.c.iii. Rental as a Trade or Business

If rental activity is nonpassive under special exceptions or by reason of the taxpayer being a real estate professional, the taxpayer would apply the concepts below in conjunction with the rules of part II.I.8.a General Application of 3.8% Tax to Business Income.

Grouping passive activities will not convert gross income from rents into other gross income derived from a trade or business.[2319]

Before exploring further the issue of real estate as a trade or business, note what the characterization of real estate as such does not do: although generally income from a trade or business is subject to self-employment (SE) tax,[2320] see part II.L.2.a.ii Rental Exception to SE Tax.

The preamble to the final regulations re NII tax explains how the IRS views rental as a trade or business (emphasis added):[2321]

> The Treasury Department and the IRS received multiple comments regarding the determination of a trade or business within the context of rental real estate. Specifically, commentators stated that Example 1 of proposed § 1.1411-5(b)(2) is inconsistent with existing case law regarding the definition of a trade or business of rental real estate. Commentators cited cases such as Fackler v. Commissioner, 45 BTA 708 (1941), *aff'd*, 133 F.2d 509 (6th Cir. 1943); Hazard v. Commissioner, 7 T.C. 372 (1946); and Lagreide v. Commissioner, 23 T.C. 508 (1954), for the proposition that the activities of a single property can rise to the level of a trade or business.
>
> The Treasury Department and the IRS agree with commentators that, in certain circumstances, the rental of a single property may require regular and continuous involvement such that the rental activity is a trade or business within the meaning of Section 162. However, the Treasury Department and the IRS do not believe that the rental of a single piece of property rises to the level of a trade or business in every case as a matter of law. For example, § 1.212-1(h) provides that the rental of real property is an example of a for-profit activity under section 212 and not a trade or business.[2322]
>
> Within the scope of a section 162 determination regarding a rental activity, key factual elements that may be relevant include, but are not limited to, the type of property (commercial real property versus a residential condominium versus personal property), the number of properties rented, the day-to-day involvement of the owner or its agent, and the type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease). Therefore, due to the large number

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[2319] Part 6.B.1.(b)(4) of the preamble explains:

> … a proper grouping under § 1.469-4(d)(1) (grouping rental activities with other trade or business activities) will not convert gross income from rents into other gross income derived from a trade or business described in proposed § 1.1411-5(a)(1).

[2320] See part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.

[2321] T.D. 9655.

[2322] This comment in the preamble seems to take out of context Reg. § 1.212-1(h), the full text of which is:

> Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. However, ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held by the taxpayer as rental property are deductible even though such property was formerly held by the taxpayer for use as a home.

That regulation does not say that rental is not a trade or business (although it appears in a regulation designed for activities that do not constitute trades or businesses. Rather, that regulation points out that property formerly held for personal use can later be used for the production or collection of income.

of factual combinations that exist in determining whether a rental activity rises to the level of a section 162 trade or business, bright-line definitions are impractical and would be imprecise. The same is true wherever the section 162 trade or business standard is used and is not unique to section 1411. The Treasury Department and the IRS decline to provide guidance on the meaning of trade or business solely within the context of section 1411. However, the Treasury Department and the IRS have modified Example 1 in § 1.1411-5(b)(3) to explicitly state that the rental property in question is not a trade or business under applicable section 162 standards.

In cases where other Code provisions use a trade or business standard that is the same or substantially similar to the section 162 standard adopted in these final regulations, the IRS will closely scrutinize situations where taxpayers take the position that an activity is a trade or business for purposes of section 1411, but not a trade or business for such other provisions. For example, if a taxpayer takes the position that a certain rental activity is a trade or business for purposes of section 1411, the IRS will take into account the facts and circumstances surrounding the taxpayer's determination of a trade or business for other purposes, such as whether the taxpayer complies with any information reporting requirements for the rental activity imposed by section 6041.

The example cited above is as follows (emphasis added):[2323]

Rental activity. A, an unmarried individual, rents a commercial building to B for $50,000 in Year 1. A is not involved in the activity of the commercial building on a regular and continuous basis, therefore, A's rental activity does not involve the conduct of a trade or business, and under section 469(c)(2), A's rental activity is a passive activity. Because paragraph (b)(1)(i) of this section is not satisfied, A's rental income of $50,000 is not derived from a trade or business described in paragraph (b)(1) of this section. However, A's rental income of $50,000 still constitutes gross income from rents within the meaning of § 1.1411-4(a)(1)(i) because rents are included in the determination of net investment income under § 1.1411-4(a)(1)(i) whether or not derived from a trade or business described in paragraph (b)(1) of this section.

The preamble explains how the final regulations relaxed the rules for nonpassive rental to one's business:[2324]

With regard to grouping and recharacterizations, commentators recommended that the final regulations clarify that determining whether income is net investment income should be based solely on its recharacterized or grouped status as nonpassive under section 469 and the regulations thereunder. Although the Treasury Department and the IRS recognize the administrative simplicity of this rule, the Treasury Department and the IRS believe that this rule is too broad as it would 'deem' certain items to be derived in a trade or business when it is unlikely that a section 162 trade or business is present. For example, see §§ 1.469-1T(e)(3)(ii)(D) (rental of property incidental to

[2323] Reg. § 1.1411-5(b)(3), Example 1.

[2324] T.D. 9655. Reg. § 1.1411-4(g)(6)(i):

To the extent that gross rental income described in paragraph (a)(1)(i) of this section is treated as not derived from a passive activity by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), such gross rental income is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section.

For what is a rental activity under Reg. § 1.469-2(f)(6), see part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity. No relief is provided for self-charged royalties. Consider the structure described in part II.E Recommended Structure for Entities.

an investment activity) and 1.469-2T(f)(3) (rental of nondepreciable property). Therefore, the final regulations do not adopt this broad approach.

> Another option advanced by some commentators is a special rule for self-charged rents similar to § 1.469-7 pertaining to self-charged interest. However, a proposed rule for self-charged rents would be more complex than the rule for self-charged interest because the amount of the net investment income exclusion must take into account the deductions allowed (depreciation, taxes, interest, etc.) that are not present in self-charged interest. A self-charged rent rule would have to exclude from gross income rents in the same way as self-charged interest, and would also exclude a share of the deductions attributable to earning the income. In addition, a rule based on § 1.469-7 would cover only rents within the context of section 1411(c)(1)(A)(i) and would not provide relief from the inclusion of the gain upon the sale of the property from net investment income. Accordingly, the final regulations do not adopt this recommendation.

> However, the Treasury Department and the IRS appreciate the concerns raised by the commentators. Therefore, the final regulations provide special rules for self-charged rental income. The final regulations provide that, in the case of rental income that is treated as nonpassive by reason of § 1.469-2(f)(6) (which generally recharacterizes what otherwise would be passive rental income from a taxpayer's property as nonpassive when the taxpayer rents the property for use in an activity in which the taxpayer materially participates) or because the rental activity is properly grouped with a trade or business activity under § 1.469-4(d)(1) and the grouped activity is a nonpassive activity, the gross rental income is deemed to be derived in the ordinary course of a trade or business. Furthermore, in both of these instances, the final regulations provide that any gain or loss from the assets associated with that rental activity that are treated as nonpassive gain or loss will also be treated as gain or loss attributable to the disposition of property held in a nonpassive trade or business.

It has been suggested that multiple rental properties in which the taxpayer invests considerable and regular effort should meet the standard of trade or business, even when an agent is engaged to carry out some of the responsibility to manage and maintain the properties.[2325] *Alvary v. U.S.*, 302 F.2d 790 (2nd Cir. 1962), discussed using agents:

> The rental of real estate is a trade or business if the taxpayer-lessor engages in regular and continuous activity in relation to the property, *Pinchot v. Commissioner*, 113 F.2d 718, 719 (2 Cir. 1940); *Gilford v. Commissioner*, 201 F.2d 735, 736 (2 Cir. 1953); *Grier v. United States*, 120 F. Supp. 395 (D. Conn. 1954), *aff'd per curiam*, 218 F.2d 603 (2 Cir. 1955), even if the taxpayer rents only a single piece of real estate. *Lagreide v. Commissioner*, 23 T.C. 508, 512 (1954); *Reiner v. United States*, 222 F.2d 770 (7 Cir. 1955); *Elek v. Commissioner*, 30 T.C. 731 (1958); *Schwarcz v. Commissioner*, 24 T.C. 733, 739 (1955). Of course the owner may carry on these activities through an agent as well as personally. *Pinchot v. Commissioner*, *supra*; *Gilford v. Commissioner*, *supra*; *Elek v. Commissioner*, *supra*; *Schwarcz v. Commissioner*, *supra*, at 739; *Lajtha v. Commissioner*, 20 T.C. M. 1961-273 (1961); 5 Mertens, *Federal Income Taxation*, 1961 Cum. Supp. § 29.06, at 112-13. If the taxpayer, personally or through his agent continuously operates

[2325] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013), also appearing in the *TM Real Estate Journal* (April 3, 2013). Footnote 76 of that articles asserts:

> The fact that services were performed by agents was not detrimental in attaining trade or business status in the following cases: *Reiner v. U.S.*, 222 F.2d 770 (7th Cir. 1955); *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953); *Post v. Commissioner*, 26 T.C. 1055 (1956). See, however, *Chicago Title & Trust Co. v. U.S.*, 209 F.2d 773 (7th Cir. 1954), where the operation of 25 rental properties managed by real estate firms was considered an investment, rather than a trade or business, of the taxpayer as he was not sufficiently engaged in the operation.

the rental property without deviation from the planned use, the trade or business is sufficiently regular to satisfy the § 122(d)(5) requirement that it be "regularly carried on by the taxpayer." *Lagreide v. Commissioner*, *supra*, at 512; *Elek v. Commissioner*, *supra*; *Schwarcz v. Commissioner*, *supra*, at 739-40; *Daniel v. Commissioner*, 19 T.C.M. 1960-274 (1960). The taxpayer's rental activities in this case clearly satisfy these requirements.[4]

> [4] *Elek v. Commissioner*, 30 T. C. 731 (1958); *Daniel v. Commissioner*, 19 T.C.M. 1960-274 (1960); *Lajtha v. Commissioner*, 20 T. C. M. 1961-273 (1961), are other cases in which a net operating loss carryover has been allowed for the 1952 Hungarian nationalization of rental property.

However, one of three inherited properties leased to chain stores on triple-net-leases did not constitute a trade or business. *Union National Bank of Troy v. U.S.*, 195 F.Supp. 382 (N.D. NY 1961), held:

> The record discloses that Louis Gross, the deceased taxpayer, was the distinguished Bank President of the Union National Bank in that city since 1939. It was there he gave his full energy and talent every business day from that time until his death. His one-third interest in 316 River Street came to him under his father's will upon the termination of a trust for his mother, May 29, 1946. This property was a substantial one in the business section of Troy. Like two others he similarly acquired by inheritance, it was subject to net lease of the entire property to chain stores. The lease on 316 River Street was dated March 15, 1930 and executed by his father for twenty years, to expire April 30, 1952, the lessee being F. W. Woolworth Company. The lease was a net lease, and there was no obligation at all on Gross and his family to maintain or repair. Taxes, water rents, ordinary assessments, were all the obligations of the lessee. It is undisputed in the record that Gross did not to any extent, directly or indirectly through agents, have anything at all to do with the management and operation of the property. His passive contact was to receive his share of the rents as paid. The extension of the lease was arranged by his cousin through a broker, and I am content to find that the taxpayer played no active part in the arrangement of such extension. A most significant factor in the record is that the income of Gross for all rented properties in 1953 was $7,887.49; in 1954 $3,594.06, as compared to his declared net income for those years of $80,213.92 and $81,264.06. It would crush reason to conclude in view of these facts that the rental of property was his trade or business. The government concedes in its brief that the taxpayer was not heavily involved in real estate in Troy outside of the inherited properties.

The result was the same with an inherited residential property in which the tenant was also inherited. *Grier v. U.S.*, 120 F.Supp. 395 (D. Conn. 1954), *aff'd* per curiam, 218 F.2d 603 (2d Cir. 1955), in which the trial court held:

> In this case the activities with relation to this single dwelling, although of long duration, were minimal in nature. Activity to rent and re-rent was not required. No employees were regularly engaged for maintenance or repair.
>
> Lacking the broader activity stressed in *Rogers v. U. S.*, D.C. Conn. 1946, 69 F.Supp. 8, and *Pinchot v. C.I. R.*, *Gilford v. C. I. R.* and *Fackler v. C. I. R.*, *supra*, the real estate in this case appears to partake more of the nature of property held for investment than property used in a trade or business. The property in this case, although used for the production of income should not be considered as used in the taxpayer's trade or business.

It has been further suggested that the Board of Tax Appeals and Tax Court have found the mere rental of real property sufficient to constitute a trade or business but that contrary decisions in various appeals courts would suggest that jurisdiction may be an important factor.[2326] The article that made these

[2326] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013), also appearing in the *TM Real Estate Journal* (April 3, 2013). Footnotes 77-79 cited *Fackler v. Commissioner*, 45 B.T.A. 708, comments offers excellent planning tips.[2327] Additional clues regarding when rental is a trade or business might be found in the rules governing tax-free split-ups/spin-offs.[2328]

The Fall 2018 meeting of the Real Estate Committee of the American Bar Association's Section of Taxation included a panel, "Real Estate Trade or Business –When Does it Matter under Tax Reform?"[2329] Here are some categories of cases cited in the slides:

— *Deductions under section 162*. *Noble*, 7 T.C. 960 (1946), *acq.* 1946-2 C.B. 4.

— *Section 1231 property*.[2330] *Fackler*, 133 F.2d 509 (6th Cir. 1943); *Hazard*, 7 T.C. 372 (1946), *acq.* 1946-2 C.B. 3; *Noble*, 7 T.C. 960 (1946), *acq.* 1946-2 C.B. 3; *Grier*, 120 F.Supp. 395 (D.C. Conn. 1954), *aff'd*, 218 F.2d 603 (2nd Cir. 1955); *Bauer*, 144 Ct.Cl. 308 (1958); *Balsamo*, 54 T.C.M. (CCH) 608 (1987); G.C.M. 38779 (July 27, 1981); P.L.R. 8350008 (Aug. 23, 1983).

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714 (1941); *Hazard v. Commissioner*, 7 T.C. 372 (1946) (former residence rented for three years prior to sale) (real estate, even a single property in appropriate circumstances, devoted to rental purposes constitutes property used in a trade or business); *Fegan v. Commissioner*, 71 T.C. 791 (1979); *Lagriede v. Commissioner*, 23 T.C. 508 (1954); *Curphey v. Commissioner*, 73 T.C. 766 (1980) (noting that the ownership and management of such properties would not necessarily, as a matter of law, constitute a trade or business, referring to *Grier v. U.S.*, 218 F.2d 603 (2d Cir. 1955), *aff'g* 120 F. Supp. 395 (D. Conn. 1954)); 561 T.M., "Capital Assets," V.D. The latter included a reference to FSA 200120036 (for purposes of the earned income credit, rental was a trade or business when the taxpayer leased the building to the corporation with continuity and regularity, and the taxpayer's primary purpose for engaging in the rental activity was for profit). Also cited by the "Capital Assets" treatise as favoring trade or business treatment when the taxpayer only holds a single parcel of real property for rent were *Post v. Commissioner*, 26 T.C. 1055 (1956), *acq.*, 1958-1 C.B. 5 (rental of a building managed by an agent was a trade or business); *Campbell v. Commissioner*, 5 T.C. 272 (1945), *acq*., 1947-1 C.B. 1 (inherited property was placed for sale or rent immediately upon being inherited); *Ohio County & Ind. Agr. Soc., Del. County Fair v. Commissioner*, 43 T.C.M. 1126 (1982) (rental property held to constitute a trade or business for Code § 513 purposes); *Crawford v. Commissioner*, 16 T.C. 678, 680-681 (1951), *acq.*, 1951-2 C.B. 2. The "Capital Assets" treatise also mentioned that the standard tends to higher for inherited property that is sold before being operated as a business. All parentheticals above in this footnote describing cases are based on these secondary sources' summaries and not the result of my reading the cases themselves. *Central States, Southeast and Southwest Areas Pension Fund v. Messina Products, LLC*, 2013 WL 466196 (7th Cir. 2013), held that rental to one's own trade or business itself constituted a trade or business for pension withdrawal liability purposes (not a tax case); the court stated that its determination was based on general "trade or business" principles as required by *Commissioner v. Groetzinger*, 480 U.S. 23 (1987). "Simply upgrading his homes with the desire to make a profit on a sale at some time in the future is not sufficient to meet the regular-and-continuous-activity test for a trade or business." *Ohana v. Commissioner*, T.C. Memo. 2014-83, which also rejected an alleged conversion from personal to business use:

> We use five factors to determine whether an individual has converted his personal residence into property held for the production of income:
> - the length of time the house was occupied by the individual as his home before placing it on the market for sale;
> - whether the individual permanently abandoned all further personal use of the house;
> - the character of the property;
> - offers to rent; and
> - offers to sell.
>
> *Grant v. Commissioner*, 84 T.C. 809, 825 (1985), *aff'd without published opinion*, 800 F.2d 260 (4th Cir. 1986); *Bolaris v. Commissioner*, 81 T.C. 840 (1983), *aff'd in part, rev'd in part on another issue*, 776 F.2d 1428, 1433 (9th Cir. 1985).

2327 Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013) , also appearing in the *TM Real Estate Journal* (April 3, 2013). For additional cases and commentary, see Kehl, "Passive Losses and Tax on Net Investment Income," *T.M. Real Estate Journal* (BNA), Vol. 29, No. 06 (6/5/2013).

2328 See part II.Q.7.f.iii Active Business Requirement for Code § 355.

2329 Slides had the name of panelists Peter Genz of King & Spalding, LLP, David Leavitt of PwC, Jim Sowell of KPMG LLP, and Tom West of the U.S. Treasury Dept. Who drafted the slides is unclear, but government officials never draft slides for bar association presentations. The slides used KPMG's logo. Peter Genz wrote a separate paper to support the slides.

2330 [my footnote:] See part II.G.6.a Code § 1231 Property.

— *Inclusion of loss within net operating loss*. *Lagreide*, 23 T.C. 508 (1954).

— *Effectively connected income for non-U.S. taxpayers*. *Pinchot*, 113 F.2d 718 (2nd Cir. 1940); *Neill*, 46 B.T.A. 197 (1942); *Barbour*, 3 T.C.M. (CCH) 216 (1944); *The Investors' Mtge. Sec. Co.*, 4 T.C.M. (CCH) 45 (1945); *Gilford*, 201 F.2d 735 (2nd Cir. 1953); *Lewenhaupt*, 20 T.C. 151 (1953), *aff'd*, 221 F.2d 227 (9th Cir. 1955); *Herbert*, 30 T.C. 26 (1958), *acq.* 1958-2 C.B. 6; *Amodio*, 34 T.C. 894 (1960), *aff'd*, 299 F.2d 623 (3rd Cir. 1962); Rev. Rul. 73-522, 1973-2 C.B. 226.

— *Qualified real property business indebtedness under section 108(c)*. P.L.R. 9426006 (Mar. 25, 1994).

— *Disqualified income under refundable earned income credit*. F.S.A. 200120036 (Mar. 28, 2001).

— *Property eligible for section 38 credit*. *Fegan*, 71 T.C. 791 (1979), *aff'd*, 81-1 U.S.T.C. ¶ 9436 (10th Cir. 1981).

— *Home office expense under section 280A*. *Curphey*, 73 T.C. 766 (1980).

— *Extension of time for payment of estate tax under section 6166*. Rev. Rul. 2006-34, 2006-1 C.B. 1172.

— *GO Zone bonus depreciation*. Notice 2006-77, 2006-2 C.B. 590.

Although the authorities arise in a number of different contexts, courts and the IRS seem to cite the cases interchangeably in determining whether a rental real estate activity rises to the level of a trade or business for purposes of the specific context

— All seem to agree that the activities of a taxpayer's agent will be taken into account in determining whether a taxpayer is engaged in a trade or business. *See, e.g., Gilford*, 201 F.2d 735 (2nd Cir. 1953); Rev. Rul. 2006-34, 2006-1 C.B. 1172.

A helpful excerpt from Rev. Rul. 2006-34 accompanies fns 6880-6881 in part III.B.5.e.ii.(a) What is a Business?, which construes "trade or business" in the context of an automatic extension of time to pay estate tax on qualifying business interests.

Equipment rental appears to have much easier standards in qualifying as a trade or business.[2331]

Combining all of the ideas above:

- The IRS considers:

[2331] See fns. 3326-3327 in part II.L.2.a.ii Rental Exception to SE Tax, discussing cases in the unrelated business income area (regarding qualified retirement plans, etc.) that apply a very low threshold of activity for treating leasing tangible personal property as a trade or business, using statutory language similar to that used in determining whether income is subject to self-employment tax. I am unaware of any authority addressing the issue of leasing tangible personal property as a trade or business outside of this arena.

- The type of property (commercial real property versus a residential condominium versus personal property),
- The number of properties rented, the day-to-day involvement of the owner or its agent, and
- The type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease).

- The IRS believes that rental of a single property may require regular and continuous involvement to constitute a trade or business, and an example in its regulations requires such participation when an individual leases a commercial property to another person. The fairest view is that, for a single property, it depends.[2332]

Thus, in planning rental activities:

1. First consider the extent to which the rental income qualifies as self-charged rental that is excluded from NII.

2. If the self-charged rental rules do not provide sufficient protection (or if the rental is not self-charged), consider moving away from leases in which the landlord does nothing and moving towards leases in which the landlord provides significant services, such as inside and outside maintenance, repairs, etc., even if the tenant ultimately bears the burden of the expenses. However, as noted in the discussion of Reg. § 1.1411-4(g)(7)(ii)(B) in part II.I.8.c.ii Real Estate Classified as Nonpassive for Real Estate Professionals, a real estate professional might not need to take this step if the professional has enough activity that does constitute a trade or business.

3. Consider that the self-charged rules might not always apply in the same way in the future as they do today. Even if the law does not change, owner, consider that ownership of the business or ownership of the rental property might change in a way that makes the self-charged rental rules no longer apply.

[2332] In analyzing the existence of a trade or business under Code § 108, Letter Ruling 9840026 reasoned:

> The rental of even a single property may constitute a trade or business under various provisions of the Code. See, *e.g.*, *Hazard v. Commissioner*, 7 T.C. 372 (1946), *acq.*, 1946-2 C.B. 3 (section 117 of the 1939 Code); *Post v. Commissioner*, 26 T.C. 1055 (1956), *acq.*, 1958-2 C.B. 7 (same); *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953) (same); *Schwarcz v. Commissioner*, 24 T.C. 733 (1955), *acq.*, 1956-1 C.B. 5 (section 122 of the 1939 Code); *Elek v. Commissioner*, 30 T.C. 731 (1958), *acq.*, 1958-2 C.B. 5 (same); *Fegan v. Commissioner*, 71 T.C. 791 (1979), *aff'd*, 81-1 USTC ¶ 9436 (10th Cir. 1981) (section 482); *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940) (section 302 of 1926 Act); *Flint v. Stone Tracy Co.*, 220 U.S. 107, 171 (1911) (Corporation Tax). However, the ownership and rental of property does not always constitute a trade or business. See *Neill v. Commissioner*, 46 B.T.A. 197 (1942); Rev. Rul. 73-522, 1973-2 C.B. 226. The issue of whether the rental of property is a trade or business of a taxpayer is ultimately one of fact in which the scope of a taxpayer's activities, either personally or through agents, in connection with the property, are so extensive as to rise to the stature of a trade or business. *Bauer v. United States*, 168 F.Supp. 539, 541 (Ct. C1. 1958); *Schwarcz v. Commissioner*, 24 T.C. 733 (1955); See *Higgins v. Commissioner*, 312 U.S. 212 (1941) (management of taxpayer's own investment portfolio not a business).
>
> In Rev. Rul. 73-522, 1973-2 C.B. 226, the Service held that rental of real property under a "net lease" does not render the lessor engaged in a trade or business with respect to such property for purposes of section 871 of the Code. Section 871 provides special rules for taxation of a nonresident alien engaged in a trade or business in the United States. Under the facts of the ruling, the taxpayer owned rental property situated in the United States that was subject to long-term leases providing for monthly payments by the lessee of real estate taxes, operating expenses, ground rent, repairs, interest and principal on existing mortgages, and insurance in connection with the leased property. See also *Neill v. Commissioner*, 46 B.T.A. 197 (1942).

For more on Rev. Rul. 73-522 and related cases regarding whether nonresident aliens holding U.S. real estate are engaging in a trade or business, see part II.E.1.e.ii Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules.

Because grouping elections are difficult to change, consider making grouping elections with these possible ownership changes in mind. Also, grouping elections can affect whether rental is considered self-charged.

4. Finally, consider contributing the property to the partnership and receiving a preferred profit return in lieu of rent, as well as a special allocation of any gain on the sale of the property. See part II.E Recommended Structure for Entities.

If the tax savings are significant enough, one might want to avoid the uncertainty of the rental issue and instead place the business operations and the rented property in the same umbrella.[2333]

See also part II.G.27 Real Estate Special Issues.

II.I.8.d. Partnership Structuring in Light of the 3.8% Tax on Net Investment Income

II.I.8.d.i. Interest for Use of Capital Compared with Distributive Share

Based on the principles described in this part II.I.8.d:

For operating businesses, a distributive share provides better tax treatment than a guaranteed payment of interest, if the partner is a limited partner in a partnership and materially participates.

Note, however, that, for taxpayers with modest incomes, NII tax does not apply, and self-employment (SE) tax looms large, because SE tax is at a high rate all the way up to the taxable wage base and applies to SE earnings regardless of the taxpayer's overall adjusted gross income.[2334]

For high income taxpayers, SE tax might be better than NII tax, because they can deduct 1.45% of the 2.9% or 3.8% Medicare tax.

II.I.8.d.ii. Overview of Interaction between Code § 1411 and Code §§ 707(c) and 736

The preamble to 2013 proposed regulations explain their concerns regarding certain compensation and exit strategies:[2335]

> Section 731(a) treats gain from distributions as gain from the sale or exchange of a partnership interest. In general, the section 1411 treatment of gain to a partner under section 731 is governed by the rules of section 1411(c)(1)(A)(iii). Such gain is thus generally treated as net investment income for purposes of section 1411 (other than as determined under section 1411(c)(4)). However, certain partnership payments to partners are treated as not from the sale or exchange of a partnership interest. These payments include section 707(c) guaranteed payments for services or the use of capital and certain section 736 distributions to a partner in liquidation of that partner's partnership interest. Because these payments are not treated as from the sale or exchange of a partnership interest, their treatment under section 1411 may differ from the general rule of

[2333] See part II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

[2334] For self-employment tax rates and strategies, see part II.L Self-Employment Tax (FICA), especially part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax, as well as part II.Q.1.d.iii Timeline for FICA and Income Taxation of Deferred Compensation, especially fn. 4068, the latter for rates.

[2335] REG-130843-13, which would apply "to taxable years beginning after December 31, 2013. However, taxpayers may apply this section to taxable years beginning after December 31, 2012 in accordance with § 1.1411-1(f).

section 1411(c)(1)(A)(iii). The proposed regulations therefore provide rules for the section 1411 treatment of these payments.

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

II.I.8.d.iii. Treatment of Code § 707(c) Guaranteed Payments under Code § 1411

Regarding guaranteed payments, the preamble to the 2013 proposed regulations explains:[2336]

> Section 707(c) provides that a partnership payment to a partner is a "guaranteed payment" if the payment is made for services or the use of the capital, and the payment amount does not depend on partnership income. Section 1.707-1(c) provides that guaranteed payments to a partner for services are considered as made to a person who is not a partner, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, section 162(a) (relating to trade or business expenses). Section 1.704-1(b)(2)(iv)(o) provides that guaranteed payments are not part of a partner's distributive share for purposes of section 704(b).
>
> The proposed regulations' treatment of section 707(c) guaranteed payments under section 1411 depends on whether the partner receives the payment for services or the use of capital. The proposed regulations exclude all section 707(c) payments received for services from net investment income, regardless of whether these payments are subject to self-employment tax, because payments for services are not included in net investment income.
>
> The Treasury Department and the IRS believe that guaranteed payments for the use of capital share many of the characteristics of substitute interest, and therefore should be included as net investment income. This treatment is consistent with existing guidance under section 707(c) and other sections of the Code in which guaranteed payments for the use of capital are treated as interest. See, for example, §§ 1.263A-9(c)(2)(iii) and 1.469-2(e)(2)(ii).

Prop. Reg. § 1.1411-4(g)(10) provides the above rules.[2337]

[2336] REG-130843-13.

[2337] The proposed regulation provides:

> Treatment of section 707(c) guaranteed payments. Net investment income does not include section 707(c) payments received for services. Except to the extent provided in paragraph (g)(11)(iii)(A) of this section, section 707(c) payments received for the use of capital are net investment income within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section.

However, I do not believe that the last sentence of the quote above ends the story; I believe that it merely suggests under what category payments for the use of capital would be tested. Prop. Reg. § 1.1411-4(g)(11)(iii)(A), described further below, applies to Code § 736(a)(2) payments for Code § 751(c) unrealized receivables and for goodwill and states that those payments are included in NII under the sale-of-business category. Prop. Reg. § 1.1411-4(g)(11)(iii)(B) coordinates with (A) and characterizes payments other than for unrealized receivables and goodwill as for services or interest. To me, this reference to treatment as NII under these buckets means merely that one tests these items under those buckets – not that they will automatically be NII; otherwise, the sale of an active business under Code § 736 would be treated less favorably than the sale of a partnership interest other than to the partnership or the sale of an interest in a sole proprietorship or S corporation, and the spirit of the preamble to the proposed regulations is to provide parity to partnership redemptions – not to place them at a disadvantage. Fn. 2342 clarifies that the Code § 1411(c)(4) exclusion from NII on the sale of a partnership interest would apply.

The self-charged interest rules apply to Code § 707(c) payments. Reg. § 1.469-7(a)(1). I believe that the "better" reading is that they apply to treat Code § 707(c) guaranteed payments for the use of capital as interest subject to the self-charged interest exclusion from NII . See fn. 2284.

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

For the self-employment consequences of guaranteed payments for services, see parts II.L.3 Self-Employment Tax: General Partner or Sole Proprietor and II.L.4 Self-Employment Tax Exclusion for Limited Partner.

II.I.8.d.iv. Treatment of Code § 736 Redemption Payments under Code § 1411

Regarding payments to a retiring partner,[2338] the preamble to the 2013 proposed regulations explains certain general ideas:[2339]

> Section 736 applies to payments made by a partnership to a retiring partner or to a deceased partner's successor in interest in liquidation of the partner's entire interest in the partnership. Section 736 does not apply to distributions made to a continuing partner, distributions made in the course of liquidating a partnership entirely, or to payments received from persons other than the partnership in exchange for the partner's interest. Section 736 categorizes liquidating distributions based on the nature of the payment as in consideration for either the partner's share of partnership property or the partner's share of partnership income. Section 736(b) generally treats a payment in exchange for the retiring partner's share of partnership property as a distribution governed by section 731. Section 736(a) treats payments in exchange for past services or use of capital as either distributive share or a guaranteed payment. Section 736(a) payments also include payments to retiring general partners of service partnerships in exchange for unrealized receivables (other than receivables described in the flush language of section 751(c)) or for goodwill (other than payments for goodwill provided for in the partnership agreement) (collectively, "Section 736(a) Property").
>
> Because the application of section 1411 depends on the underlying nature of the payment received, the section 736 categorization controls whether a liquidating distribution is treated as net investment income for purposes of section 1411. Thus, the treatment of the payment for purposes of section 1411 differs depending on whether the distribution is a section 736(b) distribution in exchange for partnership property or a section 736(a) distribution in exchange for past services, use of capital, or Section 736(a) Property. Among section 736(a) payments, the proposed regulations further differentiate the treatment of payments depending on: (i) whether or not the payment amounts are determined with regard to the income of the partnership and (ii) whether the payment relates to Section 736(a) Property or relates to services or use of capital.
>
> Section 1.469-2(e)(2)(iii) contains rules pertaining to whether section 736 liquidating distributions paid to a partner will be treated as income or loss from a passive activity. Where payments to a retiring partner are made over a period of years, the composition of the assets and the status of the partner as passive or nonpassive may change. Section 1.469-2(e)(2)(iii) contains rules on the extent to which those payments are classified as passive or nonpassive for purposes of section 469. The proposed regulations generally align the section 1411 characterization of section 736 payments with the treatment of the payments as passive or nonpassive under § 1.469-2(e)(2)(iii).

[2338] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.
[2339] REG-130843-13.

These rules regarding Code § 736 payments do not apply to distributions from qualified retirement plans or self-employment earnings.[2340]

Regarding Code § 736(b) payments for partnership property, the preamble to the 2013 proposed regulations explains certain general ideas:[2341]

> Section 736(b) payments to retiring partners in exchange for partnership property (other than payments to retiring general partners of service partnerships in exchange for Section 736(a) Property) are governed by the rules generally applicable to partnership distributions. Thus, gain or loss recognized on these distributions is treated as gain or loss from the sale or exchange of the distributee partner's partnership interest under section 731(a).
>
> The proposed regulations provide that section 736(b) payments will be taken into account as net investment income for section 1411 purposes under section 1411(c)(1)(A)(iii) as net gain or loss from the disposition of property. If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply § 1.1411-7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4).[2342] Gain or loss relating to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) regardless of whether the payments are classified as capital gain or ordinary income (for example, by reason of section 751).
>
> In the case of section 736(b) payments that are paid over multiple years, the proposed regulations provide that the characterization of gain or loss as passive or nonpassive is determined for all payments as though all payments were made at the time that the liquidation of the exiting partner's interest commenced and is not retested annually. The proposed regulations thus adopt for section 1411 purposes the section 469 treatment of section 736(b) payments paid over multiple years as set forth in § 1.469-2(e)(2)(iii)(A).

[2340] Prop. Reg. § 1.1411-4(g)(11)(i) provides:

> In general. The treatment of payments received by a retiring partner or a deceased partner's successor in interest described in section 736 is determined under the rules of this paragraph (g)(11). Section 736 payments are not distributions from a plan or arrangement described in section 1411(c)(5) and § 1.1411-8 [qualified retirement plans, etc.]. To the extent that any portion of a section 736 payment is taken into account in computing a taxpayer's net earnings from self-employment (within the meaning of § 1.1411-9), then such amount is not taken into account in computing net investment income by reason of section 1411(c)(6) and § 1.1411-9.

[2341] REG-130843-13.

[2342] This sentence is key to interpreting Prop. Reg. § 1.1411-4(g)(11)(iii). One might construe Prop. Reg. § 1.1411-4(g)(11)(iii)(A) as making certain payments per se NII; this sentence instead provides the correct context – Prop. Reg. § 1.1411-4(g)(11)(iii)(A) merely described under which bucket to categorize the payment if it is NII, and then apply the Code § 1411(c)(4) exclusion from gain on sale after placing the item in the bucket.

Thus, Code § 736(b) payments are treated as sales of partnership interests,[2343] and Code § 736(b) payments are treated as an installment sale in the year of disposition for Code § 1411 purposes[2344] even though for income tax purposes each year's payment stands alone.[2345]

Regarding Code § 736(a) payments for partnership goodwill, etc., the preamble to the 2013 proposed regulations explains certain general ideas:[2346]

> As described in part 2.B.i., section 736 provides for several different categories of liquidating distributions under section 736(a). Payments received under section 736(a) may be an amount determined with regard to the income of the partnership taxable as distributive share under section 736(a)(1) or a fixed amount taxable as a guaranteed payment under section 736(a)(2). The categorization of the payment as distributive share or guaranteed payment will govern the treatment of the payment for purposes of section 1411.
>
> The determination of whether section 736(a) payments received over multiple years are characterized as passive or nonpassive depends on whether the payments are received in exchange for Section 736(a) Property. With respect to section 736(a)(1) payments in exchange for Section 736(a) Property, § 1.469-2(e)(2)(iii)(B) provides a special rule that computes a percentage of passive income that would result if the partnership sold the retiring partner's entire share of Section 736(a) Property at the time that the liquidation of the partner's interest commenced. The percentage of passive income is then applied to each payment received. See § 1.469-2(e)(2)(iii)(B)(1). These rules apply to section 736(a)(1) and section 736(a)(2) payments for Section 736(a) Property. The proposed regulations adopt this treatment as set forth in section 469 for purposes of section 1411.

When Code § 736(a) payments for partnership goodwill, etc. are taxable as a distributive share, the preamble to the 2013 proposed regulations explains:[2347]

> Section 736(a)(1) provides that if the amount of a liquidating distribution (other than a payment for partnership property described in section 736(b)) is determined with regard to the partnership's income, then the payment is treated as a distributive share of income to the retiring partner. For purposes of section 1411, the items of income, gain, loss, and deduction attributable to the distributive share are taken into account in computing net investment income under section 1411(c)(1) in a manner consistent with the item's chapter 1 character and treatment. For example, if the partner's distributive share includes income from a trade or business not described in section 1411(c)(2), that income will be excluded from net investment income. However, if the distributive share includes, for example, interest income from working capital, then that income is net investment income.

[2343] Prop. Reg. § 1.1411-4(g)(ii)(iv) provides:

> Gain or loss attributable to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) and paragraphs (a)(1)(iii) and (d) of this section as gain or loss from the disposition of a partnership interest.

[2344] Prop. Reg. § 1.1411-4(g)(ii)(iv) provides:

> A taxpayer who elects under § 1.736-1(b)(6) must apply the principles that are applied to installment sales in § 1.1411-7(d).

[2345] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736, especially fns. 5255 and 5281 and the accompanying text.

[2346] REG-130843-13.

[2347] REG-130843-13.

> The proposed regulations treat section 736(a)(1) payments unrelated to Section 736(a) Property as characterized annually as passive or nonpassive by applying the general rules of section 469 to each payment in the year received. To the extent that any payment under section 736(a)(1) is characterized as passive income under the principles of section 469, that payment also will be characterized as passive income for purposes of section 1411.

Thus, the 2013 proposed regulations treat Code § 736(a)(1) payments consistent with their character for regular income tax purposes, including their character under the passive loss rules.[2348] If a retiring partner receives a distributive share of the partnership's income in exchange for that partner's shares of the partnership's unrealized receivables and the partner materially participated in the partnership's trade or business before retiring, the distributive share is not NII.[2349] However, payments that exceeded the partner's shares of the partnership's unrealized receivables needed to be tested annually to determine whether the distributive share of operating income and deductions would be NII, presumably because the payments (described as an incentive to retire early) were not for the partnership's underlying assets;[2350] note that a retired partner generally would not be materially participating, although it is possible that the retired partner might still have some time remaining under the rule that looks to participation in 5 of the past 10 years[2351] or if the activity were a personal service activity in which the taxpayer materially participated for any 3 years.[2352]

When Code § 736(a) payments for partnership goodwill, etc. are taxable as guaranteed payments, the preamble to the 2013 proposed regulations explains:[2353]

> Section 736(a)(2) provides that if the amount of a liquidating distribution (other than a payment for partnership property described in section 736(b)) is determined without regard to the partnership's income, then the payment is treated as a guaranteed payment as described in section 707(c). Payments under section 736(a)(2) might be in exchange for services, use of capital, or Section 736(a) Property. The section 1411 treatment of guaranteed payments for services or the use of capital follows the general rules for guaranteed payments set forth in part 2.A of this preamble. Thus, section 736(a)(2) payments for services are not included as net investment income, and section 736(a)(2) payments for the use of capital are included as net investment income.
>
> Section 736(a)(2) payments in exchange for Section 736 Property are treated as gain or loss from the disposition of a partnership interest, which is generally included in net investment income under section 1411(c)(1)(A)(iii). If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply § 1.1411-7 of these proposed regulations

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[2348] Prop. Reg. § 1.1411-4(g)(11)(ii)(A) provides:

> General rule. In the case of a payment described in section 736(a)(1) as a distributive share of partnership income, the items of income, gain, loss, and deduction attributable to such distributive share are taken into account in computing net investment income in section 1411(c) in a manner consistent with the item's character and treatment for chapter 1 purposes. See § 1.469-2(e)(2)(iii) for rules concerning the item's character and treatment for chapter 1.

See part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736. Fn. 2342 points out that the Code § 1411(c)(4) exclusion from NII on the sale of a partnership interest would apply.

[2349] Prop. Reg. § 1.1411-4(g)(11)(ii)(B), Example (1). However, the example did not exclude the income if it was from financial instruments and commodities.

[2350] Prop. Reg. § 1.1411-4(g)(11)(ii)(B), Example (2).

[2351] See part II.K.1.a.ii Material Participation.

[2352] See part II.K.1.a.ii Material Participation, including fn. 2960, referring to activity that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or is a trade or business in which capital is not a material income-producing factor.

[2353] REG-130843-13.

> to reduce appropriately the net investment income under section 1411(c)(4). To the extent that section 736(a)(2) payments exceed the fair market value of Section 736(a) Property, the proposed regulations provide that the excess will be treated as either interest income or as income in exchange for services, in a manner consistent with the treatment under § 1.469-2(e)(2)(iii).

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

When Code § 736 payments are taxable as guaranteed payments or considered attributable to the sale of the partnership's underlying assets, the preamble to the 2013 proposed regulations explains:[2354]

> The proposed regulations provide that section 1411(c)(4) applies to section 736(a)(2) and section 736(b) payments. Thus, the inclusion of these payments as net investment income may be limited if the retiring partner materially participated in all or a portion of the partnership's trade or business. The extent of any limitation is determined under the rules of § 1.1411-7.
>
> The proposed regulations provide that, when section 736 payments are made over multiple years, the characterization of gain or loss as passive or nonpassive and the values of the partnership assets are computed for all payments as though all payments were made at the time that the liquidation of the exiting partner's interest commenced, similar to the treatment in § 1.469-2(e)(2)(iii)(A).
>
> If a partner's net investment income is reduced pursuant to section 1411(c)(4), then the difference between the amount of gain recognized for chapter 1 and the amount includable in net investment income after the application of section 1411(c)(4) is treated as an addition to basis, in a manner similar to an installment sale for purposes of calculating the partner's net investment income attributable to these payments.

To the extent that a guaranteed payment redeeming a partner's interest is allocable to the partnership's unrealized receivables[2355] and goodwill,[2356] for NII purposes it is treated as gain from the disposition of a partnership interest.[2357] To the extent that a guaranteed payment redeeming a partner's interest is not allocable to the partnership's unrealized receivables and goodwill, for NII purposes it is treated as payment for services[2358] or the payment of interest consistent with its characterization under the passive loss rules.[2359]

To summarize testing regarding the passive or nonpassive character of income from trade or business activities:

2354 REG-130843-13.

2355 Within the meaning of Code § 751(c).

2356 As described and calculated in Reg. § 1.469-2(e)(2)(iii)(B). See part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736, especially fn. 3079.

2357 Prop. Reg. § 1.1411-4(g)(11)(iii)(A).

2358 Because this characterization is only for NII purposes (see fn. 2199), presumably it has no effect on the favorable treatment for self-employment tax of payments described in part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.

2359 Prop. Reg. § 1.1411-4(g)(11)(iii)(B), referring to Reg. § 1.469-2(e)(2)(ii); see part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736. The provision cross-references Reg. § 1.1411-4(g)(9), which provides that losses allowed in computing taxable income by reason of Code § 469(g) (disposition of an entire interest in a passive activity) are taken into account in computing net gain under Reg. § 1.1411-4 (d) or as properly allocable deductions under Reg. § 1.1411-4(f), as applicable, in the same manner as such losses are taken into account in computing taxable income under Code § 63. Code § 469(g), the rule governing the disposition of a passive activity, is described in part II.K.1.j Complete Disposition of Passive Activity. Note that part or all of a self-charged interest component may be excluded from NII. See fn. 2284.

- Code § 736(a)(2) guaranteed payments and Code § 736(b) payments are tested at the time of the disposition, even though for regular income tax purposes they are treated as separate payments each year.

- Code § 736((a)(1) payments are tested annually, which might be a disadvantage to a partner who no longer participates in the business, subject to certain favorable rules regarding prior participation.[2360]

II.I.8.e. NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation

Part 8 of the preamble to the 2012 proposed regulations describes how Code § 1411 approaches the sale of an interest in a partnership or S corporation:

> In most cases, an interest in a partnership or S corporation is not property held in a trade or business. Therefore, gain or loss from the sale of a partnership interest or S corporation stock will be subject to section 1411(c)(1)(A)(iii). See also section 731(a) and section 1368(b)(2) (providing that the gain recognized when cash is distributed in excess of the adjusted basis of, as applicable, a partner's interest in a partnership or a shareholder's stock in an S corporation is treated as gain from the sale or exchange of such partnership interest or S corporation stock).
>
> Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or S corporation, gain from such disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be so taken into account by the transferor under section 1411(c)(1)(A)(iii) if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest. Section 1411(c)(4)(B) applies a similar rule to a loss from a disposition.
>
> For purposes of section 1411, Congress intended section 1411(c)(4) to put a transferor of an interest in a partnership or S corporation in a similar position as if the partnership or S corporation had disposed of all of its properties and the accompanying gain or loss from the disposition of such properties passed through to its owners (including the transferor). However, the gain or loss upon the sale of an interest in the entity and a sale of the entity's underlying properties will not always match. First, there may be disparities between the transferor's adjusted basis in the partnership interest or S corporation stock and the transferor's share of the entity's adjusted basis in the underlying properties. See Example 2 of proposed § 1.1411-7(e). Second, the sales price of the interest may not reflect the proportionate share of the underlying properties' fair market value with respect to the interest sold.
>
> In order to achieve parity between an interest sale and an asset sale, section 1411(c)(4) must be applied on a property-by-property basis, which requires a determination of how the property was held in order to determine whether the gain or loss to the transferor from the hypothetical disposition of such property would have been gain or loss subject to section 1411(c)(1)(A)(iii). As described in proposed § 1.1411-4(a)(1)(iii) and proposed § 1.1411-4(d), section 1411(c)(1)(A)(iii) applies if the property disposed of is either not held in a trade or business, or held in a trade or business described in proposed § 1.1411-5. In other words, under the proposed regulations, the exception in section 1411(c)(4) is only applicable where the property is held in a trade or business not described in section 1411(c)(2). See JCT 2011 Explanation, at 364, fn. 976 (and accompanying text); Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient

[2360] For the favorable rules regarding prior participation, see text accompanying fns. 2351-2352.

Protection and Affordable Care Act" (JCX-18-10) (Mar. 21, 2010), at 135 fn. 286 (and accompanying text) (JCT 2010 Explanation). This means that the exception in section 1411(c)(4) does not apply where (1) there is no trade or business, (2) the trade or business is a passive activity (within the meaning of proposed § 1.1411-5(a)(1)) with respect to the transferor, or (3) where the partnership or the S corporation is in the trade or business of trading in financial instruments or commodities (within the meaning of proposed § 1.1411-5(a)(2)), because in these cases there would be no change in the amount of net gain determined under proposed § 1.1411-4(a)(1)(iii) upon an asset sale under section 1411(c)(4). For example, if the transferor is passive with respect to the entity's trade or business, the application of the deemed asset sale rule under section 1411(c)(4), as described in part 8.A of this preamble, would not adjust the transferor's section 1411(c)(1)(A)(iii) gain on the disposition of the interest….

Getting into the details, Reg. § 1.1411-4(a)(1)(iii) taxes as net investment income:

> Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property, except to the extent excluded by the exception described in paragraph (d)(4)(i)(A) of this section for gain or loss attributable to property held in a trade or business not described in § 1.1411-5.

Reg. § 1.1411-4(d)(4)(i)(A) provides:

> Net gain does not include gain or loss attributable to property (other than property from the investment of working capital (as described in § 1.1411-6)) held in a trade or business not described in § 1.1411-5.

Reg. § 1.1411-4(d)(4)(i)(B)(1) provides:

> A partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock is generally gain described in paragraph (a)(1)(iii) of this section. However, net gain does not include certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations as provided in § 1.1411-7.

Reg. § 1.1411-5(a) provides:

> *In general*. A trade or business is described in this section if such trade or business involves the conduct of a trade or business, and such trade or business is either--
>
> (1) A passive activity (within the meaning of paragraph (b) of this section) with respect to the taxpayer; or
>
> (2) The trade or business of a trader trading in financial instruments (as defined in paragraph (c)(1) of this section) or commodities (as defined in paragraph (c)(2) of this section).

For whether assets are used in a business, see part II.I.8.a.v Working Capital Is NII (as describing Reg. § 1.1411-6). However, ultimately part II.I.8.a.v.(b) What Is Working Capital provides an additional exclusion under Reg. § 1.1411-7, which needs to be addressed anyway, as described in Reg. § 1.1411-4(d)(4)(i)(B)(1) above.

Note that qualified self-created intangible assets used in a business are never passive; see part II.K.1.g Not Passive If Gain from Sale of Self-Created Intangible. (Goodwill is within the definition but is not specifically mentioned. For taxation of the sale of goodwill, see part II.Q.1.c Personal Goodwill and Covenants Not to Compete.[2361] Arguably, personal goodwill in connection with an individual's work in a C corporation is also excluded from NII.[2362]) Thus, such assets are not described in Reg. § 1.1411-5(a) and do qualify for the exception from NII under Reg. § 1.1411-4(a)(1)(iii). I do not view this as the exclusive way to protect gain from the sale of intangible assets from NII tax; I just wanted to point out this provision.

The preamble to the final regulations explains:[2363]

> In the case of the disposition of an interest in a partnership or an S corporation, section 1411(c)(4) provides that gain or loss from such disposition is taken into account for purposes of section 1411(c)(1)(A)(iii) only to the extent of the net gain or net loss that would be so taken into account by the transferor if all property of the partnership or S corporation were sold at fair market value immediately before the disposition of such interest. Section 1.1411-7 of the final regulations is reserved for guidance under section 1411(c)(4). However, regulations are being proposed contemporaneously with these final regulations that address the application of section 1411(c)(4) to dispositions of interests in partnerships or S corporations.

The preamble to the 2013 proposed regulations summarized these rules:[2364]

> 9. Calculation of Gain or Loss Attributable to the Disposition of Certain Interests in Partnerships and S corporations
>
> Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or of stock in an S corporation (either, a "Passthrough Entity"), gain from the disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be taken into account by the transferor if the Passthrough Entity sold all of its property for fair market value immediately before the disposition of the interest. Section 1411(c)(4)(B) provides a similar rule for losses from dispositions.
>
> The 2012 Proposed Regulations required that a transferor of a partnership interest or S corporation stock first compute its gain (or loss) from the disposition of the interest in the Passthrough Entity to which section 1411(c)(4) may apply, and then reduce that gain (or loss) by the amount of non-passive gain (or loss) that would have been allocated to the transferor upon a hypothetical sale of all of the Passthrough Entity's assets for fair market value immediately before the transfer. The Treasury Department and the IRS received several comments questioning this approach based on the commentators' reading of section 1411(c)(4) to include gain/loss from the disposition of a partnership interest or S corporation stock only to the extent of the transferor's share of gain/loss from the Passthrough Entity's passive assets.
>
> The 2013 Final Regulations do not provide rules regarding the calculation of net gain from the disposition of an interest in a Passthrough Entity to which section 1411(c)(4) may apply. After considering the comments received, the Treasury Department and the IRS have withdrawn the 2012 Proposed Regulations implementing section 1411(c)(4) and are issuing this notice of proposed rulemaking to propose revised rules for the implementation of section 1411(c)(4)

[2361] Self-created goodwill is taxed differently than purchased goodwill. See part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.
[2362] See Hesse, "Personal Goodwill and the Net Investment Income Tax," *The Tax Adviser* 5/1/2016.
[2363] T.D. 9655.
[2364] REG-130843-13.

adopting the commentators' suggestion. Accordingly, the 2013 Final Regulations reserve on this issue.

Proposed § 1.1411-7(b) provides a calculation to determine how much of the gain or loss that is recognized for chapter 1 purposes is attributable to property owned, directly or indirectly, by the Passthrough Entity that, if sold, would give rise to net gain within the meaning of section 1411(c)(1)(A)(iii) ("Section 1411 Property"). Section 1411 Property is any property owned by, or held through, the Passthrough Entity that, if sold, would result in net gain or loss allocable to the partner or shareholder that is includable in determining the partner or shareholder's net investment income under § 1.1411-4(a)(1)(iii). This definition recognizes that the items of property inside the Passthrough Entity that constitute Section 1411 Property might vary among transferors because a transferor may or may not be "passive" with respect to the property.

Proposed § 1.1411-7(c) provides an optional simplified reporting method that qualified transferors may use in lieu of the calculation described in proposed § 1.1411-7(b). Proposed § 1.1411-7(d) contains additional rules that apply when a transferor disposes of its interest in the Passthrough Entity in a deferred recognition transaction to which section 1411 applies. Proposed § 1.1411-7(f) provides rules for adjusting the amount of gain or loss computed under this paragraph for transferors subject to basis adjustments required by § 1.1411-10(d). Proposed § 1.1411-7(g) provides rules for information disclosures by a Passthrough Entity to transferors and for information reporting by individuals, trusts, and estates.

Net gain constituting NII does not include gain or loss attributable to property (other than property from the investment of working capital)[2365] held in a nonpassive trade or business.[2366]

Thus, to determine whether net gain is from property held in a trade or business:[2367]

1. A partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock is generally NII. However, net gain constituting NII does not include certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations that is attributable to their business assets, to the extent provided in Reg. § 1.1411-7.

2. In the case of an individual, estate, or trust that owns or engages in a trade or business,[2368] the determination of whether net gain that is ordinarily NII is attributable to property held in a trade or business is made at the individual, estate, or trust level.[2369]

3. In the case of an individual, estate, or trust that owns an interest in a partnership or an S corporation, and that entity is engaged in a trade or business, the determination of whether net gain that is ordinarily NII from such entity is:[2370]

    - from a passive trade or business activity is determined at the owner level; and

[2365] As described in Reg. § 1.1411-6.
[2366] Reg. § 1.1411-4(d)(4)(i)(A).
[2367] Reg. § 1.1411-4(d)(4)(i)(B).
[2368] Whether directly or indirectly through ownership of an interest in an entity that is disregarded under the check-the-box rules under Reg. § 301.7701-3.
[2369] Reg. § 1.1411-4(d)(4)(i)(B)(3).
[2370] Reg. § 1.1411-4(d)(4)(i)(B)(3).

- derived in trade or business of a trader trading in financial instruments or commodities[2371] is determined at the entity level.

See also part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

The preamble to the final regulations explains how Code § 469(g) (the rule governing the disposition of a passive activity, which is described in part II.K.1.j Complete Disposition of Passive Activity) interacts with the 3.8% tax:[2372]

> Section 469(g)(1) provides, in relevant part, that if all gain or loss realized on a disposition is recognized, the excess of any loss from that activity for such taxable year (determined after the application of section 469(b)), over any net income or gain for that taxable year from all other passive activities (determined after the application of section 469(b)), shall be treated as a loss which is not from a passive activity. The preamble to the proposed regulations requested comments on "whether the losses triggered under section 469(g)(1) upon the disposition should be taken into account in determining the taxpayer's net gain on the disposition of the activity under section 1411(c)(1)(A)(iii) or whether the losses should be considered properly allocable deductions to gross income and net gain described in section 1411(c)(1)(A)(i) through (iii)." Because section 469(g)(1) provides that the allowed loss is treated as a loss "which is not from a passive activity," there is a question whether this language prevents the allowed losses from being treated as "properly allocable deductions" from passive activities for purposes of section 1411.
>
> Commentators recommended that losses allowed under section 469(g) be taken into account in computing net gain under section 1411(c)(1)(A)(iii), and that any net loss in section 1411(c)(1)(A)(iii) resulting from the use of such losses should be treated as a properly allocable deduction under section 1411(c)(1)(B). One commentator suggested that, to the extent a taxpayer has a net loss under section 1411(c)(1)(A)(iii) that is attributable to the allowed loss under section 469(g), the excess section 469(g) loss should continue to be suspended and carried forward to offset future gain resulting from the disposition of other passive assets subject to inclusion in section 1411(c)(1)(A)(iii).
>
> The final regulations provide that section 469(g) losses, which are treated as losses from a nonpassive activity, are taken into account for net investment income purposes in the same manner in which they are taken into account for chapter 1 purposes. As discussed in the context of section 469(f), section 469 does not alter the character or nature of the suspended passive loss. If the suspended losses allowed as a current year deduction by reason of section 469(g)(1) are attributable to operating deductions in excess of operating income, such suspended losses retain that character as, in most cases, deductions described in section 62(a)(1) or 62(a)(4). However, to the extent the suspended losses are comprised of losses originating from the disposition of property (such as ordinary section 1231 losses or capital losses), those losses also retain their character when they are ultimately allowed by section 469. Therefore, losses that are allowed by reason of section 469(g) may constitute properly allocable deductions under section 1411(c)(1)(B) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) in the year they are

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[2371] Reg. § 1.1411-5(c) discusses financial instruments and commodities.

[2372] T.D. 9655. Reg. § 1.1411-4(g)(9) provides:

> *Treatment of section 469(g)(1) losses*. Losses allowed in computing taxable income by reason of section 469(g) are taken into account in computing net gain under paragraph (d) of this section or as properly allocable deductions under paragraph (f) of this section, as applicable, in the same manner as such losses are taken into account in computing taxable income (as defined in section 63).

See Reg. § 1.1411-4(g)(8)(iii), Example (2).

> allowed, depending on the underlying character and origin of such losses. The recommendations proposed by the commentators depart from the general operating principles in chapter 1 and add additional complexity. Therefore, the final regulations do not adopt the positions advanced by commentators that section 469(g)(1) suspended losses should offset the gain first, then be allowed as a properly allocable deduction or that it should continue to be suspended and carried forward.
>
> Furthermore, section 469(g)(1) losses that are allowed by reason of a fully taxable disposition of a former passive activity are also fully taken into account for net investment income. As a result of the ordering rules in sections 469(f)(1) and (g)(1), any nonpassive gain realized on the disposition that causes passive losses to be allowed would be excluded from net investment income under the general former passive activity rules discussed in part 5.E.iv of this preamble. However, to the extent that any of the nonpassive gain is included in net investment income (for example, a portion of the gain remaining after the application of section 1411(c)(4)), the final regulations allow the same amount of suspended losses described in section 469(f)(1)(A) to be included in net investment income to offset the gain. The section 469(g)(1) losses allowed by reason of the disposition of the former passive activity are allowed in full because they relate to a period of time when the activity was a passive activity and represent true economic losses from a passive activity that do not materially differ from other section 469(g)(1) losses from non-former passive activities.

Losses allowed in computing taxable income by reason of Code § 469(g) are taken into account in computing net gain or as properly allocable deductions in the same manner as such losses are taken into account in computing Code § 63 taxable income.[2373]

I do not plan to analyze here the methods of calculating gain excluded from NII under the 2013 proposed regulations. If any reader would like to alert me to planning opportunities, I would be happy to review those ideas.

II.I.8.f. Summary of Business Activity Not Subject to 3.8% Tax

This part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax hits some of the highlights of part II.I.8 Application of 3.8% Tax to Business Income but is not intended to be comprehensive. Also consider part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, especially part II.K.3.b Maximizing Flexibility to Avoid NOLs and Use Losses in the Best Year.

If a trade or business is not a long-term rental activity, then the activity is not NII if:

- During the taxable year, the owner spends more than 100 hours in the business' daily operations (a significant participation activity),[2374]

- The activity is a personal service activity, and the individual materially participated in the activity for any 3 taxable years (whether or not consecutive) preceding the taxable year,[2375] or

[2373] Reg. § 1.1411-4(f)(9).

[2374] See parts II.I.8.a.i Passive Activity Recharacterization Rules, II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, II.K.1.a.vi Proving Participation, and II.K.1.a.v What Does Not Count as Participation.

[2375] See part II.K.1.a.ii Material Participation, including fn. 2960, referring to activity that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or is a trade or business in which capital is not a material income-producing factor.

- For either the current year or any five out of the past ten years, the owner spent more than 500 hours in the business' daily operations (a material participation activity).[2376]

Note, however, that significant participation activities may be aggregated to constitute material participation, moving one from a significant participation paradigm to a material participation paradigm, so be sure you know which paradigm applies.[2377]

The significant participation activity exception covers many situations but is not a panacea:

- Various credits arising from significant participation activities might be suspended.[2378]

- From an income tax perspective, consider that losses from a significant participation activity offset regular income only in certain situations.[2379]

- The self-charged rental and interest exception described below apply only if the recipient materially participates in the payer activity. For example, if a taxpayer rents real estate to an S corporation in which the taxpayer materially participates, then the rental meets the self-charged rental exception. If the taxpayer's participation in the S corporation is "significant" but not "material" (see text accompanying fn. 2377 above), then the S corporation's income is nonpassive but the rental activity is passive investment income (subject to exclusions for real estate professionals).

- If a taxpayer works for more than 500 hours for five years, the activity continues to be nonpassive under the 5-out-of-the-last-10-years rule. Working for more than 100 hours but not more than 500 hours does not trigger the 5-out-of-the-last-10-years rule. The same idea also applies to the 3-year personal service activity rule.

Also, a 250-hour safe harbor applies to allow rental real estate to qualify as a business for the Code § 199A deduction for pass-through business entities. See part II.E.1.e.i.(a) Whether Real Estate Activity Constitutes A Trade Or Business within part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

Rental income and part or all of interest income paid to an owner of a business in which the landlord or lender, respectively, materially participate is not NII.[2380]

Rental not protected by the self-rental exception is not NII under either of the following situations:

- The taxpayer is a real estate professional and the rental activity rises to the level of being a trade or business or is not a trade or business but is grouped with a rental trade business.[2381]

- Any gain from the property's sale is included in the taxpayer's income for the taxable year, the property's rental began less than 12 months before the property was sold, and the taxpayer materially

[2376] See parts II.I.8.a General Application of 3.8% Tax to Business Income and II.K.1.a Counting Work as Participation.
[2377] See fns. 2957-2958 and accompanying text, found in part II.K.1.a.ii Material Participation.
[2378] See part II.K.1.i.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.
[2379] See part II.K.1.a Counting Work as Participation.
[2380] See part II.I.8.a.iii Qualifying Self-Charged Interest or Rent.
[2381] See parts II.I.8.c.ii Real Estate Classified as Nonpassive for Real Estate Professionals and II.I.8.c.iii Rental as a Trade or Business.

participated or significantly participated for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the property's value.[2382]

See also part II.G.27 Real Estate Special Issues.

II.I.8.g. Structuring Businesses in Response to 3.8% Tax

What might be an ideal structure for a new business entity is described in part II.E Recommended Structure for Entities.

When structuring to avoid this 3.8% tax, be careful to avoid triggering another 3.8% tax: FICA (self-employment tax). Part II.L Self-Employment Tax (FICA) describes these rules, with specific structures illustrated in parts II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker and II.L.6 SE Tax N/A to Nongrantor Trust; see also part II.E Recommended Structure for Entities. If one has to choose between the 3.8% tax on net investment income and self-employment tax, consider not only the thresholds for applying them but also the fact that the employer's 1.45% share is deductible against business income,[2383] whereas none of the 3.8% tax on net investment income is deductible.

Structuring a trust to characterize its income as nonpassive income might not be quite as easy as one might think. See part II.K.2.b Participation by an Estate or Nongrantor Trust. For other considerations regarding trusts and net investment income tax, see part II.J.3.a Who Is Best Taxed on Gross Income, especially the text accompanying fns. 2417-2421.

Note that participation by an ESBT is based on its trustee's actions, whereas participation by a QSST is based on its beneficiary's actions:

- Although switching to a QSST might facilitate participation regarding the S corporation's income, it might complicate qualifying for the self-rental exception that avoids the 3.8% tax on rental income. The self-rental exception requires the landlord to materially participate in the tenant's business.[2384] Material participation in the tenant's business includes owning an interest in the tenant's business.[2385] Suppose a nongrantor trust owns the real estate and the S corporation stock. If and to the extent that the QSST election is made, the beneficiary, not the trust, is deemed to own the stock. A solution might be to place most of the stock into a QSST, keeping some in an ESBT. The portion that is in the ESBT would qualify that trust for the self-rental exception. The governing regulations[2386] do not impose a minimum ownership requirement, so it appears that any ownership of stock by the ESBT would suffice; I leave it to the reader to decide whether leaving more than a peppercorn is advisable.

- A trust that has only one current beneficiary might be able to switch back and forth every 36 months. See part III.A.3.e.iv Flexible Trust Design.

See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income if the business has enough potential for ups and downs in its taxable income that planning for a potential significant loss becomes important.

[2382] For details and nuances, see fn. 3132 in part II.K.1.e Rental Activities.

[2383] Code § 164(f)(1).

[2384] See part II.I.8.a.iii Qualifying Self-Charged Interest or Rent Is Not NII, especially fn. 2289, and part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity, especially fn. 3088-3089.

[2385] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

[2386] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

Also, one might consider selling S corporation stock to a QSST that a third party (perhaps the client's parent) creates for the client. For a discussion of how this avoids income tax on the sale but also might require the equivalent of paying for the stock twice, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs. After the note is repaid (or 36 months, whichever occurs last), perhaps part or all of the trust would be switched to an ESBT, as discussed in part III.A.3.e.iv Flexible Trust Design.

II.I.9. Elections or Timing Strategies to Consider to Minimize the 3.8% Tax on NII

Elections to consider to minimize the tax apply to:[2387]

- Regrouping passive activities.[2388]
- Pre-2013 installment sales that might generate net investment income in 2013 and later years.
- Controlled foreign corporation and qualified electing fund stock.
- Married taxpayers, in which one spouse is a nonresident alien. Nonresident aliens are not subject to the tax.[2389]

Because the tax applies only if modified adjusted gross income (MAGI) exceeds various thresholds, consider accelerating next year's income or deferring the current year's income so that either this year or next year has MAGI below the threshold. For example:

- Accelerate or defer retirement plan distributions or change the mix between Roth and traditional IRA distributions, to the extent permitted without violating the rules requiring minimum distributions to be taken.[2390] Even though retirement plan distributions are not NII, income from distributions increases MAGI.
- Time capital gains and losses which might include, if spreading out the gain will keep MAGI below the threshold, engaging in installment sales.[2391]

II.L.4. Self-Employment Tax Exclusion for Limited Partners' Distributive Shares

A limited partner's income is not subject to SE tax,[3349] except for guaranteed payments for services rendered to a partnership that engages in a trade or business.[3350] Being passive in an entity is insufficient; the entity must actually be a state law limited partnership;[3351] later this part II.L.4 discusses when this

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[2387] Nadeau and Ellis, "The Net Investment Income Tax: Elections to Start Thinking About Now," *T.M. Memorandum* (BNA), Vol. 54, No. 07 (4/8/2013). This article's Appendix contains a handy chart.
[2388] See parts II.K.1.b.ii Grouping Activities – General Rules and II.K.1.b.iv Regrouping Activities Transitioning into 3.8% Tax on Net Investment Income.
[2389] Code § 1411(e)(1).
[2390] Code §§ 401(a)(9), 403(b)(10), 408(a)(6), 408(b)(3).
[2391] Code § 453, which is subject to Code §§ 453A and 453B.
[3349] Code § 1402(a)(13). See *Hough v. Commissioner*, T.C. Memo. 1997-361 (loss from limited partnership could not offset self-employment earnings from law practice), *aff'd* 162 F.3d 1151 (3rd Cir. 1998).
[3350] Code § 1402(a)(13). See *Howell v. Commissioner*, T.C. Memo. 2012-303 (guaranteed payments from LLC were subjected to self-employment tax), initially discussed in the Shop Talk column by Banoff and Lipton, "Does *Renkemeyer*'s Legacy of Confusion Live On?" *Journal of Taxation* (February 2013).
[3351] *Perry v. Commissioner*, T.C. Memo. 1994-215, held:

> The evidence does not support petitioner's contention that he is a limited partner. State law requires that certain formalities be observed to create a limited partnership (partnership in commendam in Louisiana). Tex. Rev. Civ. Stat.

exception has been expanded for LLCs. One case, involving a general partnership that elect limited liability protection for its general partners, has led some commentators to suggest that the Tax Court might consider a limited partner's distributive share of income to be subject to SE tax if the limited partner performs services;[3352] I agree that the language is troublesome but disagree with this suggestion, because that case did not involve a limited partnership and the legislative history cited in the text accompanying fn. 3353 clearly contemplates that a partner can be a general partner and a limited partner and benefit from the limited partner exclusion.

If a person is both a general partner and a limited partner, income attributable to that person's interest as a general partner is subject to SE tax, as described in the legislative history of the statute that excludes a limited partner's self-employment income:[3353]

> Ann. art. 6132a-1 (West Supp. 1994); La. Civ. Code Ann. arts. 2836-2848 (West Supp. 1994); *Johnson v. Commissioner*, *supra*. There is no evidence of such formalities having been observed by the owners of interests in the wells.

Norwood v. Commissioner, T.C. Memo. 2000-84, followed this:

> It is undisputed that petitioner's interest in Gallant was a general partnership interest. Accordingly, his distributive share of the partnership's trade or business income is, subject to the limitations of section 1402(b), subject to the taxes imposed by section 1401 on self-employment income. *Cokes v. Commissioner*, 91 T.C. 222, 229-230 (1988); *Anderson v. Commissioner*, T.C. Memo. 1992-130. That petitioner spent a minimal amount of time engaged in the operations of Gallant is irrelevant to this determination. *Cokes v. Commissioner*, *supra* at 233; *Anderson v. Commissioner*, *supra*. The passive activity rules under section 469 have no application in this case. Petitioner's lack of participation in or control over the operations of Gallant does not turn his general partnership interest into a limited partnership interest. A limited partnership must be created in the form prescribed by State law. *Perry v. Commissioner*, T.C. Memo. 1994-215; *Johnson v. Commissioner*, T.C. Memo. 1990-461.

[3352] See language highlighted in fn. 3362.

[3353] House Report No. 95-702, Part 1 (to accompany H.R. 7346, which became PL 95-216), October 12, 1977, p. 40, which further explained its reasons on pp. 40-41:

> Under present law each partner's share of partnership income is includable in his net earnings from self-employment for social security purposes, irrespective of the nature of his membership in the partnership. Under the bill the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership would be excluded from social security coverage. However, the exclusion from coverage would not extend to guaranteed payments (as described in section 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership. Distributive shares received as a general partner would continue to be covered. Also, if a person is both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would continue to be covered under present law.
>
> Your committee has become increasingly concerned about situations in which certain business organizations solicit investments in limited partnerships as a means for an investor to become insured for social security benefits. In these situations the investor in the limited partnership performs no services for the partnership and the social security coverage which results is, in fact, based on income from an investment. This situation is of course inconsistent with the basic principle of the social security program that benefits are designed to partially replace lost earnings from work.
>
> These advertisements and solicitations are directed mainly toward public employees whose employment is covered by public retirement systems and not by social security. Also, these advertisements frequently emphasize the point that those who invest an amount sufficient to realize an annual net income of $400 or more (the minimum amount needed to receive social security credit in a year) will eventually gain a high return on their social security contributions. Many of those who invest in limited partnerships will qualify for minimum benefits, which are heavily weighted for the purpose of giving added protection for people who have worked under social security for many years with low earnings. The cost of paying these heavily weighted benefits to limited partners must, of course, be borne by all persons covered by the social security program. The advertising injures the social security program in the public view and causes resentment on the part of the vast majority of workers whose employment is compulsorily covered under social security, as well as those people without work income who would like to be able to become insured under the social security program but cannot afford to invest in limited partnerships.

> Under present law each partner's share of partnership income is includable in his net earnings from self-employment for social security purposes, irrespective of the nature of his membership in the partnership. Under the bill the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership would be excluded from social security coverage. However, the exclusion from coverage would not extend to guaranteed payments (as described in section 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership. Distributive shares received as a general partner would continue to be covered. Also, if a person is both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would continue to be covered under present law.

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

Assigning one's income as an independent contractor to a limited partnership does not avoid SE tax if the payor does not recognize the assignment.[3354]

Although originally a limited partner lost liability protection by participating in the partnership's activities, that has not been the case for quite some time.[3355] In the passive loss area, being a general partner has a

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[3354] *Peterson v. Commissioner*, 827 F.3d 968 (11th Cir. 5/24/2016), affirming T.C. Memo. 2013-271. For as similar holding regarding an S corporation, see part II.G.25 Taxing Entity or Individual Performing Services, especially fn. 1854. Similarly, a person who controlled a partnership and was paid directly for services lost his argument that the payments really were for a distributive share of a limited partnership and therefore were excluded under Code § 1402(a)(13), because he actually did not own an interest in the partnership. *Plotkin v. Commissioner*, T.C. Memo. 2011-260. When the taxpayer established an entity as a mere shell, *Robucci v. Commissioner*, T.C. Memo. 2011-19, disregarded the entity, and in fn. 11 declined to address the IRS' other argument:

> Although it is apparently respondent's position that profit distributions to service-providing members of a multimember, professional service LLC (which is what Robucci LLC was designed to be) are never excepted from net earnings from self-employment by sec. 1402(a)(13), which so excepts distributions to a limited partner other than sec. 707(c) guaranteed payments for services rendered, the Secretary has yet to issue definitive guidance with respect to that issue, and the law remains in a state of uncertainty. See, *e.g.*, Kalinka, 9A La. Civ. L. Treatise, Limited Liability Companies and Partnerships: A Guide to Business and Tax Planning, sec. 6.2, at 423 (3d ed. 2001); Chase, Self-Employment Tax and Choice of Entity, 34 Colo. Law. 109, 112 (Dec. 2005).

[3355] Footnotes to Bishop & Kleinberger, ¶ 11.03[1][c][ii] Distinguishing limited partnership cases, *Limited Liability Companies: Tax and Business Law* (WG&L) (viewed 9/3/2016), comment:

> The 1976 version of the RULPA provided that a limited partner risked personal liability if the partner takes part in the control of the business. See, *e.g.*, *Mursor Builders, Inc. v. Crown Mountain Apartment Assocs.*, 467 F. Supp. 1316, 1331–1332 (DC Virgin Islands 1978) (limited partners liable only for debts of the partnership incurred prior to filing certificate of limited partnership); *Antonic Rigging & Erecting of Mo., Inc. v. Foundry E. Ltd. Partnership*, 773 F.Supp. 420, 430 (SD Ga. 1991) (court held that limited partner was not liable to contractor for partnership debts on the ground that limited partner participated in management). The 1985 amendments significantly changed this provision, lengthening substantially a list of safe harbors. The newest version of the Uniform Limited Partnership Act eliminates the control rule entirely. ULPA (2001), § 303.
>
> ….
>
> As for ULPA (2001), the most modern uniform limited partnership act, in § 303, eliminates the control rule entirely: A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.

A prior version of Willis & Postlewaite, *Partnership Taxation*, ¶2.02. Requirements of Section 704(e), stated:

> As originally written, the Uniform Limited Partnership Act provided that [a] limited partner shall not become liable as a general partner unless…he takes part in the control of the business. ULPA, § 7 (1916). The versions of the Revised Uniform Limited Partnership Act approved in 1976 and 1985 relaxed the control requirement by providing a safe harbor in the form of a lengthy list of activities deemed not to constitute participation in the control of the

different effect – it converts an interest as a limited partner into an interest as a general partner when determining material participation.[3356]

A limited partnership[3357] may register as a limited liability limited partnership (LLLP) to limit its general partner's liability.[3358] However, rather than using an LLLP registration or perhaps to supplement the protection provided by LLLP registration,[3359] doing business through one or more LLC subsidiaries might simplify signature lines, with individuals signing as managers of each LLC rather than officers of the S corporation general partner[3360] signing on behalf of the partnership. For a comparison, see part II.E.8 Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary.

It is uncertain how this exclusion for limited partners applies to limited liability entities, with more than one member, that are not state law limited partnerships.[3361] Reasoning that "partners who performed services for a partnership in their capacity as partners (*i.e.*, acting in the manner of self-employed persons)" were not intended to be "limited partners," *Renkemeyer, Campbell and Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), held that partners in a limited liability partnership (a general partnership that registers with the secretary of state to obtain limited liability for all partners) were subject to self-employment tax.[3362] The court pointed out that substantially:

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partnership and a limitation on a limited partner's liability for participation in activities not within the safe harbor to only those persons who transacted business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner. RULPA, § 303 (1985). Section 303 of the Uniform Limited Partnership Act approved in 2001 has eliminated the control requirement and provides that:

> A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.

RULPA, § 303 (2001). According to the commentary accompanying the act, this provision is intended to provide a full, status-based liability shield for each limited partner even when the limited partner participates in the management and control of the limited partnership. The purpose is to bring limited partners into parity with the members of a limited liability company, partners in a limited liability partnership, and corporate shareholders. It is unclear how this change in state partnership law might affect the application of federal tax law in the context of family partnerships. Nevertheless, if the limited partners are to have no role in the management of the partnership, the partnership agreement should expressly provide that the limited partners have no management power.

[3356] See part II.K.1.a.ii Material Participation, especially fn. 2967.

[3357] See part II.C.11 Limited Partnership.

[3358] See part II.C.12 Limited Liability Partnership Registration.

[3359] In Missouri, failure to timely renew LLLP status creates a lapse in the general partner's protection, which lapse cannot be cured, in contrast to the many other states that allow retroactive reinstatement.

[3360] See part II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker.

[3361] See RIA's *Fed. Tax Coord.2d* ¶A-6158. Letter Ruling 9432018 held that a member's interest generally is subject to self-employment tax. Note that the fact of limited liability is not sufficient to treat a member's interest as a limited partner interest for purposes of the Code § 469 passive loss rules. See fn 2952. Courts have ruled against the IRS when it argued that an LLC member was a limited partner for purposes of the passive loss rules (see fn. 2965); query whether they would treat an LLC member as a limited partner for SE tax purposes, especially when they have ruled that exceptions from SE tax are to be narrowly construed (see *Morehouse* and *Johnson* cases cited in fn 3314).

[3362] The court cited the following legislative history:

> Under present law each partner's share of partnership income is includable in his net earnings from self-employment for social security purposes, irrespective of the nature of his membership in the partnership. The bill would exclude from social security coverage, the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership. This is to exclude for coverage purposes certain earnings which are basically of an investment nature . However, the exclusion from coverage would not extend to guaranteed payments (as described in 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership.

It then stated:

all of the law firm's revenues were derived from legal services performed by [the partners] in their capacities as partners. [The partners] each contributed a nominal amount ($110) for their respective partnership units. Thus it is clear that the partners' distributive shares of the law firm's income did not arise as a return on the partners' investment and were not 'earnings which are basically of an investment nature.' Instead, the attorney partners' distributive shares arose from legal services they performed on behalf of the law firm.

Similarly, CCA 201436049 refused to apply the limited partner exception to an LLC, reasoning:[3363]

> Like the situation in *Renkemeyer*, Partners' earnings are not in the nature of a return on a capital investment, even though Partners paid more than a nominal amount for their Units. Rather, the earnings of each Partner from Management Company are a direct result of the services rendered on behalf of Management Company by its Partners. Similar to *Reither [*sic – *Riether]*, Management Company cannot change the character of its Partners' distributive shares by paying portions of each Partners' distributive share as amounts mislabeled as so-called "wages." Management Company is not a corporation and the "reasonable compensation" rules applicable to corporations do not apply.

However, CCA 201640014 treated an inactive member of an LLC as a limited partner, presumably consistent with the IRS' informal administrative practice of following subsections (g) through (i) of Prop. Reg. § 1.1402(a)-2:

> Franchisee owns the majority of Partnership (D percent). During the years at issue, the remaining interests in Partnership were owned by Franchisee's wife (E percent) and her irrevocable trust

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> The insight provided reveals that the intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage. The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.

These comments were made in the context of a partner who argued that limited liability made him the equivalent of a limited partner; the court was not addressing the status of a limited partner in a limited partnership. For an in-depth discussion, see Banoff, *Renkemeyer* Compounds the Confusion in Characterizing Limited and General Partners—Part 2, *Journal of Taxation*, June 2012. Part 1 was in the December 2011 issue of the Journal. See also Banoff and Lipton, "Does *Renkemeyer*'s Legacy of Confusion Live On?" *Journal of Taxation* (February 2013). In their Shop Talk column, Who's a 'Limited Partner'? More Confusion Courtesy of *Renkemeyer* and *Howell*, *Journal of Taxation* (April 2013), Banoff and Lipton discussed comments, by Ronald M. Weiner, that in *Howell* (fn. 3350) the IRS merely attacked the taxpayer's characterization of guaranteed payments as not being self-employment income. They suggested that the IRS missed the boat in failing to attack as self-employment income the taxpayer's distributive share of partnership income. *Renkemeyer* involved an LLP, whereas *Howell* involved an LLC. The authors pointed out that, in *Renkemeyer*, the partners were general partners as a matter of state law, even though they had limited liability, so the *Renkemeyer* court's analysis was much more complicated than it needed to be.

[3363] *Riether* in the quote below is cited in fn. 538, found in part III.B.7.c.viii Creative Bonus Arrangements. In that case, a married couple jointly owned an LLC that operated a business. They paid themselves salary on Forms W-2 and said that the remaining income came from their employees' work, which made that income akin to being a limited partner because they did not participate in the work. The court pointed out that Rev. Rul. 69-184 required them to report compensatory payments as guaranteed payments subject to SE tax instead of on Forms W-2, said that their incorrect reporting on Forms W-2 did not somehow excuse the failure to report their distributive share of the LLC's income as SE income given that they had not proven themselves to be limited partners, and imposed an accuracy-related penalty (the latter because they had not shown that they had relied on their income tax return preparer's advice in reporting the income as not subject to SE tax.

For using a tiered partnership structure to enable a partner's salary-type compensation to be reported on Form W-2, see text accompanying and flowchart following fn 543 in part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

CCA 201436049 might very well be the same case the IRS won that is discussed further below, *Castigliola v. Commissioner*, T.C Memo. 2017-62.

> (F percent). Partnership's operating agreement provides for only one class of unit of ownership. Neither Franchisee's wife nor her trust are involved with Partnership 's business operations and their status as limited partners for purposes of § 1402(a)(13) is not in dispute.

On the other hand, the CCA subjected to SE tax the entire distributive share of the majority owner of the LLC, who was active in the business, rejecting his argument that the portion of his distributive share that was not attributable to his work should be excluded from SE income:[3364]

> As discussed above, the *Renkemeyer* Court reviewed the legislative history and concluded that § 1402(a)(13) was intended to apply to those who "merely invested" rather than those who "actively participated" and "performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons)." *Renkemeyer*, 136 TC at 150 Although the *Renkemeyer* Court noted the partners' small capital contributions and service-generated income as factors influencing its decision that the partners in that case were not limited partners, *Renkemeyer* does not stand for the proposition that a capital-intensive partnership should be treated like a corporation for employment tax purposes. Instead, as the Tax Court has repeatedly held, partners who are not limited partners are subject to self-employment tax, even in cases involving capital-intensive oil and gas joint ventures where all of the work was performed by other parties. See *Cokes*, *Methvin*, and *Perry*. Under the *Renkemeyer* Court's interpretation of the legislative history, and consistent with the Court's holding in *Riether*, Franchisee is not a limited partner in Partnership within the meaning of § 1402(a)(13) and is subject to self-employment tax on his full distributive shares of Partnership's income described in § 702(a)(8).

[3364] Preceding this conclusion, the CCA said (emphasis added):

> Partnership concedes that under the legislative history quoted above and the *Renkemeyer* opinion, service partners in a service partnership acting in the manner of self-employed persons are not limited partners. However, Partnership argues that a different analysis should apply to limited liability members which: (1) derive their income from the sale of products, (2) have made substantial capital investments, and (3) have delegated significant management responsibilities to executive-level employees. Partnership asserts that in these cases the IRS should apply substance over form principles to exclude from self-employment tax a reasonable return on capital invested.
>
> Partnership interprets the legislative history quoted above to mean that § 1402(a)(13) applies to exclude a partner's reasonable return on capital-investment in a capital-intensive LLC partnership, regardless of the extent of the partner's involvement with the partnership's business. In effect, Partnership interprets the sentence from the legislative history This is to exclude for coverage purposes certain earnings which are basically of an investment nature as instead meaning This is to exclude for coverage purposes all earnings which constitute a reasonable return on capital invested in a capital-intensive business. Essentially, Partnership argues that the self-employment tax rules for capital intensive businesses carried on by LLC partnerships are identical to the employment tax rules for corporate shareholder employees: only reasonable compensation is subject to employment tax. Under this analysis, Partnership argues that (1) Partnership's guaranteed payments to Franchisee are reasonable compensation for Franchisee's services, and (2) Franchisee's distributive share represents a reasonable return on capital investments in Partnership's business, and therefore Franchisee is not subject to self-employment tax on his distributive share. Partnership argues that it would be inconsistent with the IRS's position in the Brinks case for the IRS to assert that Franchisee is subject to self-employment tax on his distributive share from Partnership.
>
> Partnership's arguments inappropriately conflate the separate statutory self-employment tax rules for partners and the statutory employment tax rules for corporate shareholder employees. ***Section 1402(a)(13) provides an exclusion for limited partners, not for a reasonable return on capital***, and does not indicate that a partner's status as a limited partner depends on the presence of a guaranteed payment or the capital-intensive nature of the partnership's business. Following the Court's analysis in *Riether*, Partnership cannot change the character of Franchisee's distributive shares by paying Franchisee guaranteed payments. Partnership is not a corporation and the wage and reasonable compensation rules which are applicable to corporations and were at issue in the Brinks case do not apply.

Hardy v. Commissioner, T.C. Memo. 2017-16, treated as a limited partner eligible for the exclusion from SE tax a doctor who owned a 12.5% interest in an LLC, owned together with seven other doctors, that operated a professionally managed[3365] surgery center:[3366]

> Dr. Hardy has never managed MBJ, and he has no day-to-day responsibilities there. Although he meets with the other members quarterly, he does not have any input into management decisions. He generally is not involved in hiring or firing decisions. His role and participation in MBJ have not changed since he became a member.

Contrasting Dr. Hardy's work with the lawyers practicing law in *Renkemeyer*[3367] and receiving distributive shares based on those fees from practicing law, the court pointed out:

> Dr. Hardy is receiving a distribution based on the fees that patients pay to use the facility. The patients separately pay Dr. Hardy his fees as a surgeon, and they separately pay the surgical center for use of the facility in the same manner as with a hospital. Accordingly, Dr. Hardy's distributive shares are not subject to self-employment tax because he received the income in his capacity as an investor.

This last comment, about viewing Dr. Hardy as an investor, ties into other aspects of the case. Dr. Hardy claimed that the income from the surgery center was passive, so that he could deduct passive losses against it.[3368] To avoid recharacterizing the income as nonpassive, he had to prove that he spent no more than 100 hours per year on it.[3369] The Tax Court seemed to view his quarterly meetings with other members as investor time, rather than time spent as a working owner.[3370]

When I read the case, I had expected to see this set up as a manager-managed LLC, with the non-owner CEO being the manager under the operating agreement. I was very surprised to see the most recent annual report (viewed 3/1/2017), which said that each owner is a member-manager. Other documents from the secretary of state indicate that three doctors (not Dr. Hardy) were the initial managers in 2004; the annual reports for the years involved in the case, 2008-2010 do not clarify whether Dr. Hardy was a member or a member-manager, but they also do not list as a manager a person other than the members. Taken as a whole, the court's opinion and related documentation suggest that, in this LLC, the members together had exclusive legal authority to run the business. No member had more rights to run the business than any other. Their legal rights were not akin to the legal rights of a limited partner. Collectively, their legal rights were equal and were those of general partners.

[3365] The court pointed out:

> MBJ hires its own employees and does not share any employees with Northwest Plastic Surgery. Like hospitals, MBJ directly bills patients for facility fees. MBJ then distributes to each of its members his or her share of the earnings based on the facility fees less expenses. MBJ uses a third-party accounting firm to prepare the Schedules K-1, Partner's Share of Income, Deductions, Credits, etc., for the members. MBJ does not pay physicians for their procedures.

[3366] The IRS' post-trial brief pointed out that the members approved an employee termination at the CEO's request, but the transcript indicated that was an unusual situation and that the CEO usually took care of employment issues without consulting the members as an ownership group.

[3367] See the extensive quotes from *Renkemeyer* in fn. 3362, found in this part II.L.4.

[3368] The IRS tried to require Dr. Hardy to group his activity in his medical practice with his activity in the surgery center, but the Tax Court held that his decision not to group the two activities was reasonable. See part II.K.1.b Grouping Activities, especially fns. 3025 and 3047.

[3369] See part II.K.1.i Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

[3370] See part II.K.1.a.v What Does Not Count as Participation.

Clearly, they delegated daily management to a non-owner and chose to oversee the business as mere investors, but that does not change the fact that the owners collectively had plenary legal rights to run the business on a daily basis. This looks to me like a general partnership in which the general partners agreed not to run the business themselves but rather agreed to hire staff to run the business. They are simply passive general partners. (Having limited liability does not cause one to be a limited partner, according to *Renkemeyer*,[3371] so the LLC's liability protection is of no consequence.) Neither the trial transcript nor the judge's opinion demonstrates any awareness of what Dr. Hardy's rights really were; they simply looked to his lack of activity. This approach appears to contradict *Methvin v. Commissioner*, T.C. Memo. 2015-81, involving an unincorporated venture in which the taxpayer had no management rights but nevertheless was subjected to self-employment tax.[3372]

Castigliola v. Commissioner, T.C Memo. 2017-62, held that three lawyers who were the only members in a law firm organized as a member-managed LLC were subject to SE tax on not only their guaranteed payments, which were comparable to salaries at other law firms, but also on their distributive share of the LLC's income. As was the case in *Hardy*, each member had an equal right to manage the LLC, and no member had a controlling interest. Unlike *Hardy* (where the members were passive investors), working for the LLC constituted the members' full-time jobs. Also unlike *Hardy*, the judge rigorously analyzed Code § 1402(a)(13) to determine what it means to be a limited partner.

Following *Renkemeyer*,[3373] *Castigliola* noted that "no statutory or regulatory authority defines 'limited partner' for the purposes of section 1402(a)(13)," and therefore "the term is to be given its ordinary meaning at the time of enactment."[3374] Because "*Renkemeyer* indicated that the meaning of 'limited partner' is not necessarily confined solely to the limited partnership context," the court first looked to "whether the person claiming the section 1402(a)(13) exemption held a position in an entity treated as a partnership for Federal tax purposes that is functionally equivalent to that of a limited partner in a limited partnership," asking whether a member of the LLC (a "professional limited liability company" or "PLLC") "is functionally equivalent to a limited partner in a limited partnership." The court pointed out:

> A limited partnership has two classes of partners, general and limited. *E.g.*, *Garnett v. Commissioner*, 132 T.C. at 375. General partners typically have management power and unlimited personal liability. 1 Bromberg & Ribstein, *Partnership*, sec. 1.01(B)(3) (2015-3 Supp.). On the other hand, limited partners typically lack management power but enjoy immunity from liability for debts of the partnership. *Id.*

The court noted limited partnership law when Code 1402(a)(13) was enacted in 1977 and how it has evolved since then.[3375] Applying that summary to the case at hand:

[3371] See the extensive quotes from *Renkemeyer* in fn. 3362, found in this part II.L.4.

[3372] See fn. 3344, found in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.

[3373] See the extensive quotes from *Renkemeyer* in fn. 3362, found in this part II.L.4.

[3374] Citing *Gates v. Commissioner*, 135 T.C. 1, 6 (2010), and *Perrin v. United States*, 444 U.S. 37, 42 (1979).

[3375] The court stated:

> More specifically, the exact meaning of "limited partner" may vary slightly from State to State. The Uniform Law Commission drafted the Uniform Limited Partnership Act in 1916 (ULPA (1916)), and the Revised Uniform Limited Partnership Act in 1976 (RULPA (1976)). Amendments were added to RULPA (1976) in 1985 (RULPA (1985)). Versions of these uniform acts have been adopted in most States, sometimes with modifications.
>
> Section 7 of ULPA (1916) states: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." ULPA (1916) allowed limited partners a narrow set of rights but did not specifically define which activities a limited partner could perform without losing limited partner status. See *id.* sec. 10 (allowing limited partners the rights to inspect books,

Common to each of the definitions of "limited partner" discussed above are the primary characteristics of limited liability and lack of control of the business. In this case, the respective interests in the PLLC held by Mr. Castigliola, Mr. Banahan, and Mr. Mullen made each a member of the PLLC, which was member-managed.[9] Therefore management power over the business of the PLLC was vested in each of them through the interest each held. *See id.* sec. 79-29-302 (effective after July 1, 1994). The PLLC had no written operating agreement, nor is there any evidence to show that any member's management power was limited in any way. Furthermore, all members participated in control of the PLLC: For example, they all participated in collectively making decisions regarding their distributive shares, borrowing money, hiring, firing, and rate of pay for employees. They each supervised associate attorneys and signed checks for the PLLC. On the basis of the foregoing facts, the respective interests held by Mr. Castigliola, Mr. Banahan, and Mr. Mullen could not have been limited partnership interests under any of the limited partnership acts. Therefore, they were not limited partners under section 1402(a)(13).

[9] There is no evidence to suggest that any member held a different type of interest in the PLLC or held more than one type of interest in the PLLC.

The court recognized that "a limited partnership must have at least one general partner"[3376] and, in reinforcing its conclusion that the members were not limited partners, reasoned:

This is logical, because limited partners, as discussed above, cannot participate in control of the business and maintain their limited liability. Because there must be at least one partner who is in control of the business, there must be at least one general partner. The members testified that all members participated equally in all decisions and had substantially identical relationships with the PLLC. There was no PLLC operating agreement or other evidence to suggest otherwise. But since by necessity at least one of the members must have occupied a role analogous to that of a general partner in a limited partnership, and because all of the members had the same rights and responsibilities, they must all have had positions analogous to those of general partners in a limited partnership. This conclusion is affirmed by the history of the PLLC: Before the members organized the PLLC, they operated as a general partnership; and there is no evidence that organizing as a PLLC was accompanied by any change in the way they managed the business.

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demand an accounting of partnership affairs, and receive a share of the profits and return of capital, and also allowing limited partners the same right as general partners to request dissolution and winding up of the partnership).

Section 303(a) of RULPA (1976) provides—in terms almost identical to those of ULPA (1916)—that a "limited partner" would lose limited liability protection if "in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." With regard to the meaning of "limited partner", the essential difference between ULPA (1916) and RULPA (1976) is that RULPA (1976) enumerates certain activities that a limited partner may perform without taking part in control of the business; for example, section 303(b)(5)(i) and (ii) of RULPA (1976) explicitly permits limited partners to vote on the dissolution of the partnership or the sale of substantially all of the partnership's assets.

In 1987 Mississippi adopted RULPA (1985) with some modifications. See 1987 Miss. Laws, ch. 488, sec. 303 (effective from Jan. 1, 1988); Miss. Code Ann. sec. 79-14-303 (2009). In terms almost identical to those of ULPA (1916) and RULPA (1976), the version of the limited partnership act that Mississippi adopted in 1987—and which was effective throughout the years at issue—provided that a "limited partner" would lose limited liability protection if "in addition to the exercise of his rights and powers as a limited partner, he participates in the control of the business." Miss. Code Ann. sec. 79-14-303. Like RULPA (1976), Mississippi's version provides safe harbors for various activities a limited partner may perform without losing limited liability protection. *Id.*

[3376] Citing:

See, *e.g.*, Miss. Code Ann. sec. 79-14-801 (2009) ("A limited partnership is dissolved and its affairs must be wound up upon the first of the following to occur: * * * (4) An event of withdrawal of a general partner unless at the time there is at least one other general partner[.]").

Thus, the court would not accept a headless entity,[3377] whereas *Hardy* implicitly accepted that idea because the members were mere investors who delegated daily running of the business to a skilled managerial employee. *Hardy* did not analyze either what it means to be a limited partner or what were the members' rights to run the LLC; it focused only on the fact that they did not run the LLC on a daily basis.

Moving on to other authority in this area: In light of the ascendancy of LLCs, subsections (g) through (i) of Prop. Reg. § 1.1402(a)-2 would define a limited partner, if ever finalized:

> **(g) Distributive share of limited partner.** An individual's net earnings from self-employment do not include the individual's distributive share of income or loss as a limited partner described in paragraph (h) of this section. However, guaranteed payments described in section 707(c) made to the individual for services actually rendered to or on behalf of the partnership engaged in a trade or business are included in the individual's net earnings from self-employment.
>
> **(h) Definition of limited partner.**
>
> *(1) In general.* Solely for purposes of section 1402(a)(13) and paragraph (g) of this section, an individual is considered to be a limited partner to the extent provided in paragraphs (h)(2), (h)(3), (h)(4), and (h)(5) of this section.
>
> *(2) Limited partner.* An individual is treated as a limited partner under this paragraph (h)(2) unless the individual—
>
> (i) Has personal liability (as defined in § 301.7701-3(b)(2)(ii) of this chapter) for the debts of or claims against the partnership by reason of being a partner;[3378]
>
> (ii) Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership;[3379] or
>
> (iii)Participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.
>
> *(3) Exception for holders of more than one class of interest.* An individual holding more than one class of *interest* in the partnership who is not treated as a limited partner under paragraph (h)(2) of this section is treated as a limited partner under this paragraph (h)(3) with respect to a specific class of partnership interest held by such individual if, immediately after the individual acquires that class of interest—
>
> (i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and,

[3377] *Riether*, discussed in fn. 3363, implicitly made a similar assumption when it held that a married couple that jointly owned an LLC could not claim the limited partner exclusion without proving that status.
[3378] Does this mean personal liability as an inherent state law attribute of being an owner, or personal liability because lenders require all owners to guarantee loans?
[3379] Does this mean a manager-managed LLC and the limited partner is not a manager, or member-managed with voting and nonvoting interests?

(ii) The individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in paragraph (h)(3)(i) of this section.

(4) Exception for holders of only one class of interest. An individual who is not treated as a limited partner under paragraph (h)(2) of this section solely because that individual participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year is treated as a limited partner under this paragraph (h)(4) with respect to the individual's partnership interest if, immediately after the individual acquires that interest—

(i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and

(ii) The individual's rights and obligations with respect to the specific class of interest are identical to the rights and obligations of the specific class of partnership interest held by the limited partners described in paragraph (h)(4)(i) of this section.

(5) Exception for service partners in service partnerships. An individual who is a service partner in a service partnership may not be a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section.

(6) Additional definitions. Solely for purposes of this paragraph (h)—

(i) A *class of interest* is an interest that grants the holder specific rights and obligations. If a holder's rights and obligations from an interest are different from another holder's rights and obligations, each holder's interest belongs to a separate class of interest. An individual may hold more than one class of interest in the same partnership provided that each class grants the individual different rights or obligations. The existence of a guaranteed payment described in section 707(c) made to an individual for services rendered to or on behalf of a partnership, however, is not a factor in determining the rights and obligations of a class of interest.

(ii) A *service partner* is a partner who provides services to or on behalf of the service partnership's trade or business. A partner is not considered to be a service partner if that partner only provides a de minimis amount of services to or on behalf of the partnership.

(iii)A *service partnership* is a partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

(iv)A *substantial interest in a class of interest* is determined based on all of the relevant facts and circumstances. In all cases, however, ownership of 20 percent or more of a specific class of interest is considered substantial.

(i) Example. The following example illustrates the principles of paragraphs (g) and (h) of this section:

Example. (i) A, B, and C form LLC, a limited liability company, under the laws of State to engage in a business that is not a service partnership described in paragraph (h)(6)(iii) of this section. LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute

$1x for one LLC unit. B contributes $2x for two LLC units. Each LLC unit entitles its holder to receive 25 percent of LLC's tax items, including profits. A does not perform services for LLC; however, each year B receives a guaranteed payment of $6x for 600 hours of services rendered to LLC and C receives a guaranteed payment of $10x for 1000 hours of services rendered to LLC. C also is elected LLC's manager. Under State's law, C has the authority to contract on behalf of LLC.

(ii) *Application of general rule of paragraph (h)(2) of this section*. A is treated as a limited partner in LLC under paragraph (h)(2) of this section because A is not liable personally for debts of or claims against LLC, A does not have authority to contract for LLC under State's law, and A does not participate in LLC's trade or business for more than 500 hours during the taxable year. Therefore, A's distributive share attributable to A's LLC unit is excluded from A's net earnings from self-employment under section 1402(a)(13).

(iii) *Distributive share not included in net earnings from self-employment under paragraph (h)(4) of this section*. B's guaranteed payment of $6x is included in B's net earnings from self-employment under section 1402(a)(13). B is not treated as a limited partner under paragraph (h)(2) of this section because, although B is not liable for debts of or claims against LLC and B does not have authority to contract for LLC under State's law, B does participates in LLC's trade or business for more than 500 hours during the taxable year. Further, B is not treated as a limited partner under paragraph (h)(3) of this section because B does not hold more than one class of interest in LLC. However, B is treated as a limited partner under paragraph (h)(4) of this section because B is not treated as a limited partner under paragraph (h)(2) of this section solely because B participated in LLC's business for more than 500 hours and because A is a limited partner under paragraph (h)(2) of this section who owns a substantial interest with rights and obligations that are identical to B's rights and obligations. In this example, B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to LLC. Thus, B's distributive share attributable to B's two LLC units is not net earnings from self-employment under section 1402(a)(13).

(iv) *Distributive share included in net earnings from self-employment*. C's guaranteed payment of $10x is included in C's net earnings from self-employment under section 1402(a). In addition, C's distributive share attributable to C's LLC unit also is net earnings from self-employment under section 1402(a) because C is not a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section. C is not treated as a limited partner under paragraph (h)(2) of this section because C has the authority under State's law to enter into a binding contract on behalf of LLC and because C participates in LLC's trade or business for more than 500 hours during the taxable year. Further, C is not treated as a limited partner under paragraph (h)(3) of this section because C does not hold more than one class of interest in LLC. Finally, C is not treated as a limited partner under paragraph (h)(4) of this section because C has the power to bind LLC. Thus, C's guaranteed payment and distributive share both are included in C's net earnings from self-employment under section 1402(a).

Because these regulations are merely proposed, however, taxpayers may either argue that they provide a reasonable position or ignore them as not yet being effective. In using them, consider the following:

- The material participation component of these proposed regulations generally would prevent a limited partner in a trade or business from reaching the sweet spot of avoiding both SE tax and the 3.8% tax on net investment income, unless one participates for more than 100 hours and no more than 500 hours.[3380]

- Suppose one wants to argue that one's interest in an LLC has a general partner and a limited partner component:

  - (h)(3)(ii) requires that the individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in (h)(3)(i).

  - Limited partners described in (h)(3)(i) must hold an aggregate 20% and be described in (h)(2).

  - To be described in (h)(2), a member cannot:

    - Have personal liability for the debts of or claims against the LLC by reason of being a member;

    - Have authority to contract on behalf of the LLC; or

    - Participate in the partnership's trade or business for more than 500 hours during the partnership's taxable year.

Considering that owners of operating businesses frequently make loan guarantees, making sure that 20% of the owners are never on loan guarantees, never have authority to represent the LLC in any manner, and are active in the business only within the 101-500 hour sweet spot[3381] is a tall order. And *Renkemeyer* includes very strong language against granting an exclusion from self-employment tax for an active owner in an entity that is not a limited partnership, and some are concerned that *Renkemeyer* might be extended one day to prevent limited partners in a limited partnership from excluding from SE income their distributive share as limited partners.[3382] Those who are extremely concerned about the latter might advise each partner to form his or her own S corporation to hold all of his or her interest in the business, which might simply be a straight LLC, as described in parts II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker (idea that S corporations block SE income), II.L.5.c Examples of S Corporation Blockers (narrative description of alternatives), and II.L.5.e Flowchart: LLC with S Corporation as Blocker (diagram).

In many cases, using a traditional limited partnership to govern ownership, which partnership holds one or more LLC subsidiaries that are disregarded for tax purposes, would provide more long-term flexibility regarding the conduct of future business without falling out of the protection that the proposed regulations seem to provide. If a client finds a limited partnership cumbersome to operate on a daily basis, the limited

[3380] See part II.I 3.8% Tax on Excess Net Investment Income, especially part II.I.8 Application of 3.8% Tax to Business Income, summarized at part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[3381] See text accompanying fn. 3380 in this part II.L.4.
[3382] See highlighted language fn. 3362 in this part II.L.4. At least one tax expert whom I highly regard has expressed concern that *Renkemeyer* signals trouble for a limited partner in a state law limited partnership who is active. However, that expert concedes the language highlighted in fn. 3353 very strongly supports the exclusion for an active limited partner (but not the point that it eliminates his concern). Although I strongly disagree with that concern and feel quite confident in the structure described in part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and illustrated in part II.E.6 Recommended Partnership Structure – Flowchart, I leave it up to the reader to consider this expert's views.

partnership could do business through one or more wholly owned LLCs that are disregarded for income tax purposes.[3383]

Although administratively the IRS appears to be informally following this proposed regulation, CCA 201640014, particularly fn. 3364 and the accompanying text, makes clear that taxpayers need to use limited partnerships to maximize the possibility of refuting an IRS argument in this area. I prefer the structure described in parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart.

On the other hand, if the 3.8% net investment income (NII) tax is repealed and income from active businesses does not receive favorable tax treatment relative to passive businesses, investing in an LLC as a passive business owner, as in *Hardy*,[3384] may be a model that works. In that case, consider making sure that one's time spent qualifies as investor time, rather than time spent as a working owner.[3385] I would also recommend making the person who manages the LLC be the manager. However, I remain uneasy about *Hardy*, because *Methvin* involved facts that in most ways were more sympathetic to the taxpayer than *Hardy*, yet found the taxpayer subject to SE tax. Furthermore, if NII tax is not repealed and the owner is active enough to avoid NII tax, the owner might have moved away from being a mere investor and moved closer to *Renkemeyer* and *Castigliola*. So, I am not yet convinced that one should rely on *Hardy*, and I remain firmly in favor of using limited partnerships to save SE tax.

IRS LB&I Concept Unit, "Self-Employment Tax and Partners," last updated 2/13/2019,[3386] observed on page 11:

> S corporation shareholders are subject to "reasonable compensation" rules. In contrast, partnerships generally are not required to pay partners guaranteed payments. The concept of "reasonable compensation" does not exist for partnerships and partners in the same way that it does for S corporations and shareholders.

On page 19, the Concept Unit discussed Prop. Reg. § 1.1402(a)-2(h):

> The 1997 Proposed Regulations are not final. They may not be enforced on taxpayers. Instead, the applicable analysis is the statutory language, legislative history, and case law. Taxpayers, however, may rely on the 1997 proposed regulations. In other words, the IRS will respect a partner's status as a limited partner if the partner qualifies as a limited partner under the 1997 proposed regulations.

II.M.4.d. Introduction to Code § 409A Nonqualified Deferred Compensation Rules

Before working in this area, consider reading part II.Q.1.d.i IRS Audit Guide for Nonqualified Deferred Compensation.

Enacted by the American Jobs Creation Act of 2004,[3563] Code § 409A imprints a layer of rules that supplements previously existing rules on taxing deferred compensation.[3564] It punishes service providers

[3383] See part II.B Limited Liability Company (LLC), especially the comments accompanying fns. 333-347, discussing when a single-member LLC is or is not disregarded.
[3384] In this part II.L.4, the text surrounding fn. 3365 discusses *Hardy*.
[3385] See part II.K.1.a.v What Does Not Count as Participation.
[3386] Knowledge Base – Partnerships, Book 366, Document Control Number (DCN) PST/C/366_01_01-01, found at https://www.irs.gov/pub/irs-utl/pst_c_366_01_01_01.pdf.
[3563] Although the statute became effective January 1, 2005, existing plans did not need to be modified until December 31, 2008. Notice 2007-86.
[3564] Constructive receipt, Code § 83, Code § 457(f), etc.

(employees and independent contractors) who receive deferred compensation without complying with its terms; it is so broad that even public school teachers need to be careful![3565]

The service provider must pay a penalty of 20% of the deferred compensation when it is includible in gross income.[3566] At the same time, the service provider must also pay interest to the IRS on the deferred tax, measured from the taxable year that is the later of when compensation was earned or when it was not subject to a substantial risk of forfeiture.[3567] However, these rules do not apply to compensation payments that are taxed when earned but paid in a later year.[3568]

Permissible triggering events for payments under Code § 409A include separation from service, disability, death, a specified time or fixed schedule, a change in control of the service recipient, or an unforeseeable emergency.[3569] Special rules apply to split-dollar life insurance arrangements that were entered into before 2005.[3570] These materials are not intended to provide a thorough knowledge of Code § 409A. The discussion below focuses on satisfying exceptions to Code § 409A with respect to equity and substitutes for equity.[3571]

Note, however, that the present value of a deferred compensation obligation is an expense on the business's income statement and a liability on its balance sheet. See part II.Q.1.d.ii.(b) Balance Sheet Effects of Deferred Compensation.

Also note that, to be exempt from ERISA, a plan needs to be a "top hat" plan for the benefit of a person or select group of persons with bargaining power.[3572] The employer must notify the Department of Labor that such a plan exists.[3573]

In *Keels v. Commissioner*, T.C. Memo. 2020-25, the IRS raised Code § 409A for the first time in a post-trial brief, causing the IRS to have the burden of proof. The Tax Court reasoned and held:

> To prevail under section 409A, a taxpayer must show all three of the following: first, that distributions from the plan may not occur before the taxpayer's separation from service, disability, death, an unforeseen emergency, or a change in ownership of the corporation, sec. 409A(a)(2)(A)(i)-(vi); second, that the plan does not permit acceleration of benefits except to the extent provided by regulations, sec. 409A(a)(3); and third, that the election to deferred compensation must be timely made, sec. 409A(a)(4)(B)(i). These requirements do not apply if the benefits are subject to substantial risk of forfeiture or were previously taxable. Sec. 409A(a)(1)(A)(i).

3565 Notice 2008-62.
3566 Code § 409A(a)(1)(B)(i)(I); Prop. Reg. § 1.409A-4.
3567 Code § 409A(a)(1)(B)(i)(II); Prop. Reg. § 1.409A-4.
3568 See Rev. Rul. 2007-48 (treatment of amounts vested 1/1/2009 in the scenario that is used in the ruling), stating, Under § 1.409A-1(b)(6)(i), a right to compensation income that will be required to be included in income under § 402(b)(4) is not a deferral of compensation for purposes of § 409A.
3569 The regulations and various IRS pronouncements provide very detailed rules on how to apply these concepts. The author always works with employee benefits practitioners in his firm who know these rules better than he does.
3570 Notice 2007-34. See part II.Q.4.f Split-Dollar Arrangements.
3571 For benefits of using profits interests, see part II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.
3572 'Top-Hat' Plans, part XI.C. of Deferred Compensation Arrangements, T.M. 385.
3573 The simplest way might be a letter under 29 C.F.R. § 2520.104-23. For some relief for failure to send the letter, see https://www.irs.gov/retirement-plans/irs-penalty-relief-for-dol-dfvc-filers-of-late-annual-reports and https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/correction-programs/dfvcp.

> For respondent to meet the burden of proof respondent must show that the plan fails to include any one of the three requirements above, that petitioner does not have a substantial risk of forfeiture, and that petitioner was not previously taxed on the deferred compensation. The record does not show whether petitioner's plan with State Farm meets the requirements of section 409A. The plan document probably provides these details, but it is not in the record; neither is any Form 1099-MISC sent to petitioner by State Farm. The State Farm letter does not include those details. Thus, respondent has not shown that the plan fails to meet at least one of the requirements of section 409A or whether there is a substantial risk of forfeiture. Therefore, respondent did not meet the burden of proving that section 409A applies, and on this record petitioner is not taxable on the yearend balances of his termination and extended termination accounts for the years at issue.

II.M.4.d.i. Performance Bonuses

Performance bonuses that are due March 15 after a calendar year-end can have excellent motivational effects. Because the date is fixed no later than 2.5 months after yearend, paying compensation after that fixed date would not cause the payment to violate Code § 409A if the payment is made during the calendar year including the fixed date.[3574] One glitch is that it is possible that the information needed to determine the bonus might not be available until after March 15. To avoid this, require the employee to work at least one day in the next year. For example, suppose a bonus relates to 2010 performance. Require the employee to work at least one day in 2011. Imposing this requirement means that the payment is not vested until 2011, so the payment date could be fixed at a date on or before March 15, 2012. Of course, for motivational reasons, the payment should be made in 2011 as soon as the information is available to ensure that the employee does not have to wait too long, but the important point is that the deadline for the bonus relating to 2010 work can be after March 15, 2011, to take into account practical business exigencies.

Be sure that, when a performance bonus is added to other compensation, the service provider's total compensation remains reasonable.

Performance bonuses based on profits should not constitute an equity interest under Code § 2701 if the service provider does not have any other equity interest, the service provider is not identified to the IRS or third parties as being an owner, and the service provider does not share in any losses.

II.M.4.d.ii. Pushing Back a Scheduled Retirement Date

After a plan has been set up, the employee cannot elect to postpone a scheduled payment unless the election is at least 12 months before the scheduled payment date and the payment is deferred at least 5 years.[3575] (Postponing previously deferred payments is often referred to as re-deferral.)

However, that rule might not be as big an obstacle as it seems. Suppose an employee makes $150K per year and is scheduled to receive $100K annual retirement payments from 2020-2029. Suppose that 2019 comes along, and the parties agree that employee should continue working. In that case:

- In 2019, the employee agrees to receive his $150K in compensation for 2020 over two periods: $50K in 2020 and $100K in 2030.

[3574] Reg. §§ 1.409A-1(b)(4)(i), 1.409A-3(b), (d).
[3575] Code § 409A(a)(4)(C).

- The employee receives $150K in 2020, of which $100K is the originally scheduled deferred compensation and $50K that is earned for 2020 work.

- Thus, the employee receives $150K in 2020 and earns an additional payment of $100K to be paid in 2030, the year after the $100K retirement payments were scheduled to end.

The employee has effectively pushed back retirement by one year. However, the original payment stream of $100K per year from 2020-2029 remains intact. Thus, the Code § 409A rules on postponing a stream of payments have not been violated. The above plan not only offers flexibility but also avoids the strict deadlines that apply to re-deferral.

Setting a fixed payment upon attaining a particular age would satisfy Code § 409A without causing Code § 2701 or other income or estate tax problems, and that could be coupled with disability and death benefits to provide financial security.[3576]

II.M.4.d.iii. Change in Control as a Permitted Triggering Event under Code § 409A

Change in the entity's control is an event that can trigger payment of deferred compensation without the harsh consequences of Code § 409A.[3577] Generally, such a change in control in a corporation occurs when any one person, or more than one person acting as a group, acquires ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50% of the total fair market value or total voting power of the stock of such corporation.[3578] Similar rules apply to partnerships.[3579] Using principles that apply to other forms of performance-based compensation, Code § 2701 should not apply to compensation awarded upon change of control.

II.M.4.e. Issuing Stock to an Employee

II.M.4.e.i. Issuing Stock to an Employee - Generally

For the fundamental rules underlying this part II.M.4.e.i, see part II.M.4.b.ii Income Tax Recognition Timing Rules re Equity Incentives.

An employee who receives stock as compensation for services must pay tax on that stock.[3580] For possible deferral of income tax (but not employment tax) inclusion, see part II.M.4.e.ii Code § 83(i) Election Deferring Income Tax Inclusion.

Rev. Proc. 2012-29 explains the consequences of nonvested or nontransferable stock:[3581]

[3576] See part III.B.7.c.vi, Code § 2701 Interaction with Income Tax Planning.

[3577] In order to cover earn-out provisions where the acquirer in a change of control contracts to make an immediate payment at the closing of the transaction with additional amounts payable at a later date, delayed payments may meet the requirements for a payment at a specified time or pursuant to a fixed schedule if they are paid on the same schedule and under the same terms and conditions as payments to shareholders generally pursuant to the change in control event to the extent paid not later than five years after the change in control event. Reg. § 1.409A-3(i)(5)(iv).

[3578] Reg. § 1.409A-3(i)(5)(v)(A). This applies to a change in the ownership of the corporation, a change in effective control of the corporation, or a change in the ownership of a substantial portion of the assets of the corporation. Reg. § 1.409A-3(i)(5)(i).

[3579] Third paragraph of Part VI.E. to the Preamble to the Prop. Regs., allowing taxpayers to rely on similar rules until further guidance is issued for a partnership setting. This continues to apply under section III.G. of the preamble to the final regulations.

[3580] Code § 83. Letter Ruling 201405005 is a good example of a simultaneous exit of two owners and entrance of key employees with restricted stock in an S corporation.

[3581] Footnotes below are mine and are not in the Rev Proc.

Section 83(a) provides generally that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse) as of the first time that the transferee's rights in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over the amount (if any) paid for the property is included in the service provider's gross income for the taxable year which includes such time.[3582]

Under § 1.83-3(f) of the Income Tax Regulations, property is transferred in connection with the performance of services if it is transferred to an employee or independent contractor (or beneficiary thereof) in recognition of the performance of services, or refraining from performance of services. The existence of other persons entitled to buy stock on the same terms and conditions as an employee, whether pursuant to a public or private offering may, however, indicate that in such circumstance a transfer to the employee is not in recognition of the performance of, or refraining from performance of, services. The transfer of property is subject to § 83 whether such transfer is in respect of past, present, or future services.[3583]

Section 83(b) and § 1.83-2(a) permit the service provider to elect to include in gross income the excess (if any) of the fair market value of the property at the time of transfer over the amount (if any) paid for the property, as compensation for services.[3584]

Under § 83(e)(3) and § 1.83-7(b), § 83 does not apply to the transfer of an option without a readily ascertainable fair market value at the time the option is granted. As a result, a § 83(b) election may only be made with respect to the transfer of an option that has a readily ascertainable fair market value (as defined in § 1.83-7(b)), at the time the option is granted and that is substantially nonvested (as defined in § 1.83-3(b)). If substantially nonvested property is received upon exercise of an option without a readily ascertainable fair market value at grant, a service provider is permitted to make a § 83(b) election with respect to the transfer of such property upon the exercise of the option.[3585]

Under § 1.83-2(a), if property is transferred in connection with the performance of services, the person performing such services may elect to include in gross income under § 83(b) the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse restriction, as defined in § 1.83-3(i)) over the amount (if any) paid for such property, as compensation for services. If this election is made, the substantial vesting rules of § 83(a) and the regulations thereunder do not apply with respect to such property, and except as otherwise provided in § 83(d)(2) and the regulations thereunder (relating to the cancellation of a nonlapse restriction), any subsequent appreciation in the value of the property is not taxable as compensation to the person who performed the services. Thus, the value of property with respect to which this election is made is included in gross income as of the time of transfer, even though such property is substantially nonvested (as defined in § 1.83-3(b)) at the time of transfer, and no compensation will be includible in gross income when such property becomes substantially vested.[3586]

[3582] Rev. Proc. 2012-29, § 2.01.
[3583] Rev. Proc. 2012-29, § 2.02.
[3584] Rev. Proc. 2012-29, § 2.03.
[3585] Rev. Proc. 2012-29, § 2.04.
[3586] Rev. Proc. 2012-29, § 4.01.

> In computing the gain or loss from a subsequent sale or exchange of property for which a § 83(b) election was filed, § 1.83-2(a) provides that the basis of such property shall be the amount paid for the property (if any) increased by the amount included in gross income under § 83(b).[3587]
>
> If property for which a § 83(b) election was filed is forfeited while substantially nonvested, § 83(b)(1) provides that no deduction shall be allowed with respect to such forfeiture. Section 1.83-2(a) further provides that such forfeiture shall be treated as a sale or exchange upon which there is realized a loss equal to the excess (if any) of (1) the amount paid (if any) for such property, over (2) the amount realized (if any) upon such forfeiture. If such property is a capital asset in the hands of the taxpayer, such loss shall be a capital loss.[3588]

The Rev. Proc. provided a sample form for making a Code § 83(b) election.[3589]

When stock is transferred to the employee that is subject to a substantial risk of forfeiture[3590] and is not transferable,[3591] the employee recognizes income and treated as owning the stock if the employee makes a Code § 83(b) election.[3592] Conversely, if the corporation awards nonvested stock, then the employee does not recognize compensation until the stock vests, unless the employee makes a Code § 83(b) election no later than 30 days after the award.[3593]

Similarly, in determining who is a shareholder of an S corporation: Stock that is issued in connection with the performance of services[3594] and that is substantially nonvested[3595] is not treated as outstanding stock of the corporation, and the holder of that stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes a Code § 83(b) election with respect to the stock.[3596] In the event of such an election, the stock is treated as outstanding stock of the corporation, and the holder of the stock is treated as a shareholder for purposes of subchapter S.[3597] Substantially nonvested stock with respect to

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3587 Rev. Proc. 2012-29, § 4.02.

3588 Rev. Proc. 2012-29, § 4.03.

3589 Reg. § 1.83-2(e) sets forth the requirements for the election's contents, and Rev. Proc. 2012-29 provides a way to satisfy those requirements.

3590 Within the meaning of Code § 83(c)(1).

3591 Within the meaning of Code § 83(c)(2).

3592 Rev. Rul. 83-22.

3593 Code § 83(b)(2). Letter Rulings 201405008 and 201528001 excused failure to file with the taxpayer's individual tax return a copy of a timely Code § 83(b) election; T.D. 9779 finalized without changes REG-135524-14, Property Transferred in Connection with the Performance of Services, 7/16/2015, amending Reg. § 1.83-2(c) to remove this requirement, effective for property transferred on or after January 1, 2016, the latter per Reg. § 1.83-2(g). T.D. 9779 also revoked Rev. Proc. 2012-29, in part, to the extent it requires, inconsistent with the final regulations, a taxpayer to submit a copy of a Code § 83(b) election with his or her income tax return. Note that Code § 83(b)(2) requires only the initial filing to make the election; the requirement to file the election with one's individual return appeared to be merely an administrative requirement for preparing a complete return – a requirement that the IRS appears to have abandoned as of January 1, 2015, although this apparent abandonment for 2015 was done in a peculiar way.

3594 Within the meaning of Reg. § 1.83-3(f).

3595 Within the meaning of Reg. § 1.83-3(b).

3596 Reg. § 1.1361-1(b)(3), "Treatment of restricted stock," provides:

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

3597 Reg. § 1.1361-1(b)(3), which is reproduced in fn 3596.

which a Code § 83(b) election has been made is taken into account in determining whether a corporation has a second class of stock, and such stock is not treated as a second class of stock if the stock confers rights to distribution and liquidation proceeds that are identical,[3598] to the rights conferred by the other outstanding shares of stock.[3599] See part II.A.2.i Single Class of Stock Rule, especially part II.A.2.i.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules.

Rev Proc. 2012-29, Section 5, provides various examples, the tax results of which "do not depend on whether or not the stock transferred to the employee is traded on an established securities market":

> *Example 1*. Company A is a privately held corporation and no stock in Company A is traded on an established securities market. On April 1, 2012, in connection with the performance of services, Company A transfers to E, its employee, 25,000 shares of substantially nonvested stock in Company A. In exchange for the stock, E pays Company A $25,000, representing the fair market value of the shares at the time of the transfer. The restricted stock agreement provides that if E ceases to provide services to Company A as an employee prior to April 1, 2014, Company A will repurchase the stock from E for the lesser of the then current fair market value or the original purchase price of $25,000. E's ownership of the 25,000 shares of stock will not be treated as substantially vested until April 1, 2014 and will only be treated as substantially vested if E continues to provide services to Company A as an employee until April 1, 2014. On April 1, 2012, E makes a valid election under § 83(b) with respect to the 25,000 shares of Company A stock. Because the excess of the fair market value of the property ($25,000) over the amount E paid for the property ($25,000) is $0, E includes $0 in gross income for 2012 as a result of the stock transfer and related § 83(b) election. The 25,000 shares of stock become substantially vested on April 1, 2014 when the fair market value of the shares is $40,000. No compensation is includible in E's gross income when the shares become substantially vested on April 1, 2014. In 2015, E sells the stock for $60,000. As a result of the sale, E realizes $35,000 ($60,000 sale price - $25,000 basis) of gain, which is a capital gain.
>
> *Example 2*. The facts are the same as in Example 1 above, except that E does not make an election under § 83(b). Under § 83(a), E includes $0 in gross income in 2012 as a result of the transfer of stock from Company A because the stock is not substantially vested. When the shares become substantially vested on April 1, 2014, E includes $15,000 ($40,000 fair market value less $25,000 purchase price) of compensation in gross income. E's basis in the stock as of April 1, 2014 is $40,000 ($25,000 paid for the stock and $15,000 included in income under § 83(a)). As a result of the 2015 sale of the stock for $60,000, E realizes $20,000 ($60,000 sale price - $40,000 basis) of gain, which is a capital gain.

[3598] Within the meaning of Reg. § 1.1361-1(*l*)(1), which is reproduced in fn 231 in part II.A.2.i.i.(a) Nonvoting Stock Permitted for S Corporations.

[3599] Reg. § 1.1361-1(*l*)(3), "Stock taken into account," which provides:

> Except as provided in paragraphs (b)(3), (4), and (5) of this section (relating to restricted stock, deferred compensation plans, and straight debt), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account. For example, substantially nonvested stock with respect to which an election under section 83(b) has been made is taken into account in determining whether a corporation has a second class of stock, and such stock is not treated as a second class of stock if the stock confers rights to distribution and liquidation proceeds that are identical, within the meaning of paragraph (*l*)(1) of this section, to the rights conferred by the other outstanding shares of stock.

Reg. § 1.1361-1(b)(3) is reproduced in fn 3596 in part II.M.4.e.i Issuing Stock to an Employee - Generally. Reg. § 1.1361-1(b)(4) is reproduced in the text accompanying fn 272 in part II.A.2.i.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules.

Reg. § 1.1361-1(b)(5) is reproduced in fn 293 in part II.A.2.i.x Straight Debt.

Example 3. The facts are the same as in Example 1 above, except that E terminates employment with Company A on August 1, 2013 before the shares become substantially vested. Because the excess of the fair market value of the property ($25,000) over the amount E paid for the property ($25,000) is $0, E includes $0 in gross income for 2012 as a result of the stock transfer and related § 83(b) election. When E terminates employment on August 1, 2013, the fair market value of the stock is $30,000 but Company A purchases the stock from E for $25,000 pursuant to the terms of the restricted stock agreement. As a result of the 2013 sale of the stock for $25,000, E realizes $0 in gain ($25,000 sale price - $25,000 basis).

Example 4. Company B is a publicly held corporation and Company B stock is traded on an established securities market. On April 1, 2012, in connection with the performance of services, Company B transfers to F, its employee, 25,000 shares of substantially nonvested stock in Company B. At the time of the transfer, the shares have an aggregate fair market value of $25,000. F is not required to pay Company B any consideration in exchange for the stock. The restricted stock agreement provides that if F ceases to provide services to Company B as an employee prior to April 1, 2014, F will forfeit the stock back to Company B. F's ownership of the 25,000 shares of stock will not be treated as substantially vested until April 1, 2014 and will only be treated as substantially vested if F continues to provide services to Company B as an employee until April 1, 2014. On April 1, 2012, F makes a valid election under § 83(b) with respect to the 25,000 shares of Company B stock. Because the excess of the fair market value of the property ($25,000) over the amount F paid for the property ($0) is $25,000, F includes $25,000 of compensation in gross income for 2012 as a result of the stock transfer and related § 83(b) election. The 25,000 shares of stock become substantially vested on April 1, 2014 when the fair market value of the shares is $40,000. No compensation is includible in F's gross income when the shares become substantially vested on April 1, 2014. In 2015, F sells the stock for $60,000. As a result of the sale, F realizes $35,000 ($60,000 sale price - $25,000 basis) in gain, which is a capital gain.

Example 5. The facts are the same as in Example 4 above, except that F does not make an election under § 83(b). Under § 83(a), F includes $0 in gross income in 2012 as a result of the transfer of stock from Company B because the stock is not substantially vested. When the shares become substantially vested on April 1, 2014, F includes $40,000 ($40,000 fair market value less $0 purchase price) of compensation in gross income. F's basis in the stock as of April 1, 2014 is $40,000 ($0 paid for the stock and $40,000 included in income under § 83(a)). As a result of the 2015 sale of the stock for $60,000, F realizes $20,000 ($60,000 sale price - $40,000 basis) of gain, which is a capital gain.

Example 6. The facts are the same as in Example 4 above, except that F terminates employment with Company B on August 1, 2013 and forfeits the shares before the shares become substantially vested. Because the excess of the fair market value of the property ($25,000) over the amount F paid for the property ($0) is $25,000, F includes $25,000 of compensation in gross income for 2012 as a result of the stock transfer and related § 83(b) election. In the year F terminates employment, F forfeits the 25,000 shares back to Company B and such forfeiture is treated as a sale of the shares in exchange for no consideration. Pursuant to § 1.83-2(a), F realizes no loss as the result of such sale. F is not entitled to a deduction or credit for taxes paid as the result of filing the § 83(b) election or the subsequent forfeiture of the property.

Note the unfairness in Example 6: F included an amount in income for stock F received but got no deduction – not even a capital loss – when F forfeited the stock with respect to that amount included (but would have received a deduction for any out-of-pocket purchase price)[3600]. Presumably, if F does not receive a deduction, Company B will not recognize income on account of F forfeiting the shares. Note that the result would have been different if Company B had separately bonused $25,000 cash and F had paid $25,000 cash for the stock, so long as the bonus and the payment were not tied together.

Often the corporation will "gross-up" the employee's pay by paying the employee's taxes on that compensation. If the corporation and employee are in the same income tax bracket, this arrangement will not cost anyone any income tax. For example, suppose everyone is in a 40% income tax bracket (federal and state) and $100 of stock is issued:

- The corporation receives $167 compensation deduction, consisting of $100 stock and $67 income tax withholding.

- The corporation saves $67 income tax (40% of $167). That $67 income tax savings offsets the $67 cash out-of-pocket for the withholding. Therefore, the corporation has no net cash expenditure.

- The employee incurs $67 of income tax liability (40% of the $167 compensation income). However, the $67 income tax withholding offsets that liability.

- Note that the above analysis ignores FICA.

- Note that lower corporate rates and the Code § 199A qualified business income deduction[3601] may make the employer's deduction worth less than the income tax that the service provider.

- For an S corporation, the compensation deduction benefits the shareholders, not the corporation, although the corporation indirectly benefits by reducing the need to make distributions to pay the shareholders' income tax. Note the new shareholder will benefit from this deduction, because all items are allocated pro rata, per share per day owned regardless of the timing of ownership, except to the extent that an election is made to close the books as of the date of the transfer.[3602] The election to close the books can be made only if issuance is at least 25% of the previously outstanding stock to one or more new shareholders.[3603]

Consider timing the issuance to coincide with taxable years in which the employer has sufficient ordinary income to absorb the deduction and provide a tax benefit at a sufficiently high income tax rate. Note also that, if an S corporation issues stock to its key employees in the year of the sale of the business, the deduction (if high enough) might wind up offsetting capital gain income, which is taxed at a lower rate – often too low to take advantage of the income tax dynamics described above.

Compare these concepts to the income tax dynamics of part II.Q.1.a, Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis, and more fully explored in part II.Q.1.d, Nonqualified Deferred Compensation.

Nonvested stock options provide the least complication when the exercise price is no less than the amount of the underlying stock's value. This approach avoids the forfeiture described above. It also avoids the

[3600] Although the Example cited a regulation, Code § 83(b)(1) mandates the position the regulation takes.
[3601] See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.
[3602] See part III.B.2.j Tax Allocations upon Change of Interest, particularly III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.
[3603] Reg. § 1.1361-1(g)(2)(i)(C).

need to comply with the restrictions that Code § 409A imposes on nonqualified deferred compensation.[3604]

If an employee is upset about stock being diluted when other investors enter and the buyer pays the employee the amount necessary to make up for the dilution, the payments in excess of a pro-rata purchase price that the buyer designates as being compensation is taxed as such.[3605]

Also, a corporation cannot treat a person as a shareholder with the same rights as the other shareholder and then claim that the stock was not yet vested to try to obtain a deduction at a later time when the stock was more valuable.[3606]

II.M.4.e.ii. Code § 83(i) Election Deferring Income Tax Inclusion

Notice 2018-97 explains this provision of the 2017 tax law changes:

> Section 83 generally provides for the federal income tax treatment of property transferred in connection with the performance of services. Section 13603 of the Act amended section 83 by adding section 83(i) to allow certain employees to defer recognition of income attributable to the receipt or vesting of qualified stock.

Notice 2018-97, part III.B, "Employment Taxes (including Income Tax Withholding)," explains in subpart 1, "General,":

> Employment taxes under Subtitle C of the Code include Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) tax, and federal income tax withholding. The Act made no amendments to FICA and FUTA taxation with respect to deferral stock. Thus, the FICA and FUTA taxation of deferral stock is unaffected by the Act. See H.R. Rep. No. 115-466, at 501 (2017).[1]
>
> [1] See H.R. Rep. No. 115-466, pages 496-497 for a discussion of FICA and FUTA taxation.
>
> The Act did amend the income tax withholding provisions in the Code with respect to deferral stock. Specifically, section 13603(b) of the Act amended the income tax withholding provisions, as described below, to conform the income tax withholding provisions in section 3401 and section 3402 to the income taxation of deferral stock. The remainder of the discussion of employment taxes concerns only federal income tax withholding.
>
> Section 3402(a) provides that, except as otherwise provided in section 3402, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary. The term "wages" is defined in section 3401(a) for income tax withholding purposes as including all remuneration for services performed by an employee for his or her employer including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions.

[3604] See footnote 3646.

[3605] *Brinkley v. Commissioner*, T.C. Memo. 2014-227, *aff'd* 808 F.3d 657 (5th Cir. 2015) (penalties assessed for the manner in which the taxpayer engaged in self-help merely through tax return positions rather than by negotiating a better deal with the company).

[3606] *Qinetiq U.S. Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 2015-123, *aff'd* 119 A.F.T.R.2d 2017-330 (4th Cir. 1/6/2017). See part II.M.4.b When is an Award or Transfer to an Employee Includible in the Employee's Income.

Section 3401(i), as added by section 13603(b)(1) of the Act, provides that for purposes of section 3401(a), qualified stock (as defined in section 83(i)) with respect to which an election is made under section 83(i) is treated as wages (1) received on the earliest date described in section 83(i)(1)(B), and (2) in an amount equal to the amount included in income under section 83 for the taxable year which includes such date. Thus, under section 3401(i), the amount of the deferral stock included in gross income is treated as wages subject to federal income tax withholding on the earliest date described in section 83(i)(1)(B), which sets forth the end date of the applicable deferral period.

Section 3402(t), which was added by section 13603(b)(2) of the Act, provides that, in the case of any qualified stock with respect to which an election is made under section 83(i), (1) the rate of tax under section 3402(a) must not be less than the maximum rate in effect under section 1 (37% in 2018), and (2) such stock is treated for purposes of section 3501(b) in the same manner as a noncash fringe benefit. Section 3501(b) provides that the taxes imposed by Subtitle C with respect to noncash fringe benefits must be collected (or paid) by the employer at the time and in the manner prescribed by the Secretary by regulations. Questions and Answers 5 and 6 of § 31.3501(a)-1T provide that the employer is liable for the payment of the tax with respect to a noncash fringe benefit regardless of whether the benefit is paid by another entity.

Noncash fringe benefits that fall within section 3501(b) generally are subject to the provisions of Announcement 85-113, 1985-31 I.R.B. 31, which provides guidelines for withholding, paying, and reporting employment tax on taxable noncash fringe benefits. Announcement 85-113 provides generally that taxpayers may rely on the guidelines in the announcement until the issuance of regulations that supersede the temporary and proposed regulations under section 3501(b). No regulations have been issued under section 3501(b) that supersede the announcement. Thus, Announcement 85-113 generally is applicable to current payments of noncash fringe benefits, and until further regulatory guidance is issued, it applies to deferral stock, except as limited by the specific rules of section 3401(i) and the terms of the announcement itself, as discussed further below.

Section 2 of Announcement 85-113 sets out the general income tax and accounting rule, which provides, in relevant part, that employers must withhold the applicable income tax on the date the benefits are paid and must deposit the withheld taxes under the regular rules for tax deposits. The employer may make a reasonable estimate of the value of the fringe benefit on the date the fringe benefit is paid for purposes of meeting the timely deposit requirements. The actual value of the fringe benefit must be determined by January 31 of the following year and reported on Form W-2, Wage and Tax Statement, and Form 941, Employer's Quarterly Federal Tax Return (or Form 944, Employer's Annual Federal Tax Return, if applicable instead of Form 941).

Announcement 85-113 states that if the employer underestimates the value of the fringe benefit and as a result deposits less than the amount required to be deposited (that is, the amount the employer would be required to deposit if the employer had correctly withheld the applicable taxes), the employer may be subject to the failure to deposit penalty under section 6656. Under Announcement 85-113, if the employer overestimates the value and deposits more than the amount required, the employer may claim a refund or elect to have the overpayment applied to the employer's next Form 941 (or other employment tax return).

Generally, under § 31.6205-1(d)(2), if an employer collects less than the correct amount of income tax required to be withheld from wages during a calendar year, the employer must collect the amount of the undercollection on or before the last day of the year by deducting the amount from remuneration of the employee. Under § 31.6205-1(d)(2),[2] if such a deduction is not made, the obligation of the employee to the employer with respect to the undercollection is a matter for settlement between the employee and the employer within the calendar year. However, in the case of noncash fringe benefits, Announcement 85-113 permits the employer to recover the undercollection of income tax withholding from the employee after the end of the calendar year during which the wage payment is made, as long as the recovery occurs prior to April 1 of the year following the year in which the benefits are paid. This rule in Announcement 85-113 applies to the amount included in wages under section 3401(i). Thus, with regard to any income tax withholding that the employer deposits for deferral stock included in wages under section 3401(i) that has not been collected from the employee, the employer may recover the income tax from the employee prior to April 1 of the year following the year in which the inclusion in wages under section 3401(i) occurs.

[2] The reference in Announcement 85-113 is to the section of the regulations (§ 31.6205-1(c)(4)) setting forth the same principle in the section 6205 regulations before amendments to the regulations after 1985. See T.D. 9405, 72 FR 37376 (July 1, 2008).

Section 3401(i) provides the specific date on which deferral stock must be treated as wages for income tax withholding purposes and the special rules for timing of inclusion in income under Announcement 85-113 available with respect to certain noncash fringe benefits do not apply.[3] The withholding rates described in section 2 of Announcement 85-113 also do not apply to deferral stock because, under section 3402(t)(1), the income tax withholding rate under section 3402(a) "shall not be less than the maximum rate of tax in effect under section 1." The Treasury Department and the IRS expect that proposed regulations providing further guidance on section 83(i) will provide that the rate of withholding under section 3402(t)(1) on deferral stock is the maximum rate of tax in effect under section 1 and will provide that withholding is applied (1) without reference to any payment of regular wages, (2) without allowance for the number of allowances or other dollar amounts claimed by the employee on Form W-4, Employee's Withholding Allowance Certificate, (3) without regard to whether the employee has requested additional withholding, and (4) without regard to the withholding method used by the employer. Thus, under the anticipated proposed regulations, only one rate, the maximum rate of tax under section 1, would be used in withholding on deferral stock under section 3402(t), and employers would not be able to increase or decrease the rate at the request of the employee. Under Code section 3402(t) and this notice and unless and until superseding guidance is issued, with respect to wages resulting from deferral stock under section 3402(t), employers must withhold taxes at the maximum rate of income tax under section 1 without regard to whether the employee has requested additional withholding and without regard to any withholding allowances or dollar amounts entered on the employee's Form W-4.

[3] Announcement 85-113 provides two rules applicable to the date of payment of some noncash fringe benefits that do not apply to deferral stock. The first rule allows payors of certain noncash fringe benefits to treat the benefits as paid on any day(s) during the year so long as they treat benefits provided in a calendar year as paid not later than December 31 of the calendar year. The second rule allows employers to treat certain benefits paid during the last two months of the year (or any shorter period) as paid during the subsequent calendar year. However, Announcement 85-113 provides that neither of these two rules applies when the fringe benefit is the transfer of personal property (either tangible or intangible) of a kind normally held for investment or the transfer of real property. Because deferral stock is personal property of a kind normally held for investment, neither of these rules may be used with respect to deferral stock.

In summary, deferral stock constitutes wages under section 3401(i) and is treated as received on the earliest date described in section 83(i)(1)(B) in an amount equal to the amount included in income under section 83 for the taxable year that includes such date. When the wages are treated as paid under section 3401(i), the employer must make a reasonable estimate of the value of the stock and make deposits of the amount of income tax withholding liability based on that estimate. The wages included under section 3401(i) are subject to withholding at the maximum rate of tax in effect under section 1, and withholding is determined without regard to the employee's Form W-4. By January 31 of the following year, the employer must determine the actual value of the deferral stock on the date it is includible in the employee's income and report that amount and the withholding on Form W-2 and Form 941. With respect to income tax withholding for the deferral stock that the employer pays from its own funds, the employer may recover that income tax withholding from the employee until April 1 of the year following the calendar year in which the wages were paid.

An employer that fails to deduct and withhold federal income tax under section 3402 is liable for the payment of the tax whether or not the employer collects it from the employee, unless section 3402(d) applies.[4] Section 3402(d) provides that if the employer fails to deduct and withhold the correct amount of income tax withholding, and thereafter the income tax against which the tax under section 3402 may be credited is paid, the tax imposed under section 3402(a) shall not be collected from the employer. Section 3402(d) does not relieve the employer from liability for any penalties in respect of the failure to deduct and withhold.

[4] Section 3403, Section 31.3403-1.

Code § 83(i)(1) provides:[3607]

In general. For purposes of this subtitle—

(A) *Timing of inclusion*. If qualified stock is transferred to a qualified employee who makes an election with respect to such stock under this subsection, subsection (a) shall be applied by including the amount determined under such subsection with respect to such stock in income of the employee in the taxable year determined under subparagraph (B) in lieu of the taxable year described in subsection (a).

(B) *Taxable year determined*. The taxable year determined under this subparagraph is the taxable year of the employee which includes the earliest of—

(i) the first date such qualified stock becomes transferable (including, solely for purposes of this clause, becoming transferable to the employer),

(ii) the date the employee first becomes an excluded employee,

(iii) the first date on which any stock of the corporation which issued the qualified stock becomes readily tradable on an established securities market (as determined by the Secretary, but not including any market unless such market is recognized as an established securities market by the Secretary for purposes of a provision of this title other than this subsection),

[3607] Subtitle A consists of Code §§ 1-1563.

(iv) the date that is 5 years after the first date the rights of the employee in such stock are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, or

(v) the date on which the employee revokes (at such time and in such manner as the Secretary provides) the election under this subsection with respect to such stock.

The Conference Agreement to P.L. 115-97 (12/22/2017) provides:

> … it is intended that the limited circumstances outlined in section 83(c)(3) and applicable regulations apply with respect to the determination of when stock first becomes transferrable or is no longer subject to a substantial risk of forfeiture. For example, income inclusion cannot be delayed due to a lock-up period as a result of an initial public offering. Finally, it is intended that the transition rule provided with respect to compliance with the 80-percent and employer notice requirements not be expanded beyond these specific items.

The principles of Code § 83(c)(3) are in part II.M.4.b.ii Income Tax Recognition Timing Rules re Equity Incentives.

Note that the amount of income inclusion is determined (and realized) under the normal rules of Code § 83(a); all Code § 83(i) does is defer taxation (recognition) of that income – perhaps to a taxable year in which the stock's value is less than that on which the Code § 83(a) taxation is based. The employee is treated as the owner for purposes of any activity relating to that stock, including allocating S corporation income if applicable.[3608]

Code § 83(i)(2), "Qualified stock," provides:

(A) *In general*. For purposes of this subsection, the term "qualified stock" means, with respect to any qualified employee, any stock in a corporation which is the employer of such employee, if—

(i) such stock is received—

(I) in connection with the exercise of an option, or

(II) in settlement of a restricted stock unit, and

(ii) such option or restricted stock unit was granted by the corporation—

(I) in connection with the performance of services as an employee, and

(II) during a calendar year in which such corporation was an eligible corporation.

(B) *Limitation*. The term "qualified stock" shall not include any stock if the employee may sell such stock to, or otherwise receive cash in lieu of stock from, the corporation at the time that the rights of the employee in such stock first become transferable or not subject to a substantial risk of forfeiture.

[3608] See Eustice, Kuntz & Bogdanski, *Federal Income Taxation of S Corporations* (WG&L), particularly ¶¶ 3.03[21][c] Deferral Election, 11.03[2] Stock Options.

(C) *Eligible corporation*. For purposes of subparagraph (A)(ii)(II)—

(i) *In general*. The term "eligible corporation" means, with respect to any calendar year, any corporation if—

(I) no stock of such corporation (or any predecessor of such corporation) is readily tradable on an established securities market (as determined under paragraph (1)(B)(iii)) during any preceding calendar year, and

(II) such corporation has a written plan under which, in such calendar year, not less than 80 percent of all employees who provide services to such corporation in the United States (or any possession of the United States) are granted stock options, or are granted restricted stock units, with the same rights and privileges to receive qualified stock.

(ii) *Same rights and privileges*. For purposes of clause (i)(II)—

(I) except as provided in subclauses (II) and (III), the determination of rights and privileges with respect to stock shall be made in a similar manner as under section 423(b)(5),

(II) employees shall not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount, so long as the number of shares available to each employee is more than a de minimis amount, and

(III) rights and privileges with respect to the exercise of an option shall not be treated as the same as rights and privileges with respect to the settlement of a restricted stock unit.

(iii) *Employee*. For purposes of clause (i)(II), the term "employee" shall not include any employee described in section 4980E(d)(4) or any excluded employee.

(iv) *Special rule for calendar years before 2018*. In the case of any calendar year beginning before January 1, 2018, clause (i)(II) shall be applied without regard to whether the rights and privileges with respect to the qualified stock are the same.

"Restricted stock unit" is explained below.[3609]

Notice 2018-97, part III.A, "Application of the 80% Requirement," provides:

> As described above, section 83(i)(2)(C) defines an "eligible corporation," in relevant part, as, with respect to any calendar year, any corporation that has a written plan under which, in such calendar year, not less than 80% of all employees who provide services to the corporation in the United States (or any possession of the United States) are granted stock options, or are granted RSUs, with the same rights and privileges to receive qualified stock. Stakeholders have asked whether the 80% requirement of section 83(i)(2)(C)(i)(II) with respect to a calendar year is applied on a cumulative basis that takes into account stock options or RSUs granted in prior calendar years.

[3609] See text accompanying fn 3611.

The determination of whether a corporation qualifies as an eligible corporation is made "with respect to any calendar year." Furthermore, to meet the 80% requirement, the corporation must have granted "in such calendar year" stock options to 80% of its employees or RSUs to 80% of its employees. Therefore, the determination that the corporation is an eligible corporation must be made on a calendar year basis, and whether the corporation has satisfied the 80% requirement is based solely on the stock options or the RSUs granted in that calendar year to employees who provide services to the corporation in the United States (or any possession of the United States). In calculating whether the 80% requirement is satisfied, the corporation must take into account the total number of individuals employed at any time during the year in question as well as the total number of employees receiving grants during the year (in each case, without regard to excluded employees or part-time employees described in section 4980E(d)(4)), regardless of whether the employees were employed by the corporation at the beginning of the calendar year or the end of the calendar year.

The Treasury Department and the IRS have determined that interpreting the 80% requirement of section 83(i)(2)(C)(i)(II) with respect to a calendar year on a cumulative basis that takes into account stock options or RSUs granted in prior calendar years is contrary to the language of the statute and is not a reasonable good faith interpretation of the 80% requirement. Accordingly, the transition rule in section 13603(g) of the Act does not apply to such an interpretation.

Code § 83(i)(3) provides:

Qualified employee; excluded employee. For purposes of this subsection—

(A) *In general*. The term "qualified employee" means any individual who—

(i) is not an excluded employee, and

(ii) agrees in the election made under this subsection to meet such requirements as are determined by the Secretary to be necessary to ensure that the withholding requirements of the corporation under chapter 24 with respect to the qualified stock are met.

(B) *Excluded employee*. The term "excluded employee" means, with respect to any corporation, any individual—

(i) who is a 1-percent owner (within the meaning of section 416(i)(1)(B)(ii))[3610] at any time during the calendar year or who was such a 1 percent owner at any time during the 10 preceding calendar years,

(ii) who is or has been at any prior time—

(I) the chief executive officer of such corporation or an individual acting in such a capacity, or

(II) the chief financial officer of such corporation or an individual acting in such a capacity,

[3610] [footnote not in statute]: Code § 416(i)(1)(B)(ii), "1-Percent Owner," provides:

For purposes of this paragraph, the term "1-percent owner" means any person who would be described in clause (i) if "1 percent" were substituted for "5 percent" each place it appears in clause (i).

Code § 416(i)(1)(B)(i) is reproduced in fn 3097 in part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception.

(iii) who bears a relationship described in section 318(a)(1) to any individual described in subclause (I) or (II) of clause (ii), or

(iv) who is one of the 4 highest compensated officers of such corporation for the taxable year, or was one of the 4 highest compensated officers of such corporation for any of the 10 preceding taxable years, determined with respect to each such taxable year on the basis of the shareholder disclosure rules for compensation under the Securities Exchange Act of 1934 (as if such rules applied to such corporation).

For Code § 318(a), see part II.Q.7.a.viii Code § 318 Family Attribution under Subchapter C.

The Conference Agreement to P.L. 115-97 (12/22/2017) provides:

> It is intended that the requirement that 80 percent of all applicable employees be granted stock options or be granted restricted stock units apply consistently to eligible employees, whether they are new hires or existing employees.

Notice 2018-97, part III.B, "Employment Taxes (including Income Tax Withholding)," explains in subpart 2, "Escrow Arrangement,":

> Section 83(i)(3)(A)(ii) provides the Secretary with authority to impose any requirements as the Secretary determines to be necessary to ensure that the withholding requirements of the corporation under chapter 24 with respect to the qualified stock are met. In order to be a qualified employee, an employee making an election under section 83(i) must agree in the election to these requirements.
>
> Pursuant to the authority provided to the Secretary under section 83(i)(3)(A)(ii), in order to be a qualified employee an employee making a section 83(i) election with respect to qualified stock must agree in the election that all deferral stock will be held in an escrow arrangement, the terms of which are consistent with the following requirements:
>
> (i) The deferral stock must be deposited into escrow before the end of the calendar year during which the section 83(i) election is made and must remain in escrow until removed in accordance with clause (ii) or the corporation has otherwise recovered from the employee an amount equal to the corresponding income tax withholding obligation under section 3401(i) for the taxable year determined in accordance with section 83(i)(1)(B).
>
> (ii) At any time between the date of income inclusion under section 83(i)(1)(B) and March 31 of the following calendar year, the corporation may remove from escrow and retain the number of shares of deferral stock with a fair market value equal to the income tax withholding obligation that has not been recovered from the employee by other means. The fair market value of the shares must be determined pursuant to the rules in § 1.409A-1(b)(5)(iv). The fair market value used for purposes of this calculation is the fair market value of the shares at the time the corporation retains shares held in escrow to satisfy the income tax withholding obligation.
>
> (iii) Any remaining shares held in escrow after the corporation's income tax withholding obligation has been met, whether by retention of shares in accordance with clause (ii) or otherwise, must be delivered to the employee as soon as reasonably practicable thereafter.

The Treasury Department and the IRS have concluded that the escrow arrangement described above adequately ensures the statutory income tax withholding requirements of the corporation will be met and that this approach is less burdensome than alternatives that would require a cash outlay by the corporation or the employee before the due date for the relevant withholding, and thus allow less flexibility with respect to resource allocation. If the corporation and the employee do not agree to deposit the deferral stock into an escrow arrangement consistent with the terms outlined above, the employee is not a "qualified employee" within the meaning of section 83(i)(3). The Treasury Department and the IRS are aware that this has the effect of allowing a corporation to preclude its employees from making section 83(i) elections by declining to establish an escrow arrangement consistent with the terms outlined above.

Future guidance on section 83(i)(3)(A)(ii) may establish alternative or substitute mechanisms to ensure a corporation's income tax withholding requirements are satisfied. Such mechanisms may be more restrictive than the above described escrow arrangement.

Code § 83(i)(4), "Election," provides:

(A) *Time for making election*. An election with respect to qualified stock shall be made under this subsection no later than 30 days after the first date the rights of the employee in such stock are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, and shall be made in a manner similar to the manner in which an election is made under subsection (b).

(B) *Limitations*. No election may be made under this section with respect to any qualified stock if—

(i) the qualified employee has made an election under subsection (b) with respect to such qualified stock,

(ii) any stock of the corporation which issued the qualified stock is readily tradable on an established securities market (as determined under paragraph (1)(B)(iii)) at any time before the election is made, or

(iii) such corporation purchased any of its outstanding stock in the calendar year preceding the calendar year which includes the first date the rights of the employee in such stock are transferable or are not subject to a substantial risk of forfeiture, unless—

(I) not less than 25 percent of the total dollar amount of the stock so purchased is deferral stock, and

(II) the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis.

(C) *Definitions and special rules related to limitation on stock redemptions*.

(i) *Deferral stock*. For purposes of this paragraph, the term "deferral stock" means stock with respect to which an election is in effect under this subsection.

(ii) *Deferral stock with respect to any individual not taken into account if individual holds deferral stock with longer deferral period*. Stock purchased by a corporation from any individual shall not be treated as deferral stock for purposes of subparagraph (B)(iii) if such individual (immediately after such purchase) holds any deferral stock with respect to which an election has been in effect under this subsection for a longer period than the election with respect to the stock so purchased.

(iii) *Purchase of all outstanding deferral stock*. The requirements of subclauses (I) and (II) of subparagraph (B)(iii) shall be treated as met if the stock so purchased includes all of the corporation's outstanding deferral stock.

(iv) *Reporting*. Any corporation which has outstanding deferral stock as of the beginning of any calendar year and which purchases any of its outstanding stock during such calendar year shall include on its return of tax for the taxable year in which, or with which, such calendar year ends the total dollar amount of its outstanding stock so purchased during such calendar year and such other information as the Secretary requires for purposes of administering this paragraph.

Code § 83(i)(5), "Controlled groups," provides:

For purposes of this subsection, all persons treated as a single employer under section 414(b) shall be treated as 1 corporation.

Code § 83(i)(6) provides:

Notice requirement. Any corporation which transfers qualified stock to a qualified employee shall, at the time that (or a reasonable period before) an amount attributable to such stock would (but for this subsection) first be includible in the gross income of such employee—

(A) certify to such employee that such stock is qualified stock, and

(B) notify such employee—

(i) that the employee may be eligible to elect to defer income on such stock under this subsection, and

(ii) that, if the employee makes such an election—

(I) the amount of income recognized at the end of the deferral period will be based on the value of the stock at the time at which the rights of the employee in such stock first become transferable or not subject to substantial risk of forfeiture, notwithstanding whether the value of the stock has declined during the deferral period,

(II) the amount of such income recognized at the end of the deferral period will be subject to withholding under section 3401(i) at the rate determined under section 3402(t), and

(III) the responsibilities of the employee (as determined by the Secretary under paragraph (3)(A)(ii)) with respect to such withholding.

Notice 2018-97, part III.C, "Designation of Stock as Not Eligible for Section 83(i) Election," provides:

As described above, section 83(i) imposes a number of requirements and limitations that must be met for a section 83(i) election to be allowed. Although the election, if allowed, may be made by an employee, the corporation is responsible for creating the conditions that would allow an

> employee to make the election. Stakeholders have indicated that a corporation may wish to compensate its employees with equity-based compensation for which no section 83(i) election may be made. As noted above, a corporation can preclude its employees from making section 83(i) elections by declining to establish an escrow arrangement as described in Section III.B.2 of this notice. As a result, a corporation need not be concerned that it would inadvertently create the requisite conditions for its employees to make section 83(i) elections or be required to comply with the notice requirement of section 83(i)(6). If a corporation does not intend to deposit qualified stock into an escrow arrangement (as described in Section III.B.2 of this notice) or otherwise create the conditions that would allow an employee to make the section 83(i) election, the terms of a stock option or RSU may provide that no election under section 83(i) will be available with respect to stock received upon the exercise of the stock option or settlement of the RSU. This designation would inform employees that no section 83(i) election may be made with respect to stock received upon exercise of the option or settlement of the RSU even if the stock is qualified stock.

Code § 83(i)(7), "Restricted stock units," provides:

> This section (other than this subsection), including any election under subsection (b), shall not apply to restricted stock units.

The Conference Agreement to P.L. 115-97 (12/22/2017) describes restricted stock units:[3611]

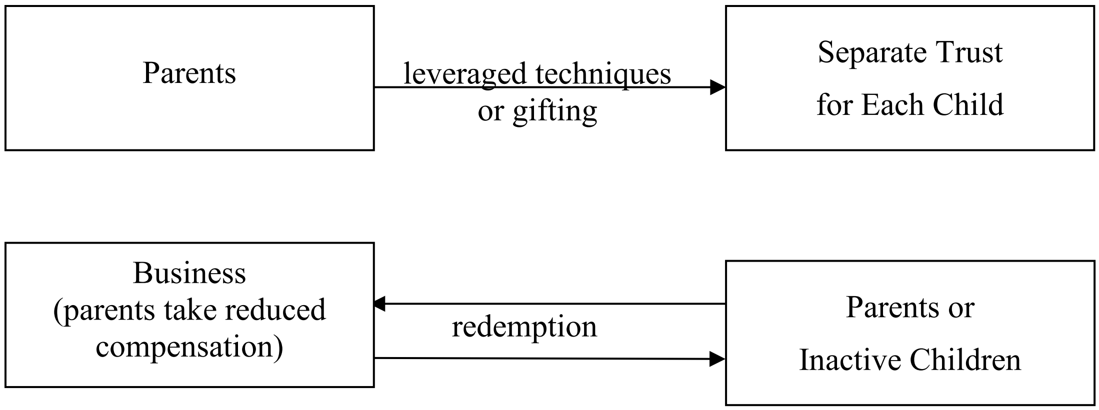
> A restricted stock unit ("RSU") is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee's right to receive the future amount may be subject to a condition, such as continued employment for a certain period or the attainment of certain performance goals. The payment to the employee of the amount due under the arrangement is referred to as settlement of the RSU . The arrangement may provide for the settlement amount to be paid in cash or as a transfer of employer stock (or either). An arrangement providing RSUs is generally considered a nonqualified deferred compensation plan and is subject to the rules, including the limits, of section 409A.

The Conference Agreement explains why Code § 83(i) does not apply to RSUs:

> The provision does not apply to income with respect to nonvested stock that is includible as a result of a section 83(b) election. The provision clarifies that Section 83 (other than the provision), including subsection (b), shall not apply to RSUs. Therefore, RSUs are not eligible for a section 83(b) election. This is the case because, absent this provision, RSUs are nonqualified deferred compensation and therefore subject to the rules that apply to nonqualified deferred compensation.

[3611] "Restricted stock unit" is also important to understand for Code § 83(i)(2), defining "Qualified stock." See text preceding fn 3609.

II.M.4.e.iii. Succession Planning Using Redemptions When Parent is Living



Leveraged Techniques of Gifting

The first chart represents the concept that leveraged techniques, such as GRATs and sales to irrevocable grantor trusts, result in all of the next generation having an equal interest in the business. See part III.B.1, Transfers During Life.

This might be through one trust that later splits through the trustee's power to divide or a family agreement or through separate trusts created from inception.

Reducing or Eliminating Parents or Inactive Owners

Inactive owners generally wish to maximize their return through distributions and by keeping compensation down.

Active owners typically wish to reinvest earnings to grow the business and wish to have incentive compensation.

The business entity might redeem the inactive owners to minimize future conflict.

If the older generation is still working in the business, then the older generation might agree to take less compensation. This might have income tax consequences to partnerships[3612] or S corporations,[3613] but it would not have gift tax consequences.

If the entity is an S corporation, then a partial redemption that the tax law treats as a distribution rather than a redemption might actually be favorable if it can be made out of AAA. See part II.Q.7.b Redemptions or Distributions Involving S Corporations.

The corporation might use a promissory note to redeem a parent's interest in a corporation.[3614]

[3612] Code § 704(e).

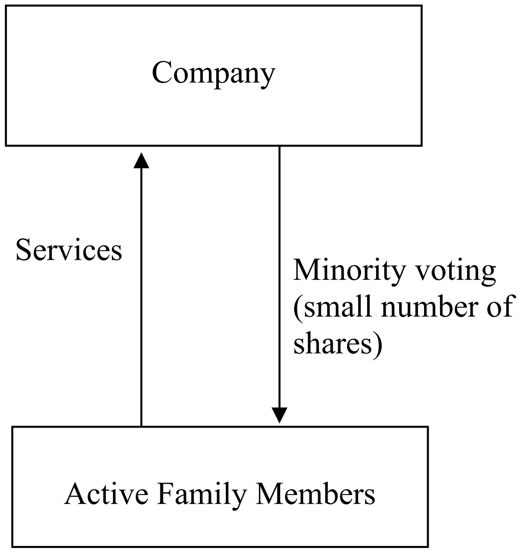
[3613] Code § 1366(e).

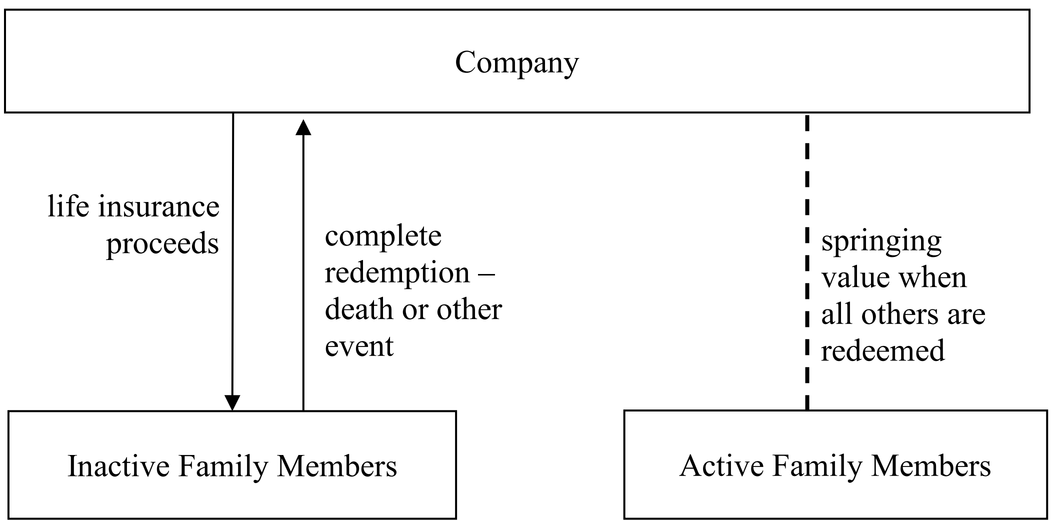
[3614] Letter Ruling 9408018, which held:

> The execution, as described above, of Notes A and B by Company with a stated annual interest rate that is the greater of either (i) 120 percent of the applicable federal mid-term rate on the date the redemption agreement is executed or (ii) the rate that is sufficient to provide the promissory note with "adequate stated interest" within the meaning of

II.M.4.e.iv. Succession Planning Using Redemptions Funded by Life Insurance

Consider the following business succession strategy:





From a tax perspective, this structure can help solve the problem of inactive owners want to maintain their equity position, but key employees need entrepreneurial incentive to run and grow the business.

section 1274(c)(2) of the Code, will not result in a gift subject to gift tax. The interest rate that will be stated in the notes will be at least equal to the applicable federal long-term rate under section 1274(d)(1)(A) for the month during which the notes are executed. Therefore, for federal gift tax purposes, the fair market value of Note A and Note B will be the principal amount stated in each note. This ruling (number (11)) is conditioned on both of the following assumptions being met (i) there is no indication that the notes will not be paid according to their terms and (ii) the corporation's ability to pay the notes is not otherwise in doubt.

See also fn 6852 in part III.B.5.b Promissory Notes.

Below are some issues:

1. If a C corporation, make an S election. This will enable the profits to be distributed to the inactive owners using only one level of tax.

2. Grant incentive compensation to key employees based on formula.

3. Recapitalize into voting and nonvoting, for example, by issuing 19 shares of nonvoting for every share of voting stock; a similar idea would apply to an LLC or other entity taxed as a partnership.

4. Issue voting stock to key employees as compensation for services so that:

    - Key employees and inactive owners have an appropriate balance of voting power.

    - Key employees receive compensation increases or bonuses only if part of the agreements made when restructuring or if approved by inactive owners. Similarly, key employee compensation decreases only if part of the agreements made when restructuring or if approved by key employees.

    - Distributions are made according to a set formula and can be increased only if approved by key employees. Similarly, distributions decrease only if part of the agreements made when restructuring or if approved by inactive owners.

5. Life insurance funds a buy-sell agreement.

    - When all of the inactive owners' interests are redeemed, the only ownership remaining is held by the key employees. Thus, their small ownership suddenly blossoms into sole ownership.

    - If a cross-purchase (each owner holds insurance on the lives of the other owners and uses the proceeds to buy stock at death) is used rather than a redemption, then the key employees' ownership might increase more quickly, depending on how the cross-purchase is structured.

    - A cross-purchase is generally better from a tax perspective.

        - It is less risky from an estate tax perspective. Redemption agreements typically exclude the life insurance from the calculated purchase price. The IRS might be able to persuade a court to disregard that exclusion and count the life insurance as part of the business' value for estate tax purposes. See II.Q.4.h Establishing Estate Tax Values.

        - C corporations might be subjected to alternative minimum tax on the death benefit.

        - If a redemption is used, S corporations and partnerships might experience income tax basis distortions,[3615] and S corporations that have significant accumulated E&P from when they were C corporations would lose AAA.[3616]

[3615] See part II.Q.7.b.iii S Corporation Receipt of Life Insurance Proceeds, which discusses the impact on S corporations, but the same principles would seem to apply to partnerships.
[3616] Part II.Q.7.b.iv S Corporation Distributions of, or Redemptions Using, Life Insurance Proceeds. Although life insurance adds to each shareholder's stock basis, it adds to the other adjustments account rather than to AAA.

- However, if one owner leaves the business and a policy (or interest in a policy) is transferred to another owner, beware of the transfer-for-value rules, which might subject the death benefit to income tax.[3617]

- Cross-purchases and redemptions entail various nontax risks. Neither is perfect. Probably the safest method, which is a little complicated, is the life insurance LLC:

  - The owners of the main company are also members of the LLC. Each owner is specially allocated the responsibility for paying premiums on the other owners and the benefit of the associated life insurance death benefit.

  - A corporate trustee (or other independent deep pocket) serves as the manager and may be removed only by consent of all the members.

  - The manager's only job is to hold policies, collect premiums, and hold proceeds until all parties agree on implementation of the buy-sell agreement.

  - This avoids various business and tax risks, including the transfer for value rule that might apply when owners come and go.[3618]

  - For details, see part II.Q.4.i Life Insurance LLC.

If one expects to sell a business interest for all cash in a few years and would like to defer capital gain on the sale of a business interest, consider selling the business interest in an installment sale to a nongrantor trust. The note might be interest-only for a few years, with principal payments beginning some time after the business interest is expected to be sold. The trust receives basis for the full amount of the promissory and can sell the business interest tax-free to the extent of that basis.

Similar principles apply to the sale of land or other property that is not depreciable or amortizable.

Potential pitfalls include the following:

- If the trust is a related person (which usually is the case) and it re-sells the business interest within two years, the original seller's deferred gain is accelerated.

- The original seller's death will not generate a basis step-up in the note. If the original seller had simply held the business interest until death, part or all of the gain would be eliminated by basis step-up. Consider buying term insurance against the risk of loss of the financial benefit of the basis step-up.

- Be sensitive to possible acceleration of the deferred gain if the original seller later transfers the installment note, including by gift (or transfer to or from a nongrantor trust), or pledges the note.

- Beware of the possible need to pay interest on the deferred tax liability if the sale exceeds $5 million.[3619]

[3617] Code § 101(a)(2).
[3618] See part II.Q.4.b Transfer for Value Rule; Basis.
[3619] Code § 453A(b)(2).

- The part of the gain on the sale of a partnership interest attributable to "hot assets" is not eligible for installment sale treatment.

- The direct or indirect sale of depreciable or amortizable assets to a related party (the nongrantor trust) might trigger ordinary income tax.

II.M.4.f. Issuing a Profits Interest to a Service Provider

II.M.4.f.i. Overview of Profits Interest; Contrast with Code § 409A

Issuing a profits interest usually makes more sense than issuing stock to the employee, in that a service provider usually is interested more in sharing the fruits of the business' future success than in buying its existing assets. Awarding a profits interest is also less expensive, because it does not require buying any of the business' current value.

Code § 409A does not apply to the issuance of a profits interest.[3620] The profits interest could turn into golden handcuffs that avoid the strict rules on timing that Code § 409A imposes. For example, a partnership distributes enough of the service partner's share of profits to pay the service partner's income taxes. The rest of the service partner's share of profits is accumulated in the service partner's capital account and may be subject to any timing rules the parties choose. Because the service partner has already paid income tax on this accumulated income, this deferral does not offend the principles of Code § 409A,

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[3620] Notice 2005-1, Q&A 7 (third sentence). For a general discussion of the broader topic, see, The Proper Tax Treatment of the Transfer of a Compensatory Partnership Interest and also Finding the Right Balance: A Critical Analysis of the Major Proposals to Reform the Taxation of Carried Interests in Private Equity, both in *Tax Lawyer*, Vol. 62, No. 1 (Fall 2008). This Notice continued to apply under section III.G of the preamble to the final regulations under Code § 409A and still applies under the final regulations pursuant to Section 4 of Notice 2007-86. Reg. § 1.409A-1(b)(7) has the following text: Arrangements between partnerships and partners. [Reserved.] The preamble to the final regulations, T.D. 9321, provides:

> (G.) Arrangements Between Partnerships and Partners
>
> The proposed regulations did not address the application of section 409A to arrangements between partnerships and partners, and these final regulations also do not address such arrangements. The statute and the legislative history of section 409A do not specifically address arrangements between partnerships and partners providing services to a partnership and do not explicitly exclude such arrangements from the application of section 409A. Commentators raised a number of issues, relating both to the scope of the arrangements subject to section 409A and the coordination of the provisions of subchapter K and section 409A with respect to those arrangements that are subject to section 409A. The Treasury Department and the IRS are continuing to analyze the issues raised in this area. Notice 2005-1, Q&A-7 provides interim guidance regarding the application of section 409A to arrangements between partnerships and partners. Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A-7 and sections II.E. and VI.E. of the preamble to the proposed regulations.
>
> Notice 2005-1, Q&A-7 provided that until further guidance is issued for purposes of section 409A, taxpayers may treat the issuance of a partnership interest (including a profits interest) or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock. For this purpose, taxpayers may apply the principles applicable to stock options or stock appreciation rights under these final regulations, as effective and applicable, to equivalent rights with respect to partnership interests.
>
> Taxpayers also may continue to rely upon the explanation in the preamble to the proposed regulations regarding the application of section 409A to guaranteed payments for services described in section 707(c). As stated in that preamble, until further guidance is issued, section 409A will apply to guaranteed payments described in section 707(c) (and rights to receive such guaranteed payments in the future), only in cases where the guaranteed payment is for services and the partner providing services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the guaranteed payment or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.

which are concerned about the timing of taxation. For more on Code § 409A, see part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

Profits interests have Code § 2701 consequences for family-controlled businesses, so the transferor either prepares to be treated as making a gift of the capital account that would ordinarily be associated with the profits interest or retains preferred payments that help reduce the impact of Code § 2701. For a discussion of how Code § 2701 might apply, see III.B.7.c Code § 2701 Interaction with Income Tax Planning.

Also, receiving a profits interest causes the service provider to be taxed as a partner for all of that person's compensation, because bona fide members of a partnership are not employees for tax purposes.[3621]

II.M.4.f.ii. Tax Effects of Profits Interests

Below we discuss that issuing a profits interest generally does not have a tax consequence.

Then we discuss that certain sales of compensatory partnership interests are recharacterized from long-term to short-term capital gains.

II.M.4.f.ii.(a). Tax Effects of Issuing a Profits Interest

Reg. § 1.721-1(b)(1) provides (highlighting added):

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. To the extent that an interest in capital representing compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under section 691.

Under Rev. Proc. 93-27, if a person receives a profits interest[3622] for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, generally the IRS will

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[3621] See note 538. For self-employment tax on guaranteed payments, see text accompanying notes 3347-3348.

[3622] Under the Rev. Proc., a profits interest is a partnership interest other than a capital interest. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest. For the rules on revaluing partnership assets and adjusting capital accounts when that occurs, see part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts), especially fn. 498.
See *Mark IV Pictures, Inc. v. Commissioner*, T.C. Memo. 1990-571, which held:

> Deciding whether a partner's interest in a partnership is a capital interest, rather than a mere profits interest, turns on whether that partner has the right to receive a share of the partnership's assets upon a hypothetical winding up and

not treat the receipt of such an interest as a taxable event for the partner or the partnership. However, that rule does not apply:

(1) If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;

(2) If within two years of receipt, the partner disposes of the profits interest; or

(3) If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Code § 7704(b).

If Rev. Proc. 93-27 applies, the profits interest is treated as a capital asset when the service provider sells it.

Rev. Proc. 2001-43 applies Rev. Proc. 93-27 to the grant of a partnership profits interest that is substantially nonvested for the provision of services to or for the benefit of the partnership. Under Section 4 of Rev. Proc. 2001-43, the service provider will be treated as receiving the interest on the date of its grant, and a Code § 83(b) election will not be required, if:

.01 The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;

.02 Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and

.03 All other conditions of Rev. Proc. 93-27 are satisfied.

If Rev. Proc. 2001-43 does not apply to the grant of a substantially nonvested partnership profits interest and if case law[3623] does not provide otherwise, then the service provider recognizes ordinary income (and

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> liquidation immediately following acquisition of the interest, rather than the mere right to share in future partnership earnings or profits. Here, a fair reading of paragraphs 2.4 and 9.2 of the Articles indicates that the general partners had the *right to receive* a specified share of the partnerships' liquidation proceeds (assets). Thus, even if no partnership proceeds remained to be distributed to the general partners after distributing the liquidating proceeds in accordance with section 545.42, they nevertheless had the *right to receive* a share of the partnerships' assets.
>
> Based on the foregoing, we conclude that the general partners received a capital interest in their respective limited partnerships. See sec. 1.721-1(b)(1), Income Tax Regs.

A similar result was *Hensel Phelps Construction Co. v. Commissioner*, 74 T.C. 939 (1980), *aff'd* 703 F2d 485 (10th Cir. 1983). Reg. § 1.721-1(b)(1) provides:

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services….

[3623] *Diamond v. Commissioner*, 56 T.C. 530 (1971 reviewed decision) (taxing service partner on issuance of profits interest), *aff'd* 492 F.2d 286 (7th Cir. 1974); *Campbell v. Commissioner*, T.C. Memo. 1990-162 (finding taxation on issuance), *rev'd* the partnership is deemed to have paid compensation) when the profits interest vests. The holding period for a later sale of the profits interest would be based on the date of vesting, rather than the date of grant.

The IRS has proposed regulations[3624] that would change these rules for profits interests, effective only when the regulations are finalized. Under the proposed regulations, a service provider would be required to recognize income upon receipt of a vested profits interest. A Code § 83(b) election would be required to treat a substantially nonvested profits interest as if it were vested. At any rate, determining the value of the profits interest generally would require an appraisal and complicate future accounting on many levels. IRS Notice 2005-43 proposes a Rev. Proc. to allow taxpayers to elect to determine the value based on the awarded partnership interest's liquidation value determined immediately after the grant of the partnership interest. If the partnership interest is merely a profits interest, the liquidation value would be zero. The proposed Rev. Proc. would supersede Rev. Proc. 93-27 and Rev. Proc. 2001-43; however, until the proposed Rev. Proc. is finalized, taxpayers may continue to rely on Rev. Proc. 93-27 and Rev. Proc. 2001-43.

Furthermore, the preamble to subsequent proposed regulations[3625] announced:

> The Treasury Department and the IRS are aware of transactions in which one party provides services and another party receives a seemingly associated allocation and distribution of partnership income or gain. For example, a management company that provides services to a fund in exchange for a fee may waive that fee, while a party related to the management company receives an interest in future partnership profits the value of which approximates the amount of the waived fee. The Treasury Department and the IRS have determined that Rev. Proc. 93-27 does not apply to such transactions because they would not satisfy the requirement that receipt of an interest in partnership profits be for the provision of services to or for the benefit of the partnership in a partner capacity or in anticipation of being a partner, and because the service provider would

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943 F.2d 815 (8th Cir. 1991) (finding no taxation on issuance); *St. John v. U.S.*, 53 A.F.T.R.2d 84-718 (C.D. Ill. 1983) (no taxation because partnership's success was undetermined and speculative); *Kenroy, Inc. v. Commissioner,* T.C. Memo. 1984-232 (no taxation because partnership's liabilities exceeded assets); *United States v. Frazell*, 339 F.2d 885 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965) (taxation on capital shift even though original partners held a preferred profits interest). The Eighth Circuit in *Campbell* cited an earlier version (that has since been updated) of McKee, Nelson & Whitmire, ¶5.02 Distinguishing Taxable From Nontaxable Service-Connected Transfers of Partnership Interests: Is There a Difference Between Capital and Profits Interests? *Federal Taxation of Partnerships & Partners* (WG&L), and of Willis & Postlewaite, ¶4.06 Partnership Profits Interest Received in Exchange for Services, *Partnership Taxation*.

[3624] REG-105346-03, proposing changes to Reg. §§1.83-3, 1.83-6, 1.704-1, 1.706-3, 1.707-1, 1.721-1, and 1.761-1. Over the past several years, various proposals to tax hedge fund managers on the sale of their profits interests have had a chilling effect on the progress of these proposed regulations, particularly since the safeguards needed to make those proposals effective would cause radical changes in this area of tax law, well beyond the scope of taxing hedge fund managers.

[3625] REG-115452-14 (7/22/2015), which continued:

> Further, the Treasury Department and the IRS plan to issue a revenue procedure providing an additional exception to the safe harbor in Rev. Proc. 93-27 in conjunction with the publication of these regulations in final form. The additional exception will apply to a profits interest issued in conjunction with a partner forgoing payment of an amount that is substantially fixed (including a substantially fixed amount determined by formula, such as a fee based on a percentage of partner capital commitments) for the performance of services, including a guaranteed payment under section 707(c) or a payment in a non-partner capacity under section 707(a).
>
> In conjunction with the issuance of proposed regulations (REG-105346-03; 70 FR 29675-01; 2005-1 C.B. 1244) relating to the tax treatment of certain transfers of partnership equity in connection with the performance of services, the Treasury Department and the IRS issued Notice 2005-43, 2005-24 I.R.B. 1221. Notice 2005-43 includes a proposed revenue procedure regarding partnership interests transferred in connection with the performance of services. In the event that the proposed revenue procedure provided for in Notice 2005-43 is finalized, it will include the additional exception referenced.

effectively have disposed of the partnership interest (through a constructive transfer to the related party) within two years of receipt.

Returning to the law when this portion was written, should one file a Code § 83(b) election, to preserve future capital gain treatment on the profits interest holder's future sale of the profits interest due to any noncompliance with the Revenue Procedures, either by the structure or by subsequent events within two years after the grant? If the profits interest's issuance is determined to be like the issuance a capital interest (for example, if it is determined that the book-up[3626] on issuance of the profits interest undervalued the partnership's assets), then filing a Code § 83(b) election would trigger income on issuance. Consider, however, that the tax economics if capital gain treatment were disallowed are not necessarily so bad, if certain tax indemnification agreements are in place:

Example

Suppose the basis at the time of the subsequent sale is zero (all profits have been paid out), the fair market value is $100x, the federal and state capital rate is 20%, and the federal and state income tax rate is 40%.

If the profits interest is given capital gain treatment, the holder of the profits interest pays $20x tax on the sale.

If the profits interest is deemed not to have been property until the sale (due to lack of vesting, etc.), then the following should occur:

- The holder receives $100x from the sale, which is deemed compensation income.
- The partners pay $67x withholding to the federal and state taxing authorities, covering the tax on the $100x and the $67x (40% of $167x is $67x). This is also deemed income to the holder of the profits interest.
- The partners deduct $167x compensation, saving $67x of tax, assuming they have basis for this deduction.
- The $67x tax savings to the partners pays for $67x withholding they paid.
- Except as described below, nobody pays anything out-of-pocket on the holder's receipt of the $100x sale proceeds.
- The partners pay capital gain tax on the sale proceeds they are deemed to have received.
- An appropriate adjustment needs to be made to the allocations set forth above so that the holder reimburses the partners for their capital gain tax paid on the sale, which capital gain tax the parties had originally assumed the holder would have paid.

[3626] See footnote 3537.

Articles explain some of the nuances and practical implications of profits interests[3627] and some prominent authors' reconsideration of their position that a taxable issuance of a profits interest might not be a big deal.[3628]

II.M.4.f.ii.(b). Code § 1061 - Certain Sales of Compensatory Partnership Interests Recharacterized from Long-Term to Short-Term Gains

Effective for taxable years beginning after December 31, 2017, special rules apply when a taxpayer transfers certain compensatory partnership interests, with surprising results when transferring to a related party.

Subject to exceptions, Code § 1061 targets an "applicable partnership interest," which is:[3629]

> any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business.

The House report, which was accepted by the Conference Committee, elaborated:

> It is intended that partnership interests shall not fail to be treated as transferred or held in connection with the performance of services merely because the taxpayer also made contributions to the partnership, and the Treasury Department is directed to provide guidance implementing this intent.

However, an "applicable partnership interest," does not include "an interest held by a person who is employed by another entity that is conducting a trade or business (other than an applicable trade or business) and only provides services to such other entity."[3630]

Before getting into which businesses are being targeted, let's focus on the type of equity interest being targeted. Code § 1061(c)(4) provides:

> *Exceptions*. The term "applicable partnership interest" shall not include-
>
> (A) any interest in a partnership directly or indirectly held by a corporation, or
>
> (B) any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with-
>
> (i) the amount of capital contributed (determined at the time of receipt of such partnership interest), or
>
> (ii) the value of such interest subject to tax under section 83 upon the receipt or vesting of such interest.

3627 Schippel, Should My CEO Be My Partner? A Practical Approach to Dealing with LLC and Partnership Equity Compensation, *TM Memorandum*, Vol. 53, No. 5 (2/27/2012).
3628 Banoff & Lipton's Shop Talk column, "So You Received a Taxable Profits Interest-Maybe You *Should* Care!" *Journal of Taxation* (2/2016), reconsidering their 11/2015 column.
3629 Code § 1061(c)(1).
3630 Code § 1061(c)(1).

Thus, if a corporation provides services and receives a partnership interest of any kind, Code § 1061 does not apply. The House report, which was accepted by the Conference Committee, elaborated:

> For example, if two corporations form a partnership to conduct a joint venture for developing and marketing a pharmaceutical product, the partnership interests held by the two corporations are not applicable partnership interests.

However, Notice 2018-18 announced that regulations would provide retroactively that this exception applies to C corporations, not S corporations, which rule is now in Reg. §§ 1.1061-3(b)(2) and 1.1061-3(f)(2).

The other exception above is the right to share in partnership capital commensurate with the partner's capital contribution or the actually taxed value of services provided.[3631] The House report, which was accepted by the Conference Committee, elaborated:

> An applicable partnership interest does not include any capital interest in a partnership giving the taxpayer a right to share in partnership capital commensurate with the amount of capital contributed (as of the time the partnership interest was received), or commensurate with the value of the partnership interest that is taxed under section 83 on receipt or vesting of the partnership interest. For example, in the case of a partner who holds a capital interest in the partnership with respect to capital he or she contributed to the partnership, if the partnership agreement provides that the partner's share of partnership capital is commensurate with the amount of capital he or she contributed (as of the time the partnership interest was received) compared to total partnership capital, the partnership interest is not an applicable partnership interest to that extent.

Thus the provision is directly targeting nontaxable issuances of profits interests described in part II.M.4.f.ii.(a) Tax Effects of Issuing a Profits Interest. Consider, however, what happens if the partnership is not a straight pro-rata deal. What if the partnership involves preferred returns? How about multiple tiers of preferred returns – commonly referred to as waterfalls? What does it mean for the right to share in partnership capital to be commensurate with the partner's capital contribution?

Now, on to the targeted businesses:

Code § 1061(c)(1) provides:

> *Applicable trade or business*. The term "applicable trade or business" means any activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of-
>
> (A) raising or returning capital, and
>
> (B) either-
>
> > (i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or
> >
> > (ii) developing specified assets.

[3631] Code § 1061(c)(4)(B).

"Specified asset" means securities,[3632] commodities,[3633] real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.[3634] The House report, which was accepted by the Conference Committee, elaborated:

> Developing specified assets takes place, for example, if it is represented to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider or of others acting in concert with or at the direction of a service provider. Services performed as an employee of an applicable trade or business are treated as performed in an applicable trade or business for purposes of this rule. Merely voting shares owned does not amount to development; for example, a mutual fund that merely votes proxies received with respect to shares of stock it holds is not engaged in development.
>
> *Specified assets*
>
> Under the provision, specified assets means securities (generally as defined under rules for mark-to-market accounting for securities dealers), commodities (as defined under rules for mark-to-market accounting for commodities dealers), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified. A commodity for this purpose means any (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity or notional principal contract, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified. For purposes of the provision, real estate held for rental or investment does not include, for example, real estate on which the holder operates an active farm.
>
> A partnership interest, for purposes of determining the proportionate interest of a partnership in any specified asset, includes any partnership interest that is not otherwise treated as a security for purposes of the provision (for example, an interest in a partnership that is not widely held or publicly traded). For example, assume that a hedge fund acquires an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held; the partnership interest is a specified asset for purposes of the provision.

[3632] As defined in Code § 475(c)(2) without regard to its last sentence. Reg. § 1.1061-1(a) includes "interests in partnerships qualifying as securities (as defined in section 475(c)(2) without regard to the last sentence thereof)."

[3633] As defined in Code § 475(e)(2).

[3634] Code § 1061(c)(3). Reg. § 1.1061-1(a) includes in the definition of "Specified Assets" looking through partnerships to the extent described in Reg. § 1.1061-2(b)(1)(iii) and also includes "options or derivative contracts with respect to any of" the items described above as "Specified Assets."

Suppose we have a compensatory partnership interest, that shares in capital disproportionately to the contribution, and a targeted business, all as described above, so that the taxpayer has an "applicable partnership interest." What are the consequences?

Code § 1061(a) treats as a short-term capital gain the excess, if any, of the taxpayer's (A) net long-term capital gain with respect to applicable partnership interests for a taxable year, over (B) the taxpayer's net long-term capital gain with respect to such interests for such taxable year computed by using a more-than-three-year holding period in determining whether a gain or loss is long-term.[3635] Thus, if the taxpayer's applicable partnership interests held for more than one year but not more than three years are sold at a net loss, Code § 1061(a) does not recharacterize the character of the loss. Here's how Code § 83 interacts with the holding period rule, according to the Conference Committee report:

> The conferees wish to clarify the interaction of section 83 with the provision's three-year holding requirement, which applies notwithstanding the rules of section 83 or any election in effect under section 83(b). Under the provision, the fact that an individual may have included an amount in income upon acquisition of the applicable partnership interest, or that an individual may have made a section 83(b) election with respect to an applicable partnership interest, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest.

Explaining the exception to this rule in Code §§ 1061(b)[3636] and (c)(5),[3637] the House report, which was followed by the Conference Committee on this issue, said:

> A special rule provides that, as provided in regulations or other guidance issued by the Secretary, this rule does not apply to income or gain attributable to any asset that is not held for portfolio investment on behalf of third party investors. Third party investor means a person (1) who holds an interest in the partnership that is not property held in connection with an applicable trade or business (defined below) with respect to that person, and (2) who is not and has not been actively engaged in directly or indirectly providing substantial services for the partnership or any applicable trade or business (and is (or was) not related to a person so engaged). A related person for this

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[3635] Code § 1061(a) provides:

> *In general*. If one or more applicable partnership interests are held by a taxpayer at any time during the taxable year, the excess (if any) of-
>
> (1) the taxpayer's net long-term capital gain with respect to such interests for such taxable year, over
>
> (2) the taxpayer's net long-term capital gain with respect to such interests for such taxable year computed by applying paragraphs (3) and (4) of sections 1222 by substituting "3 years" for "1 year",
>
> shall be treated as short-term capital gain, notwithstanding section 83 or any election in effect under section 83(b).

The Conference Committee report concludes:

> Thus, the provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount of such gain calculated as if a three-year (not one-year) holding period applies. In making this calculation, the provision takes account of long-term capital losses calculated as if a three-year holding period applies.

[3636] Which provides:

> *Special rule*. To the extent provided by the Secretary, subsection (a) shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.

[3637] Which provides:

> *Third party investor*. The term "third party investor" means a person who-
>
> (A) holds an interest in the partnership which does not constitute property held in connection with an applicable trade or business; and
>
> (B) is not (and has not been) actively engaged, and is (and was) not related to a person so engaged, in (directly or indirectly) providing substantial services described in paragraph (1) for such partnership or any applicable trade or business.

> purpose is a family member (within the meaning of attribution rules[833]) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.
> [833] Sec. 318(a)(1).

In addition to related party transfers not qualifying for this exception, they also do not qualify for the netting of gains and losses that Code § 1061(a) allows regarding the sale of applicable partnership interests held for more than one year but not more than three years. The House Report explains Code § 1061(d):[3638]

> *Transfer of applicable partnership interest to related person*
>
> If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, then the taxpayer includes in gross income as short-term capital gain so much of the taxpayer's net long-term capital gain attributable to the sale or exchange of an asset held for not more than three years as is allocable to the interest. The amount included as short-term capital gain on the transfer is reduced by the amount treated as short-term capital gain on the transfer for the taxable year under the general rule of the provision (that is, amounts are not double-counted). A related person for this purpose is a family member (within the meaning of attribution rules[834]) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.
> [834] Sec. 318(a)(1).

For Code § 318(a)(1), see part II.Q.7.a.viii Code § 318 Family Attribution under Subchapter C.

The government must require appropriate reporting[3639] and issue regulations or other guidance as is necessary or appropriate to carry out the purposes of Code § 1061.[3640]

T.D. 9945 (1/13/2021) provides final regulations explaining Code § 1061. Schreiber, "Carried interests regulations are finalized," *The Tax Adviser* (1/8/2021), explains:

> Because the application of the Sec. 1061 carried interest rules requires a clear determination of the holding period of a partnership interest that is, in whole or in part, an [applicable partnership interest], the final regulations also provide clarifying amendments to Regs. Sec. 1.1223-3, which governs partnership-interest holding periods. The regulations also make clarifying amendments to Regs. Sec. 1.702-1(a)(2), regarding partners' distributive shares of partnership capital gains and losses, and Regs. Sec. 1.704-3(e), providing that a method for aggregating gains and losses by a

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[3638] Code § 1061(d), "Transfer of applicable partnership interest to related person," provides:

(1) *In general*. If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, the taxpayer shall include in gross income (as short term capital gain) the excess (if any) of-
  (A) so much of the taxpayer's long-term capital gains with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to such interest, over
  (B) any amount treated as short term capital gain under subsection (a) with respect to the transfer of such interest.
(2) *Related person*. For purposes of this paragraph, a person is related to the taxpayer if-
  (A) the person is a member of the taxpayer's family within the meaning of section 318(a)(1), or
  (B) the person performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

For Code § 318(a)(1), see part II.Q.7.a.viii Code § 318 Family Attribution under Subchapter C.

[3639] Code § 1061(e).

[3640] Code § 1061(f).

securities partnership will not be considered reasonable unless it takes into account the application of Sec. 1061.

The regulations generally apply to tax years of owner-taxpayers and passthrough entities beginning on or after the date they are published in the Federal Register. (The regulations have been submitted to the Office of the Federal Register, but a publication date has not yet been scheduled.) Regs. Sec. 1.1061-3(b)(2)(i) (regarding an S corporation for which an election under Sec. 1362(a) is in effect) applies to tax years beginning after Dec. 31, 2017.

Regs. Sec. 1.1061-3(b)(2)(ii) (regarding a passive foreign investment company with a qualifying electing fund election in effect) applies to tax years beginning after Aug. 14, 2020.

Owner-taxpayers or passthrough entities may choose to apply the final regulations in their entirety to a tax year beginning after Dec. 31, 2017, if they consistently and entirely apply the final regulations to that year and all later years.

IRS provided additional guidance through News Release IR-2021-215 and https://www.irs.gov/businesses/partnerships/section-1061-reporting-guidance-faqs.

II.M.4.f.iii. What Happens If a Nonvested Partnership Interest Does Not Qualify As a Profits Interest

Crescent Holdings, LLC v. Commissioner[3641] determined the tax consequences of an unvested interest in partnership capital and profits:

- The taxpayer's partnership interest was conditioned upon his future performance of substantial services. In other words, it wasn't vested.

- If the partnership had liquidated immediately after the unvested partnership interest was awarded, the agreement would have allocated liquidation proceeds to the taxpayer. Therefore, the unvested partnership interest was not a pure profits interest and was subject to Code § 83 income taxation.

- The Tax Court held that, under Code § 83, the taxpayer did not own the partnership interest for tax purposes and was taxed on only the cash that was distributed to him. Instead, the unvested, undistributed profits were taxable to those who would have received them if he had terminated employment.

- Furthermore, if the taxpayer were to become vested (no requirement to perform future substantial services), he would be taxable on the fair market value of the partnership interest at the time of vesting.

This case illustrates the big swing that can occur when awarding a partnership interest without making sure it is a pure profits interest. Until this case, most tax lawyers assumed that the only tax consequence to not having a pure profits interest was possible inclusion of the fair market value of the profits interest in the recipient's income. The remaining partners would get a corresponding deduction, and presumably they could use the taxes saved from the deduction to pay the recipient's taxes. Now the stakes are higher: if the recipient has a falling out with the partnership and challenges the income tax treatment, the income

[3641] 141 T.C. 477 (2013). For an exhaustive analysis, see Carman and Banoff, "*Crescent Holdings*: Unvested Capital Partner Avoids Income Allocations, But Many Questions Remain," *Journal of Taxation* (WG&L), Vol. 120, No. 4 (April 2014).

allocated to the recipient might instead be taxed to the other partners; however, the tax distribution was made to the recipient and might not be available to the remaining partners.

In light of this case, consider the following measures:

- When including in the partnership agreement a reference to the parties' intent that the partnership interest be a profits interest described in Rev. Procs. 93-27 and 2001-43, add language along the lines of: "Without limiting the generality of the foregoing, if the [partnership] were to liquidate immediately after granting [the profits interest], holders of [the profits interest]would receive no payment in respect of [the profits interest]."

- Include a savings clause that, if the IRS does find that we didn't have a good profits interest and this reallocation occurs, the recipient shall refund any tax distributions. That would remove a terminated employee's incentive to challenge the K-1 and hopefully provide cash to pay the partners' taxes.

II.M.4.f.iv. Alternative If a Prospective Partner Wants a Capital Interest Instead of a Profits Interest

Profits interests are great because they are forward-looking. Sometimes, however, the prospective partner insists on having a share of the existing business. The easiest, most certain way to do that is to give the new partner a share of capital and report granting the partnership interest as compensation, much as when one would issue corporate stock.[3642]

An alternative approach might work - if the insistent partner is willing to take some risk. The partnership agreement could allocate net income to the new partner until the new partner's capital account increases to the desired level. That approach would not generate the desired results if the partnership does not earn enough income to increase the partner's capital account sufficiently. Also, if the income allocated to the partner is ordinary income, the partner risks having this ordinary income generate a capital loss if the partner is unable to sell the partnership interest for enough in the future (plus the fact that the basis acquired by this ordinary income would tend to offset future capital gain).

Some partnerships allocate gross income to generate this result, leading to more certainty of the partner's capital account attaining the desired level. However, if the IRS views the allocation of gross income as being certain, the IRS might assert that the agreement to allocate gross income generates compensation immediately, so one might want to take that possibility into account when considering the effect of the agreement.

II.P.3. Conversions

Conversion to a C corporation is less taxing than conversion from a C corporation. Often, start-up businesses open as a pass-through entity (partnership or S corporation) to enable the owner to deduct initial losses, and then convert to a C corporation when they become profitable. To the extent that timing is discussed below, it is when changes in entity arise from check-the-box elections, which elections generally may be effective up to 75 days before the date of filing.[3788]

[3642] See part II.M.4.e.i Issuing Stock to an Employee - Generally.

[3788] Reg. § 301.7701-3(c)(1)(iii) provides:

> *Effective date of election*. An election made under paragraph (c)(1)(i) of this section will be effective on the date specified by the entity on Form 8832 or on the date filed if no such date is specified on the election form. The effective

An eligible entity may elect to be classified other than its default classification or to change its classification, by filing Form 8832.[3789] If an eligible entity makes an election under the preceding sentence to change its classification (other than an election made by an existing entity to change its classification as of the effective date of this section), the entity cannot change its classification by election again during the 60 months succeeding the effective date of the election.[3790] However, the IRS may permit the entity to change its classification by election within the sixty months if more than 50% of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election.[3791] An election by a newly formed eligible entity that is effective on the date of formation is not considered a change for purposes of the 60-month rule.[3792]

Regarding taxpayer identification numbers, Reg. § 301.6109-1(h), "Special rules for certain entities under § 301.7701-3," provides:

> (1) *General rule*. Any entity that has an employer identification number (EIN) will retain that EIN if its federal tax classification changes under § 301.7701-3.
>
> (2) *Special rules for entities that are disregarded as entities separate from their owners*.
>
> (i) *When an entity becomes disregarded as an entity separate from its owner*. Except as otherwise provided in regulations or other guidance, a single owner entity that is disregarded as an entity separate from its owner under § 301.7701-3, must use its owner's taxpayer identifying number (TIN) for federal tax purposes.
>
> (ii) *When an entity that was disregarded as an entity separate from its owner becomes recognized as a separate entity*. If a single owner entity's classification changes so that it is recognized as a separate entity for federal tax purposes, and that entity had an EIN, then the entity must use that EIN and not the TIN of the single owner. If the entity did not

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> date specified on Form 8832 can not be more than 75 days prior to the date on which the election is filed and can not be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days prior to the date on which the election is filed, it will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, it will be effective 12 months after the date it was filed. If an election specifies an effective date before January 1, 1997, it will be effective as of January 1, 1997. If a purchasing corporation makes an election under section 338 regarding an acquired subsidiary, an election under paragraph (c)(1)(i) of this section for the acquired subsidiary can be effective no earlier than the day after the acquisition date (within the meaning of section 338(h)(2)).

[3789] Reg. § 301.7701-3(c)(1)(i).

[3790] Reg. § 301.7701-3(c)(1)(iv). T.D. 8697 (12/18/1996) provides:

> The sixty month limitation only applies to a change in classification by election; the limitation does not apply if the organization's business is actually transferred to another entity.

The preamble to the proposed regulations, PS-43-95 (5/1996), followed a sentence similar to the above with:

> For example, an organization could liquidate into its parent, terminate and reform as another entity (e.g., by merger), or contribute its business to another organization without restriction.

[3791] Reg. § 301.7701-3(c)(1)(iv).

[3792] Reg. § 301.7701-3(c)(1)(iv). The preamble to the proposed regulations, PS-43-95 (5/1996), commented:

> The sixty month limitation only applies to a change in classification by election. Thus, if a new eligible entity elects out of its default classification effective from its inception, that election is not a change in the entity's classification.

Letter Ruling 201516034 confirmed that electing out of default classification is not a change in the entity's classification. The ruling permitted corporate subsidiaries to convert to LLCs under their original state law and for those LLCs to elect corporation taxation, after which the LLCs converted to LLCs governed by a different state's laws, and the newest LLCs were also permitted to elect corporation taxation.

already have its own EIN, then the entity must acquire an EIN and not use the TIN of the single owner.

(3) *Effective date*. The rules of this paragraph (h) are applicable as of January 1, 1997.

II.P.3.a. From Corporations to Partnerships and Sole Proprietorships

If an entity that elected taxation as a corporation that has more than one owner elects under Reg. § 301.7701-3(c)(1)(i) to be classified as a partnership, the corporation is deemed to distribute all of its assets and liabilities to its owners, who immediately contribute all of the distributed assets and liabilities to the partnership.[3793] The deemed transactions are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective on January 1, the deemed transactions are treated as occurring immediately before the close of December 31 and must be reported as of December 31. Thus, the last day of the corporation's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1.[3794]

If an entity that elected taxation as a corporation that has only one owner elects under Reg. § 301.7701-3(c)(1)(i) to be classified as a disregarded entity, the corporation is deemed to distribute all of its assets and liabilities to its single owner in liquidation of the corporation.[3795] The deemed transaction is treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective on January 1, the deemed transaction is treated as occurring immediately before the close of December 31 and must be reported as of December 31. Thus, the last day of the corporation's taxable year will be December 31 and the first day of the individual's taxable year regarding the activity will be January 1.[3796] If a parent corporation converts a wholly-owned subsidiary corporation to a single member LLC that is disregarded for tax purposes, the conversion constituted a tax free liquidation of the subsidiary under Code § 332.[3797]

The liquidation of a corporation is a taxable event.[3798] The corporation (or its shareholders through K-1s if it is an S corporation) is taxed on the extent by which any asset's fair market value (FMV) exceeds its basis.[3799] Each shareholder generally realizes capital gain or loss on the difference between the FMV received and the stock's adjusted basis. This double tax can be expensive.[3800]

II.P.3.b. Conversion from C Corporation to S Corporation

Converting from a C corporation to an S corporation can trigger LIFO recapture for companies that carry an inventory[3801] or built-in gain tax when assets are sold with a certain number of years after the S election.[3802]

3793 Reg. § 301.7701-3(g)(1)(ii).
3794 Reg. § 301.7701-3(g)(3).
3795 Reg. § 301.7701-3(g)(1)(iii).
3796 Reg. § 301.7701-3(g)(3).
3797 Letter Ruling 201452016.
3798 See Code §§ 336 and 337.
3799 Contributing property with a built-in loss within 2 years of liquidation so as to avoid gain on liquidation generally would not work. Code § 336(d)(2).
3800 See, *e.g.*, Everett, Hennig, and Raabe, Converting a C corporation into an LLC: Quantifying the Tax Costs and Benefits, *Journal of Taxation* (Aug. 2010).
3801 See part II.P.3.b.i LIFO Recapture.
3802 See part II.P.3.b.ii Built-in Gain Tax.

Any S corporations that have not cleansed themselves of C corporation earnings and profits encounter constraints regarding too much investment income[3803] and reduced benefits from tax-exempt interest.[3804]

II.P.3.b.i. LIFO Recapture

If a C corporation inventoried goods under the LIFO method immediately before making an S election, it shall include in income the LIFO recapture amount in its last taxable year as a C corporation (for which its inventory then receives appropriate basis adjustments.[3805]

The corporation pays tax imposed on this conversion in its last C year and first three S years.[3806]

Considering that any inventory on hand is likely to be sold during the recognition period for the built-in gain tax, this recapture avoids double taxation. On the other hand, the corporation might have been able to maintain its old layer of inventory for tax purposes during the entire built-in gain recognition period, and this might be viewed as an additional tax burden.

II.P.3.b.ii. Built-in Gain Tax on Former C Corporations under Code § 1374

II.P.3.b.ii.(a). Explanation of Built-in Gain Tax on Former C Corporations under Code § 1374

When any asset is disposed of within 5 years of the S election,[3807] generally double taxation applies - normal taxation as a flow-through entity, plus a separate corporate level tax imposed on the lesser of the

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[3803] See part II.P.3.b.iii Excess Passive Investment Income.

[3804] See part II.P.3.b.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

[3805] Code § 1363(d)(1).

[3806] Code § 1361(d)(2). FSA 20153001F discussed the treatment of a consolidated group with a C corporation parent being acquired by an S corporation and became a Qualified Subchapter S Subsidiary. The FSA included the following clarification:

> The recapture date is the day before the effective date of the S election. Treas. Reg. § 1.1363-2(c)(1). However, with reference to transactions described in § 1.1363-2(a)(2) (including Qsub elections), there appears to be a typo in the regulations. Treas. Reg. § 1.1363-2(c)(1) states that for a nonrecognition transaction described in § 1.1363-2(a)(2) or (b)(2), the recapture date is the date of the transfer of the partnership interest to the S corporation. However, only section (b)(2) refers to a transfer of a partnership interest, (a)(2) refers to transfers of LIFO inventory assets by the C corporation to an S corporation. The LIFO recapture amount is determined as of the end of the recapture date for S corporation elections described in § 1.1363-2(a)(1), and as of the moment before the transfer occurs for nonrecognition transactions (including Qsub elections) described in 1.1363-2(a)(2). Treas. Reg. § 1.1363-2(c)(2).

[3807] Code § 1374(d)(7) generally provides a 5-year recognition period, which was 7 years for a sale in 2009 or 2010 or 10 years for a sale before then. Code § 1374(d)(7) describes the recognition period as follows:

> (A) *In general*. The term 'recognition period' means the 5-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation. For purposes of applying this section to any amount includible in income by reason of distributions to shareholders pursuant to section 593(e), the preceding sentence shall be applied without regard to the phrase '5-year'.
>
> (B) *Installment sales*. If an S corporation sells an asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received shall be governed by the provisions of this paragraph applicable to the taxable year in which such sale was made.

Letter Ruling 201150023 includes some nuances as the 2011 transition rules related to an installment sale. The ABA Section of Taxation S corporations Committee meeting in May 2015 discussed various nuances to Code § 1374(d)(7) before the Protecting Americans from Tax Hikes Act of 2015 enacted the language quoted above; see Thompson Coburn document no. 6214396.

gain on disposition or the unrealized gain on the effective date of the S election.[3808] The corporation must disclose its unrealized built-in gain annually.[3809]

Generally, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer.[3810] Assets subject to this tax include inventory (but see part II.P.3.b.i LIFO Recapture) and a cash basis taxpayer's accounts receivable,[3811] as well as goodwill;[3812] however, an accrual taxpayer's the receipt of franchise fees not constituting a sale or exchange of a capital asset under Code § 1253(a) are not subject to built-in gain tax.[3813] If a corporation

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[3808] Code § 1374. For ways to minimize this tax using a charitable remainder trust, see part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax. Also, see generally, Dealing with the S corporation Built-In Gains Tax, Parts 1 and 2, *Journal of Taxation* (April and May 2008). Reg. § 1.1374-2(a) provides that an S corporation is taxed is the lesser of:

(1) Its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover (pre-limitation amount);
(2) Its taxable income determined by using all rules applying to C corporations as modified by section 1375(b)(1)(B) (taxable income limitation); and
(3) The amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior taxable years (net unrealized built-in gain limitation).

[3809] Form 1120S (2014), page 2, Schedule B, question 8. To avoid an understatement penalty, the taxpayer might consider hiring an appraiser to value the more significant items that have value that differs from basis. For a taxpayer to rely on a professional's advice, Reg. § 1.6664-4(c)(1)(i) provides;

> *All facts and circumstances considered*. The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

If the taxpayer obtains more than one opinion of value, the taxpayer does not need to provide the tax return preparer with an earlier appraisal if a later appraisal was obtained to correct errors and incorporate more current data. *The Ringgold Telephone Company v. Commissioner*, T.C. Memo. 2010-103 (no penalty assessed for underpayment of built-in gain tax). The court also rejected the IRS' criticism of the taxpayer's failure to give the tax return preparer a copy of a memorandum suggesting a value, because the memorandum was prepared primarily as a marketing tool, not as an objective valuation.

[3810] Reg. § 1.1374-4(b)(1). This determination disregards any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation. Reg. § 1.1374-4(b)(3), Example (4) discusses deferred prepayment income, and Example (5) discusses changes in accounting methods. For further discussion of various items of built-in gain, see McMahon and Simmons, Where Subchapter S Meets Subchapter C, *Tax Lawyer*, vol. 67, No. 2 (Winter 2014), saved as Thompson Coburn LLP doc. no. 6177833.

[3811] For accounts receivable, the S corporation takes them account in full when it collects them, but it takes into account no more than their fair market value at the time of the S election if it sells them to a third party instead. Reg. § 1.1374-4(b)(3), Example (1). For long-term contracts accounted for under the completed contract method, income that would have been earned before the S election under the percentage of completion method is built-in gain. Reg. § 1.1374-4(g).

[3812] Reg. § 1.1374-3(c), Example (1).

[3813] Letter Ruling 200411015 involved the following situation:

> Franchisees pay [taxpayer] a license fee upon grant of the license and monthly royalty fees which are composed of a fixed fee portion and a variable fee portion. Except for the limited use allowed by the Agreements, [taxpayer] retains a significant power, right, or continuing interest in the franchise and terminates any Agreement in violation of the terms and conditions of the license grant. The grant or transfer of franchise rights pursuant to an Agreement does not constitute a sale or exchange of a capital asset under section 1253(a).

The ruling held:

> The income of [taxpayer] with respect to the receipt of the license fees and royalty fees from franchisees after the Conversion Date will not be treated as recognized built-in gain within the meaning of section 1374(d).
>
> We express no opinion about the tax treatment of the license fees or royalty fees under other provisions of the Code and regulations or the tax treatment of any conditions existing at the time of, or the effects resulting from, the license fees and royalty fees that are not specifically covered by the above ruling. We also express no opinion about the tax treatment under 1374 of any income or gain that may be realized by [taxpayer] during the recognition period except as specifically provided above.

sells an asset before or during the recognition period and reports the income from the sale using the installment method during or after the recognition period, that income is subject to built-in gain tax.[3814]

This gain can be offset by built-in losses,[3815] such as a cash basis taxpayer's accounts payable.[3816] Thus, a cash basis taxpayer with accounts receivable at the time of the S election should be able to offset that built-in gain by its board of directors declaring a bonus, constituting reasonable compensation, before the S election, which bonus is payable while an S corporation.[3817]

An accrual taxpayer's deductions deferred by reason of the economic performance rules count as built-in losses.[3818]

Regulations prevent avoiding this tax merely by dropping assets into a partnership.[3819] However, if the corporation owns the partnership at the time of the S election, valuation discounts might reduce the amount of built-in gain. A charitably inclined business might consider part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.

II.P.3.b.ii.(b). Consider S Election Even If Plan to Sell Within 5 Years

Even if one plans to sell the corporation within five years, one might find an S election useful and then revert back to a C corporation if the sale does occur during that time, if all of the following are present:

[3814] Reg. § 1.1374-4(h). Also watch out for acceleration as described in part II.G.16 Limitations on the Use of Installment Sales

[3815] Reg. § 1.1374-2(a)(1).

[3816] Reg. § 1.1374-4(b)(2) provides that, generally:

> …any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation).

Under an accrual method of accounting, a liability is incurred and generally is taken into account in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Reg. § 1.461-1(a)(2)(i). For example, if the corporation is involved in a lawsuit at the time of the S election, amounts paid as a result of the lawsuit are built-in losses only if a judgement had been awarded at the time of the S election. Reg. § 1.1374-4(b)(3), Examples (2) and (3). If an accrual method taxpayer would have been able to deduct amounts owed to related parties before making the S election and Code § 267(a)(2) suspended the deduction until after the S election was made, those expenses might be built-in losses under Reg. § 1.1374-4(c)(1). A similar rule applies to compensation appropriately accrued before the S election but suspended under Code § 404(a)(5) until after the S election was made. Reg. § 1.1374-4(c)(2).

[3817] S. Rep. No. 445, 100th Cong., 2d Sess. 65 (1988), states:

> As an example of these built-in gain and loss provisions, in the case of a cash basis personal service corporation that converts to S status and that has receivables at the time of the conversion, the receivables, when received, are built-in gain items. At the same time, built-in losses would include otherwise deductible compensation paid after the conversion to the persons who performed the services that produced the receivables, to the extent such compensation is attributable to such pre-conversion services. To the extent such built-in loss items offset the built-in gains from the receivables, there would be no amount subject to the built-in gains tax.

Eustice & Kuntz, ¶ 7.06[4][f] Computation of Tax; Use of Certain Losses and Deductions to Reduce Tax Base, Federal Income Taxation of S corporations, views this as an accurate statement of current law.

[3818] Reg. § 1.1374-4(b)(2) provides that:

> In determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer for purposes of this paragraph, section 461(h)(2)(C) and § 1.461-4(g) (relating to liabilities for tort, worker's compensation, breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts, taxes, and other liabilities) do not apply.

[3819] Reg. § 1.1374-4(i).

- The corporate stock is not eligible for the exclusion from gain on sale of the stock under Code § 1202 described in part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation. Being an S corporation for any significant period would blow the exclusion.[3820]

- The company does not have too much inventory subject to tax under part II.P.3.b.i LIFO Recapture. Note that any tax imposed on LIFO recapture is spread over several years.

- The company does not expect to dispose of significant assets subject to built-in gain tax.[3821] If the company reports on the cash receipts and disbursements method, then its accounts receivable and other accrued income in excess of its accounts payable and other accrued expenses would be subject to built-in gain tax; however, if it is on the accrual method, the income would already have been recognized and the built-in gain tax would not apply.[3822]

Making the S election would allow the shareholders to extract earnings during that period income-tax free, whether those earnings are extracted through distributions or when selling their stock.

If stock in the company is sold as just a straight stock sale, then either the buyer keeps the S election going (and benefits from to) or terminates the S election. If the buyer requires a basis step-up on the corporation's assets as described in part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold, then the seller might need to revoke the S election to avoid the built-in gain tax. Either way, terminating the S election might very well be relatively straightforward so that this process of turning on and then off the S election might have few bad tax effects (if the three bullet points above work out) and are advantageous while the election is in effect. See parts II.P.3.d Conversion from S Corporation to C Corporation and II.A.2.k Terminating an S Election.

II.P.3.b.iii. Excess Passive Investment Income

If a C corporation with accumulated earnings and profits (E&P)[3823] elects S status, it might be subject to a supplemental tax and lose its S status if it has excess passive investment income.[3824] The corporation can avoid this treatment by carefully planning its gross receipts or by distributing its E&P.[3825] Inadvertent

[3820] See fn. 5002.
[3821] See part II.P.3.b.ii.(a) Explanation of Built-in Gain Tax on Former C Corporations under Code § 1374.
[3822] See fns. 3810-3818.
[3823] Reg. § 1.1375-1(b)(4) refers to Code § 1362(d)(3) and the regulations thereunder in determining E&P. E&P is based on C corporation principles under Code § 312 and taxed by Code § 316 when distributed. Code § 1371(c). E&P are the earnings and profits of any corporation, including the S corporation or an acquired or predecessor corporation, for any period with respect to which an S election was not in effect. Reg. § 1.1362-2(c)(3).
[3824] Code §§ 1362(d)(3), 1375. Certain S corporations may disregard pre-1983 earnings and profits. 2007 Small Business Act P.L. 110-28, Sec. 8235.
[3825] Planning before the conversion might also help. Starr and Sobol, *S corporations: Operations*, T.M. 731-2nd, suggests at IV.B:

> Comment: When a C corporation converts to an S corporation, accumulated E&P is likely to be overstated, since timing differences originating in C status will tend to reverse while in S corporation status. As a result, excessive dividend distributions will be necessary to fully deplete the account. Conversely, when an S corporation converts to a C corporation, these timing differences may prove advantageous in that the accumulated E&P would reflect the reversal in C status while not being affected by the origination of the item in S status.
>
> Instances where timing differences come into play when switching from C to S or S to C status include:
> - accelerated cost recovery deductions for taxable income, but straight-line for accumulated E&P;
> - installment method elected for taxable income, but not allowed for accumulated E&P; and
> - special LIFO inventory adjustments required for accumulated E&P, but generally not required for taxable income.

termination relief may be available if the corporation distributes its E&P after violating the excess passive investment income test.[3826]

Some points on planning gross receipts to avoid excess passive investment income treatment include:

- Although the statute defines rent as tainted income,[3827] that characterization does not apply if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental activity.[3828] For this purpose, "rent" does not include "income realized by a

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[3826] Letter Ruling 201710013.

[3827] Code § 1362(d)(3)(C)(i).

[3828] Reg. § 1.1362-2(c)(5)(ii)(B)(2), which provides:

> *Rents derived in the active trade or business of renting property*. Rents does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

When describing net leases, the regulation did not clarify whether it was referring to leases in which the tenant does everything to rather leases in which the tenant reimburses the landlord for expenses the landlord incurs. If the taxpayer has very significant concern about this issue, consider making the lease a fixed annual rent that is enough to cover annual expenses – which may or may not be acceptable to the landlord in that the landlord assumes the risk of unexpected expenses.

Rev. Rul. 81-197 addressed leasing aircraft. Reimbursing the renter's expenses under a one-year lease, where the tenant does all of the work, did not make rental be active. However, chartering aircraft was active, where (a) the owner provides all pilots, fuel, catering, and operating supplies, and pays for all hull and liability insurance, landing and parking fees, taxes, and governmental fees and charges, (b) pilots who are its employees have primary authority for the safety and actual operation of the aircraft, and (c) it enters into a management agreement with the aircraft manufacturer to secure assistance in maintaining the aircraft.

A corporation did not provide significant services or incur substantial costs when it provided furniture for the bungalows (used as vacation homes) and a recreation area maintained by the corporation, as well as tables and cards use in that area, sponsored bingo games for the adults and parties for the children at which small prizes were given, and sponsored parties for the adults, providing food and entertainment, all of which cost approximately 0.15% of revenue. *Feingold v. Commissioner*, 49 T.C. 461(1968). Performing decorating, repair, maintenance and cleaning services at the lessee's separate expense did not make active the rental of stadium suites active, but income from concessions, stadium club membership fees and dues, and electronic scoreboard advertising was active. Letter Ruling 8247052 (GCM 38915 apparently provided the underlying analysis).

Letter Ruling 201725022 held that the following medical office lease was active:

> X contracts with an independent leasing agent to assist in soliciting prospective tenants for M, negotiating leases and renewals, and overseeing post-leasing activities such as build-outs and renovations of suite space. X, with the assistance of the independent leasing agent, drafts, proposes, presents, and negotiates letters of intent to lease available suite spaces. Negotiation for leasing regularly requires the use of an independent space planner to design and tailor the spaces for prospective tenants. Once letters of intent are accepted, X, with the assistance of the independent leasing agent, prepares, finalizes, and executes the lease agreements with prospective tenants. Renewals of leases are similarly handled by X, which are often complicated by requests for concessions and renegotiation of the leasing rate. Renewals often require significant time and attention by X.
>
> X, through its employees, its agents, and the agents' employees, provides certain services in maintaining and repairing of the buildings, common areas, and grounds of M. X utilizes a standard lease agreement for its tenants, and under the lease agreements X has the obligation to provide certain services with respect to the leasing of space within M and to maintain or repair the following items: the heat and air conditioning systems, plumbing, hot water heaters, exterior lighting, signs, lawn care and gardening, roofs and exterior walls, exterior walkways, courtyards, parking areas, electricity, water and sewer, drainage, and garbage pickup.
>
> In addition, the following specific services are provided to M and its tenants by an employee or independent contractor/worker of X: daily walk-through inspections of M to report on water breaks, lighting outage, vandalism, damage to building exteriors and certain interior spaces; sweeping, cleaning and maintaining the common areas of M

landowner under a share-farming arrangement where the landowner participates to a material degree in the production of farm commodities through physical work or management decisions, or a combination of both,"[3829] but the payment of costs may be sufficient to cause a farm arrangement to be nonpassive under this test.[3830] See also part II.G.27.b Real Estate as a Trade or Business.

- Gross receipts (rather than net income) of nonpassive income from partnerships in which the corporation is invested may be counted;[3831] some income from controlled foreign corporations might also count as nonpassive income.[3832] Investing in oil and gas partnerships frequently helps generate

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> such as sideways, walkways, and parking lot; routine periodic inspection of building exteriors and interiors, including foundations, roofs, exterior lighting, grounds, and parking lot and engaging in maintenance and repairs as needed; treating the roofs of the buildings for moss growth yearly; recoating and resurfacing the parking lot; routine and periodic maintenance of the numerous heating and air conditioning units; renovating vacant suites for leasing; routine and periodic maintenance of the plumbing and sewer lines, and their repair and replacement as needed; maintenance, repair and replacement of exterior lighting and selected interior lighting; janitorial services for selected units and common areas; exterior window washing; regular maintenance of grounds and lawn care, and landscaping services when necessary; seasonal snow removal and ice control; weekly trash removal; periodic pest and vermin control; and emergency response and property access for public safety.

Additional authority is in *United States Tax Reporter* ANN ¶ 13,799.27 Rents; Bittker & Eustice, ¶ 6.04. Events Terminating Election, *Federal Income Taxation of Corporations & Shareholders* (WG&L); Eustice, Kuntz & Bogdanski, ¶ 5.04[2][b] Rents, *Federal Income Taxation of S Corporations*; Christian & Grant, ¶ 11.03 Rents, *Subchapter S Taxation* (WG&L).

[3829] Rev. Rul. 61-112. See Letter Rulings 8927039, 9003056, 9514005, 200002033, 200217045, and 200739008, all cited in Thompson Coburn LLP doc. no. 6513203 (which would need to be sanitized before sharing), which is the background for Letter Ruling 201812003 (which approved S corporation status and an ESBT election when the trust that was the sole shareholder was required to cause the corporation to distribute real estate to charity, facts that were present but were not discernible from the ruling). *Kennedy v. Commissioner*, T.C. Memo. 1974-149, held that crop-sharing was passive rental when the corporation furnished nothing except the use of the land and the tenant furnished all the management, labor, supplies, etc.

Citing Rev. Rul. 61-112, Rev. Rul. 67-423 held that, when a corporation owns farmland it leases to a tenant under a crop-sharing arrangement that generates government payments under acreage reserve and conservation reserve programs and the landlord materially participates in the management of the farm production, the payments which the landlord receives under the foregoing programs are not "rents" for personal holding company income tax purposes. TAM 6211239430A, which also cited Rev. Rul. 61-112, held that crop-sharing payments were "rents" for personal holding company income tax purposes where the corporation did nothing and the tenant furnishes all of the equipment and performs all of the work.

GCM 35957 (1974) cited Rev. Rul. 61-112, among other authority, in analyzing whether crop-sharing constituted unrelated business taxable income.

GCM 35247 (1973) cited Rev. Rul. 61-112, among other authority, in analyzing whether crop-sharing constituted a business for purposes of estate tax deferral under Code § 6166.

[3830] Letter Ruling 201722019 approved as nonpassive both of the following:

> X is engaged in the business of farming and owns n acres in State. X has leased the land for sharecropping (Sharecropping Lease Arrangement) continuously beginning in Date 3. Beginning in Year, the land was leased to Y. Pursuant to the Sharecropping Lease Arrangement, all taxes, assessments or charges levied or assessed on products of the land must be paid by X and Y based in proportion to the percentage of crops to which X and Y are entitled. X and Y each pay one half of the actual cost of fertilizer and soil conditioner. X pays the cost of the power and fuel necessary to operate the drainage pumping plants as well as the cost of maintaining the irrigation and drainage canals and irrigation pipe line. X is also responsible for paying box rent and the grower's share of the state inspection fee. Any processing expenses incurred with the preparation of crops for sale, which are related to X's share of the crops, are paid by X. X also determines the percentage of Property to be farmed and the types of crops to be planted. Further, X is at risk for crop yields and marketing.
>
> In Year, X signed a new lease agreement (Rental Lease Arrangement) with Y for lease of Property. Under the lease, X's expenses are between o% and p% of X's rental income. X is responsible for providing and maintaining insurance on all improvements and fixtures owned by X. Further, X pays the costs and expenses associated with the repair, maintenance and replacement of the irrigation drainage pumps as well as the insurance, water reclamation tax, water rights fees, water coalition dues and property taxes.

[3831] Rev. Rul. 71-455; see also Reg. § 1.702-1(a)(8)(ii).

[3832] CCA 201030024.

sufficient nonpassive gross receipts.[3833] Any gross receipts separately stated on such a K-1 would be reflected only in a worksheet provided in the Instructions for Form 1120S.[3834]

- In the case of sales or exchanges of stock or securities, gross receipts shall be taken into account only to the extent of the gains, without deduction for losses.[3835] For other capital assets, losses are netted against gains.[3836]

The corporation can distribute its E&P. Generally, distributions from an S corporation come first as generally[3837] nontaxable distributions of its accumulated adjustments account (AAA), then are treated as dividends to the extent of E&P, and then as a return of basis and gain on sale.[3838] However, an S corporation may, with the consent of all of its affected shareholders, elect to ignore AAA with respect to all distributions made during the taxable year for which the election is made.[3839]

Generally, a distribution of E&P must be effected using a distribution of money or other property.[3840] For these purposes, a distribution is taken into account on the date the corporation makes the distribution, regardless of when the distribution is treated as received by the shareholder.[3841] AAA at the close of the taxable year is applied to distributions during the taxable and pro-rated among them if they exceed AAA.[3842]

"Property" means money, securities, and any other property, but does not include stock in the corporation making the distribution (or rights to acquire such stock).[3843] However, no distribution of property is

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[3833] For a summary of the issue, see 723 T.M. III.D.7.b.; see also part II.P.1.a.i Allocations of Income in Partnerships. Specific examples include Letter Rulings 200005012 (publicly traded partnership engaged in the purchasing, gathering, transporting, storage and resale of crude oil, refined petroleum products, and natural gas liquids, as well as some related activities), 200027037 (publicly traded limited partnerships engaged in the business of purchasing, gathering, transporting, trading, storage, and resale of crude oil, refined petroleum, and other chemical products), 200147034 (one publicly traded partnership's business consisted of purchasing, gathering, transporting, trading, storage and resale of crude oil and refined petroleum products and related activities, and the other's consisted of interstate and intrastate crude oil transportation, terminalling and storage, as well as crude oil gathering and marketing activities), 200240043 (publicly traded partnerships engaged in the business of purchasing, gathering, transporting, trading, storing, and reselling crude oil and refined petroleum products), 200309021 (publicly traded partnership engaged in the purchasing, gathering, transporting, trading, storage, and resale of crude oil, refined petroleum, and other mineral or natural resources), 200327004 (publicly traded partnership engaged in the purchasing, gathering, transporting, trading, marketing, storing, and reselling of crude oil, refined petroleum products, and natural gas liquids), and 200928024 (publicly traded partnerships engaged in the active trade of purchasing, gathering, transporting, trading, storage and/or resale of crude oil and refined petroleum products and related activities). It is best to document that the corporation's investment strategy is to provide for liquidity and also to diversify its investment risk.

[3834] The 2016 Instructions provide a worksheet to compute the excess net passive income tax for line 22a. The schedule computing the excess net passive income items includes+:

*Income and deductions on lines 1, 2, and 5 are from total operations for the tax year. This includes applicable income and expenses from page 1, Form 1120S, as well as those imported separately on Schedule K.

[3835] Code § 1362(d)(3)(B)(ii).

[3836] Code § 1362(d)(3)(B)(i).

[3837] If and to the extent that the basis of a shareholder's stock is less than the shareholder's allocable AAA, the distribution of AAA would be taxed as a capital gain. Code § 1368(c)(1), (b)(2).

[3838] Code § 1368(c).

[3839] Code § 1368(e)(3)(A). Affected shareholder means any shareholder to whom a distribution is made by the S corporation during the taxable year. Code § 1368(e)(3)(B).

[3840] Code § 316(a). See Reg. § 1.1368-1(c).

[3841] Reg. § 1.1368-1(b).

[3842] Reg. § 1.1368-1(b), (c).

[3843] Code § 317(a).

required if an S corporation elects to distribute all or part of its E&P through a deemed dividend, in which case: [3844]

- The corporation will be considered to elected to bypass AAA for that year.

- The deemed dividend may not exceed the E&P on the last day of the taxable year, reduced by any actual distributions of E&P made during the taxable year.

- The amount of the deemed dividend is considered, for all tax purposes,[3845] as if it were distributed in money to the shareholders in proportion to their stock ownership, received by the shareholders, and immediately contributed by the shareholders to the corporation, all on the last day of the corporation's taxable year.

A corporation makes an election for a taxable year by attaching a statement to a timely filed (including extensions) original or amended return required to be filed for that taxable year, which statement must include the amount of the deemed dividend that is distributed to each shareholder,[3846] as well as consent by each affected shareholder.[3847]

A deemed dividend might be attractive when dividend tax rates are low, if one expects to need to take distributions in excess of AAA is a future year. However, if the shareholder might later sell the stock to a third party or wait to have the stock redeemed until it obtains a basis step-up on death, then it's possible that distributions will never exceed AAA. In that case, investing in assets that generate nonpassive gross receipts might be a lot less painful than paying tax on a deemed dividend. If the majority shareholder does not want to mess with a closely-held business or active rental, then my experience has been that investing 1-3% of the corporation's assets in oil and gas partnerships will be sufficient to generate sufficient nonpassive gross receipts.[3848]

If a corporation does not know about the possible loss of its S election under the excess passive investment income rules and terminates its S election as a result of these rules, consider applying for inadvertent termination relief in which the corporation and shareholders agree to a retroactive deemed dividend described above.[3849]

II.P.3.b.iv. Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds

Tax-exempt income does not increase AAA.[3850]

Therefore, any tax-exempt income, although not taxable to the shareholders when earned, would be taxable dividends when distributed to the shareholders to the extent that the corporation has no remaining AAA but has E&P.

[3844] Reg. § 1.1368-1(f)(3).
[3845] However, the dividend deemed distributed to a qualified subchapter S trust does not constitute trust accounting income and therefore is not required to be distributed to the beneficiary. Letter Ruling 200446007.
[3846] Reg. § 1.1368-1(f)(5)(iii).
[3847] Reg. § 1.1368-1(f)(5)(ii).
[3848] See footnote 3833.
[3849] Letter Rulings 201351013, 201629001.
[3850] Code § 1368(e)(1)(A). This includes tax-free receipts beyond just municipal bonds. See part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations and Letter Ruling 201440013.

Even if the corporation has plenty of AAA, a need for AAA might later arise, such as tax-free redemptions of part of a shareholder's stock.[3851]

These issues are spelled out more in part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations.

II.P.3.b.v. Conversion from S Corporation to C Corporation then Back to S Corporation

CCA 201446021 asserted that, when an S election terminates, its accumulated adjustments account (AAA) is wiped out. Therefore, the IRS reasoned, if the corporation later becomes an S corporation, its AAA starts from scratch.

However, any distribution of ***money***[3852] by a corporation with respect to its stock during a post-termination transition period (generally, the first C corporation year after the S election terminate) is applied against and reduce the adjusted basis of the stock, to the extent that the amount of the distribution does not exceed AAA.[3853] Rev. Rul. 2019-13 clarifies that this treatment applies if and to the extent that a redemption if recharacterized as a Code § 301 distribution.[3854]

Thus, if the S corporation status is terminated, one should consider promptly distributing earnings as cash; although one might loan them back to the corporation if it needs the cash, the IRS may treat that as a step transaction that is a note distribution that does not qualify as a distribution of money.[3855] If one is planning a termination, consider distributing on the last day of the last S corporation taxable year a formula note equal to AAA as of that date. See part II.P.3.d Conversion from S Corporation to C Corporation for

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[3851] If a state law redemption is treated as a distribution under Code § 302(b)(2) or (3) and Code § 302(c), then it is a tax-free distribution to the extent of AAA. See part II.Q.7.b. Redemptions or Distributions Involving S Corporations.

[3852] The law refers to "money," and the 2017 legislative history refers to "distributions of cash."

[3853] Code § 1371(e)(1). Code § 1377(b)(1) and Reg. § 1.1377-2(b) determine the post-termination transition period.

[3854] See parts II.Q.7.a.iii Redemption Taxed Either as Sale of Stock or Distribution; Which Is Better When and II.Q.7.b Redemptions or Distributions Involving S Corporations. The facts of Rev. Rul. 2019-13 are:

> X is a corporation that once was a C corporation and later elected to be an S corporation under § 1362(a) of the Code. X's S election terminated under § 1362(d), such that it is now a C corporation. A, an individual, owns all 100 shares of the outstanding stock of X. X is a calendar-year taxpayer. At the time of its conversion to an S corporation, X had accumulated earnings and profits (E&P) of $600x and no current E&P. At the time of the termination of its S election, X's AAA was $800x and its accumulated E&P was still $600x. During X's post-termination transition period, X redeems 50 of A's 100 shares of X stock for $1,000x. X makes no other distributions during the post-termination transition period. Pursuant to § 302(d) of the Code, the redemption is characterized as a distribution subject to § 301. For the taxable period that includes the redemption, X has current E&P of $400x.

Rev. Rul. 2019-13 holds:

> If, during a former S corporation's post-termination transition period, the corporation distributes cash in redemption of a shareholder's stock, which is characterized as a distribution subject to § 301, the corporation should reduce its AAA to the extent of the proceeds of the redemption pursuant to § 1368. The redemption of 50 of A's 100 shares of X stock for $1,000x is characterized as a reduction of X's $800x of AAA with the remaining $200x characterized as a dividend under § 301(c)(1).

[3855] See *McKelvy v. United States*, 478 F.2d 1217 (Ct. Cl. 1973); *DeTreville v. United States*, 445 F.2d 1306 (4th Cir. 1971); *Fountain v. Commissioner*, 59 T.C. 696 (1973); and *Roesel v. Commissioner*, 56 T.C. 14 (1971). In the first three cases, the corporation did not have cash on hand to honor the checks, and the loan or other transaction was needed to avoid bouncing checks. In *Roesel*, 56 T.C. at 26, the court noted, "The conversations which were had between Milling's president or comptroller and the shareholders with respect to the purported loans, the degree of correspondence between the book overdrafts created by Milling's distributions and the amounts purportedly loaned back by its shareholders, the close proximity in time of the purported loans and the issuance of checks by Milling, and the correlation between the amounts purportedly loaned by each shareholder and his interest in Milling, all serve to establish that the purported distributions and loans were but parts of interrelated transactions which must be viewed as such for tax purposes."

discussion about additional opportunities for former S corporations whose owners at the time of revocation are the same as those on December 22, 2017.

A better strategy might be for the S corporation to do a tax-free "F" reorganization,[3856] in which the existing S corporation becomes a wholly-owned subsidiary of a new parent S corporation, which parent is owned by the original S corporation's shareholders immediately before the reorganization. The parent makes an S election, and the subsidiary elects taxation as a Qualified Subchapter S Subsidiary (QSub).[3857] The original S corporation initially is disregarded from the parent, giving the parent all of the subsidiary's AAA.[3858] Later, the subsidiary's QSub election is revoked, keeping the AAA intact at the parent level, notwithstanding that the subsidiary is now taxed as a C corporation. That way, if the subsidiary later becomes a QSub, the AAA remain to help carry out distributions to the shareholders.

This strategy also might allow a faster conversion back to taxation as an S corporation, because the S election was never terminated and therefore the five year waiting period[3859] would appear not to apply.[3860] Because the QSub is wholly owned, the deemed liquidation when the QSub election is made again generally would be nontaxable.[3861]

Another alternative would be for the S corporation to transfer one or more businesses to one or more C corporations (or to separate LLCs, which elect C corporation treatment once the transfers are complete).

However, an S corporation may want to issue a promissory note before converting to C corporation, so that it can make payments to shareholders after the C corporation conversion without those payments being taxable dividends; this strategy seems appealing but may have some disadvantages relating to the related interest income and expense.[3862] The only way this accomplishes the intended result is if the C corporation subsidiary is the borrower. Unfortunately, the deemed issuance of a promissory note upon the deemed Code § 351 transaction may constitute "boot" that triggers income tax on formation.[3863] The corporation may try to borrow from a third party immediately before the conversion and distribute its AAA to its shareholders, followed by them loaning back to the corporation after it becomes a C corporation to repay the debt; however, this solution is subject to two caveats (among others referred to in fn 3863). First, liabilities in excess of debt on the deemed Code § 351 formation of the C corporation may trigger income tax on that excess; see part II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities. Second, consider whether such a tight sequence may constitute a step transaction, along the lines noted in fn 3855.

The "F" reorganization strategy is especially important when converting to a C corporation the stock of which generally would qualify for the exclusion described in part II.Q.7.k. Although a corporation that had been an S corporation cannot qualify for the exclusion, the S corporation can form a C corporation whose stock does qualify for the exclusion,[3864] which generally requires a transfer of assets and liabilities to a new entity. This reorganization strategy facilitates a seamless transition as a matter of state law – the old corporation turns into a new C corporation for income tax purposes. However, if the old corporation

[3856] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.
[3857] See part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3858] Reg. § 1.1368-2(d)(2).
[3859] See fn 321 in part II.A.2.k Terminating an S Election.
[3860] See fns 202-204 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3861] See fn 209 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3862] See part II.E.2.b Converting from S Corporation to C Corporation.
[3863] See fn 3425 and accompanying text in part II.M.2.a Initial Incorporation – Generally.
[3864] See fns 5002-5004 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

becomes a C corporation directly, it retains its old tax ID,[3865] which will show a history of having been an S corporation. That history may lead the IRS to question whether the deemed brand-new C corporation is, in fact, a prior S corporation, even though the QSub regulations clearly say it is. To avoid such questions, the cumbersome asset/liability transfer may be the better way to go. Query whether one might convert the old corporation into an LLC on a tax-free and seamless state law basis, then the parent transfers the LLC into a new C corporation (or do some other equivalent seamless conversion).

Finally, consider the built-in gain tax described in part II.P.3.b.ii Built-in Gain Tax on Former C Corporations under Code § 1374. That tax is imposed when as asset with unrecognized built-in gain when the corporation converts from C to S is sold within five years. This can be pernicious when an S corporation converts to C and then back to S again. For example, an asset has a zero basis and a $1 million value before the corporation revokes its S election. The asset grows to be worth $1.3 million before the corporation switches back from C to S. The full $1.3 million of unrealized gain constitutes built-in gain, even though only $300,000 of the appreciation occurs while taxed as a C corporation.

To avoid the problem described in the preceding paragraph, consider not simply revoking the S election when first converting to C corporation. Instead, leave behind in an S corporation parent any highly appreciated assets and lease them to the C corporation, while contributing the rest of the business to a C corporation.

II.P.3.c. Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations

Transfers from a sole proprietorship to a corporation, including a disregarded LLC electing corporate taxation,[3866] are generally nontaxable.[3867]

However, shifting from a partnership to a corporation might cause the partners to recognize gain or lose their suspended losses.[3868]

Consider what adjustments might be required to convert a partnership interest, which might have capital accounts disproportionate to profit and loss sharing and might have profit in loss sharing that is not "straight-up," into shares, generally would have identical distribution and liquidation rights (and must have such rights in the case of an S corporation).

II.P.3.c.i. Formless Conversion

When an entity taxed as a partnership elects taxation as a corporation, the partnership is deemed to contribute all of its assets and liabilities to the corporation in exchange for stock in the corporation; and, immediately thereafter, the partnership liquidates by distributing the stock of the corporation to its partners.[3869] The deemed transactions are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective

[3865] Reg. § 301.6109-1(i)(3), reproduced in full in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3866] Reg. § 301.7701-3(g)(1)(iv).
[3867] See part II.M.2.a. Initial Incorporation – Generally.
[3868] See part II.M.2.c Contribution of Partnership Interest to Corporation.
[3869] Reg. § 301.7701-3(g)(1)(i). Under Rev. Rul. 2004-59, when a formless conversion occurs under state law, Rev. Rul. 84-111 does not apply. Rev. Rul. 84-111 describes the differences in the basis and holding periods of the various assets received by the corporation and the basis and holding periods of the stock received by the former partners provided the steps described are actually undertaken and the underlying assumptions and purposes for the conclusions in the revenue ruling are applicable. Except to the extent inconsistent with the above, see the text accompanying footnotes 5125-5213 for tax effects of liquidating a partnership.

on January 1, the deemed transactions are treated as occurring immediately before the close of December 31 and must be reported by the owners of the entity on December 31. Thus, the last day of the partnership's taxable year will be December 31 and the first day of the corporation's taxable year will be January 1.[3870]

A partnership can be converted directly into an S corporation; the corporation is not deemed formed until the partnership is deemed to have distributed its assets to the corporation:[3871]

- Suppose that, on January 1, 2009, X, a calendar year taxpayer, is taxed as a partnership. X elects to be taxed as a corporation for federal tax purposes, effective January 1, 2010. On February 1, 2010, X files an S election, effective January 1, 2010. Each person who held stock in X on January 1, 2010 also holds stock at the time the S election is made. When X elects to be taxed as a corporation, the following steps are deemed to occur: X contributes all of its assets and liabilities to the corporation in exchange for stock in the corporation, and immediately thereafter X liquidates by distributing the stock of the association to its partners. These deemed steps are treated as occurring immediately before the close of the day before the election is effective.[3872] Thus, the partnership's taxable year ends on December 31, 2009, and the corporation's first taxable year begins on January 1, 2010. Therefore, the partnership will not be deemed to own the stock of the corporation during any portion of the association's first taxable year beginning January 1, 2010, and X is eligible to elect to be an S corporation effective January 1, 2010. Additionally, because the partnership's taxable year ends immediately before the close of the day on December 31, 2009, and the corporation's first taxable year begins at the start of the day on January 1, 2010, the deemed steps will not cause X to have an intervening short taxable year in which it was a C corporation.

- On January 1, 2009, Y, a calendar year taxpayer, is taxed as a partnership. Y converts into a corporation under a state law formless conversion statute, effective January 1, 2010. As a result of the conversion, Y is classified as a corporation for federal tax purposes. On February 1, 2010, Y files an S election, effective January 1, 2010. Each person who held stock in Y on January 1, 2010 also holds stock at the time the S election is made. The result is the same as above.

Of course, the simplest way would be just to make the S election, by the partnership filing IRS Form 2553.[3873]

Because S corporations can have only a single class of stock,[3874] capital accounts need to be made proportionate to interests in profits and losses before converting to an S corporation.[3875]

II.P.3.c.ii. Transfer of Partnership Assets and Liabilities to a Newly Formed Corporation in Exchange for All of its Stock

If the conversion is not a formless conversion described above, the IRS provides for three scenarios.[3876] In each situation, the steps the partners and partnerships take are parts of a plan to transfer the partnership operations to a corporation organized for valid business reasons in exchange for its stock and were not

[3870] Reg. § 301.770l-3(g)(3).
[3871] Rev. Rul. 2009-15.
[3872] Reg. § 301.7701-3(g)(3)(i).
[3873] See fn. 362.
[3874] See II.A.2.i Single Class of Stock Rule, for a description of the single class of stock rules and those rules' surprising flexibility.
[3875] See fn 364 in part II.B Limited Liability Company (LLC).
[3876] Rev. Rul. 84-111. However, see fn 3869 in part II.P.3.c.i Formless Conversion.

devices to avoid or evade recognition of gain. Because the federal income tax consequences of the three situations are the same, each partnership is considered to made a nontaxable contribution of its assets and liabilities to a corporation in exchange for its stock,[3877] followed by a distribution of the stock to the partners in liquidation of the partnership.[3878]

In the first situation, the partnership transfers all of its assets to newly-formed corporation in exchange for all the outstanding stock of the corporation and the assumption by the corporation of the partnership's liabilities. The partnership then terminates by distributing all the stock of the corporation to the partners in proportion to their partnership interests. The tax results are:

- No gain or loss is recognized by the partnership when it transfers all of its assets to the corporation in exchange for the corporation's stock and the assumption by the corporation of the partnership's liabilities.[3879]

- The corporation's basis in the assets received from the partnership equals their basis to the partnership immediately before their transfer to the corporation.[3880]

- The partnership's basis of the stock received from the corporation is the same as the partnership's basis in the assets transferred to the corporation, reduced by the liabilities assumed by the corporation, which assumption is treated as a payment of money to the partnership.[3881]

- The corporation's assumption of the partnership's liabilities decreases each partner's share of the partnership liabilities, thus, decreasing the basis of each partner's partnership interest.[3882]

- On distribution of the stock to the partners, the partnership terminates.[3883]

- The basis of the stock distributed to the partners in liquidation of their partnership interests is, with respect to each partner, equal to the adjusted basis of the partner's interest in the partnership.[3884]

- The partnership's holding period for the stock received in the exchange includes its holding period in the capital assets and Code § 1231 assets transferred (to the extent that the stock was received in exchange for such assets).[3885]

- To the extent the stock was received in exchange for neither capital nor Code § 1231 assets, the partnership's holding period for such stock begins on the day following the date of the exchange.[3886]

- The corporation's holding period in the assets transferred to it includes the partnership's holding period.[3887]

[3877] Code § 351.
[3878] Rev. Rul. 70-239.
[3879] Code § 351.
[3880] Code § 362(a). However, Reg. § 1.362-3 reduces the basis of property acquired in loss importation transaction.
[3881] Code § 358.
[3882] See Code §§ 752 and 733.
[3883] Code § 708(b)(1)(A).
[3884] Code § 732(b),
[3885] Code § 1223(1).
[3886] See Rev. Rul. 70-598.
[3887] Code § 1223(2).

- When the partnership distributes the stock to its partners, the partners' holding periods includes the partnership's holding period of the stock.[3888]

In the second situation, the partnership distributes all of its assets and liabilities to its partners in proportion to their partnership interests, terminating the partnership. The partners then transfer all the assets received from the partnership to a new corporation in exchange for all the corporation's outstanding stock and the corporation's assumption of the partnership's liabilities that had been assumed by the partners. The tax results are:

- On the transfer of all of the partnership's assets to its partners:
  - The partnership terminates.[3889]
  - The basis of the assets (other than money) distributed to the partners in liquidation of their partnership interests is, with respect to each partner, equal to the adjusted basis of the partner's interest, reduced by the money distributed.[3890]
- The decrease in the partnership's liabilities resulting from the transfer to its partners was offset by the partners' corresponding assumption of such liabilities, so that the net effect on the basis of each partner's interest in the partnership, with respect to the liabilities transferred, was zero.[3891]
- No gain or loss is recognized by the partnership's former partners when the partnership transfers its assets and liabilities to the corporation in exchange for its stock.[3892]
- The (former) partners' basis in the corporation's stock is the same as their basis in the assets received in the partnership's liquidation and the transfer to the corporation, reduced by the liabilities assumed by the corporation, which assumption is treated as a payment of money to the partners.[3893]
- The corporation's basis in the assets received from the (former) partners equals the (former) partners' basis immediately before the transfer to the corporation.[3894]
- The partners' holding periods for the assets the partnership distributes to them includes the partnership's holding period.[3895]
- The partners' holding periods for the stock received in the exchange includes the partners' holding periods in the capital assets and Code § 1231 assets transferred to the corporation (to the extent that the stock was received in exchange for such assets).[3896]
- However, to the extent that the stock received was in exchange for neither capital nor Code § 1231 assets, the holding period of the stock begins on the day following the date of the exchange.

[3888] Code §§ 735(b) and 1223. Furthermore, such distribution will not violate the Code § 368(c) control requirement.
[3889] Code § 708(b)(1)(A).
[3890] Code § 732(b).
[3891] Code § 752.
[3892] Code § 351.
[3893] Code §§ 358(a) and 732(b).
[3894] Code §§ 362(a) and 732(c). However, Reg. § 1.362-3 reduces the basis of property acquired in loss importation transaction.
[3895] Code § 735(b).
[3896] Code § section 1223(1).

- The corporation's holding period of the partnership's assets received in the exchange includes the partners' holding periods.[3897]

In the third situation, the partners transfer their partnership interests to a newly-formed corporation in exchange for all the corporation's outstanding stock. This exchange terminates the partnership, and all of its assets and liabilities became assets and liabilities of the corporation. The tax result is:

- No gain or loss is recognized by the partners on the transfer of the partnership interests to the corporation in exchange for the corporation's stock.[3898]

- When the transfer partners transfer their partnership interests to the corporation, the partnership terminates.[3899]

- The partners' basis of the stock received from the corporation in exchange for their partnership interests equals the basis of their partnership interests transferred to the corporation, reduced by the partnership's liabilities assumed by the corporation, the release from which is treated as a payment of money to the partners.[3900]

- The corporation's basis for the assets received in the exchange equals the basis of the partners in their partnership interests.[3901]

- The corporation's holding period includes the partnership's holding period in the assets.

- The holding period of the stock received by the former partners includes each respective partner's holding period for the partnership interest transferred,[3902] except that the holding period of the stock that was received by the partners in exchange for their interests in any unrealized receivables, inventory, or various depreciable or amortizable assets of the partnership that are neither capital assets nor Code § 1231 assets begins on the day following the date of the exchange.

II.P.3.d. Conversion from S Corporation to C Corporation

Before discussing the consequences of such a conversion, consider forming an S corporation parent before converting an S corporation directly into a C corporation, or a similar transaction, for the reasons described in fns 3856-3864 in part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation and the closing comments in that part II.P.3.b.v.

See part II.A.2.k Terminating an S Election, which includes the fact that conversion from S status to C status requires an additional tax return if done mid-year and precludes an S election for 5 years.

Converting from an S corporation to a C corporation may require the corporation to switch from the cash receipts and disbursements method of accounting to the accrual method. Generally, a C corporation

[3897] Code § 1223(2).
[3898] Code § 351.
[3899] Code § 708(b)(1)(A).
[3900] Code §§ 358 and 752(d).
[3901] Allocated under Code § 732(c).
[3902] Code § 1223(1).

cannot use the cash method,[3903] unless the corporation conducts a qualified farming business,[3904] is a qualified personal service corporation,[3905] or has gross receipts that are no more than $25 million (after 2018 adjusted for inflation).[3906]

If a corporation was an S corporation on or before December 21, 2017, during the 2-year period beginning on December 22, 2017 revokes its S election, and the owners of the stock of which, determined on the date the revocation is made, are the same owners (and in identical proportions) as on December 22, 2017 (an "eligible terminated S corporation"), then any adjustment required by a change in accounting method under Code § 481(a)(2) which is attributable to that revocation is taken into account ratably during the 6-taxable year period beginning with the year of change.[3907] A taxpayer may also apply this rule if is not required to change from cash to accrual but does anyway.[3908]

Note that S corporation earnings might be extracted in cash tax-free in the first C corporation taxable period after the final S corporation yearend.[3909] Converting the corporation into a QSub before converting it to a C corporation might also be used to preserve the AAA of a corporation whose S election is revoked.[3910]

Additionally, after that first C Corporation taxable period, an eligible terminated S corporation's distribution is chargeable to accumulated earnings and profits, in the same ratio as the amount of such AAA bears to the amount of such accumulated earnings and profits.[3911] The preamble to final regulations, T.D. 9914 (10/20/2020), explains:

> **Background**
>
> In the case of an S corporation, as defined in section 1361(a)(1) of the Internal Revenue Code (Code), having accumulated earnings and profits (as described in section 316(a)(1) of the Code (AE&P)) that makes a distribution of property to which section 301 would otherwise apply, section

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[3903] Code § 448(a)(1).

[3904] Code § 448(d)(1), "Farming business," provides that a "qualified personal service corporation" is any corporation:

(A) *In general*. The term "farming business" means the trade or business of farming (within the meaning of section 263A(e)(4)).

(B) *Timber and ornamental trees*. The term "farming business" includes the raising, harvesting, or growing of trees to which section 263A(c)(5) applies.

[3905] Code § 448(d)(2), "Qualified personal service corporation," provides:

(A) substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and

(B) substantially all of the stock of which (by value) is held directly (or indirectly through 1 or more partnerships, S corporations, or qualified personal service corporations not described in paragraph (2) or (3) of subsection (a)) by-

- (i) employees performing services for such corporation in connection with the activities involving a field referred to in subparagraph (A),
- (ii) retired employees who had performed such services for such corporation,
- (iii) the estate of any individual described in clause (i) or (ii), or
- (iv) any other person who acquired such stock by reason of the death of an individual described in clause (i) or (ii) (but only for the 2-year period beginning on the date of the death of such individual).

To the extent provided in regulations which shall be prescribed by the Secretary, indirect holdings through a trust shall be taken into account under subparagraph (B).

[3906] Code § 448(b), (c).

[3907] Code § 481(d).

[3908] Rev. Proc. 2018-44, modifying Rev. Proc. 2018-31, § 15.01(3).

[3909] See fn. 3853, found in part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation.

[3910] See part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation, especially fns. 3856-3858.

[3911] Code § 1371(f).

1368(c)(1) of the Code generally treats the amount of the distribution not in excess of the S corporation's accumulated adjustments account (as defined in § 1.1368-2(a)(1) (AAA)) or the recipient shareholder's adjusted basis in such S corporation's stock as excluded from the shareholder's gross income. Section 1368(c)(2) provides that the remaining portion of the distribution is treated as a dividend (as defined in section 316(a)) to the extent of the S corporation's AE&P. Finally, section 1368(c)(3) provides that any amount of the distribution in excess of the S corporation's AAA and AE&P is applied against the shareholder's remaining adjusted basis in the stock, with any amount exceeding that adjusted basis treated as gain from the sale or exchange of property.

Generally, a distribution by a C corporation to its shareholders with respect to their stock ownership is treated as a taxable dividend to the extent of the corporation's earnings and profits. See sections 301(c) and 316(a). However, following the termination of a corporation's S election made under section 1362 of the Code (S election), section 1371(e) of the Code allows shareholders of the resulting C corporation to benefit from the corporation's former status as an S corporation with respect to distributions of money during the corporation's post-termination transition period (PTTP), which is generally the one-year period after the corporation terminates its S election. Specifically, during the PTTP, a distribution of money by the C corporation is characterized as a distribution from the corporation's AAA. The receipt of such a distribution is tax-free to the extent of the recipient shareholder's basis in its stock and the corporation's AAA balance. If the distribution exceeds the recipient shareholder's basis in its stock, but not the corporation's AAA, then the distribution is tax-free to the extent of the recipient shareholder's basis, with the remainder treated as gain from the sale of property. If the distribution exceeds the corporation's AAA, then the excess is taxed as a dividend from current earnings and profits (as described in section 316(a)(2) (CE&P)) or any AE&P from the corporation's previous existence as a corporation taxed under subchapter C. Without section 1371(e), shareholders of the former S corporation would be precluded from receiving distributions allocable to AAA.

Section 13543(a) and (b) of Public Law 115-97, 131 Stat. 2054, 2155 (2017), commonly referred to as the Tax Cuts and Jobs Act (TJCA), amended the Code by adding new sections 481(d) and 1371(f), effective as of December 22, 2017, the date of enactment of the TCJA.

Section 481(d)(1) of the Code permits a corporation that qualifies as an eligible terminated S corporation (ETSC) to take into account any 481 adjustments (as defined in part II. C of the Summary of Comments and Explanation of Revisions) which are attributable to the revocation of an S election over the section 481(d) inclusion period, which is the six-taxable-year-period beginning with the year of change (as defined in part II. C of the Summary of Comments and Explanation of Revisions). Section 481(d)(2) defines an ETSC as a C corporation meeting the following three requirements: (i) The corporation was an S corporation on December 21, 2017; (ii) the S corporation revoked its election under section 1362(a) to be an S corporation (that is, the S election) during the two-year period beginning on December 22, 2017 (revocation requirement); and (iii) the owners of the stock of the corporation, determined on the date the corporation made a revocation of its S election, are the same owners (and own identical proportions of the corporation's stock) as on December 22, 2017 (shareholder identity requirement).

Section 1371(f) extends the period during which shareholders of an ETSC can benefit from its AAA generated during the corporation's former status as an S corporation (ETSC period) by providing that, in the case of distributions of money following the PTTP, (i) the distributing ETSC's AAA is allocated to a distribution of money to which section 301 would otherwise apply (qualified distribution), and (ii) the qualified distribution is chargeable to AE&P in the same ratio as the amount of such AAA bears to the amount of such AE&P. In enacting section 1371(f), Congress determined that "it is important to provide rules to ease the transition from S corporation to C corporation for the affected taxpayers" because, based on the TCJA's revisions to the Code, "taxpayers that previously elected to be taxed as S corporations may prefer instead to be taxed as C corporations." H. Rept. 115-409, 115th Cong., 1st Sess., at 245 (Nov. 14, 2017) (House Report).

On November 7, 2019, the Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking (REG-131071-18) in the Federal Register (84 FR 60011) containing proposed regulations under section 1371 and proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 481 and 1377 (proposed regulations). The Treasury Department and the IRS received 16 written or electronic comments responding to the proposed regulations. All comments received on the proposed regulations are available at http://www.regulations.gov or upon request. As no request for a public hearing was received, no hearing was held. After full consideration of the comments received, this Treasury decision adopts generally the proposed regulations with certain modifications in response to the comments received, as described in the Summary of Comments and Explanation of Revisions.

Summary of Comments and Explanation of Revisions

I. Overview

The final regulations retain the approach and structure of the proposed regulations, with certain revisions. This Summary of Comments and Explanation of Revisions discusses those revisions, as well as the comments received in response to the proposed regulations.

II. Comments on Qualification as an Eligible Terminated S Corporation

A. Significance of Date of Revocation of S Election

To qualify as an ETSC under section 481(d)(2), a corporation must satisfy the revocation requirement by making a revocation of its S election during the two-year period beginning on December 22, 2017 (two-year period). See section 481(d)(2)(A)(ii) (setting forth the revocation requirement); proposed § 1.481-5(b)(2) (same). In addition, the shareholder identity requirement must be satisfied by the same shareholders owning identical proportions of the corporation's stock on two dates: December 22, 2017, and the date on which the corporation made a revocation of its S election. See section 481(d)(2)(B) (setting forth the shareholder identity requirement); proposed § 1.481-5(b)(3) (same). But see proposed § 1.481-5(c)(1) (identifying five categories of share transfers that do not result in a change in shareholder ownership for purposes of section 481(d)(2)(B)). Consequently, the date on which a corporation makes a revocation of its S election is critical for determining ETSC qualification.

A corporation can allow the effective date of its S election revocation to occur automatically by operation of section 1362(d)(1)(C), or it can specify an effective date under section 1362(d)(1)(D). For example, a revocation made before the 16th day of the third month of an S corporation's taxable year generally is effective retroactively on the first day of that taxable year. See section 1362(d)(1)(C)(i); § 1.1362-2(a)(2)(i). In contrast, a revocation made after the 15th day of the third month of a corporation's taxable year generally is effective prospectively on the first day of the corporation's following taxable year. See section 1362(d)(1)(C)(ii); § 1.1362-2(a)(2)(i). Alternatively, the corporation may specify an immediate or prospective effective date for a revocation by expressing a date (in terms of a stated day, month, and year) that occurs on or after the date on which the revocation is made. See section 1362(d)(1)(D); § 1.1362-2(a)(2)(ii).

1. Retroactive Effective Date of the Revocation Determines ETSC Status

One commenter suggested that the final regulations revise proposed § 1.481-5(b)(2) to confirm that, in the case of a revocation with a retroactive effective date pursuant to section 1362(d)(1)(C)(i), the revocation may be treated as occurring on the retroactive effective date for purposes of ETSC qualification. Based on the stated congressional goal of facilitating the transition from S corporation status to C corporation status, the commenter contended that taxpayers reasonably could have interpreted the statute to indicate that compliance with the shareholder identity requirement would be tested on the retroactive revocation's effective date. In support of this contention, the commenter correctly noted that, in the absence of such an interpretation, a corporation would not satisfy the shareholder identity requirement for qualifying as an ETSC in proposed § 1.481-5(b)(2) and (3) if the corporation (i) had the same shareholders (and in identical proportions) on both December 22, 2017, and the retroactive effective date of the revocation, but (ii) experienced a change in shareholder ownership during the period between the retroactive effective date of the revocation and the date on which the revocation was made.

The Treasury Department and the IRS agree with the commenter's interpretation. Proposed § 1.481-5(b)(2) and (3) directly address revocations with prospective effective dates, which can be specified with significant flexibility in the revocation. A retroactive effective date for a revocation results solely by operation of section 1362(d)(1)(C)(i) and § 1.1362-2(a)(2)(i) and, in such instance, is always effective on the first day of the corporation's taxable year. To confirm the commenter's interpretation, § 1.481-5(c)(2) of the final regulations provides that, solely with regard to revocations with retroactive effective dates, a revocation may be treated as having been made on the effective date of such revocation. Accordingly, for purposes of § 1.481-5(b)(2) and (3), a corporation may test compliance with the revocation requirement and the shareholder identity requirement on either the date the revocation was made or, in the case of a revocation with a retroactive effective date, the date the revocation was effective.

2. Application of Section 7503 to a Revocation of an S Election

As discussed in part II. A of this Summary of Comments and Explanation of Revisions, the revocation requirement of section 481(d)(2)(A)(ii) requires that a corporation must make a revocation during the two-year period to qualify as an ETSC. Section 7503 provides that, "when the last day prescribed under authority of the internal revenue laws for performing any act falls on Saturday, Sunday, or a legal holiday, the performance of such act shall be considered timely if it is performed on the next succeeding day which is not a Saturday, Sunday, or a legal holiday." Because a revocation is an act made under authority of the internal revenue laws (that is, section 1362 of the Code), section 7503 applies for purposes of determining whether the revocation was made within the required two-year period. As a result of the application of section 7503 in conjunction with section 1362 and § 1.1362-2(a)(2), December 23, 2019 (a Monday), is the last day of the two-year period. Therefore, a revocation made on that date would be treated as made within the two-year period. Without the application of section 7503, December 21, 2019 (a Saturday), would have been the last day of the two-year period.

To avoid any doubt, these final regulations clarify the text of § 1.1362-2(a)(2) to provide explicitly that section 7503 applies where the last day prescribed for making a revocation occurs on a

Saturday, Sunday, or legal holiday. Therefore, a revocation made on December 23, 2019, will be treated as made during the two-year period.

B. Applicability of PTTP and ETSC Period to S Corporations With No AE&P

Following the termination of an S election, section 1371(e) permits shareholders of the resulting C corporation to benefit from the corporation's former status as an S corporation with respect to distributions of money during the corporation's PTTP, which generally is the one-year period after the corporation terminates its S election. Specifically, during the PTTP, a distribution of money by the C corporation is characterized as a distribution from the corporation's AAA. The receipt of such a distribution is tax-free to the extent of the recipient shareholder's basis in the stock with respect to which the shareholder received the distribution, and is taxed as gain from the sale of property to the extent the distribution exceeds the shareholder's basis in that stock. See section 1371(e)(1). If the corporation exhausts its AAA during the PTTP, subsequent distributions are subject to treatment under section 301.

A commenter requested confirmation that the rules regarding distributions made during the PTTP, including section 1371(e) and § 1.1377-2, apply if the corporation did not have AE&P at the time that it terminated its S election. Section 1371(e)(1) provides special treatment to distributions made by a corporation during the PTTP if such distributions (i) consist of money and (ii) are made with respect to the corporation's stock. Those two conditions would be satisfied regardless of whether the distributing corporation had AE&P. Therefore, the Treasury Department and the IRS agree with the commenter's interpretation of section 1371(e) and § 1.1377-2, but have determined that no clarifying revisions to the regulations are necessary in this regard.

The commenter also requested confirmation that the rules regarding distributions made during the ETSC period would apply if the distributing corporation did not have AE&P as of the effective date of the revocation. Example 1 of proposed § 1.1371-1(d) illustrates that, if an ETSC has no AE&P as of the beginning of the day on which the revocation is effective, its historical AE&P is zero. Pursuant to proposed § 1.1371-1(a)(2)(ix) and (x), such a corporation would enter its ETSC period with a AAA ratio of 1 and an AE&P ratio of zero. Therefore, each qualified distribution would be characterized as a distribution of AAA. Based on the guidance provided in Example 1, as well as the definition of the "AAA ratio" set forth in proposed § 1.1371-1(a)(ii), the Treasury Department and the IRS have determined that no clarifying revisions to the regulations are necessary in this regard.

C. Application of Section 481(d) to Qualified Subchapter S Subsidiaries

If an S corporation wholly owns the stock of a domestic C corporation that is not an ineligible corporation described in section 1361(b)(2), the S corporation may elect under section 1361(b)(3)(B)(ii) and § 1.1361-3 to treat the C corporation as a qualified subchapter S subsidiary (QSub) such that (i) the QSub will no longer be treated as a separate corporation and (ii) all of the QSub's assets, liabilities, and items of income, deduction, and credit will be treated as assets, liabilities, and such items (as the case may be) of the S corporation parent. If the requirements of section 1361(b)(3)(B) cease to be satisfied with respect to a QSub, including by reason of the revocation of the parent's S election, section 1361(b)(3)(C)(i) and § 1.1361-5(b)(1)(i) provide that the corporation's QSub election is terminated such that the QSub is treated, for purposes of the Code, as (i) a newly formed C corporation subsidiary separate from the parent and (ii) acquiring all of its assets (and assuming all of its liabilities) from the parent through an exchange to which section 351 of the Code applies (deemed section 351 exchange).

If the taxable income of any taxpayer, including a corporation, for the current year (year of change) is computed under a method of accounting that is different from the method of accounting used by the taxpayer in the preceding year (accounting method change), section 481 requires that the taxpayer must take into account those adjustments that are determined to be necessary solely by reason of the accounting method change to prevent items of income or expense from being duplicated or omitted (481 adjustments). Section 481(a). The 481 adjustments are generally taken into account in computing the taxpayer's taxable income in the year of change. However, section 481(c) permits a taxpayer, in such manner and subject to such conditions prescribed in regulations by the Secretary of the Treasury or his delegate (Secretary), to take 481 adjustments into account in computing taxable income for the taxable year or years permitted under such regulations. As noted earlier, section 481(d)(1) permits an ETSC to take into account any 481 adjustments that are attributable to the revocation of an S election over a six-taxable year period beginning with the year of change (that is, the section 481(d) inclusion period).

Commenters have correctly observed that section 481(a) and (d) do not apply to an ETSC's newly formed C corporation subsidiary (ETSC corporate subsidiary) that operated as a QSub prior to the revocation of its parent's S election. Upon such a revocation, the ETSC corporate subsidiary is treated as acquiring all of its assets and assuming all of its liabilities from the ETSC in a deemed section 351 exchange. See section 1361(b)(3)(C)(i); § 1.1361-5(b)(1)(i). A corporation formed for a business purpose is a taxpayer separate from its shareholder(s). See generally *Moline Properties v. Commissioner*, 319 U.S. 436 (1943). As a result of the ETSC corporate subsidiary's status as a new C corporation with no prior taxable year (rather than, for example, as a successor under section 381(a) of the Code), commenters have noted that the ETSC corporate subsidiary lacks any historical method of accounting from which to change. Compare § 1.446-1(e)(1) (providing that a taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return) with section 381(c)(4) (providing that, in general, a successor corporation must use the method of accounting used by the predecessor corporation as of the date of the section 381(a) transaction).

Notwithstanding those observations of the law, commenters have requested that the final regulations extend the section 481(d) inclusion period to an accrual method ETSC corporate subsidiary that operated as a cash method QSub of a cash method S corporation prior to the revocation of the parent's S election. These commenters highlighted that, in the deemed section 351 exchange required by section 1361(b)(3)(C)(i) and § 1.1361-5(b)(1)(i) that results from the revocation of the parent's S election, the accounts receivable of a former cash method QSub would be deemed transferred to the accrual method ETSC corporate subsidiary with a zero basis. See generally *Raich v. Commissioner*, 46 T.C. 604 (1966) (holding that trade accounts receivable of a cash method transferor received by an accrual basis transferee in a section 351 exchange had a zero basis). Therefore, the ETSC corporate subsidiary would recognize income as it collects amounts on the transferred receivables. In the case where the ETSC corporate subsidiary collects the entire amount of the transferred receivables during its first taxable year, commenters contended that the ETSC corporate subsidiary's inability to include the amount received over the six-year section 481(d) inclusion period would inappropriately disadvantage the former QSub as compared to its former S corporation parent.

The Treasury Department and the IRS understand the commenters' concerns regarding the statutorily limited application of section 481(d) and observe that the commenters' request is not unique to the application of section 481(d), but rather addresses the longstanding treatment of former S corporations and QSubs under section 481 with regard to a deemed section 351 exchange.

Throughout the nearly 25-year period since the 1996 enactment of the QSub provisions under section 1361, section 481(a)(2) and any inclusion period for a 481 adjustment have not applied with respect to former QSubs. See section 1308 of the Small Business Job Protection Act of 1996, Public Law 104-188, 110 Stat. 1755, 1782-3 (August 20, 1996). See also Rev. Proc. 97-27, 1997-1 C.B. 680, section 5.02(3)(a) (providing a four-year amortization period solely to taxpayers that have a 481 adjustment); Rev. Proc. 2015-13, 2015-5 I.R.B. 419, section 7.03(1) (same). After considering the commenters' analysis and the explicit reference in section 481(d) to section 481(a)(2), the Treasury Department and the IRS have determined that section 481(d) does not apply to ETSC corporate subsidiaries, but rather maintains the longstanding application of section 481(a) solely to taxpayers that make an accounting method change. Accordingly, there is no authority under section 481(d) to extend the section 481(d) inclusion period to ETSC corporate subsidiaries.

Commenters also contended that the Treasury Department and the IRS could override the limited scope of section 481(d) through special QSub regulations issued under the authority provided by section 481(c), which, in the case of a taxpayer making an accounting method change, authorizes regulations permitting a taxpayer to take any 481 adjustment into account in computing taxable income for the taxable year or years permitted under such regulations. For example, commenters suggested that the final regulations permit an accrual method ETSC corporate subsidiary to elect to treat the assets received (and liabilities assumed) by the ETSC corporate subsidiary in the deemed section 351 exchange as though the subsidiary had owned such assets (and had such liabilities) in a prior taxable year, thereby creating an accounting method change upon the revocation. However, this approach contradicts the explicit text of section 1362(b)(3)(C)(i), which provides that, "[f]or purposes of this title" (that is, for purposes of all of the provisions of the Code), an ETSC corporate subsidiary "shall be treated as a new corporation."

In the alternative, commenters suggested that the final regulations could permit taxpayers to treat the assets received (and liabilities assumed) by an ETSC corporate subsidiary as though still owned by the former S corporation on the date on which the former S corporation becomes an ETSC. Under this approach, the ETSC's 481 adjustment would be computed as if the ETSC owned such assets and was subject to such liabilities. For support, these commenters highlighted anti-abuse regulations issued under section 263A of the Code (UNICAP anti-abuse regulations) that utilized this alternative approach. See § 1.263A-7(c)(4)(ii) (providing an anti-abuse rule regarding the use of section 351 exchanges to avoid application of section 263A). However, the UNICAP anti-abuse regulations were issued under the authority of section 263A(h)(1) rather than the authority granted the Secretary under section 481(c). See 52 FR 10052, 10059 (March 30, 1987). Section 263A(h)(1) requires the Secretary to "prescribe rules to carry out the purpose of section 263A, including regulations to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of this section." Section 263A(j)(1).

The Treasury Department and the IRS have considered the commenters' suggested approaches for extending the section 481(d) inclusion period to ETSC corporate subsidiaries but have determined that section 481(c) would not support either approach. Section 481(c) and § 1.481-1(c)(2) provide the general rule that the 481 adjustment is taken into account in computing taxable income in the year of change, unless the Commissioner prescribes a different taxable year or years to take the 481 adjustment into account under §§ 1.446-1(e)(3) and 1.481-4. Any regulations issued under section 481(c) can apply only "[i]n the case of any change described in [section 481](a)" with regard to "adjustments required by [section 481](a)(2)." As acknowledged by the commenters, section 481(a) does not apply to an ETSC corporate subsidiary because such entity is newly formed and therefore could not have had a prior accounting method to potentially change.

Based on the foregoing, the final regulations do not adopt either of the commenters' alternative suggestions or provide any inclusion period for ETSC corporate subsidiaries under section 481. The Treasury Department and the IRS, however, note that TCJA amendments to section 448(c) of the Code have significantly expanded the applicability of the cash method to C corporations, including ETSC corporate subsidiaries. As amended by section 13102(a) of the TCJA (131 Stat. 2054, 2102-3), section 448(c) provides that a C corporation may use the cash method if the corporation has average annual gross receipts not exceeding $25 million (adjusted for inflation) for its three prior taxable years. Prior to the TCJA, the gross receipts threshold under section 448(c) was $5 million. As a result, fewer ETSC corporate subsidiaries will be required to adopt the accrual method as their permissible method of accounting for their first tax return than if the section 448(c) gross receipts threshold had not been increased from $5 million to $25 million.

III. Comments Regarding the Post-Termination Transition Period

The last sentence of § 1.1377-2(b), as in effect prior to the effective date of these final regulations (no-newcomer rule), limited the special treatment provided under section 1371(e)(1) (with respect to distributions of money during a corporation's PTTP) solely to those shareholders who were shareholders of the corporation at the time that it terminated or revoked its S election (collectively, legacy shareholders). Because the rules pertaining to the PTTP and to the ETSC period serve a similar objective of easing the transition from S corporation to C corporation status, the Treasury Department and the IRS determined that the rules regarding newcomers (that is, non-legacy shareholders) should be consistent. See preamble to the proposed regulations, Explanation of Provisions, part IV. Therefore, based on the rationale for rejecting a no-newcomer rule with respect to the ETSC period, as set forth in part II. A of the Explanation of Provisions of the preamble to the proposed regulations, the Treasury Department and the IRS determined that such a rule should also not apply with respect to the PTTP and proposed the removal of the no-newcomer rule in § 1.1377-2(b). See *Id.*

A. Reliance on the § 1.1377-2(b) No-Newcomer Rule

One commenter expressed concern that elimination of the no-newcomer rule in § 1.1377-2(b) could alter bargained-for economic results if a legacy shareholder had transferred less than all of its shares prior to November 7, 2019 (that is, the publication date of the proposed regulations) or after that date but pursuant to a binding agreement entered into before that date. In particular, the commenter contended that legacy shareholders who transferred less than all of their shares would have expected that only legacy shareholders could receive distributions of AAA during the PTTP, and perhaps even during the ETSC period. According to the commenter, this expectation would have reduced the bargained-for price for the transferred shares to reflect the tax benefit of the future tax-free distributions.

The commenter provided an example in which a sole shareholder of an ETSC sold 40 percent of its stock to a third-party. The sale price was set prior to November 7, 2019, and the parties assumed that the no-newcomer rule would limit distributions of AAA to the legacy shareholder during the PTTP, and that a similar rule would apply during the ETSC period. Under the proposed elimination of the no-newcomer rule in § 1.1377-2(b), however, the newcomer, and not the legacy shareholder, would be eligible to receive 40 percent of any AAA distributed during the PTTP or ETSC period. The commenter observed that the newcomer's accession to a 40 percent interest in the corporation's AAA during the PTTP and ETSC period amounts to a transfer of a tax benefit from the legacy shareholder to the newcomer for no consideration, contrary to the parties' expectations. Therefore, the commenter recommended that the final regulations include an additional transition rule. Under this rule, if shares of a former S corporation were transferred to a newcomer pursuant to a binding agreement entered into before the applicability date of the final regulations, then, except upon unanimous agreement of current shareholders of a corporation that are legacy shareholders, the no-newcomer rule would apply during the PTTP, and a similar rule would apply during the ETSC period.

The Treasury Department and the IRS understand the concern underlying the commenter's recommendation. However, the Treasury Department and the IRS intended the applicability date provisions in the proposed regulations, and as adopted in these final regulations, to afford corporations transition flexibility in applying § 1.1377-2(b) with regard to the PTTP. Section 1.1377-2(b), as revised by the final regulations to eliminate the no-newcomer rule for special treatment under section 1371(e)(1) of distributions of money by a corporation with respect to its stock during the post-termination transition period applies to a corporation's taxable years beginning after the date of publication of the final regulations. In the case of a corporation using the calendar year as its annual accounting period, newcomers are not entitled to receive distributions of AAA before January 1, 2021, unless the corporation chooses to apply § 1.1377-2(b) before January 1, 2021. Corporations to which the commenter's transition rule would have applied generally will thus have completed their PTTPs prior to the applicability of § 1.1377-2(b). Distributions of AAA during those PTTPs would have been limited to legacy shareholders. Additionally, the commenter's proposed transition rule would add complexity in administering these rules. Accordingly, the Treasury Department and the IRS have determined that the applicability date provisions, as set forth in the proposed regulations and adopted in these final regulations, balance appropriately the protection of legacy taxpayers' expectations with the goal of the Treasury Department and the IRS to minimize complexity and administrative difficulties for S corporations, their shareholders, and the IRS.

With regard to the ETSC period, as discussed in part II. A of the Explanation of Provisions of the preamble to the proposed regulations, section 1371(f) does not contain a no-newcomer rule similar to § 1.1377-2(b), and the Treasury Department and the IRS have concluded that it is inappropriate to adopt one. Corporations may have applied a similar analysis of section 1371(f) and made distributions of AAA to newcomers during their respective ETSC periods. Providing an alternate rule in these final regulations for the ETSC period could unexpectedly alter taxpayers' bargained-for economic results. Therefore, the Treasury Department and the IRS have determined that the best way to address this situation is to allow but not require corporations to apply the final regulations addressing distributions made during the ETSC period to taxable years beginning on or before the date that these final regulations are published in the Federal Register.

B. Consideration of Request for an Additional 120-Day PTTP

A commenter recommended that the final regulations provide a new 120-day PTTP that would begin on the applicability date of the final regulations. The commenter noted that this new PTTP would create an opportunity for any C corporation with undistributed AAA that expired at the end of its PTTP to restore and distribute such AAA pursuant to section 1371(e)(1) and § 1.1377-2. The commenter contended that the elimination of the no-newcomer rule only for terminations that occur after the issuance of the proposed regulations disadvantages corporations that terminated their S election more than one year prior to issuance of the proposed regulations, as compared to corporations that terminated their S election after the issuance of the proposed regulations.

The Code sets forth a statutory definition of the PTTP that includes detailed limits on its duration. Specifically, section 1377(b)(1)(A), (B), and (C) provide three separate durations for the PTTP, the respective applicability of which depends upon particular events. While the Treasury Department and the IRS acknowledge the concerns raised by the commenter, the final regulations do not adopt the commenter's recommendation because (i) section 1377(b) provides specific, detailed, and unambiguous guidance on the duration of a PTTP, and (ii) the recommended revision to § 1.1377-2 exceeds the scope of the authority granted to prescribe regulations under sections 1371 or 1377.

IV. Consideration of Comment Regarding Treatment of ETSC Status and AAA as Section 381 Items

In the case of certain asset acquisitions, section 381(a) generally requires the acquiring corporation to succeed to and take into account the tax items described in section 381(c) of the distributor or transferor corporation. See section 381(a) (describing distributions to which section 332 of the Code applies and transfers to which section 361 of the Code applies that are carried out in connection with certain reorganizations described in section 368(a)(1) of the Code); section 381(c) (enumerating tax items of the distributor or transferor corporation that the acquiring corporation succeeds to and takes into account under section 381(a)).

A commenter requested that the final regulations confirm that ETSC status and AAA constitute tax items that an acquiring corporation would succeed to or take into account under section 381(a). The Treasury Department and the IRS have considered the issue raised by the commenter but have determined that further study would be required to promulgate the appropriate rule. In addition, the Treasury Department and the IRS have concluded that this issue exceeds the scope of the final regulations because whether AAA constitutes a tax item to which a successor may succeed under section 381 is not limited to the ETSC context. Therefore, the final regulations do not address the commenter's request.

Applicability Dates

These regulations generally apply to taxable years beginning after October 20, 2020. See §§ 1.481-6(b), 1.1371-1(e), 1.1371-2(d), and 1.1377-3(c). However, a corporation may choose to apply the rules set forth in §§ 1.481-5, 1.1371-1, and 1.1371-2 in their entirety to taxable years beginning on or before October 20, 2020. If a corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently, and the corporation must continue to apply the rules in §§ 1.481-5, 1.1371-1, and 1.1371-2 in their entirety for the corporation's subsequent taxable years.

In addition, a corporation generally may choose to not apply the no-newcomer rule in § 1.1377-2(b) to taxable years beginning on or before October 20, 2020 and with respect to which the period described in section 6501(a) as applied to that corporation has not expired. If a corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently, and the corporation must adopt §§ 1.481-5, 1.1371-1, 1.1371-2 (if an ETSC), and § 1.1377-2(b) in their entirety and continue to apply those rules in their entirety for the corporation's subsequent taxable years.

II.P.3.e. Conversion from Qualified Subchapter S Subsidiary to Single Member LLC

The merger of a Qualified Subchapter S Subsidiary ("QSub") into an LLC wholly owned by the QSub's parent has no income tax consequences.[3912]

II.P.3.f. Conversions from Partnership to Sole Proprietorships and Vice Versa

When a sole proprietorship organized as an LLC adds a member, it becomes a partnership. If the original member sells part his or her interest in the LLC to a new member, then he or she is deemed to have sold a corresponding portion of the LLC's assets to the new member,[3913] as follows:[3914]

> In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.
>
> Under section 1001, A recognizes gain or loss from the deemed sale of the 50% interest in each asset of the LLC to B.
>
> Under section 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.
>
> Under section 722, B's basis in the partnership interest is equal to $5,000, the amount paid by B to A for the assets which B is deemed to contribute to the newly-created partnership. A's basis in the partnership interest is equal to A's basis in A's 50% share of the assets of the LLC.
>
> Under section 723, the basis of the property treated as contributed to the partnership by A and B is the adjusted basis of that property in A's and B's hands immediately after the deemed sale.
>
> Under section 1223(1), A's holding period for the partnership interest received includes A's holding period in the capital assets and property described in section 1231 held by the LLC when it converted from an entity that was disregarded as an entity separate from A to a partnership. B's holding period for the partnership interest begins on the day following the date of B's purchase of the LLC interest from A. See Rev. Rul. 66-7, 1966-1 C.B. 188, which provides that the holding period of a purchased asset is computed by excluding the date on which the asset is acquired. Under section 1223(2), the partnership's holding period for the assets deemed transferred to it includes A's and B's holding periods for such assets.

[3912] Reg. § 1.1361-5(b)(3), Example (2). See fn. 144 for details.

[3913] See T.D. 8844 (preamble to regulations on entity conversions) (11/29/99) and Rev. Rul. 99-5. See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. See also The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations *TM Memorandum* (BNA) (3/16/2009), and AICPA Comments to IRS on Rev. Rul. 99-5 on Disregarded Entities (6/5/2013), found at http://www.aicpa.org/advocacy/tax/partnerships/downloadabledocuments/comments-on-rev-ruling-99-5-v-6-5-13submit.pdf.

[3914] Rev. Rul. 99-5, Situation 1.

However, if the new member pays the LLC for a member interest, then the old and new member are deemed to have formed a partnership, which generally qualifies as a nontaxable transaction,[3915] as follows:[3916]

> In this situation, the LLC is converted from an entity that is disregarded as an entity separate from its owner to a partnership when a new member, B, contributes cash to the LLC. B's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest.
>
> Under section 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.
>
> Under section 722, B's basis in the partnership interest is equal to $10,000, the amount of cash contributed to the partnership. A's basis in the partnership interest is equal to A's basis in the assets of the LLC which A was treated as contributing to the newly-created partnership.
>
> Under section 723, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A's hands. The basis of the property contributed to the partnership by B is $10,000, the amount of cash contributed to the partnership.
>
> Under section 1223(1), A's holding period for the partnership interest received includes A's holding period in the capital and section 1231 assets deemed contributed when the disregarded entity converted to a partnership. B's holding period for the partnership interest begins on the day following the date of B's contribution of money to the LLC. Under section 1223(2), the partnership's holding period for the assets transferred to it includes A's holding period.

Thus, the parties can control whether the original owner is taxed and the new owner gets an inside basis step-up, or the original owner is not taxed and the new owner does not get an inside basis step-up.[3917] However, the parties can have their cake and eat it, too: in the latter case, the new owner can transfer the partnership interest to another partnership (or corporation) in a tax-free transaction and get an inside basis step-up.[3918]

When an LLC with more than one member is taxed as a partnership, and the number of members later is reduced to one, it becomes a sole proprietorship for tax purposes. When one member buys out the other(s), the selling member(s) is(are) taxed based on the rules for selling a partnership interest, and the remaining member (essentially the new sole proprietor) is deemed to have bought all of the LLC's assets on that

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[3915] See T.D. 8844 (preamble to regulations on entity conversions) (11/29/99), Rev. Rul. 99-5, and part II.M.3 Buying into or Forming a Partnership (especially part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership). See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. Letter Ruling 200633019 discusses a large variety of tax issues when a trust contributes a diversified portfolio of marketable securities to a single-member LLC and then distributes LLC interests to the remaindermen; Letter Ruling 201628008 includes a more abbreviated discussion of such a transaction. See also The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations 201351018 (BNA) (3/16/2009).
[3916] Rev. Rul. 99-5, Situation 2.
[3917] See part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue.
[3918] See parts II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss), II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000 and II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

date, with no tacking of holding period for any portion of the assets.[3919] Furthermore, payments that would have been deductible by a partnership had it continued in existence are deductible by the successors to the partnership.[3920]

Pierre v. Commissioner[3921] was a reviewed opinion (12-6 vote) holding that gifts and sales of interests in a single-member limited liability company (LLC) be treated for gift tax purposes as transfers of interests in an entity rather than transfers of the underlying assets.

Initially, the transferor was the LLC's sole owner. Some LLC interests were gifted, and the rest were sold. The IRS asserted that the transfers were of the LLC's underlying assets, not interests in the LLC. It tried to apply the principles of Rev. Rul. 99-5, Situation 1, which provides:

> In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

The Tax Court majority rejected the application of the check-the-box rules[3922] to this gift. Those provisions apply only "where not otherwise distinctly expressed or manifestly incompatible with the intent" of other provisions in the tax law.[3923] Fundamental gift tax precepts require that one look to the bundle of rights transferred. The Tax Court held that, under state law, an LLC interest (not an interest in the underlying assets) was transferred; applying the check-the-box regulations would be manifestly incompatible with fundamental gift tax precepts. *Pierre* is quoted in length in part III.B.1.e Valuation Issues.

The court distinguished between classifying the entity and describing the nature of the assets that were transferred. This fine line might breed litigation in the transfer tax area.

II.P.3.g. Rescissions, Including Rescinding Conversion of Entity

The IRS often respects rescissions for income tax purposes[3924] when a transaction is reversed in the same taxable year. The IRS explains:[3925]

[3919] Rev. Rul. 99-6; see also part II.Q.8 Exiting From or Dividing a Partnership; see Letter Ruling 201723009 when such a transaction is done inside a consolidated group. See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. See also "The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations," *TM Memorandum* (BNA) (3/16/2009). For a myriad of tax issues raised in this situation, criticizing Rev. Rul. 99-6, see AICPA Comments on Revenue Ruling 99-6 on Conversions from Partnerships to Disregarded Entities (10/1/2013), found at http://www.aicpa.org/advocacy/tax/partnerships/downloadabledocuments/comments-on-rev-ruling-99-6-submit.pdf. The AICPA points to very different results when a purchaser buys 99% instead of 100%.

[3920] Rev. Rul. 75-154.

[3921] 133 T.C. 24 (2009). For income tax treatment of a gift of the entire interest in a single member LLC, see fn. 345.

[3922] Reg. §§ 301.7701-1 through 301.7701-3.

[3923] Code § 7701(a) (introductory language).

[3924] The IRS does not have a clear policy for estate and gift tax law. However, *Neal v. U.S.*, 187 F.3d 626 (3rd Cir. 1999) allowed a rescission under Pennsylvania law and considered the gift incomplete because of it.

[3925] Rev. Rul. 80-58. Although the ruling is old, it is still viable. Rev. Proc. 2013-3, Section 5.02(1) indicated that the IRS was considering its position in the rescission area. Rev. Proc. 2014-3, Section 1.02(6) mentioned that Section 5.02(1) was deleted

> The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.
>
> The annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. That is, each taxable year is a separate unit for tax accounting purposes…..
>
> In Situation 1 the rescission of the sale … placed A and B at the end of the taxable year in the same positions as they were prior to the sale. Thus, … the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction…..
>
> In Situation 2, as in Situation 1, there was a completed sale in 1978. However, unlike Situation 1, because only the sale and not the rescission occurred in 1978, at the end of 1978 A and B were not in the same positions as they were prior to the sale….[T]he rescission in 1979 is disregarded with respect to the taxable events occurring in 1978.
>
> In both situations, the annual accounting period principle requires the determination of income at the close of the taxable year without regard to subsequent events.

Gateway Hotel Partners, LLC v. Commissioner[3926] upheld the requirement that the transaction cannot qualify for rescission unless undone by the end of the taxable year. *Blagaich v. Commissioner*[3927] also

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and that Section 3.02(8) was added, the latter providing that whether a completed transaction can be rescinded for Federal income tax purposes is an issue on which the IRS will not issue a private letter ruling. At the May 2014 meeting of the Sales, Exchanges & Basis Committee of the American Bar Association's Section of Taxation, a government representative informally stated that withdrawing its study of the area indicates that the IRS has reaffirmed its commitment to Rev. Rul. 80-58. Materials for that meeting prepared by Section practitioner members are saved as Thompson Coburn document 6044351. For more on Rev. Rul. 80-58, see New York State Bar Association Tax Section Report on the Rescission Doctrine (Report No. 1216) (8/11/2010) at www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1216-Report.pdf, citing Sheldon I. Banoff, Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud, *Taxes – The Tax Magazine* (Dec. 1984) at 942; and David H. Schnabel, Revisionist History: Retroactive Federal Tax Planning (2009) (unpublished manuscript), mentioning that an earlier version is published at 60 *Tax Lawyer* 685 (2007).

[3926] T.C. Memo. 2014-5.

[3927] T.C. Memo. 2016-2, holding:

> … In general, the annual accounting period principle reflected in section 451, considered in the light of the judicially articulated claim-of-right doctrine, limits application of the rescission exception such that, without regard to subsequent events, income received by the taxpayer under a claim of right and retained by her at the close of the taxable year must be included in gross income for that year. See [*Penn v. Robertson*, 115 F.2d 167, 175 (4th Cir. 1940)]; Rev. Rul. 80-58, Situation 2, 1980-1 C.B. at 182.
>
> ….
>
> The facts show that, in 2010, petitioner took possession of the whole amount in question, $400,000, without any substantial limitations or restrictions as to its disposition. She recognized no liability and made no provision to repay that amount until nearly three years later. None of the cases petitioner cites as allowing a relaxation of the same-year requirement for rescission is factually comparable to her own, and they provide no rationale for departing from the general rule.
>
> With respect to the equitable concerns petitioner raised in her motion—The equities in this case simply do not support strict adherence to the one-year guideline in the rescission doctrine.—we note only that our statutory mandate does not permit us to decide this case on the basis of general principles of equity. See *Knapp v. Commissioner*, 90 T.C. 430,

refused to apply rescission to a payment that the taxpayer returned over three years later after payment, when she did so only after being order by a court to do so. However, in another case, a taxpayer was permitted to rescind a disclaimer based on erroneous tax advice, more than two years after the disclaimer, after joining the IRS as a party to a legal action to rescind.[3928]

The IRS approved a rescission of a conversion from partnership to corporation where everything happened in one year and the taxpayer had a good nontax reason.[3929] The IRS has also allowed a taxpayer to rescind a restructuring involving a subsidiary to reverse unintended adverse Federal income tax consequences.[3930] However, the IRS will not issue any more letter rulings in this area.[3931]

A taxpayer cannot unilaterally recast a transaction merely because the taxpayer decides that documenting it differently would have produced a better tax result.[3932]

For the rescission to be effective, both parties must be put back in their original positions.[3933] A January 2005 article further analyzes the rescission doctrine.[3934]

> 440 (1988) (citations omitted) (The Tax Court is a court of limited jurisdiction. *** We have only the powers expressly conferred on us by Congress, and may not apply equitable principles to expand our jurisdiction beyond the limits of section 7442.), *aff'd*, 867 F.2d 749 (2d Cir. 1989).

The court rejected the taxpayer's reliance on *Hope v. Commissioner*, 55 T.C. 1020, 1030 (1971), *aff'd*, 471 F.2d 738 (3d Cir. 1973), which the court said:

> suggests that the rescission doctrine may apply even when repayment of a gain does not formally occur in the year of receipt, but only if, before the end of the year, [the] taxpayer recognizes his liability under an existing and fixed obligation to repay the amount received and makes provisions for repayment.

The court rejected the taxpayer's reliance on *Guffey v. United States*, 339 F.2d 759 (9th Cir. 1964), which case the court described:

> In *Guffey*, the installment purchasers of the Guffeys' home sued to rescind the sale contract when, in the following year, they discovered dry rot, moved out, and refused to make further payments. A settlement was reached under which the purchasers' suit was dismissed and the Guffeys obtained a quitclaim deed and retained the previously received payments as rent.…While the Court of Appeals did state that it can fairly be said that the settlement with the *** original purchasers was, in substance, a reduction in the purchase price, *id.*, the Guffeys returned nothing to the original purchasers, the original purchasers apparently agreeing that the payments could be kept as rent. The sort of passive unwinding of the agreement that occurred in *Guffey* did not and could not occur in the case at bar; the only way Mr. Burns could be restored to status quo ante was if petitioner returned the $400,000.

[3928] *Breakiron v. Gudonis*, 106 A.F.T.R.2d 2010-5999 (D. Mass. 2010). The IRS was joined as a party when it attempted to collect gift tax. In another disclaimer case, the court dismissed the IRS as a party. *Van Vliet v. Van Vliet*, 115 A.F.T.R.2d 2015-803 (E.D. Va. 2015).

[3929] Letter Ruling 200952036.

[3930] Letter Ruling 201008033.

[3931] Rev. Proc. 2017-3, Section 3.02(8), listed as a no-rule area "whether a completed transaction can be rescinded for Federal income tax purposes."

[3932] *Makric Enterprises, Inc. v. Commissioner*, TC Memo 2016-44, 119 A.F.T.R.2d ¶ 2017-580 (5th Cir. 3/27/2017).

[3933] Citing *Hutcheson v. Commissioner*, T.C. Memo. 1996-127 for that proposition, *Fitch v. Commissioner*, T.C. Memo. 2012-358, rebuffed IRS arguments in favor of rescinding a sale of a CPA practice, which was followed by a repurchase shortly thereafter when the original buyer's health deteriorated unexpectedly:

> The repurchase agreement, by its own terms, effected a sale of the C.P.A. practice from Mr. Gronke to Mr. Fitch and not an unwinding of the earlier sale. There is no evidence that Mr. Fitch and Mr. Gronke intended to abrogate, cancel, or void the sale agreement. Furthermore, we do not believe that the repurchase agreement returned them to their original positions. The C.P.A. practice continued as a dynamic, ongoing enterprise for approximately 4-1/2 months after the sale transaction, and we cannot say that Mr. Fitch received the C.P.A. practice back in the exact same condition in which he had sold it. Accordingly, we find that the sale and repurchase transactions were not rescinded.

Query whether the court was just being sympathetic to the seriously ill parties and really would set such a high bar if the taxpayers had sought to rescind the agreement.

[3934] Morehouse, The Rescission Doctrine: Tax Do-Overs, Another Roll Of the Dice, *TM Real Estate Journal* (BNA) (1/7/2015).

An S election may be rescinded until the last day on which the election could have been timely made.[3935] The IRS will not permit a revocation that is more retroactive than that.[3936] A corporation may rescind such a revocation at any time before the revocation becomes effective, but only with the consent of each person who consented to the revocation and each person who became a shareholder of the corporation within the period beginning on the first day after the date the revocation was made and ending on the date on which the rescission is made.[3937]

II.P.3.h. Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization

When transferring a corporation's business to a new partnership, consider doing the following:

1. The shareholders form a new corporation with ownership identical to the old corporation's ownership.

2. The old corporation converts or is merged into a limited liability company that is a disregarded entity.

3. Either the new corporation then transfers its member interest in the LLC to a limited partnership, or the LLC itself admits one or more additional members to convert the LLC to an entity taxed as a partnership.

To qualify as an F reorganization[3938] nontaxable for federal income tax purposes (always check state income tax rules), this or any other transaction must result in a mere change in identity, form, or place of organization of one corporation.[3939] A transaction involving an actual or deemed transfer is a mere change only if:

- Immediately after the reorganization, all the stock of the resulting corporation, including any stock of the resulting corporation issued before the reorganization, must have been distributed (or deemed distributed) in exchange for stock of the transferor corporation;[3940]

- The same person or persons must own all of the stock of the transferor corporation, determined immediately before the reorganization, and of the resulting corporation, determined immediately after the reorganization, in identical proportions;[3941]

[3935] Reg. § 1.1362-2(a)(2)(i).
[3936] Christian & Grant, ¶32.02. Revocation, *Subchapter S Taxation* (WG&L), cites varies IRS correspondence to that effect.
[3937] Reg. § 1.1362-2(a)(4).
[3938] Code § 368(a)(1)(F).
[3939] Reg. § 1.368-2(m)(1). For an analysis of the background to this regulation and its impact, see Kliegman and Chen, Some Ado About a Nothing: Final F Reorganization Regulations, *TM Memorandum* (BNA) (4/4/2016). The article suggests that Rev. Rul. 68-349 appears to violate the requirements of the text accompanying fns. 3940-3941; it has been suggested that informal comments at the January 2016 meeting of the American Bar Association's Section of Taxation indicate that the government might not have considered the regulations' impact on that ruling.
[3940] However, a de minimis amount of stock issued by the resulting corporation other than in respect of stock of the transferor corporation to facilitate the organization of the resulting corporation or maintain its legal existence is disregarded. Reg. § 1.368-2(m)(1)(i).
[3941] However, this requirement is not violated if one or more holders of stock in the transferor corporation exchange stock in the transferor corporation for stock of equivalent value in the resulting corporation, but having different terms from those of the stock in the transferor corporation, or receive a distribution of money or other property from either the transferor corporation or the resulting corporation, whether or not in exchange for stock in the transferor corporation or the resulting corporation. Reg. § 1.368-2(m)(1)(ii).

- The resulting corporation does not hold any property or have any tax attributes[3942] immediately before the reorganization;[3943]

- The transferring corporation completely liquidates, for federal income tax purposes, in the reorganization;[3944]

- Immediately after the reorganization, no corporation other than the resulting corporation holds property that was held by the transferor corporation immediately before the reorganization, if such other corporation would, as a result, succeed to and take into account the items of the transferor corporation described in Code § 381(c);[3945] and

- Immediately after the reorganization, the resulting corporation does not hold property acquired from a corporation other than the transferor corporation if the resulting corporation would, as a result, succeed to and take into account the items of such other corporation described in Code § 381(c).[3946]

The last two bullet points emphasize that tax attributes cannot change in an F reorganization.[3947] Thus, when a corporation engages in an F reorganization, the part of the tax year before the reorganization and the part after constitute a single tax year,[3948] and the resulting corporation must file a single full-year return using the same EIN;[3949] however, if the old corporation was domestic and the new one is foreign, the

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[3942] Including those specified in Code § 381(c).

[3943] However, this requirement is not violated if the resulting corporation holds or has held a de minimis amount of assets to facilitate its organization or maintain its legal existence, and has tax attributes related to holding those assets, or holds the proceeds of borrowings undertaken in connection with the potential F reorganization. Reg. § 1.368-2(m)(1)(iii).

[3944] However, the transferor corporation is not required to dissolve under applicable law and may retain a de minimis amount of assets for the sole purpose of preserving its legal existence. Reg. § 1.368-2(m)(1)(iv).

[3945] Reg. § 1.368-2(m)(1)(v). The preamble, T.D. 9739, explains:

> Thus, a transaction that divides the property or tax attributes of a Transferor Corporation between or among acquiring corporations, or that leads to potential competing claims to such tax attributes, will not qualify as a Mere Change.

[3946] Reg. § 1.368-2(m)(1)(vi). The preamble, T.D. 9739, explains:

> Thus, a transaction that involves simultaneous acquisitions of property and tax attributes from multiple transferor corporations (such as the transaction described in Rev. Rul. 58-422, 1958-2 CB 145) will not qualify as a Mere Change.

[3947] The preamble, T.D. 9739, says:

> From a federal income tax perspective, F reorganizations are generally neutral, involving no change in ownership or assets, no end to the taxable year, and inheritance of the tax attributes described in section 381(c) without a limitation on the carryback of losses. See, for example, Rev. Rul. 96-29 (discussed in section 3.B.ii. of the Background); § 1.381(b)-1(a)(2).

[3948] Reg. § 1.381(b)-1(a)(2) provides:

> *Reorganizations under section 368(a)(1)(F)*. In the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the acquiring corporation shall be treated (for purposes of section 381) just as the transferor corporation would have been treated if there had been no reorganization. Thus, the taxable year of the transferor corporation shall not end on the date of transfer merely because of the transfer; a net operating loss of the acquiring corporation for any taxable year ending after the date of transfer shall be carried back in accordance with section 172(b) in computing the taxable income of the transferor corporation for a taxable year ending before the date of transfer; and the tax attributes of the transferor corporation enumerated in section 381(c) shall be taken into account by the acquiring corporation as if there had been no reorganization.

[3949] Rev. Rul. 73-526, Situation (3) described these facts:

> Corporation R was chartered in state X. It reincorporated in state Y as corporation S, a new corporate entity under the laws of state Y. The assets and liabilities of R were transferred to corporation S. Prior to the reincorporation, corporation R had been assigned an identifying number. Except for the technical difference of forming a new corporate entity chartered in state Y, the surviving corporation, S, is the same corporation as the transferor corporation, R. The same business with the same assets and the same stockholders is continued in the newly chartered entity.

F reorganization does close the tax year.[3950] In a purely domestic F reorganization, the new corporation's filing a tax return runs the statute of limitations for the old corporation's activity that was reported on the new corporation's return.[3951]

Continuity of the business enterprise and a continuity of interest are not required to qualify as an F reorganization.[3952]

Subject to certain limitations, an F reorganization might consist of a series of related transactions that together result in a mere change of one corporation.[3953]

> Consequently, the reincorporation constitutes a reorganization within the meaning of section 368(a)(1)(F) of the Internal Revenue Code of 1954. Under section 1.381(b)-1(a)(2) of the Income Tax Regulations, the acquiring corporation is treated just as the transferor corporation would have been treated in the absence of a reorganization, and the taxable year of the transferor does not close on the date of transfer. Thus, a final return is not required of corporation R in this transaction.

Rev. Rul. 73-526 concluded:

> Since the surviving corporation, S, is for Federal income tax purposes treated as the same corporation as the transferor corporation, R, the identifying number assigned to corporation R should be continued in use by corporation S after the transaction.

[3950] Reg. § 1.367(a)-1(e).

[3951] *New Capital Fire, Inc. v. Commissioner*, T.C. Memo. 2017-177, rejecting the IRS' contention that failing to file a return for the old corporation kept the statute of limitations open. The new corporation's return properly disclosed the F reorganization. The court held:

> New Capital's 2002 return purported to and did include Old Capital's income from January 1 through December 4, 2002. Respondent has not alleged, and we do not find, that New Capital's 2002 return was false or fraudulent with intent to evade tax as it pertains to Old Capital. It was respondent's duty to determine, within the period of limitations provided by section 6501(a), whether New Capital's 2002 return, as it pertains to Old Capital, was erroneous in any respect. The exception under section 6501(c)(3) does not apply. Accordingly, assessment of the determined deficiency and additions to tax is barred by the statute of limitations.

[3952] Reg. § 1.368-2(m)(2).

[3953] Reg. § 1.368-2(m)(3), which provides:

> *Series of transactions*. A potential F reorganization consisting of a series of related transactions that together result in a mere change of one corporation may qualify as a reorganization under section 368(a)(1)(F), whether or not certain steps in the series, viewed in isolation, could be subject to other Code provisions, such as sections 304(a), 331, 332, or 351. However, see paragraph (k) of this section for transactions that qualify as reorganizations under section 368(a) and will not be recharacterized as a mere change as a result of one or more subsequent transfers of assets or stock.

The preamble, T.D. 9739, explains:

> In some cases, business or legal considerations may require extra steps to complete a transaction that is intended to qualify as a Mere Change. As discussed in section 3.B.i. of the Background, the Treasury Department and the IRS concluded that the words however effected in the statutory definition of F reorganization reflect a Congressional intent to treat a series of transactions that together result in a Mere Change as an F reorganization, even if the transfer (or deemed transfer) of property from the Transferor Corporation to the Resulting Corporation occurs indirectly. The Final Regulations confirm this conclusion by providing that a Potential F Reorganization consisting of a series of related transactions that together result in a Mere Change may qualify as an F reorganization, whether or not certain steps in the series, viewed in isolation, might, for example, be treated as a redemption under section 304(a), as a complete liquidation under section 331 or section 332, or as a transfer of property under section 351. For example, the first step in an F reorganization of a corporation owned by individual shareholders could be a dissolution of the Transferor Corporation, so long as this step is followed by a transfer of all the assets of the Transferor Corporation to a Resulting Corporation. However, see § 1.368-2(k) for completed reorganizations that will not be recharacterized as a Mere Change as a result of one or more subsequent transfers of assets or stock, such as where a Transferor Corporation transfers all of its assets to its parent corporation in liquidation, followed by the parent corporation's retransfer of those assets to a new corporation. See also Rev. Rul. 69-617, 1969-2 CB 57 (an upstream merger followed by a contribution of all the target assets to a new subsidiary corporation is a reorganization under sections 368(a)(1)(A) and 368(a)(2)(C)).

The preamble further discussed such a reorganization's role in a larger transaction:

It has been suggested that substantive changes of ownership that were not allowed before these regulations are now allowed:[3954]

- Exchanging stock for stock of equivalent value but with different terms, or

- Either the old or new corporations distributing cash or other property.

Sometimes a conversion generally involves a direct or indirect merger of a corporation into an unincorporated entity taxed as a corporation.[3955] For example, an LLC that is taxed as an S corporation can move assets comprising one line of business into a new parent LLC taxed as an S corporation that assumes its tax attributes and then under Code § 355 distribute assets comprising another line of business into another LLC taxed as an S corporation.[3956] Generally, for an S corporation, I recommend that the

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> As discussed in section 3.B.ii. of the Background, the Treasury Department and the IRS recognized that an F reorganization may be a step, or a series of steps, before, within, or after other transactions that effect more than a Mere Change, even if the Resulting Corporation has only a transitory existence following the Mere Change. In some cases an F reorganization sets the stage for later transactions by alleviating non-tax impediments to a transfer of assets. In other cases, prior transactions may tailor the assets and shareholders of the Transferor Corporation before the commencement of the F reorganization. Although an F reorganization may facilitate another transaction that is part of the same plan, the Treasury Department and the IRS have concluded that step transaction principles generally should not recharacterize F reorganizations because F reorganizations involve only one corporation and do not resemble sales of assets.

[3954] McMahon, Recent Developments in Federal Income Taxation of Corporations and Partnerships, 64th Annual Montana Tax Institute (10/14/2016).

[3955] A direct approach is found Reg. § 1.368-2(m)(4), Example (8), and the logistics are explained in Letter Ruling 200839017. See Riser, Hiding Your Stuff in Plain Sight (Without Trusts): Dr. FUnbundle (or How I Learned to Stop Worrying and Love Sec. 368(a)(1)(F)), American Bar Association Section of Real Property, Trust & Estate Law, 2009 Spring Symposia, discussing Letter Ruling 200701017. See also Rev. Ruls. 64-250, 73-256, and 2008-18 and Letter Rulings 200528021, 200622025, and 200719005. See also Kalinka, Transfer of an Interest in an LLC Taxed As an S corporation Raises Many Questions, p. 23 *Taxes-The Tax Magazine* (October 2007); Christian & Grant, ¶ 29.07. 'F' Reorganizations, *Subchapter S Taxation* (WG&L); and Gassman, Crotty, and O'Leary, The Estate Planner's Guide to New Parent F Reorganizations, *Estate Planning Journal* (WG&L), May 2008. These issues were discussed at the Asset Protection Committee Meeting of the American College of Trust & Estate Counsel (ACTEC) in the Fall of 2009, which included some practical materials for LLCs taxed as S corporations that are available to ACTEC Fellows. For whether a new employer identification number (IRS tax ID) is needed, see fns 193-196 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub). Although Rev. Rul. 2008-18 says that the new entity retains the new entity's S election, I had suggested that the new entity file IRS Form 2553. However, Form 8869, line 14 asks, "Is this election being made in combination with a section 368(a)(1)(F) reorganization described in Rev. Rul. 2008-18, where the subsidiary was an S corporation immediately before the election and a newly formed holding company will be the subsidiary's parent?" and provides the following instructions:

> This box should be checked "Yes" if this election is being made pursuant to a reorganization under section 368(a)(1)(F) and Rev. Rul. 2008-18. This occurs when a newly formed parent holding company holds the stock of the subsidiary that was an S corporation immediately before the transaction and the transaction otherwise qualifies as a reorganization under section 368(a)(1)(F). No Form 2553, Election by a Small Business Corporation, is required to be filed by the parent. See Rev. Rul. 2008-18, 2008-13 I.R.B. 674, for details.

Letter Ruling 199947034, found in fn. 7053, ruled that Code § 2701 did not apply to such a reorganization.

See fn. 362 in part II.B Limited Liability Company (LLC) if the new entity is an LLC electing taxation as an S corporation and fn. 197 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub) regarding the timing of an LLC electing S corporation status before acquiring a QSub.

[3956] Letter Ruling 201638004. The facts were:

(1) The X members will contribute all of their X equity units to Y, a newly formed-State X limited liability company, in exchange for all of the Y equity units.
(2) X will elect to become, or by default will become, a disregarded entity or qualified subchapter S subsidiary for Federal tax purposes. After this step, Y expects to continue X's S corporation election.

LLC file a new Form 2553, election to be taxed as an S corporation, which converts the LLC to a corporation and makes an S election at the same time;[3957] however, when an existing S corporation passes its S corporation tax attributes to a new parent through a Code § 368(a)(1)(F) reorganization in which the old corporation becomes a qualified subchapter S subsidiary (QSub), only a QSub election is made, which results in the parent becoming an S corporation, as described in fn 3955. Query whether one wants to file Form 2553 for the new parent anyway, in case the Code § 368(a)(1)(F) reorganization is somehow deficient. Regarding tax IDs of those involved in Code § 368(a)(1)(F) reorganizations, see fns 3955-3957 and parts II.G.1 How and When to Obtain or Change an Employer Identification Number (EIN) and II.P.3 Conversions.

Letter Ruling 202102007 involved the following facts and rulings:

> **Summary of Facts**
>
> Oldco, prior to the Completed Transaction, was a publicly traded State A corporation and the common parent of an affiliated group of corporations that filed a consolidated federal income tax return (the "Oldco Group"). Oldco owned all the stock of Sub 1, which in turn held substantially all of the assets and operations of the Oldco Group.
>
> Oldco formerly operated a business that generated Historic Liabilities. Prior to the Completed Transaction, the Historic Liabilities were obligations of Oldco for state law purposes. Oldco undertook the Completed Transaction (described below) in order to separate its core business operations from the Historic Liabilities and to better manage the Historic Liabilities.
>
> **Completed Transaction**
>
> The Completed Transaction has been completed as of the date of this ruling, but either the tax return has not yet been filed for the year in which the transaction was completed or the tax return was filed for the year in which the transaction was completed, but this ruling request was filed prior to the filing of the tax return.

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(3) X will distribute the assets comprising the Retained Business to Y in a transaction that it expects to be disregarded for Federal income tax purposes. After this step, X would continue to hold the assets comprising the Distributed Business.
(4) Y will transfer all of the equity units of X to Z, a newly-formed State X limited liability company, solely in exchange for all of the Z equity units. After this step, Z will hold only the equity units in X, which continues to hold the assets comprising the Distributed Business.
(5) Y will distribute pro rata all of the equity units of Z to Y's members in a transaction intended to qualify under section 355 of the Internal Revenue Code (the Distribution).

After reciting various representations, the ruling held:
(1) For purposes of determining whether Steps 1 and 2, viewed together, result in the realization of gain or loss under section 1001 (see *Weiss v. Stearn*, 265 U.S. 242 (1924)), or a reorganization under section 368(a)(1)(F) (see Rev. Rul. 72-206, 1972-1 C.B. 104), Steps 3 through 5 shall be disregarded.
(2) For U.S. Federal income tax purposes, Steps 3 through 5 will be treated as a direct transfer of the Distributed Business by Y to Z in exchange for all of the equity units of Z and the assumption of associated liabilities, followed by the pro rata distribution by Y of all of the equity units of Z to Y's members.
(3) X's S election will not terminate as a result of the completion of Steps 1 and 2, but continues for Y.

[3957] See fn. 362 and the accompanying and following text. Also consider what happens if there is some defect in Form 2553 that might make its filing invalid. Is converting into a partnership or a C corporation the lesser of two evils? If the latter, consider filing Form 8832 before Form 2553.

The steps of the Completed Transaction are set forth below:

(i) On Date 1, Oldco formed Newco, a State A corporation.

(ii) On Date 2, Newco formed LLC, a State A limited liability company that will be treated as a disregarded entity for federal income tax purposes.

(iii) On Date 3, Oldco merged with and into LLC, with LLC as the surviving entity. In the merger, the Oldco shareholders exchanged their shares of Oldco stock for shares of Newco stock. Steps (i) through (iii), collectively, are referred to as the "Potential Reorganization."

Newco shareholders held no economic interest in LLC following the Potential Reorganization, except by reason of their ownership of Newco stock. At all times before and following the Potential Reorganization, Newco had the sole authority to appoint LLC's board of directors.

(iv) On Date 4, Newco and LLC entered into the Support Agreement, whereby Newco agreed to contribute funds to LLC in order to ensure LLC's ongoing solvency.

(v) On Date 4, LLC distributed the stock of Sub 1 to Newco.

Representations

The taxpayer makes the following representations with respect to the Completed Transaction:

a) LLC is a domestic eligible entity under Treas. Reg. § 301.7701-3(a).

b) For all tax, accounting, financial statement, books, records, and corporate purposes, Newco and LLC have reported and will consistently report and treat Newco as the sole member and sole owner of LLC immediately before and immediately after the Potential Reorganization.

c) Except for the issue of the Shareholder Rights included in the LLC Agreement, the Potential Reorganization will qualify as a reorganization under section 368(a)(1)(F).

Rulings

Based solely on the information provided and the representations set forth above, we rule as follows regarding the Completed Transaction:

1) At the time of and immediately after the Potential Reorganization, LLC was an entity disregarded as separate from Newco under Treas. Reg. § 301.7701-3(b)(1)(ii) for federal income tax purposes.

2) The Shareholder Rights included in the LLC Agreement will not preclude the Potential Reorganization from otherwise qualifying as a reorganization under section 368(a)(1)(F).

Consider a different approach when the corporation has sold all of its business assets. See part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale.

II.Q.1.a.iii. Migrating to a Partnership Structure

For what might be an ideal partnership structure, see part II.E Recommended Structure for Entities, especially parts II.E.3 Recommended Structure for Start-Ups, II.E.4 Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure, II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons, and II.E.6 Recommended Partnership Structure – Flowchart.

Parts II.E.7 Migrating into Partnership Structure and II.E.9 Real Estate Drop Down into Preferred Limited Partnership explain how to get there.

II.Q.1.b. Leasing

Some assets used in a business might be held outside of the business and then leased to the business. The buyer continues to lease these assets from the seller. Such lease payments are deductible to the buyer and taxable to the seller, and the seller is not necessarily at risk in that the seller might be able to sell the property to a third party. If a partnership holds the business, the partnership that conducts business operations can save its owners self-employment (SE) tax by leasing real estate instead of owning it;[4000] However, equipment leasing generally would be subject to SE tax.[4001] Also note that Florida and perhaps other states impose a tax on gross rents.

If a long-term lease provides rent above the property's fair rental value, a lease termination payment is deductible as an ordinary business expense, even if the tenant buys the property;[4002] however, be prepared for a fight with the IRS and to go to District Court, because the Tax Court will require the taxpayer to capitalize the lease termination fee outside of the Sixth Circuit.[4003] On the other hand, amounts a lessee receives for the cancellation of a lease are considered as amounts received in exchange for that lease;[4004] although this exchange treatment does not affect whether the lease is a capital asset as to the lessee,[4005] it very well may be.[4006]

4000 Real estate rental income received on a long-term basis is not subject to self-employment tax, Reg. § 1.1402(a)-4(a) (see part II.L.2.a.ii Rental Exception to SE Tax, especially fn. 3321), whereas the rent deduction would reduce self-employment income, if any, of the operating business. In early years of owning the real estate, rent deductions might not produce much saving relative to depreciation, interest expense, insurance and taxes; in later years, however, the saving might be significant. Although rental income generally is subject to the 3.8% tax on net investment income (NII), rental to a business with sufficient common ownership is not NII. See part II.I.8.c Application of 3.8% Tax to Rental Income.

4001 See part II.L.2.a.ii Rental Exception to SE Tax, fns 3326-3330.

4002 *ABC Beverage Corporation v. U.S.*, 756 F.3d 438 (6th Cir. 2014) (of $9M purchase price, $6.25M allocated to lease termination expense).

4003 *Union Carbide Foreign Sales Corp. v. Commissioner*, 115 T.C. 423 (1993) (holding that Code § 167(c)(2) compelled that result). Code § 167(c)(2) provides:

> If any property is acquired subject to a lease-
> (A) no portion of the adjusted basis shall be allocated to the leasehold interest, and
> (B) the entire adjusted basis shall be taken into account in determining the depreciation deduction (if any) with respect to the property subject to the lease.

The Sixth Circuit's opinion in fn. 4002 pointed out that the purchase extinguished the lease; because the lease did not continue after the purchase, the property was not acquired subject to the lease.

4004 Code § 1241.

4005 Reg. § 1.1241-1(a).

4006 In Letter Ruling 200045019, the tenant entered into a commercial lease, then later claimed that the rent that it paid was too high because it used the property primarily for residential purposes. After stating that the local housing authority ruled in the tenant's favor, the Ruling continued:

City's rent control law gives a tenant the right to continued possession of a property and establishes the maximum rent that may be charged. This right of possession is for an indefinite time period. The landlord may evict such a tenant only under specific circumstances as listed in the Statute.

As a result of the determination that the Premises were subject to the rent control law, the landlord agreed to pay Taxpayer $s in return for Taxpayer surrendering all lease and statutory rights to the Premises. This agreed sum represents $m plus $n to cover estimated taxes. The estimated tax amount was determined under the assumption that Taxpayer's gains from the transaction would be treated as capital gains. Further, the landlord agreed to pay an additional amount, up to $u, plus interest and penalties, if the Internal Revenue Service determines that the gain is ordinary. Finally, the landlord agreed to pay $v to a law firm to cover Taxpayer's legal fees.

In finding that the lease termination payment was capital gain, the Ruling reasoned:

> We note that section 1231, rather than section 1221, may apply to the instant case because the facts indicate that Taxpayer's leasehold may have been used in part, or for a portion of the lease period, for the conduct of Taxpayer's business. Business use of real property precludes that property from receiving capital asset treatment under section 1221(2). However, we do not need to determine whether the leasehold is excluded under section 1221(2) because it will either be a section 1221 capital asset or a section 1231 asset. In either case, the gain recognized on the exchange of the leasehold will be capital, rather than ordinary.
>
> In Rev. Rul. 72-85, 1972-1 C.B. 234, the Service determined that a leasehold of land used in a trade or business is section 1231 property, even if it is of indefinite duration. This revenue ruling clarified Rev. Rul. 56-531, 1956-2 C.B. 983, which holds, in part, that the Service acquiesces in *McCue Bros. & Drummond, Inc. v. Commissioner*, 19 T.C. 667 (1953), *acq.* 1956-2 C.B. 7, *aff'd*, 210 F.2d 752 (2d Cir. 1954), *cert. denied*, 348 U.S. 829 (1954).
>
> The petitioner in *McCue Bros.* leased a hat shop in New York City. For a portion of his occupancy, the petitioner held the property under a written lease. However, after the lease expired, the petitioner continued to occupy the property under a "statutory tenancy" by virtue of the New York rent control laws that had taken effect shortly before the end of the written lease. In affirming the Tax Court in *McCue Bros.*, the Second Circuit stated that it was immaterial whether the petitioner held the property under a lease or through the rent control laws. The court stated, "we think the right of possession under a lease or otherwise, is a ...substantial property right which does not lose its existence when transferred. If it is sold by the tenant to a third person, the gain derived therefrom is a capital gain." 210 F.2d at 753. The court further stated that the holding period began when the statutory right of possession attached. *Id.* at 754.
>
> In *Stotis v. Commissioner*, T.C. Memo. 1996-431, the Tax Court came to a similar result in the case of a residential leasehold. Mr. Stotis, the petitioner, leased space in an apartment building that he used as a residence. The landlord, desiring to use the real estate for other purposes, entered into a surrender agreement with the petitioner whereby the petitioner exchanged his right in the property for a cash payment. The Tax Court held that the petitioner's leasehold interest in a residence was a capital asset, and that the petitioner's sale of the leasehold interest constituted a sale or exchange, taxable as capital gain.
>
> The facts of this case are not clear as to whether the property in question is properly treated as real property used in the trade or business for purposes of sections 1221 and 1231. If it is not real property used in the trade or business, the leasehold interest is a capital asset under section 1221. If it is real property used in the trade or business, any gain attributable to the sale or exchange of the leasehold interest is treated as long-term capital gain under section 1231. Taxpayer's holding period began with the vesting of the statutory right of occupancy on c. Therefore, Taxpayer held the property for more than one year. Additionally, under Rev. Rul. 72-85, the fact that Taxpayer's leasehold interest under the rent control laws was for an indefinite period does not preclude section 1231 long-term capital gain treatment.
>
> Under section 1241, amounts received by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), are considered as amounts received in exchange for such lease or agreement.
>
> Based on the foregoing, we conclude that the amounts received by Taxpayer are considered amounts received in exchange for Taxpayer's leasehold interest in the Premises. Further, we conclude that Taxpayer realized long-term capital gain on the sale of the leasehold interest. Taxpayer's interest in the Premises is either a capital asset under section 1221 or real property used in the trade or business under section 1231. In either event, gain realized from the sale of the leasehold interest is treated as long-term capital gain. Payments of the legal fees and income taxes are part of the purchase price to the extent that such payments are given in exchange for Taxpayer's leasehold interest and not for Taxpayer abandoning some other legal right or property not related to the transaction in question.

Note, however, that, gain from the sale of a Code § 1231 asset may be different than gain from the sale of a capital asset. If the taxpayer had Code § 1231 losses in a prior year, those losses may have converted the gain to ordinary income. See part II.G.6.a Code § 1231 Property, especially fns. 1453-1454.

Reg. § 1.162-11(a), "Acquisition of a leasehold," provides:

> If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. For disallowance of deduction for income taxes paid by a lessee corporation pursuant to a lease arrangement with the lessor corporation, see section 110 and the regulations thereunder. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in amortizing the costs incurred after July 28, 1958, of acquiring a lease. See § 1.197-2 for rules governing the amortization of costs to acquire limited interests in section 197 intangibles.

Generally, real property should not be held in the entity that conducts the business. As discussed above, for self-employment tax purposes it should not be owned by a partnership that has business operations. Because appreciated real estate cannot be distributed from a corporation without triggering either premature (in the case of an S corporation) or double (in the case of a C corporation) taxation under Code § 311,[4007] usually real estate should not be held in a corporation (see footnote 370 for some of the issues, including basis step-up issues, involved in whether real estate should be in a corporation).

II.Q.1.c. Personal Goodwill and Covenants Not to Compete

II.Q.1.c.i. Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation

If the business entity does not require its key employees to agree not to compete, the key employees might leave and take their contacts with them. Thus, in such situations the key employees really "own" the business' goodwill. When the business is sold, the buyer would buy goodwill from the person who owns the goodwill, pay key employees not to compete, pay the key employees to work in the business, or a combination of any of these.

When self-created goodwill is sold, generally the seller receives favorable capital gain treatment and the buyer deducts over 15 years the sum of the payments;[4008] furthermore, that capital gain may qualify for an exclusion from the 3.8% tax on net investment income.[4009] (Also goodwill that is not being amortized

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[4007] Code § 311 provides that, when a corporation distributes property, the distribution constitutes a sale or exchange by the corporation. See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders. Together with the rules governing income taxation of shareholders:

- For an S corporation, generally this means that the shareholders are taxed on the exchange (with favorable capital gain rates often available), receive an increased tax basis in their stock equal to the gain reported, reduce the basis of their stock to the extent of the value of the property that was distributed, and adjust to fair market value the basis of the property that was distributed.
- For a C corporation, generally this means that the corporation pays income tax (with favorable capital gain rates not available) and the shareholders are taxed on the distribution as a dividend, thus generating two layers of tax. However, as with an S corporation, the distributed property's basis is adjusted to fair market value.

[4008] *Horton v. Commissioner*, 13 T.C. 143 (1949) (income from the sale of goodwill is capital gain, whereas income from a noncompete agreement is ordinary income); Code § 197(a), (d)(1)(A) (deduction for amortizing goodwill). Although Reg. § 1.197-2(d)(2) disallows amortization deductions for self-created goodwill, it allows amortization when the taxpayer buys the goodwill (including from someone who bought it from the taxpayer). *Fitch v. Commissioner*, T.C. Memo. 2012-358 rebuffed an IRS attack on repurchased goodwill using a very simple contract. But for Code § 197, goodwill is not amortizable. Reg. § 1.167(a)-3(a).

[4009] See text accompanying and preceding fn 2361 in part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

and is held by a partnership would be eligible for a basis step if a Code § 754 election is in place.[4010]) This capital gain treatment may incentivize taxpayers to allocate proceeds from sales of intangibles to goodwill, because the sale of some intangibles generates ordinary income instead of capital gain, as described in part II.G.19.b Sale or Exchange of Intellectual Property - Capital Gain vs. Ordinary Income. However, ordinary income treatment applies to the sale to a related party,[4011] which applies whether or not the goodwill was being amortized.[4012] Furthermore, the amortization of goodwill causes it to lose its status as a capital asset, which in some circumstances can cause part or all of the gain on sale to lose capital treatment.[4013] Additional rules are described in the text accompanying fn 1659 in part II.G.19.d Amortization of Code § 197 Intangibles.

[4010] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 5442. For an example of the effect of a Code § 754 election on goodwill that is being amortized, see fn. 5616 in part II.Q.8.e.iv Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).

[4011] See parts II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), which applies to sale of an S corporation's goodwill, and II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

[4012] See text accompanying fn. 4855.

[4013] Letter Ruling 200243002 ruled that the sale of goodwill that has not been amortized is taxed as a capital gain, but goodwill that is being amortized is not a capital asset and therefore was subject to tax at ordinary income rates. However, amortizable goodwill may be eligible for capital gain treatment as described in part II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, especially fn. 1447. Because capital gain treatment in that situation arises solely by reason of Code § 1231, any Code § 1231 gain is taxed as ordinary income if and to the extent the taxpayer has unrecaptured Code § 1231 losses. Code § 1231 losses are ordinary losses generated by the sale of Code § 1231 property (property used in a trade or business).

Elaborating on the above, Letter Ruling 200243002 reasoned:

> It is well settled that prior to enactment of § 197, goodwill and going concern value were considered to be intangible and nonamortizable capital assets within the meaning of § 1221, by both the Service and the courts. Rev. Rul. 65-180, 1965-2 C.B. 279; Rev. Rul. 55-79, 1955-1 C.B. 370; *UFE, Inc. v. Commissioner*, 92 T.C. 1314, 1323 (1989) ("going-concern value is an intangible, nonamortizable capital asset that is often considered to be part of goodwill"); *Patterson v. Commissioner*, 810 F.2d 562, 569 (6th Cir. 1987) (stating that "any amount paid for goodwill, since it does not waste, becomes a nonamortizable capital asset," and "amounts received by a seller for the goodwill or going concern value of the business are taxed at the more favorable capital gains rates"); *Better Beverages, Inc. v. United States*, 619 F.2d 424, 425 n. 2 (5th Cir. 1980) ("goodwill is a capital asset"); *Dixie Finance Co. v. United States*, 474 F.2d 501, 506 n. 5 (5th Cir. 1973) (goodwill is a capital asset and amounts received therefor in excess of the seller's basis are treated as capital gains, but represent a nonamortizable capital investment resulting in no corresponding deduction for the purchaser); *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963) ("[i]t is settled that goodwill, as a distinct property right, is a capital asset under the tax laws "); *Michaels v. Commissioner*, 12 T.C. 17 (1949) ("[w]e entertain no doubt that goodwill and such related items as customers' lists are capital assets").
>
> Prior to enactment of § 197, goodwill and going concern value were not considered property used in the trade or business of a character which is subject to the allowance for depreciation provided in § 167, and thus were not excluded from the definition of capital asset by reason of § 1221(a)(2) of the Code. Under § 197, an amortizable section 197 intangible is treated as property of a character which is subject to the allowance for depreciation under § 167. Thus, goodwill and going concern value which are amortizable section 197 intangibles are not capital assets for purposes of § 1221, but if used in a trade or business and held for more than one year, gain or loss upon their disposition generally qualifies as § 1231 gain or loss. Taxpayer has questioned whether enactment of § 197 has changed the treatment of goodwill and going concern value as capital assets for goodwill and going concern value that do not qualify as amortizable section 197 intangibles.
>
> In this case, Taxpayer represents that at the time of each sale of the c, the Goodwill is either self-created Goodwill of the selling entity (or a subsidiary of the selling entity acquired by the selling entity in a stock transaction) or Goodwill acquired by the selling entity (or a subsidiary of the selling entity acquired by the selling entity in a stock transaction) from third parties prior to August 11, 1993. While it is possible that a selling entity acquired the Goodwill after July 25, 1991, and prior to August 11, 1993, Taxpayer also represents that no retroactive election was made under § 1.197-1T. These representations are material representations. Based solely on Taxpayer's representations with respect to the Goodwill, we conclude that the Goodwill is not an amortizable section 197 intangible, and furthermore

Also, the sale and subsequent amortization of goodwill turns it into a "hot" asset, reducing opportunities for deferral on its sale.[4014] Whether or not goodwill is being amortized, a controlled corporation's sale or distribution of goodwill might generate ordinary income,[4015] as would a sale involving a partnership.[4016]

When a covenant not to compete is involved, generally the seller receives ordinary income treatment and the buyer deducts the present value of the payments over 15 years.[4017]

Thus, compensation for current services, which is deductible in full when paid, is much more beneficial to buyers than either of the above alternatives. Taxpayers tend to assign consideration in a sale to whatever produces the fastest deduction – ongoing services, office equipment, etc. Note that assigning a low value to goodwill or a non-compete agreement can have very practical effect – reducing or eliminating damages[4018] – if the agreement is broken, so the buyer is trading deductions for economic risk.

Even if goodwill is taxed to the seller at capital gain rates, deferred compensation[4019] is more tax-efficient than a payment for goodwill; however, the deferred compensation agreement constitutes a liability on the company's balance sheet that might impair its ability to obtain credit. The benefit of the immediate deduction for compensation for personal services is likely to be of so much benefit to the buyer that the buyer should be willing to pay extra to the seller so that the seller's proceeds after ordinary income tax exceed what the seller would have received for goodwill net of capital gain tax. For example, suppose the seller receives $100 for zero basis goodwill. If the seller's combined federal and state capital gain rate is 20%, the seller receives $80 net of tax. If the buyer pays 40% federal and state tax, the buyer must generate $167 of ordinary income to pay the $100 that it pays the seller. Thus, the buyer needs to earn $167 so that the seller receives $80 net of tax. However, if the buyer and seller both have 40% combined federal and state income taxes, then the seller would need just over $133 in ordinary income to net the same $80 after taxes. Thus, with a compensation payment of $134-$166, both the seller and buyer are better off (ignoring

is not subject to depreciation under § 167. Thus, the Goodwill is not property that is of a character subject to the allowance for depreciation provided in § 167.

Because we conclude the Goodwill is not an amortizable section 197 intangible and is not property that is of a character subject to the allowance for depreciation provided in § 167, we further conclude that the Goodwill sold by Taxpayer qualifies as a capital asset under § 1221. Although § 197 now provides that goodwill and going concern value that is an amortizable section 197 intangible are not capital assets for purposes of § 1221, it does not address the treatment of goodwill and going concern value that is not an amortizable section 197 intangible, nor does it change prior law treatment of goodwill and going concern value.

[4014] See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests, especially fn. 5414, referring to part II.Q.8.b.i.(f) Code § 751 – Hot Assets.

[4015] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), especially fns. 4852-4856.

[4016] See part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

[4017] Code § 197(a), (d)(1)(E), (f)(3) (buyer's deduction) (see fn 1658 and the rest of part II.G.19.d Amortization of Code § 197 Intangibles); Rev. Rul. 69-643 (seller's income); *Kinney v. Commissioner*, 58 T.C. 1038 (1972); *Coleman v. Commissioner*, T.C. Memo. 2004-126. *Recovery Group Inc. v. Commissioner*, T.C. Memo. 2010-76, held that payments under a one-year covenant not to compete agreed to in connection with the redemption of an employee's stock were deductible over 15 years. The IRS and taxpayer contested the meaning of entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof. The court agreed with the IRS that "thereof" modifies "trade or business," and that "interest" means an ownership interest of any percentage, large or small. The court held alternatively that the employee's 23% stock ownership was substantial.

[4018] A result reported to have happened in *Healthcase v. Orr*, 2016 Cal. App. Unpub. LEXIS 440 (1/20/2016) per *Business Valuation Update*, vol. 22, no. 4 (4/2016).

[4019] Before working in this area, consider reading part II.Q.1.d Nonqualified Deferred Compensation, especially part II.Q.1.d.i IRS Audit Guide for Nonqualified Deferred Compensation..

the deduction[4020] the buyer receives for capitalized goodwill in a purchase-of-goodwill scenario). A seller needs "strong proof" that a payment is for goodwill taxable as capital gain rather than a covenant not to compete taxable as ordinary income.[4021]

II.Q.1.c.ii. Consulting Agreement in Lieu of Covenant Not to Compete

Given that a seller needs "strong proof"[4022] that a payment is for goodwill[4023] and that payments are amortizable over 15 years if for goodwill or covenants not to compete,[4024] consider retaining the seller on a consulting agreement.[4025] The buyer might very well need the seller's cooperation to transitions employees, customers, and vendors. If the purchase is amicable, hiring the seller to a lucrative consulting contract can provide not only valuable business benefits but also immediate income tax deductions.

Beware, however, that a consulting contract might very well prevent the seller from having a separation from service that might be needed under Code § 409A. Although that provision is generally viewed as applying to deferred compensation, various payments or noncash benefits triggered by a change in job status might constitute deferred compensation that might require a "separation from service" to avoid imposition of the harsh consequences of Code § 409A.[4026]

Furthermore, when a property right concerns the contractual right to perform a service and receive compensation for the service, a payment made to terminate the contract cannot be considered a capital asset unless the contract confers something more than the right to perform services or receive compensation for services performed.[4027] When an insurance company retains all rights regarding a

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[4020] Although the deduction is valuable, the discounted present value is relatively small, considering that discount rates are high when the sale of a closely-held business is involved. For example, if $100 were capitalized and deducted over 15 years with a 40% tax saving, the extra tax benefit would be $2.67 per year, compared with an immediate tax saving of $20 in not having capital gain on the sale of goodwill. At a 20% discount rate, the present value of these deductions would be $12.48; at a 33% discount rate, the present value would be $7.98.

[4021] *Muskat v. United States*, 554 F.3d 183 (1st Cir. 2009); *Kinney*, fn. 4017. For more on *Muskat*, see fn 5316 in part II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill. *Dunlap v. Commissioner*, T.C. Summary Opinion 2020-10 held:

> There was no agreement between Mary Kay and Ms. Dunlap with respect to any sale of a business or goodwill. Other than the reference to goodwill in the preamble to some documents, there is no evidence in the record that would support a sale of a business interest. The payments under the FSP are calculated on the basis of sales and commissions and are being paid at a rate of 60% of a high average tiered sales activity. Lastly, Ms. Dunlap had no rights or legal relationship with the consultants and sales directors in her tiered Mary Kay activity. Accordingly, her goodwill argument does not change the outcome of this case.

[4022] Because the "strong proof" rule "drives at the contracting parties' intentions," conflicting testimony as to that intent precludes summary judgment from being granted. *Cotto-Vázquez v. U.S.*, 127 A.F.T.R.2d 2021-XXXX (D. P.R. 3/11/2021).

[4023] See fn. 4021.

[4024] See part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.

[4025] For whether a consultant is an employee, independent contractor, or partner, see *Thoma v. Commissioner*, T.C. Memo. 2020-67.

[4026] See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.Q.1.d Nonqualified Deferred Compensation.

[4027] *Trantina v. U.S.*, 512 F.3d 567 (9th Cir. 2008), held:

> The parties spend considerable time in the briefs discussing cases involving the question of whether a contractual right qualifies as a capital asset. These cases demonstrate that, when the property right asserted concerns the contractual right to perform a service and receive compensation for the service, a payment made to terminate the contract cannot be considered a capital asset unless the contract confers something more than the right to perform services or receive compensation for services performed. See, *e.g.*, *Furrer*, 566 F.2d at 1117; *Vaaler v. United States*, 454 F.2d 1120, 1122 (8th Cir. 1972) ("[T]he courts have quite uniformly held that contracts for the performance of personal services are not capital assets and that the proceeds from their transfer or termination will not be accorded capital gains treatment but will be considered to be ordinary income."); *Md. Coal & Coke Co. v. McGinnes*, 350 F.2d 293, 294 (3d Cir. 1965) (per

policies an agent sold, termination payments made to the agent cannot be considered a sale of rights with respect to those policies.[4028]

II.Q.1.c.iii. Does Goodwill Belong to the Business or to Its Owners or Employees?

For purposes of valuing a business:[4029]

> In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by

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curiam) (finding a contract giving the taxpayer an exclusive sales agency not to be a capital asset because it did not confer on the taxpayer "some interest or estate in or encumbrance upon some property with which the contract is concerned"); *United States v. Dresser Indus., Inc.*, 324 F.2d 56, 60–61 (5th Cir. 1963) (finding that the exclusive right to practice a patent did constitute a capital asset); *Nelson Weaver Realty Co. v. Comm'r*, 307 F.2d 897, 899–901 (5th Cir. 1962) (finding sale of mortgage servicing contract along with files, ledgers, and records to be a capital asset); *Dorman v. United States*, 296 F.2d 27, 29 (9th Cir. 1961) (finding that an option to become a full partner in a business venture constituted a capital asset); *Brown v. Comm'r*, 28 T.C.M. (CCH) 1330, 1332 (T.C. 1969) ("A payment in discharge of [the right to receive commissions on policies], unlinked to the policies themselves by any proprietary interest, is simply a substitute for ordinary income."). The question in the present case is thus whether the Corporate Agreement conferred on Trantina some right or interest beyond the right to perform the services required by the agreement or to receive compensation for the services performed under the agreement….

We adopt the reasoning of the Seventh Circuit. A precondition to realizing a long-term capital gain is the ownership of a capital asset. Yet under the express terms of Trantina's Corporate Agreement with State Farm, Trantina simply had no property that could be sold or exchanged. The Corporate Agreement contains a provision nearly identical to the one that the *Baker* court found to be controlling. Trantina's Corporate Agreement states:

> Information regarding names, addresses, and ages of policyholders of the Companies; the description and location of insured property; and expiration or renewal dates of State Farm policies acquired or coming into the Agent's possession during the effective period of this Agreement, or any prior agreement, except information and records of policyholders insured by the Companies pursuant to any governmental or insurance industry plan or facility, are trade secrets wholly owned by the Companies. forms and other materials, whether furnished by State Farm or purchased by the Agent, upon which this information is recorded shall be the sole and exclusive property of the Companies.

Given this blanket reservation of all property rights to State Farm, it is unclear exactly what Trantina could have sold or exchanged. Trantina could not sell back to State Farm something that it already owned.

[4028] *Baker v. Commissioner*, 338 F3d 789 (7th Cir. 2003), held:

> Fundamentally, in order to have the ability to sell something, one must own it. Because Warren Baker did not own any property related to the policies, he could not sell anything. Section D of the Agreement provides:
>
> > Information regarding names, addresses, and ages of policyholders of the Companies; the description and location of insured property; and expiration or renewal dates of State Farm policies ... *are trade secrets wholly owned by the Companies*. All forms and other materials, whether furnished by State Farm or purchased by you, upon which this information is recorded *shall be the sole and exclusive property of the Companies*.
>
> (emphasis added). Thus, according to the terms of the Agreement, Warren Baker did not own anything related to the policies.
>
> As the Tax Court noted, Baker returned everything used in the daily course of business to State Farm. He returned the books, records, and customer lists because the Agreement designated them as the "sole and exclusive property" of State Farm.

Baker also dismissed the insurance agent's argument that he sold goodwill; see fn 4031 in part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees? This reasoning was also applied in *Pexa v. U.S.*, 121 AFTR.2d 2018-XXXX (D. CA 5/8/2018).

[4029] Rev. Rul. 59-60, Section 4.02(f).

the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.

"Goodwill is often defined as the expectation of continued patronage by existing customers."[4030] (However, in the insurance industry, policy records and policyholder information are the goodwill, and payments to agents tend to be for covenants not to compete.)[4031] Generally, if a business subjects its owners or employees to a covenant not to compete, the business owns the related goodwill; otherwise, generally the owners or employees own the goodwill.[4032] Personal goodwill reflects the owners'

[4030] *Estate of Adell v. Commissioner*, T.C. Memo. 2014-155, citing *Network Morning Ledger Co. v. United States*, 507 U.S. 546, 572-573 (1993).

[4031] *Baker v. Commissioner*, 338 F3d 789 (7th Cir. 2003) (highlighting added):

> Goodwill is the expectation of continued patronage. *Newark Morning Ledger Co. v. United States*, 507 U.S. 546, 555 (1993). Goodwill enables a purchaser to step into the shoes of the seller. *Decker v. Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988) (quoting *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 681 (5th Cir. 1971)). Courts have recognized that the insurance industry treats policy records and policyholder information as goodwill. *Schelble v. Commissioner*, 130 F.3d 1388, 1394 (10th Cir. 1997); *Marsh & McLennan, Inc. v. Commissioner*, 420 F.2d 667, 669–70 (3d Cir. 1969).
>
> As noted above, Baker did not own any assets related to the business. Goodwill cannot be transferred apart from the business with which it is connected. 38 Am.Jur.2d Goodwill § 10. We find reliance for our position in *Schelble v. Commissioner*, 130 F.3d 1388 (10th Cir. 1997) and *Vaaler v. United States*, 454 F.2d 1120 (8th Cir. 1972). In , the taxpayer argued that "extended earnings" payments made to him after terminating his position as an insurance agent constituted proceeds from the sale of goodwill . The court rejected the taxpayer's argument, finding that no sale of vendible assets occurred. *Schelble*, 130 F.3d at 1394. Citing *Elliott v. United States*, 431 F.2d 1149, 1154 (10th Cir. 1970), the court noted that for tax purposes, a sale of goodwill takes place "only when the business or a part of it, to which the goodwill attaches is sold." *Id.* at 1394. In *Vaaler v. United States*, the Eighth Circuit rejected a similar argument made by the taxpayer. It also cited *Elliott* for the same proposition, adding that as a general agent, the taxpayer built up goodwill for the insurance company, which belonged to the company. *Vaaler*, 454 F.2d at 1123; see also *Webster Investors, Inc. v. Commissioner*, 291 F.2d 192, 195 (2d Cir. 1961).
>
> While Baker built the insurance agency; the tools he used were on loan from State Farm. State Farm's termination payments were not for the sale of a business where a buyer was able to step into the seller's shoes. Baker owned nothing. Thus, he could sell no assets, including goodwill. We agree that goodwill was developed during Baker's tenure; however, it was not his to sell.
>
> Since Baker has failed to establish that the payments were consideration for the sale or exchange of a capital asset, the Commissioner's deficiency determination is upheld. One final point we briefly address: Baker asks if the purpose for the payments are not in consideration for goodwill, what are they? We agree with the Tax Court's conclusion that (a portion of) State Farm's payments were for a covenant not to compete. See, *e.g.*, *Clark v. Commissioner*, 67 T.C.M. 3105 (1994); *Foxe v. Commissioner*, 53 T.C. 21 (1969). The Agreement provides that Baker would not induce any State Farm policyholder to change coverage or solicit coverage through a competitor for one year. The tax consequences of such language are settled: the consideration a buyer pays a seller for a covenant not to compete is taxable as ordinary income. *Patterson v. Commissioner*, 810 F.2d 562, 569 (6th Cir. 1987); *Sonnleitner v. Commissioner*, 598 F.2d 464, 466 (5th Cir. 1979).

Baker similarly rejected an insurance agent's assertion that the agent sold other contractual rights for a capital gain; see fn 4028 in part II.Q.1.c.ii Consulting Agreement in Lieu of Covenant Not to Compete.

[4032] Shin, Lightened Taxpayer Burdens in the Sale of Personal Goodwill After *H&M, Inc. v. Commissioner*, *Tax Lawyer*, Vol. 67, No. 2 (Winter 2014), saved as Thompson Coburn LLP doc. no. 6177834; *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998); *Norwalk v. Commissioner*, T.C. Memo. 1998-279; *Bross Trucking, Inc.. v. Commissioner*, T.C. Memo. 2014-107 (lack of non-compete precluded corporate goodwill regarding owner-officer's relationships; owner's sons developed relationships with owner's customers when owner shut down owner's business due to regulatory hassles and sons started new corporation; workforce intangible not deemed transferred when only 50% of the employees of the old corporation worked for the new corporation); *Estate of Adell v. Commissioner*, T.C. Memo. 2014-155 (lack of non-compete precluded corporate goodwill regarding owner-officer's relationships; customers did business with owner's son because they trusted the son personally; son was qualified to run the business). Conversely, goodwill generated while a covenant not to compete is in place is owned by the business entity, even though it was generated by the professional who was the sole owner of a personal service corporation. *Howard v. U.S.*, 106 A.F.T.R.2d 2010-5533 (E.D. Wash. 2010), *aff'd* 108 AFTR.2d 2011-5993 (9th Cir. 2011); *Kennedy v. Commissioner*, T.C. Memo. 2010-206 (payments were consideration for services rather than goodwill; payments relationships with customers; to prove that these relationships had value, the purchasing business should hire the sellers and not just sign a covenant not to compete with them.[4033] Generally, a sale of goodwill is recognized only if paired with the sale of a business; . *Potter v. Commissioner*, T.C. Memo. 2018-153, held:

> The questions of whether goodwill existed and was transferred are questions of fact. *Butler v. Commissioner,* 46 T.C. 280, 287 (1966). Petitioners scream for *Martin Ice Cream Co. v. Commissioner* (Martin Ice Cream), 110 T.C. 189 (1998), to rule the day because what Mr. Potter "sold" were his relationships with the various buyers of Green Country's products. In *Martin Ice Cream*, 110 T.C. at 207-208, the Court held that the benefits of the relationships with supermarket chains that a shareholder, Arnold Strassberg, cultivated were not the corporation's assets; Mr. Strassberg was the owner and seller of those assets. Thus, the corporation - *Martin Ice Cream Co.* - was not liable for tax due on payments for the shareholder's assets. The Court decided that the goodwill was not a corporate asset in Martin Ice Cream and did not address how the individual shareholder—Mr. Strassberg - should be taxed on the payments. See *Kennedy v. Commissioner*, T.C. Memo. 2010-206, 100 T.C.M. (CCH) 268, 274-275 (2010). Thus, *Martin Ice Cream* is not controlling here.
>
> What is controlling is the fact that Mr. Potter did not sell a trade or business. See *Baker v. Commissioner*, 118 T.C. 452 (2002) (holding that the taxpayer did not sell a trade or business to which goodwill could attach), *aff'd*, 338 F.3d 789 (7th Cir. 2003). "To qualify as the sale of goodwill, the taxpayer must demonstrate that he sold `the business or a part of it, to which the goodwill attaches." *Id*. at 465 (quoting *Schelble v. Commissioner*, 130 F.3d 1388, 1394 (10th Cir. 1997), *aff'g* T.C. Memo. 1996-269). Although a party to the asset purchase agreement between Oldcastle and Green Country, Mr. Potter did not sell any assets to Oldcastle or to Green Country. The word "sale" means "a transfer of property for a fixed price in money or its equivalent". *Schelble v. Commissioner*, 130 F.3d at 1394 (quoting *Iowa v. McFarland*, 110 U.S. 471, 478 (1884)); see also *Commissioner v. Brown*, 380 U.S. 563, 571 (1965). Potter Sales' office furniture, computers, and vehicles were included in the assets Oldcastle acquired when it purchased Green Country's assets, but it paid nothing for them.[10] Additionally, Potter Sales had only one client, Green Country. The relationships that Mr. Potter fostered were with Green

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varied based on success of seller's efforts to transition customers to buyer; part of payments were for non-compete; taxpayer failed to prove economics of allocation, the court finding that goodwill was a tax-motivated afterthought that occurred late in the negotiations) (distinguished from *Martin Ice Cream*) (self-employment tax imposed; reliance on tax advisor avoided negligence penalty); *H & M, Inc. v. Commissioner*, T.C. Memo. 2012-290 (insurance agent's name and talents were more highly valued than his incorporated insurance agency's name, so compensation payments to agent were not disguised payments to his agency followed by dividends to him; characterization as goodwill or compensation was not raised). See Kliegman and Turkenich, Goodwill Games: Determining the Existence And Ownership of Goodwill In a Closely Held Business, *T.M. Memorandum* (BNA) (9/22/2014).

For more details on sending business as a gift, see fn., part III.B.1.a.v Sending Business.

[4033] *Solomon v. Commissioner*, T.C. Memo. 2008-102, held:

> The *Martin Ice Cream* case is distinguishable from this case. First, the record does not persuade us, nor do we find as a fact, that the value of Solomon Colors in the market was attributable to the quality of service and customer relationships developed by Robert Solomon or Richard Solomon. Rather, the record reflects our finding that Solomon Colors, as a business of processing, manufacturing, and sale, rather than one of personal services, did not depend entirely on the goodwill of its employees for its success. See *Schilbach v. Commissioner*, T.C. Memo. 1991-556; *cf. Longo v. Commissioner*, T.C. Memo. 1968-217. Second, unlike the founder of Haagen-Dazs in *Martin Ice Cream*, who signed an agreement with Strassberg in his personal capacity, Robert Solomon and Richard Solomon were not named as the sellers of any asset but were included in the sale in their individual capacities solely to guarantee that they would not compete with Prince. Third, the fact that Prince required noncompete agreements, but not employment or consulting agreements, of Robert Solomon and Richard Solomon makes it unlikely that Prince was purchasing the personal goodwill of these individuals.

Country's clients; the client contacts were not his to sell. See *Foxe v. Commissioner*, 53 T.C. 21, 26 (1969) (finding that an insurance salesman's personal contacts with customers did not amount to goodwill because the insurance company owned the customer contacts). Therefore, the 2010 termination payment was for Mr. Potter's right to service Green Country's clients and receive ordinary income; it was not for the sale of Mr. Potter's goodwill, because the client contacts were not his to sell.

[10] Nor did Mr. Potter "exchange" property for another property that was materially different in either kind or extent. See sec. 1.1001-1(a), Income Tax Regs.

Sometimes a variety of factors reduce a company's goodwill, and having the next generation start a new company without so much baggage creates a viable company without making a gift of goodwill.[4034]

If the business is inside an entity taxed as a C or an S corporation, paying for the business' going concern value (of which goodwill tends to be a very significant part) results in short-term double or triple taxation.[4035] If the entity has only one owner, one can set the stage for a more tax-advantaged exit strategy by ***not*** subjecting the owner to a covenant not to compete. For a multiple-owner entity, the business reasons might trump the tax issues, so one might more strongly consider migrating to the ideal business structure[4036] so that one can put these protections in place as soon as possible without complicated issues. The problem with migrating from a corporation to a pass-through entity is that the IRS will argue that goodwill is being distributed from the corporation to the owners and then into the new entity, and a distribution from a corporation to its owners is a taxable event.[4037] If the owners of the new entity are different from but are the natural objects of the bounty of the owners of the original entity, the IRS might also argue that the deemed distribution and transfer constitute a gift.[4038]

A sole proprietorship or partnership does not face these concerns. A sole proprietorship can convert into a partnership tax free by granting the new owner a profits interest in the partnership.[4039] The partnership can then engage in a redemption that obtains the most income tax-efficient result. Thus, a sole proprietorship or partnership is free to enter into covenants not to compete without complicating income tax exit strategies.

II.Q.1.c.iv. Goodwill (and other intangible) Anti-Churning Rules

Generally, an anti-churning rule provides that goodwill and going concern value are not amortizable if:[4040]

1. The intangible was held or used at any time on or after July 25, 1991, and on or before such date of enactment by the taxpayer or a related person,

[4034] See part II.Q.7.h.v Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014).
[4035] See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis.
[4036] See parts II.E Recommended Structure for Entities, II.Q.7.h Distributing Assets; Drop-Down into Partnership and II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill.
[4037] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.
[4038] See part III.B.1.a.v Sending Business. Taxpayers won, but it cost them significant legal fees.
[4039] See part II.M.4.f Issuing a Profits Interest to a Service Provider. The new owner can also contribute capital to the new business, which generally is tax-free (see part II.M.3 Buying into or Forming a Partnership), but be wary of part II.M.3.e Exception: Disguised Sale.
[4040] Code § 197(f)(9)(A).

2. The intangible was acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before such date of enactment, and, as part of the transaction, the user of such intangible does not change, or

3. The taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991, and on or before such date of enactment.

If the business did not exist on July 25, 1991, the anti-churning would not apply because the goodwill did not yet exist.[4041]

For purposes of these rules, a person is "related" to any person only if the related person bears a relationship to such person specified in Code § 267(b)[4042] or 707(b)(1),[4043] or the related person and such person are engaged in trades or businesses under common control.[4044] In applying Code § 267(b) or 707(b)(1) to this test, use 20% instead of 50%.[4045] A person shall be treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.[4046]

However, if the anti-churning rule applies only because the related party's ownership is more than 20% instead of more than 50%, then this rule is subject to an exception.[4047] To qualify for the exception, the person from whom the taxpayer acquired the intangible must elect to recognize gain on the disposition of the intangible and to pay a tax on such gain which, when added to any other income tax on such gain under this title, equals such gain multiplied by the highest income tax rate applicable to such person.[4048] If this exception applies, then the goodwill or concern value is prevented from being amortized only to the extent that the taxpayer's adjusted basis in the intangible exceeds the gain recognized.[4049]

Also, the anti-churning rule does not apply to the acquisition of any property by the taxpayer if the basis of the property in the taxpayer's hands is determined under Code § 1014(a) (basis adjustment by reason of death).[4050]

Code § 197 also does not permit amortization of any intangible acquired in a transaction, one of the principal purposes of which is to avoid the anti-churning rules.[4051]

[4041] Letter Ruling 200551018, which noted the following representations:

> … Taxpayer represents that Taxpayer began operations during 1994. Furthermore, Taxpayer represents that none of the assets used in the formation of Taxpayer constituted a previous trade or business. Thus, Taxpayer's goodwill asset did not exist during the section 197(f)(9) transition period, and the anti-churning rules of section 197(f)(9) do not apply.

[4042] Code § 267(b) is reproduced in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses.
[4043] For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.
[4044] Code § 197(f)(9)(C)(i). The common control test used is that provided in Code § 41(f)(1)(A) and (B).
[4045] Code § 197(f)(9)(C)(i).
[4046] Code § 197(f)(9)(C)(ii).
[4047] Code § 197(f)(9)(B)(i).
[4048] Code § 197(f)(9)(B)(ii).
[4049] Code § 197(f)(9)(B).
[4050] Code § 197(f)(9)(D).
[4051] Code § 197(f)(9)(E). This provision also prevents amortization of any asset acquired in a transaction that was postponed to avoid the requirement that the intangible be acquired after the date of the enactment of Code § 197.

Reorganizing a tiered structure using nontaxable contributions under Code § 721[4052] and nontaxable distributions under Code § 731[4053] may avoid triggering the anti-churning rules so as to allow the pre-transaction amortization of post-1993 intangibles to continue.[4054]

With respect to any increase in the basis of partnership property under Code § 732, 734, or 743, determinations under the anti-churning rules are made at the partner level, and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets.[4055] See part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

Letter Ruling 201906002 sets forth applicable rules and reasoning for partnerships:[4056]

> Section 197(f)(9)(E) provides that with respect to any increase in the basis of partnership property under §§ 732, 734, or 743, determinations under § 197(f)(9) shall be made at the partner level and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets.
>
> Section 1.197-2(g)(3) provides that any increase in the adjusted basis of a § 197 intangible under...§ 743(b) (relating to the optional adjustment to the basis of partnership property after transfer of a partnership interest) is treated as a separate § 197 intangible. For purposes of determining the amortization period under § 197 with respect to the basis increase, the intangible is treated as having been acquired at the time of the transaction that causes the basis increase, except as provided in § 1.743-1(j)(4)(i)(B)(2) (dealing with an increase in the basis of the item of the partnership's recovery property under § 743(b) that is attributable to § 704(c) built-in gain when the partnership elects to use the remedial allocation method).
>
> Section 1.197-2(h)(1)(i) provides that this paragraph (h) applies to § 197(f)(9) intangibles. For this purpose, § 197(f)(9) intangibles are goodwill and going concern value that was held or used at any time during the transition period and any other § 197 intangible that was held or used at any time during the transition period and was not depreciable or amortizable under prior law.
>
> Section 1.197-2(h)(1)(ii) provides that the purpose of the anti-churning rules of § 197(f)(9) and § 1.197-2(h) is to prevent the amortization of § 197(f)(9) intangibles unless they are transferred after the applicable effective date in a transaction giving rise to a significant change in ownership or use. Special rules apply for purposes of determining whether transactions involving partnerships give rise to a significant change in ownership or use. See § 1.197-2(h)(12). The anti-churning rules are to be applied in a manner that carries out their purpose.
>
> Section 1.197-2(h)(6)(i) provides, in pertinent part, that a person is related to another person for purposes of § 1.197-2(h) if the person bears a relationship to that person that would be specified (A) in § 267(b) (determined without regard to § 267(e)), and by substitution, § 267(f)(1), if those

[4052] See part II.M.3 Buying into or Forming a Partnership, especially part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.
[4053] See part II.Q.8.b.i Distribution of Property by a Partnership, especially part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions.
[4054] Letter Ruling 201709003.
[4055] Code § 197(f)(9)(E). For details, see Reg. § 1.197-2(h)(12); see also fn. 3731, found in part II.P.1.a.i Allocations of Income in Partnerships. For an example of the effect of a Code § 754 election on goodwill that is being amortized, see fn. 5616 in part II.Q.8.e.iv Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).
[4056] See also text accompanying and preceding fn 5434 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

sections were amended by substituting 20 percent for 50 percent or (B) in § 707(b)(1) if that section were amended by substituting 20 percent for 50 percent.

Section 1.197-2(h)(6)(ii) provides that a person is treated as related to another person for purposes of § 1.197-2(h) if the relationship exists, in the case of a single transaction, immediately before or immediately after the transaction in which the intangible is acquired.

Section 1.197-2(h)(12)(i) provides that in determining whether the anti-churning rules apply to any increase in the basis of a § 197(f)(9) intangible under § 743(b), the determinations are made at the partner level and each partner is treated as having owned and used the partner's proportionate share of partnership property. In determining whether the anti-churning rules apply to any transaction under another section of the Internal Revenue Code, the determinations are made at the partnership level, unless under § 1.701-2(e) the Commissioner determines that the partner level is more appropriate.

Section 1.197-2(h)(12)(v)(A) provides, generally, that the anti-churning rules do not apply to an increase in the basis of a § 197 intangible under § 743(b) if the person acquiring the partnership interest is not related to the person transferring the partnership interest. In addition, the anti-churning rules do not apply to an increase in the basis of a § 197 intangible under § 743(b) to the extent that ...

(2) The partnership interest being transferred was acquired after the partnership acquired the § 197(f)(9) intangible, provided -

(i) The § 197(f)(9) intangible was acquired by the partnership after August 10, 1993, and is not amortizable with respect to the partnership;

(ii) The partnership interest being transferred was held after the partnership acquired the § 197 intangible by a person or persons (the post-contribution person or persons) other than the person transferring the partnership interest or persons who were related to the person transferring the partnership interest; and

(iii) The acquisition of such interest by the post-contribution person or persons was not part of a transaction or series of related transactions in which the person transferring the partnership interest or persons related to the person transferring the partnership interest acquired such interest.

Section 1.197-2(h)(12)(v)(B) provides that, solely for purposes of § 1.197-2(h)(12)(v)(A)(1) and (2), a partner who acquires an interest in a partnership in exchange for a contribution of property to the partnership is deemed to acquire a pro rata portion of that interest in the partnership from each person who is a partner in the partnership at the time of contribution based on each such partner's proportionate interest in the partnership.

Rev. Rul. 87-115, 1987-2 C.B. 163, states that when an upper-tier partnership has a § 754 election in effect, the transfer of an interest in the upper-tier partnership is treated as a transfer of an interest in the upper-tier partnership's interest in the lower-tier partnership for purposes of § 743. Such an election shall apply with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year when such election was filed and all subsequent years, unless revoked by the partnership, subject to § 1.754-1(c).

Section 754 provides that if a partnership files an election in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted ...in the case of a transfer of a partnership interest, in the manner provided in § 743. Such an election shall apply with respect to all distributions by the property by the partnership and to all transfers of interests in the partnership during the taxable year when such election was filed and all subsequent years, unless revoked by the partnership, subject to § 1.754-1(c).

Section 743(b) provides, in part, that in the case of a transfer of an interest in a partnership by sale or exchange, a partnership with respect to which the election provided in § 754 is in effect shall increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property.

Of the requirements for amortization under § 197, only the anti-churning rules are in question in this case. Special rules are provided for partnerships in § 1.197-2(h)(12), and specific rules for § 743(b) basis adjustments are provided in § 1.197-2(h)(12)(v).

Rev. Rul. 87-115 is described in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

Letter Ruling 201906002 reasoned:[4057]

On Date1 (after August 10, 1993), Partnership3 was formed by Partnership5 and Partnership1 in a transaction that qualified for non-recognition under § 721(a). Partnership5 contributed the Intangible Asset to Partnership3 in exchange for its interest in Partnership3, and Partnership1 contributed cash and other assets in exchange for its interest in Partnership3. Partnership3 has used the Intangible Asset since then in its trade or business. Under § 1.197-2(h)(12)(v)(B), each of the partners of Partnership3 was deemed to acquire their interest in Partnership3 from the other, and each was deemed to acquire a proportional interest in the assets of Partnership3. Since the Intangible Asset was not amortizable in Partnership5's hands, it is also not amortizable in the hands of Partnership3. Section 197(f)(2) and § 1.197-2(g)(2). This will continue to be true after the transactions subject to this ruling occur.

This ruling addresses the § 743(b) adjustments that are allocable to the Intangible Asset that result from the transfer of Partnership2 and Partnership3 interests to NewCo2, a newly formed corporation in a non-taxable transaction. Each § 743(b) adjustment results in a separate intangible asset that is analyzed under § 1.197-2(h)(12)(v) at the partner level. Sections 1.197-2(g)(3) and 1.197-2(h)(12)(i). Partners are treated as directly owning and using their proportionate share of partnership assets. Section 197(f)(9)(E).

In this case, the anti-churning rules do not apply to a § 743(b) adjustment if one of two tests is met, either (i) the transferee is not related to the transferor or (ii) the requirements of § 1.197-2(h)(12)(v)(A)(2) are met. The basis adjustments do not satisfy the first test because the transferor and the transferee of any actual or deemed transfer of Partnership3 interests as a result of the Transaction will be related within the meaning of § 197(f)(9)(C)(i) and § 1.197-2(h)(6) immediately before and after the Transaction. Thus, any transferee entitled to a basis adjustment will be related to the transferor for purposes of the anti-churning rules. Therefore, the basis

[4057] See also text accompanying and preceding fn 5434 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

adjustments will be amortizable under § 197(a) only if the requirements of § 1.197-2(h)(12)(v)(A)(2) are met.

Principals Transactions

In the case of the interests in Partnership3 that Partnership1 and Partnership2 acquired in the Principals transactions, the Partnership3 interests that are transferred to NewCo2 were originally owned by Partnership5 and distributed to the exercising Principal through a series of non-recognition transactions. Taxpayer has represented that no Principal exercised their D in connection with, or as part of a plan that included, the formation of Partnership3.

With respect to the interests in Partnership3 acquired by Partnership1 and Partnership2 from the Principals, the requirements of § 1.197-2(h)(12)(v)(A)(2) are met because:

(i) The Principals transactions occurred after Partnership3 acquired the Intangible Asset and, therefore, the interests in Partnership3 that Partnership1 and Partnership2 acquired in the Principals transactions occurred after Partnership3 acquired the Intangible Asset. Also, Partnership3 acquired the Intangible Asset after August 10, 1993, and the Intangible Asset is not amortizable in the hands of Partnership3;

(ii) The Principals' interests in Partnership3 that are being transferred were held after Partnership3 acquired the Intangible Asset by Partnership5, a person other than Partnership1 or Partnership2. Further, Taxpayer has represented that Partnership5 has never been related to Partnership1 or its predecessor, or Partnership2, within the meaning of § 197(f)(9)(C)(i) and § 1.197-2(h)(6); and

(iii) The acquisition of the interests in Partnership3 by Partnership5 was not part of a transaction or series of related transactions in which Partnership1 and Partnership2 acquired its Partnership3 interest from the Principals. That is, the exercise of the D occurred in transactions independent from the formation of Partnership3.

Public Trading

With respect to the interests in Partnership3 acquired by Partnership1 upon the formation of Partnership3 on Date1, the requirements of § 1.197-2(h)(12)(v)(A)(2) are met because:

(i) Partnership1 acquired its interest in Partnership3 after Partnership3 acquired the Intangible Asset. Also, Partnership3 acquired the Intangible Asset after August 10, 1993, and the Intangible Asset is not amortizable in the hands of Partnership3; and

(ii) In its letter dated July 31, 2018, Taxpayer represents, subject to confirmation by ongoing diligence, Taxpayer reasonably estimates that as of Date3, through public trading and issuances of limited partnership interests, [Redacted Text] percent or more of the economic interests in Partnership1 have changed ownership since Partnership1 acquired its interests in Partnership3 in Year1.

As stated in Rev. Rul. 87-115, when an upper-tier partnership has a § 754 election in effect, any § 743(b) adjustment resulting from the deemed transfer is segregated and allocated solely to the transferee of the upper-tier partnership interest.

Further, with respect to any increase in the basis of partnership property under § 743, a partnership is treated as an aggregate of its owners under the anti-churning rules. Section 197(f)(9)(E).

Applying § 1.197-2(h)(12)(i), for purposes of § 1.197-2(h)(12)(v)(A)(2)(iii), the public owners of Partnership1 are treated as acquiring interests in Partnership3 when each public owner purchased an interest in Partnership1, subsequent to the formation of Partnership3 in Year1. Because the public owners of Partnership1 acquired interests in Partnership3 after those interests were held by unrelated owners in transactions independent from the formation of Partnership3, § 1.197-2(h)(12)(v)(A)(2)(ii) and (iii) are satisfied for those acquisitions.

Based on Taxpayer's representation in a letter dated July 31, 2018 that, Taxpayer reasonably estimates that as of Date3, which is one business day before Date 4, through public trading and issuances of limited partnership interests, [Redacted Text] percent or more of the economic interests in Partnership1 have changed ownership since Partnership1 acquired its interests in Partnership3 in Year1, the increases to the tax basis of the Intangible Asset for the benefit of Newco2 or Partnership2 under § 743(b) resulting from Partnership1's transfer of interests in Partnership3 to Newco2 are amortizable under § 197(a) to the extent those interests were treated as previously acquired by public investors since the formation of Partnership3 on Date1.

CONCLUSIONS

Based solely on the facts and representations submitted and the law and analysis as set forth above, we rule that the increases to the tax basis of the Intangible Asset, a § 197(f)(9) intangible, under § 743(b) for the benefit of NewCo2 or Partnership2, that result from the Transaction will be amortizable under § 197(a) to the extent those basis adjustments relate to interests that (i) were previously acquired from the Principals or (ii) were treated as previously acquired by public investors subsequent to the formation of Partnership3 on Date1.

Except as expressly set forth above, no opinion is expressed or implied concerning the federal tax consequences of the facts described above under any other provision of the Code or regulations. Specifically, no opinion is expressed or implied concerning the federal income tax treatment of any transactions described in this letter, including the Transaction that Taxpayer represents occurred on Date4.

This letter ruling is conditioned upon Taxpayer demonstrating the extent that the ownership of Partnership1's interests changed between Date1 and Date3.

II.Q.1.d. Nonqualified Deferred Compensation

For draconian measures that can apply to compensation paid in a year different from the year is which it was earned (as well as detrimental balance sheet effects), see part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

II.Q.1.d.i. IRS Audit Guide for Nonqualified Deferred Compensation and Other Noncash Compensation (other than fringe benefits)

In "Nonqualified Deferred Compensation Audit Techniques Guide (June 2015)," the IRS explained its view on deferred compensation and similar tools and described audit techniques.[4058]

II.Q.1.d.ii. Using Nonqualified Deferred Compensation to Facilitate a Sale

II.Q.1.d.ii.(a). Income Tax Issues when Using Nonqualified Deferred Compensation to Facilitate a Sale

A common tactic had been to pay the seller compensation for past services rendered. The theory was that, during its formative years, the business did not have the financial ability to compensate the owner for all that the owner did to develop the business into the successful operation it is today. When the business would be sold, finally the business would have sufficient resources to express its gratitude for the owner's past services. The business might pay the owner all at once; or, it might pay this bonus over time to provide the owner with a nice stream of retirement income. This compensation could be paid by the buyer or the seller. If the buyer makes the payments, it deducts them as it makes them and reduces the purchase price to take into account the present value of the payments. If the seller makes the payments, the seller would want to deduct the payments against the sale proceeds or against the interest or income equity component of any deferred sale proceeds.[4059]

Under 2017 tax reform, the service recipient may have a lower rate as a C corporation or as a pass-through entity than the service provider. See part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities. This has always been a problem when the compensation paid exceeds ordinary taxable income, but now it may apply regarding most or all of the deferred compensation payments.

Also, under Code § 409A, one is required to have a written plan in place as soon as a legally binding right to nonqualified deferred compensation exists.[4060] Thus, if at the time of sale compensating the owner for past services is reasonable and necessary,[4061] and the entity can show that a legally binding right to compensation for past services did not exist until that time, then the strategy described in the preceding

[4058] LB&I-04-0615-005, found at http://www.irs.gov/Businesses/Corporations/Nonqualified-Deferred-Compensation-Audit-Techniques-Guide.

[4059] The seller would not want to liquidate the entity that owned the business until after these payments are made. Otherwise, the payments would constitute an additional capital loss or reduction of capital gain rather than a deduction against ordinary income. *Arrowsmith, Exec. v. Commissioner*, 344 U.S. 6 (1952).

[4060] A plan is any arrangement or agreement providing for a deferral of compensation. Code § 409A(d)(1), (3). If the payment is reasonable because it relates to past services, then it constitutes deferred compensation, and its material terms must be documented in writing to satisfy Code § 409A. Reg. § 1.409A-1(c)(3)(i). The written plan must be in place when the service provider obtains a legally binding right to the compensations. Reg. § 1.409A-1(a)(1). One might argue that compensation was earned in a prior year, but there was no legally binding right to payments based on that service, and now it is necessary and reasonable to pay for those past services to retain the employee. *Aries Communications Inc. v. Commissioner*, T.C. Memo. 2013-97 (comparing actual amounts paid in prior years against what was shown to have been higher reasonable compensation for those years), following the factors in *Elliotts* in fn. 31 as well the independent investor test of *Metro Leasing & Dev. Corp. v. Commissioner*, 376 F.3d 1015, 1019 (9th Cir. 2004), *aff'g* 119 T.C. 8 (2002). Although the author would make such an argument regarding past services on audit, the author would prefer to have more certainty when planning in light of Code § 409A's expansive reach. See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

[4061] See part II.A.1.b.i Compensating Individuals, especially fn. 31.

paragraph may be used. Absent a prior written plan, however, convincing a court that the owner was undercompensated might be very difficult.[4062]

A more conservative approach would be to have a plan in place when the business is doing well but is not yet sold, which plan vests over time. That strategy is described later.[4063] Alternatively, consider paying an immediate lump sum if a plan is not already in place and the payor has enough income to absorb the deduction.[4064] An immediate lump sum payment often is very unattractive to the buyer (who has cash flow issues and might not need that much deduction in a single year) or seller (who might rather receive payments over time to avoid accelerating income tax if adequate safeguards are in place to protect the payment).

Deferred compensation in an S corporation will not raise second-class of stock issues unless a principal purpose of the agreement is to circumvent the single class of stock rules.[4065]

II.Q.1.d.ii.(b). Balance Sheet Effects of Deferred Compensation

Before establishing a deferred compensation agreement, ask the company's outside CPA to determine what the balance sheet effect is going to be.

Then have the client take that information to the company's lenders to discuss the impact on balance sheet loan covenants. Same with any companies that provide construction bonds, etc., if the company is in such a line of business.

I have seen the balance sheet liability cause deferred compensation agreements to be killed.

II.Q.1.d.iii. Timeline for FICA and Income Taxation of Deferred Compensation

Here is a timeline for FICA and income taxation of deferred compensation when the service recipient is not a tax-exempt entity:

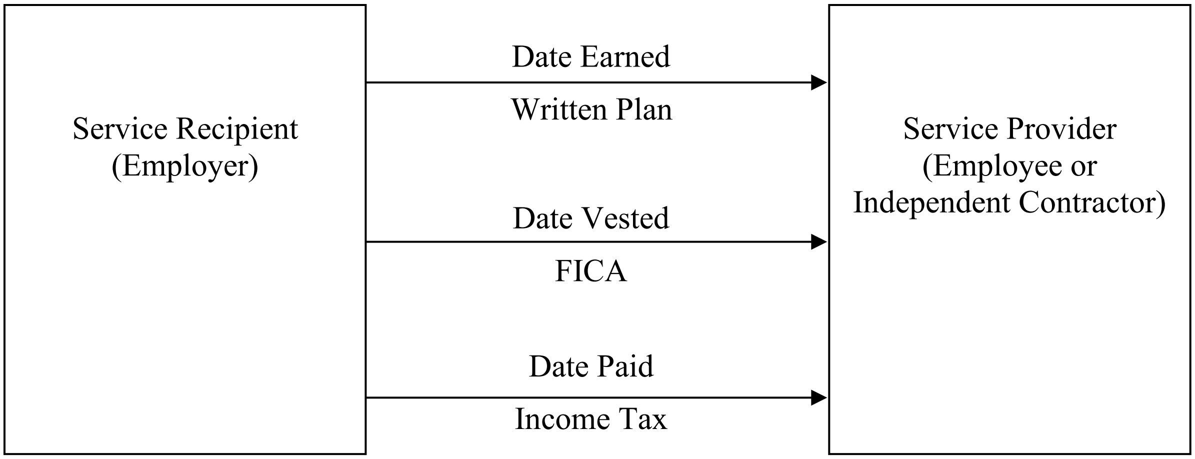
4062 *PK Ventures, Inc. v. Commissioner*, T.C. Memo. 2006-36, *aff'd sub nom. Rose v. Commissioner*, 101 A.F.T.R.2d 2008-1888 (11th Cir. 2008), disallowed deductions for such deferred compensation beyond what the IRS conceded. *Thousand Oaks Residential Care Home I, Inc. v. Commissioner*, T.C. Memo. 2013-10, found credible testimony that compensation was intended as catchup compensation – payment of back salaries that were not paid in prior years due to insufficient cash flow. However, the court applied the independent investor test (see fn. 31) to determine that the catch-up compensation was unreasonably high.

4063 See part III.B.7.c.vi Deferred Compensation.

4064 A special exception to Code § 409A applies to payments that occur immediately after the payment becomes vested if the taxpayer can prove that the payment was contingent on continuing to provide services from the date the service had been performed until the date that occurred during the current year. Reg. § 1.409A-1(b)(4)(i). The preamble to the final regulations, T.D. 9321, rejected cross-referencing existing rules:

> The final regulations generally adopt the definition of substantial risk of forfeiture set forth in the proposed regulations. Several commentators requested that the definition of substantial risk of forfeiture be the same as the definition of substantial risk of forfeiture in § 1.83-3(c). However, the definition of substantial risk of forfeiture for purposes of compensatory transfers of property under section 83 reflects different policy concerns from those involved in section 409A, and there are also practical differences between transfers of restricted property and promises to pay deferred compensation. This is reflected in the provisions of section 409A(e)(5), directing the Secretary of the Treasury Department to issue regulations disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of section 409A. Accordingly, the final regulations do not adopt this suggestion.

4065 See part II.A.2.i.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules, especially fns. 273-274.



Date Earned. Need to have written plan in place before service provider obtains legally enforceable rights – either required or best practice to be in place before performing service.

Date Vested. "Vested" corresponds to no further obligation to perform services. FICA will be due on present value[4066] and will not be due when the benefits are paid.[4067] This vesting is often beneficial when employee's compensation, for the year in vesting occurs, exceeds the taxable wage base ($142,800 in 2021 and $147,000 in 2022) because it is taxed at 2.9% (1.45% x 2) or 3.8% (for compensation in excess of $200,000 for a single person or $250,000 for a married person filing jointly) instead of 15.3% (7.65% x 2).[4068] The employer and employee can negotiate whether the employer should pay the employee an additional bonus to cover the additional FICA withholding in the year of vesting. On one hand, the employee might not have the cash flow to pay the FICA, since the employee has not been paid this deferred amount. On the other hand, the employee's share of FICA is properly taxed to the employee, and it is taxed at a lower rate than it would be if the plan had not been in effect, so it's only fair for the employee to pay this additional FICA. Note, however, that the FICA deferred compensation regulations do not

[4066] Reg. § 31.3121(v)(2)-1(c)(2).

[4067] Code § 3121(v)(2)(B). Reg. § 31.3121(v)(2)-1(d)(2) provides how much income on this initially taxed amount is also excluded from FICA wages when paid.

[4068] FICA tax (for employer and employee combined, or for self-employment tax purposes) is 15.3% on annual income up to the taxable wage base (TWB) and 2.9% on all annual income above the TWB until $200,000 (single) or $250,000 (married), above which it is 3.8%. FICA consists of Old-Age, Survivors, and Disability Insurance benefits (OASDI) and Medicare's Hospital Insurance program (HI). The OASDI tax is 6.2% for employer and 6.2% for employee, for a total of 12.4%, imposed only up to the TWB. The HI tax is 1.45% for employer and 1.45% for employee, imposed on all FICA wages. See http://www.ssa.gov/OACT/COLA/cbb.html for the past and current TWB; see also part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax. Most of the FICA tax on the present value will be at the lower 2.9% or 3.8% rate. When payments are made in future years, they will not be subject to FICA tax. This could save around $15,959 of FICA tax each year ($128,700 TWB for 2018, multiplied by the 12.4% spread between 15.3% and 2.9%; if wages were taxed at 3.8% the savings would be $14,801). The savings is slightly less than indicated, because it does not consider that the employer receives a deduction for the employer's one-half portion of FICA.

provide a discount for the credit risk (that the employer might not be able to pay) that the employee assumes,[4069] and the employee cannot get the FICA back if the employer defaults.[4070]

Date Paid. Income tax is due when paid or constructively received, but FICA is not due since that was already paid.[4071] Code § 409A places strict limits on events that accelerate payment and events that delay payment.

[4069] Reg. § 31.3121(v)(2)-1(c)(2)(ii) provides:

> For purposes of this section, the present value must be determined as of the date the amount deferred is required to be taken into account as wages under paragraph (e) of this section using actuarial assumptions and methods that are reasonable as of that date. For this purpose, a discount for the probability that an employee will die before commencement of benefit payments is permitted, but only to the extent that benefits will be forfeited upon death. In addition, the present value cannot be discounted for the probability that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk associated with any deemed or actual investment of amounts deferred under the plan, the risk that the employer, the trustee, or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies. Nor is the present value affected by the possibility that some of the payments due under the plan will be eligible for one of the exclusions from wages in section 3121(a).

[4070] *Balestra v. U.S.*, 803 F.3d 1363 (Ct. Fed. Cl. 2014), holding:

> Sections 3101(b) and 3121(v)(2) required these benefits to be calculated and taxed when he retired, but do not require the use of a risk-adjusted discount rate nor a refund corresponding to the benefits plaintiff never received.

The Federal Circuit, at 803 F.3d 1363 (2015), affirmed the Court of Claims, validating Reg. § 31.3121(v)(2)-(1)(c)(2)(ii):

> Treasury's path to calculating the amount deferred in terms of the compensation's present value without consideration of an employer's financial condition is reasonably discernable. Treasury explained that it sought simple, workable, and flexible rules when valuing future benefits. It devised a regulation that satisfied these goals while comporting with the governing statute. This is neither arbitrary nor capricious. It may seem unfair in a specific instance such as this, but in balancing the desire for simplicity against the ideal of ultimate comprehensiveness, the agency must be allowed a reasonable degree of discretion. We cannot say that this one example of consequent unfairness by the agency results in invalidating the rule-making.

[4071] However, if an amount deferred is required to be taken into account in a particular year, but the employer fails to pay the additional FICA tax resulting from that amount, then the amount deferred and the income attributable to that amount must be included as wages when actually or constructively paid. Reg. § 31.3121(v)(2)-1(d)(1)(ii)(A). An employer that fails to withhold upfront and then causes the employees to pay more FICA when they retire is liable to the employees. *Davidson v. Henkel Corporation*, 115 A.F.T.R.2d ¶ 2015-321 (D. Mich. 2015). AM 2017-001 clamps down to an extent when employers do not follow the rules:

> As noted above, § 31.3121(v)(2)-1(d)(1)(ii) describes the steps to be taken if an employer fails to use the special timing rule as required for part or all of the amounts an employee defers under a NQDC plan. If an employer fails to pay FICA tax on amounts deferred as required under § 3121(v)(2), the employer is required to adjust its employment tax returns for any years for which the period of limitations has not expired to report and pay the additional FICA tax attributable to the amounts deferred and required to be included under the special timing rule. See § 6205 and § 31.6205-1(a) and (b) of the regulations with regard to making interest-free adjustments of underpayments. If the employer does so, the nonduplication rule will apply to the payment of the deferred compensation. However, the general timing rule will apply to any amounts deferred and income attributable to those amounts deferred for closed years that cannot be adjusted.
>
> Upon discovery that they have not correctly applied the special timing rule under § 3121(v) to pay FICA tax when required under the regulations, some employers have requested a closing agreement to permit them to pay FICA tax in a subsequent year that is prior to the year of payment in order to reduce the amount of total FICA taxes that would otherwise be due under the general timing rule if FICA tax was applied at the time of payment of the wages. The employer may also want to avoid application of the allocation rule in § 31.3121(v)(2)-1(d)(1)(ii)(B) that imposes FICA tax on a portion of each payment if the employer took some portion (but not all) of the NQDC into account for FICA tax under the special timing rule.
>
> Because the applicable regulations provide the mechanism for the payment of FICA taxes in the case of NQDC which is not timely taken into account under the special timing rule in § 31.3121(v)(2)-1(a)(2), as a policy matter, a closing agreement should not be entered into if it that has the effect of avoiding application of this regulatory mechanism. The existence of the special transition rule in the regulations for years for which the period of limitations had expired

One might also consider whether FICA tax rates might increase in the future as Social Security and Medicare payments for the Baby Boomers increase. Vesting no later than December 31, 2012 should be considered to avoid the additional 0.9% tax on wages in excess of $250,000 (joint return) or $200,000 (single returns) that was added by the 2010 health care act.[4072]

Furthermore, the state in which the service provider worked may not subject the deferred compensation to tax except to the extent paid to the service provider while he or she is a resident of that state.[4073]

Because various tax-exempt entities have no incentive to accelerate income, the present value of the future payments is taxed when vested instead of when paid.[4074] Such an employer includes a State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State, and any other organization (other than a governmental unit) exempt from income tax.[4075] When the employee receives the deferred payments, the payments are exempt from FICA (as described above)[4076] but, to the extent of the interest component arising from the present value calculation, would be subject to income tax.[4077] If deferring payments is important to the employer, then the employer should consider paying up-front enough to pay for the employee's up-front taxes and deferring most or all of the rest. Note that the arrangement saves FICA relative to what otherwise might have been the parties' expectations,[4078] so they might want to consider that savings when negotiating the deferred compensation arrangement.

II.Q.2. Consequences of IRS Audit Exposure for Prior Years' Activities

Consider the impact of part II.G.20 IRS Audits and whether the buyers might want a price adjustment if such audits occur:

- C Corporation. An audit changing a prior year's tax position results in the new shareholders paying the tax.

- S corporation. An audit changing a prior year's tax position results in the former shareholders paying the tax, except to the extent that the change relates to C corporation years,[4079] built-in gain tax,[4080] tax on excess net passive income,[4081] or any other taxes or penalties (for example, payroll taxes) imposed on the entity itself.

- Partnership. Depending on the situation, tax imposed by reason an audit changing a prior year's tax position might be paid by the partnership or by the former partners. Of course, taxes or penalties (for example, payroll taxes) other than income tax might be imposed on the entity itself.

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at the time the regulations were finalized reinforces the importance of adhering to the rules contained in § 31.3121(v)(2)-1(d)(1)(ii) for determining the FICA tax due upon payment of amounts that were deferred in prior years and that should have been taken into account under § 3121(v)(2) in such prior years but for which the period of limitations has since expired.

[4072] Code § 3101(b)(2).

[4073] See part II.Q.8.b.ii.(g) Code § 736 Payments as Retirement Income – Possible FICA and State Income Tax Benefits, fns. 5309-5312.

[4074] Code § 457(f)(1)(A), which applies to payments made by an eligible employer.

[4075] Code § 457(e)(1).

[4076] See fn. 4067.

[4077] Code § 457(f)(1)(B).

[4078] See discussion accompanying fns. 4066-4070.

[4079] Changes to C corporation years might result not only in more tax but also more earnings & profits (E&P); for the latter, see part II.Q.7.b Redemptions or Distributions Involving S Corporations (effect of E&P on taxation of distributions).

[4080] See part II.P.3.b.ii Built-in Gain Tax on Former C Corporations under Code § 1374.

[4081] See part II.P.3.b.iii Excess Passive Investment Income.

II.Q.3. Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future

If one expects to sell a business interest for all cash in a few years and would like to defer capital gain on the sale of a business interest, consider selling the business interest in an installment sale to a nongrantor trust. The note might be interest-only for a few years, with principal payments beginning some time after the business interest is expected to be sold. The trust receives basis for the full amount of the promissory note and can sell the business interest tax-free to the extent of that basis.

Similar principles apply to the sale of land or other property that is not depreciable or amortizable.

Potential pitfalls include the following:

- If the trust is a related person (which usually is the case) and it re-sells the business interest within two years, the original seller's deferred gain is accelerated.[4082]

- The original seller's death will not generate a basis step-up in the note.[4083] If the original seller had simply held the business interest until death, part or all of the gain would be eliminated by basis step-up. Consider buying term insurance against the risk of loss of the financial benefit of the basis step-up.

- Be sensitive to possible acceleration of the deferred gain if the original seller later transfers the installment note, including by gift (or transfer to or from a nongrantor trust),[4084] or pledges the note.[4085]

- Beware of the possible need to pay interest on the deferred tax liability if the sale exceeds $5 million.[4086]

- The part of the gain on the sale of a partnership interest attributable to "hot assets" is not eligible for installment sale treatment.[4087]

- The direct or indirect sale of depreciable or amortizable assets to a related party (the nongrantor trust) might trigger ordinary income tax.[4088]

Dealers cannot use the installment method with respect to:[4089]

(A) *Personal property*. Any disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan.

(B) *Real property*. Any disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.

[4082] Code § 453(e).
[4083] Code § 1014(c).
[4084] See part II.G.16 Limitations on the Use of Installment Sales for that or other accelerating events.
[4085] Code § 453A(d).
[4086] Code § 453A(c)(4).
[4087] See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests.
[4088] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).
[4089] Code § 453(b)(2)(A). The quoted language is from Code § 453(*l*)(1) and is subject to exceptions in Code § 453(*l*)(2).

When entities disposed of real properties that were held for sale to customers in the ordinary course of their trades or businesses, they were not permitted to use the installment method to account for their sales of real properties made by contract for deed.[4090]

See also part II.G.27 Real Estate Special Issues.

II.Q.4. Consequences of a Buy-Sell Agreements Not Dependent on Choice of Entity

This part II.Q.4.g begins with practical issues of part II.Q.4.a Funding the Buy-Sell.

Because life insurance is so commonly used to fund buy-sell agreements, it then delves into various life insurance issues in parts:

- II.Q.4.b Transfer for Value Rule; Basis
- II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035
- II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy)
- II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies
- II.Q.4.f Split-Dollar Arrangements
- II.Q.4.g Income Tax Trap for Business-Owned Life Insurance

The next issue is part II.Q.4.h Establishing Estate Tax Values, which includes not only gift/estate tax issues in transferring a business interest but also estate tax issues caused by life insurance held by a business to redeem the insured's business interest.

To avoid the latter, the owners might agree to buy each other's interest on death (a "cross purchase"). A solution to several issues raised by a cross purchase is in part II.Q.4.i Life Insurance LLC.

II.Q.4.a. Funding the Buy-Sell

Insurance is by far the most common method by which a buy-sell agreement is funded, whichever form of agreement is used. Special rules apply if the beneficiary is two generations (or the equivalent) younger

[4090] See *SI Boo, LLC v. Commissioner*, T.C. Memo. 2015-19; see fn. 3331 and the accompanying text for this case's facts and analysis.

than the insured.[4091] If a business owner has a parent with an estate tax problem, that parent's estate tax problem might lend itself to a special opportunity to pay for the policies that fund the buy-sell.[4092]

Not enough attention is focused on disability insurance, which can protect the business' cash flow due to the interruption caused and might also help fund buyouts. To the extent disability is to benefit the disabled person, one should avoid the draconian Code § 409A rules,[4093] which have a stringent disability provision,[4094] and instead pay the key employee compensation sufficient for that person to buy his or her own disability policy.

Having life insurance proceeds paid directly to the selling shareholder does not make the sale tax-free; rather, the payment is treated just as would be any other payment to a seller[4095] (which might be tax-free if the seller has sufficient basis, for example because of a basis step-up in the business interest).

[4091] If the policy proceeds are $250,000 or more, the life insurance company will need to verify with the beneficiary that the beneficiary is not a skip person receiving a payment subject to generation-skipping transfer (GST) tax; otherwise the insurance company might need to file relevant forms reporting and paying GST tax. Reg. § 26.2662-1(c)(2)(vi) explains:

> *Example (1). Insurance proceeds less than $250,000.* On August 1, 1997, T, the insured under an insurance policy, died. The proceeds ($200,000) were includible in T's gross estate for Federal estate tax purposes. T's grandchild, GC, was named the sole beneficiary of the policy. The insurance policy is treated as a trust under section 2652(b)(1), and the payment of the proceeds to GC is a transfer from a trust for purposes of chapter 13. Therefore, the payment of the proceeds to GC is a direct skip. Since the proceeds from the policy ($200,000) are less than $250,000, the executor is liable for the tax imposed by chapter 13 and is required to file Form 706.
>
> *Example (2). Aggregate insurance proceeds of $250,000 or more.* Assume the same facts as in Example 1, except T is the insured under two insurance policies issued by the same insurance company. The proceeds ($150,000) from each policy are includible in T's gross estate for Federal estate tax purposes. T's grandchild, GC1, was named the sole beneficiary of Policy 1, and T's other grandchild, GC2, was named the sole beneficiary of Policy 2. GC1 and GC2 are skip persons (as defined in section 2613). Therefore, the payments of the proceeds are direct skips. Since the total value of the policies ($300,000) exceeds $250,000, the insurance company is liable for the tax imposed by chapter 13 and is required to file Schedule R-1 of Form 706.
>
> *Example (3). Insurance proceeds of $250,000 or more held by insurance company.* On August 1, 1997, T, the insured under an insurance policy, dies. The policy provides that the insurance company shall make monthly payments of $750 to GC, T's grandchild, for life with the remainder payable to T's great grandchild, GGC. The face value of the policy is $300,000. Since the proceeds continue to be held by the insurance company (the trustee), the proceeds are treated as if they were transferred to a trust for purposes of chapter 13. The trust is a skip person (as defined in section 2613(a)(2)) and the transfer is a direct skip. Since the total value of the policy ($300,000) exceeds $250,000, the insurance company is liable for the tax imposed by chapter 13 and is required to file Schedule R-1 of Form 706.
>
> *Example (4). Insurance proceeds less than $250,000 held by insurance company.* Assume the same facts as in Example 3, except the policy provides that the insurance company shall make monthly payments of $500 to GC and that the face value of the policy is $200,000. The transfer is a transfer to a trust for purposes of chapter 13. However, since the total value of the policy ($200,000) is less than $250,000, the executor is liable for the tax imposed by chapter 13 and is required to file Form 706.
>
> *Example (5).* On August 1, 1997, A, the insured under a life insurance policy, dies. The insurance proceeds on A's life that are payable under policies issued by Company X are in the aggregate amount of $200,000 and are includible in A's gross estate. Because the proceeds are includible in A's gross estate, the generation-skipping transfer that occurs upon A's death, if any, will be a direct skip rather than a taxable distribution or a taxable termination. Accordingly, because the aggregate amount of insurance proceeds with respect to Company X is less than $250,000, Company X may pay the proceeds without regard to whether the beneficiary is a skip person in relation to the decedent-transferor.

[4092] This tool, generational split-dollar, is described as it was approved in fns. 4325-4327 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4093] See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

[4094] See part III.B.7.c.vi Deferred Compensation, especially fn. 7131.

[4095] For an analogous situation, see Rev. Rul. 70-254, which is based on *Landfield Finance Company v. U.S.*, 418 F. 2d 172 (7th Cir. 1969), which in turn is based on Reg. § 1.101-1(b)(4).

Funding with life insurance under a cross-purchase plan will require that each shareholder own a life insurance policy on the life of every other shareholder. If there are more than three owners, however, policy ownership can become complicated and a stock redemption agreement may make better sense. One alternative to a stock redemption agreement may be a trusteed agreement whereby the trustee would act as custodian of the policies and purchase one life insurance policy for each shareholder. This avoids the need for multiple policies when there are more than two shareholders. If a stock redemption arrangement is employed, the corporation purchases a life insurance policy on each shareholder. Upon the shareholder's death, the beneficiary then uses the proceeds to purchase the decedent's shares. Similarly, as described in a Letter Ruling, the shareholders could form a limited liability company to own life insurance on each other, with the manager of the LLC retaining the proceeds until the parties agree on proper application of the proceeds.[4096] Also note that split-dollar life insurance arrangements[4097] are subject to Code § 409A rules restricting the events upon which deferred compensation can be paid, the violation of which trigger significant tax, penalties, and interest.[4098] When drafting a shareholder agreement using life insurance, consider authorizing transfers of the policy to the insured for fair market value to avoid Code § 409A risks; defining the value as cash surrender value might not be sufficient, particularly because features, such as no-lapse guarantees (which is the equivalent of prepaid insurance that is not revealed on annual insurance policy statements), provide additional value that is tracked through the life insurance company's internal "shadow account" that can provide surprising results when the insurance company issues IRS Form 712.[4099] Also, make sure that any rights an insured might have to purchase a policy others hold on his life arise only as a collateral consequence of acts or events of independent significance,[4100] so that they do not constitute an incident of ownership.[4101]

[4096] See part II.Q.4.i Life Insurance LLC.

[4097] Split-dollar is a cash value life insurance financing arrangement described in Reg. §§ 1.61-22 and 1.7872-15, with cross-references found in Reg. §§ 1.83-6(a)(5) (income tax treatment on rollout of employee split-dollar), 1.301-1(q) (shareholder arrangements), and 1.1402(a)-18 (self-employment tax issues). See part II.Q.4.f Split-Dollar Arrangements, especially part II.Q.4.i.ii.(b) Corporate Ownership of Policy, including *Machacek v. Commissioner*, where the Sixth Circuit, reversing the Tax Court and ignoring the parties' briefs, held that Reg. § 1.301-1(q) caused economic benefits under even compensatory split-dollar agreements to be treated as distributions and not compensation income to an employee-shareholder.

[4098] Notice 2007-34 sets forth transition rules. See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules, for a discussion of Code § 409A, including the permissible triggering events. Events that terminate pre-2005 split-dollar agreements often do not comply with these permissible triggering events, so a review of pre-2005 split-dollar agreements is a good idea. See Zaritsky, Aghdami & Mancini, ¶8.02. Life Insurance Funding, *Structuring Buy-Sell Agreements: Analysis With Forms*.

[4099] In the case of a split-dollar arrangement entered into on or before September 17, 2003, and which is not materially modified after that date, only the cash surrender value of the contract is considered to be property. Reg. § 1.83-3(e). Reg. §§ 20.2031-8 and 25.2512-6 determine the value for estate and gift tax purposes - based primarily on interpolated terminal reserve as a measure of the replacement value; see fn. 4117 for more information on this authority.

[4100] See part III.B.1.i Transfers with Contingencies Based on Acts of Independent Significance.

[4101] Letter Ruling 8049002 held that no incidents of ownership existed when a shareholder agreement gave the decedent the option to purchase policies at a price equal to the transfer value (cash surrender value), which option was exercisable only if decedent terminated his shareholder relationship with the corporation by offering all stock to the corporation and/or the other principal. This first-refusal option would become operative when a shareholder receives a bona fide offer, a shareholder terminates employment, or a shareholder becomes totally and permanently incapacitated. At date of death, although the option was still outstanding, the decedent had not terminated his shareholder relationship or acted in any way to exercise his option with respect to the insurance policies. The ruling was based on Rev. Ruls. 72-307, 75-50, and 79-46, from which the IRS gleaned an absence of incidents of ownership because the decedent could not independently initiate the events which would enable him to gain control over the policies (except, perhaps, by terminating employment, and, even then, he would not control the corporation's decision to repurchase). Thus, he lacked not only the practical ability to exercise any power with respect to these policies but also any power over the policies. Letter Ruling 9233006 also found no incidents of ownership when shareholders could buy policies on their respective lives and, thus, prevent cancellation of these policies only if the corporation redeems their stock interests in the event that the insured is disabled for a prescribed period of time, the insured declines to

If a shareholder is uninsurable, a sinking fund may be used to accumulate funds for premium payments or at least to provide a down payment. The remainder of the purchase price can be subject to an installment agreement whereby the payments can be spread out over a long time period.

When using life insurance, make sure the beneficiary is the owner. Otherwise, when the insured dies, the owner is deemed to have transferred the death benefit to the beneficiary.[4102]

In a redemption agreement, the value of the insurance on the decedent's life will not be includable in the decedent's gross estate for federal estate tax purposes if the corporation is the owner and beneficiary of the policy,[4103] and the insurance proceeds received by the corporation will not be subject to income tax.[4104] Unless a valid agreement that satisfies Code § 2703[4105] provides otherwise, the insurance proceeds will, however, be considered in valuing the decedent's interest in the business,[4106] but perhaps offset by the buy-sell obligation.[4107]

Insurance premiums used to fund the agreement are not deductible by the corporation.[4108] Same with "any interest paid or accrued on any indebtedness with respect to 1 or more life insurance policies owned by the taxpayer covering the life of any individual, or any endowment or annuity contracts owned by the taxpayer covering any individual."[4109] This rule disallowing interest does "not apply to any interest paid or accrued on any indebtedness with respect to policies or contracts covering an individual who is a key person to the extent that the aggregate amount of such indebtedness with respect to policies and contracts covering such individual does not exceed $50,000."[4110] In this context, "key person" means an officer or 20% owner, except that the number of individuals who may be treated as key persons with respect to any taxpayer cannot exceed the greater of (A) five individuals, or (B) the lesser of 5% of the total officers and employees of the taxpayer or 20 individuals.[4111] In this context, a "20% owner" means any person who

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participate in the sale of the corporation to a third party, or the insured declines to participate in a public offering of the corporation's stock. Thus, the right to acquire the insurance policies and thus, prevent cancellation would arise as a collateral consequence of acts or events of independent significance. That ruling also cited Rev. Ruls. 84-130 and 80-255. The ability to cancel a death benefit by divorcing one's spouse does not generate Code § 2038(a)(1) inclusion; see part III.D Code § 2038.

[4102] *Goodman v. Commissioner of Internal Revenue*, 156 F.2d 218 (2nd Cir. 1946).

[4103] Rev. Rul. 82-85, relying on Reg. § 20.2042-1(c)(6), which is reproduced in part II.Q.4.i.ii.(b) Corporate Ownership of Policy. If the decedent controls the entity that owns the policy and the insurance proceeds are not payable to the corporation or otherwise used for a valid business purpose (such as in satisfaction of a business debt of the corporation) so that the net worth of the corporation is increased by the amount of such proceeds, then the proceeds are includible in the decedent's estate. Reg. § 20.2042-1(c)(6). For purposes of determining whether a decedent controlled stock, the decedent will not be attributed ownership of a trust that the decedent did not create with respect to which the decedent was not the deemed owner under the grantor trust income tax rules. Letter Rulings 9808024 (decedent not deemed owner of trust and therefore not attributed stock ownership), 9511046 (decedent attributed stock ownership as deemed owner of QSST). Also, Code § 2035 causes inclusion if the life insurance proceeds are payable to a third party for other than a Reg. § 20.2042-1(c)(6) business purpose and: (a) the corporation, for less than adequate and full consideration, assigns an insurance policy on the stockholder's life and the stockholder then disposes of control of the corporation, or (b) within three years of death the stockholder had a controlling interest in a corporation that owns a life insurance policy on the stockholder's life. Rev. Rul. 90-21. Situation (2) of Rev. Rul. 90-21 reasoned that a shareholder who holds a non-controlling interest would not hold incidents of ownership; however, the facts did not indicate whether the shareholder had any authority to exercise any control over the policy.

[4104] Code § 101(a)(1). However, the death benefit might trigger significant alternative minimum tax (AMT), because book-tax differences generate an AMT preference. See part II.Q.7.a.v Redemptions and Alternative Minimum Tax.

[4105] See part II.Q.4.h Establishing Estate Tax Values.

[4106] Reg. § 20.2031-2(f); *Newell v. Commissioner*, 66 F.2d 102 (7th Cir. 1933).

[4107] In the *Blount* case, cited in footnote 4371, the Tax Court included the life insurance in the business' value, but the 11th Circuit reversed, holding that the buy-sell obligation offset the inclusion in the company's value.

[4108] Code § 264(a)(1).

[4109] Code § 264(a)(4). However, such interest reduces earnings and profits if the payor is a C corporation. Rev. Rul. 2009-25.

[4110] Code § 264(e)(1). However, Code § 264(e)(2) may limit the interest deduction to a particular rate.

[4111] Code § 264(e)(3).

owns directly 20% or more of the outstanding stock of a corporation, stock possessing 20% or more of the total combined voting power of all stock of a corporation, or 20% or more of the capital or profits interest in a partnership.[4112] For purposes of determining stock ownership and applying the $50,000 debt limit, all members of a controlled group are treated as one taxpayer, and this limitation shall be allocated among the members of such group in such manner as the Treasury/IRS may prescribe.[4113]

A cross-purchase generally would constitute a taxable sale, treated as a capital gain.[4114] In many cases, a cross-purchase or a redemption that is paid over time can qualify for tax deferral as an installment sale.[4115] However, tax deferral on installment sales can be limited,[4116] so do not assume that it is available without our first having the rules thoroughly researched.

In a cross-purchase arrangement, the value of life insurance owned on the decedent's life by a surviving shareholder will not be included in the decedent's estate for federal estate tax purposes, but the decedent's gross estate will include the value of life insurance the decedent owned on the lives of the surviving shareholders. Premiums paid by the shareholders to fund the agreement are not deductible by the shareholders, and the insurance proceeds paid to the surviving shareholders will not be subject to income tax. Generally, a transferred policy would be valued for income tax purposes at its fair market value, rather than its Form 712 value. *Matthies v. Commissioner*, 134 T.C. 141 (2010 regarding tax years 2000 and 2001), rejected the taxpayer's attempt to used interpolated terminal reserve for income tax purposes, although the rejection appears to have responded to the taxpayer's failure to prove value when engaging in what many people call a pension rescue plan that the court considered to be a scheme. The case also held that, if and to the extent that cash surrender value is used, the value does not consider charges imposed on a surrender of the policy. Rev. Proc. 2005-25 applies generally in the context of valuing compensation under Code §§ 79, 83 and 402. Except for split-dollar arrangements and except for employee trusts and annuity plans subject to Code §§ 402(b) and 403(c), Reg. § 1.83-3(e) provides:

> In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any undivided interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property for purposes of this section.

For qualified retirement plan purposes, see Reg. § 1.402(a)-1(a)(2), the preamble to which is T.D. 9223, which does a good job of explaining how that rule changed. Reg. § 1.402(a)-1(a)(2) requires that surrender charges be ignored in calculating the amount of a distribution from a qualified retirement plan. However, for a nonexempt employee trust (a trust established to fund payments of compensation to be made in the future), surrender charges are considered. *Schwab v. Commissioner*, 136 T.C. 120 (2011) (when surrender charges exceeded cash value, policies valued based on prepaid death benefit when no other evidence of value was introduced), *aff'd* 715 F.3d 1169 (9th Cir. 2013), and *Lowe v. Commissioner*, T.C. Memo. 2011-106. *Lowe* summarized the holding of the Schwab Tax Court opinion, contrasting the qualified retirement plan concept of entire cash value against the nonexempt employee trust concept of entire value:

> We concluded that while the entire cash value of a life insurance policy is determined without regard to surrender charges, the entire value of a life insurance policy is determined by its fair market value, which may include surrender charges. We thus rejected the simple proposition that surrender charges should never

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4112 Code § 264(e)(4).

4113 Code § 264(e)(5)(A). Code § 264(e)(5)(B), "Controlled group," provides:

> For purposes of this paragraph, all persons treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414 shall be treated as members of a controlled group.

4114 However, in a partnership, part of the sale might constitute ordinary income under Code § 751. See part II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner.

4115 Code § 453.

4116 Code § 453A.

> count or that they should always count, instead reading section 402(b) to require a court to consider the payment of surrender charges as part of a more general inquiry into the policy's fair market value.

Lowe pointed out that the Tax Court denied the IRS' motion for reconsideration of *Schwab*. In denying the IRS' motion for summary judgment, the *Lowe* court held:

> The facts of the instant case are virtually identical to those presented in *Schwab*. The policies were variable universal life insurance policies with steep premiums, and both were distributed from nonexempt employee trusts in late 2003. Both policies carried surrender charges that rendered the accumulated value of the policy zero or less than zero. In Schwab we decided that the fair market values of the policies the taxpayers received were less than their accumulated values. Here, we are unable to determine the fair market value of Mr. Lowe's policy because the record does not allow us to do so.

Thus, the Tax Court appears to heavily weigh surrender charges in determining the value of a policy for income tax purposes, if a specific rule does not apply to override that. Specific rules to the contrary include qualified retirement plans (discussed above) and split-dollar arrangements (Reg. § 1.61-22(d)(4)(i)). Reg. § 1.83-3(e) provides further:

However, in the case of the transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, which was part of a split-dollar arrangement (as defined in § 1.61-22(b)) entered into (as defined in § 1.61-22(j)) on or before September 17, 2003, and which is not materially modified (as defined in § 1.61-22(j)(2)) after September 17, 2003, only the cash surrender value of the contract is considered to be property. Where rights in a contract providing life insurance protection are substantially nonvested, see § 1.83-1(a)(2) for rules relating to taxation of the cost of life insurance protection.

For estate and gift tax purposes, the IRS Form 712 value is usually, but not always, appropriate.[4117]

[4117] Reg. § 25.2512-6(a) provides:

> The value of a life insurance contract or of a contract for the payment of an annuity issued by a company regularly engaged in the selling of contracts of that character is established through the sale of the particular contract by the company, or through the sale by the company of comparable contracts. As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used.

Reg. § 20.2031-8(a)(1), (2) provide:

> (1) The value of a contract for the payment of an annuity, or an insurance policy on the life of a person other than the decedent, issued by a company regularly engaged in the selling of contracts of that character is established through the sale by that company of comparable contracts. An annuity payable under a combination annuity contract and life insurance policy on the decedent's life (e.g., a retirement income policy with death benefit) under which there was no insurance element at the time of the decedent's death (see paragraph (d) of § 20.2039-1) is treated like a contract for the payment of an annuity for purposes of this section.
>
> (2) As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when, at the date of the decedent's death, the contract has been in force for some time and further premium payments are to be made, the value may be approximate by adding to the interpolated terminal reserve at the date of the decedent's death the proportionate part of the gross premium last paid before the date of the decedent's death which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such an approximation is not reasonably close to the full value of the contract, this method may not be used.

Rev. Rul. 78-137 held:

> In general, the replacement cost of a single premium policy will determine the value of the policy for gift tax purposes. *United States v. Ryerson*, 312 U.S. 260 (1941), Ct. D. 1488, 1941-1 C.B. 447. The replacement cost is based upon the single premium cost of a comparable policy. *Candler v. Allen*, 43 F.Supp. 435 (M.D. Ga. 1942). Generally, the estate

In a cross purchase funded by life insurance, consider not only the transfer for value but also income tax rules when an owner enters or exits the ownership group. How will policies on the existing owners be transferred to the new owner? How will policies that a departing owner owns be transferred when that person leaves, and how will policies on that person's life be transferred from the other owners? Consider not only income tax but also Code § 409A nonqualified deferred compensation issues. One might use a Life Insurance LLC to minimize these potentially adverse tax consequences – particularly when new insurance can be obtained.[4118]

Using split-dollar arrangements[4119] to fund a cross-purchase might also help when unwinding the arrangement. The insured pays the premiums and is deemed the policy owner under the split-dollar regulations,[4120] but the other business owners are entitled to the term insurance component of the death benefit and hold title and all other incidents of ownership with respect to the policy.[4121] If the insured leaves the business, the policy is transferred to the insured (or, preferably, an irrevocable grantor trust established by the insured); the transfer of the policy to the insured is not deemed a transfer for income tax purposes because the insured was already deemed to be the owner.

II.Q.4.b. Transfer for Value Rule; Basis

II.Q.4.b.i. Transfer for Value Rule Generally

If life insurance policies can be transferred among the shareholders or from the corporation to the shareholders, the transfer for value rules must be examined. The transfer-for-value rule states that, if

> tax and gift tax provisions are in *pari materia*. *Sanford Estate v. Commissioner*, 308 U.S. 39 (1939), Ct. D. 426, 1939-2 C.B. 340.
>
> In order for an insurance policy to qualify as a comparable contract within the meaning of section 20.2031-8(a), the policy must provide the same economic benefits as the policy owned by the decedent. *Candler v. Allen*, above at 437. The economic benefits of a single premium life insurance policy consist of an entire bundle of rights including the right to surrender the policy, the right to retain it for investment virtues, the right to borrow the cash surrender value of the policy and the right to payment of the face amount on the death of the insured. *Guggenheim v. Rasquin*, 312 U.S. 254 (1941), Ct. D. 1487, 1941-1 C.B. 445; *Candler v. Allen*, above at 437. All of the economic benefits of the decedent's policy must be taken into consideration. To single out one economic benefit of the decedent's policy and to disregard the others is, in effect, to substitute a different property interest for the one that was owned by the decedent. *Cf. Guggenheim v. Rasquin*, above at 257.
>
> Since the cash surrender value of the replacement policy is less than the cash surrender value of the decedent's policy, the replacement policy does not reflect all of the economic benefits of the policy owned by the decedent. Therefore, the replacement policy is not a comparable contract within the meaning of section 20.2031-8(a) of the regulations. Accordingly, in the present case, the value of the policy owned by A on the life of A's child shall be determined, for Federal estate tax purposes, by reference to a comparable contract that reflects all of the economic benefits of the decedent's policy. If, however, information pertaining to a comparable contract is not obtainable, the value of the policy shall be determined by reference to the interpolated terminal reserve value of the policy pursuant to section 20.2031-8(a)(2) of the regulations, quoted above.

¶ 3.02[2][a][iii] of Zaritsky & Leimberg, *Tax Planning with Life Insurance: Analysis With Forms* (WG&L), provides an interesting discussion. Also see Anoia, Mendelsohn, and Slane, Complexities of Life Insurance Policy Valuation, *Estate Planning Journal* (June 2014), especially for some insightful analysis of valuing no-lapse guarantee policies.

[4118] See part II.Q.4.i, Life Insurance LLC.

[4119] See part II.Q.4.f Split-Dollar Arrangements.

[4120] Reg. § 1.61-22(c).

[4121] To avoid estate tax inclusion under Code § 2042.

consideration is given for the transfer of an insurance policy, then the proceeds of the policy will be taxed as income to the owner-beneficiary upon the insured's death.[4122] Specifically:[4123]

> A transfer for valuable consideration means any transfer of an interest in a life insurance contract for cash or other consideration reducible to a money value.

Under prior regulations,[4124] the IRS had taken the position that, when an insured transfers a policy on his life to his business co-owner, and his co-owner does the same, the transfer for value rules apply, and the death proceeds will be exempt only to the extent of the new premiums paid after the transfer, with the balance of the proceeds being taxed as ordinary income;[4125] given that T.D. 9879 (10/31/2019) changed the regulation to require "cash or other consideration reducible to a money value," that position should no longer apply. A policy without cash value is subject to these rules.[4126]

Reg. § 1.101-1(g)(9), Example (9)(i) treats a nontaxable exchange – a contribution to a partnership in exchange for a partnership interest under Code § 721(a)[4127] – as a transfer for valuable consideration. Also, Reg. § 1.101-1(g)(10), Example 10 assumes that a transfer to a corporation is a transfer for value.

The transfer for value rule does not apply to transfers made to the insured, a corporation in which the insured is an officer or stockholder, a partner of the insured,[4128] a partnership in which the insured is a

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[4122] Code § 101(a)(2) provides, subject to certain exceptions:

> In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee.

Code § 101(a)(1) is the general rule that death benefits are not taxable.

[4123] Reg. § 1.101-1(f)(5).

[4124] Before T.D. 9879 (10/31/2019) was issued, Reg. § 1.101-1(b)(4) provided:

> … a "transfer for a valuable consideration" is any absolute transfer for value of a right to receive all or a part of the proceeds of a life insurance policy. Thus, the creation, for value, of an enforceable contractual right to receive all or a part of the proceeds of a policy may constitute a transfer for a valuable consideration of the policy or an interest therein. On the other hand, the pledging or assignment of a policy as collateral security is not a transfer for a valuable consideration of such policy or an interest therein, and section 101 is inapplicable to any amounts received by the pledgee or assignee.

[4125] Letter Ruling 7734048, reasoning:

> In the case of *Monroe v. Patterson*, 197 F.Supp. 146 (N.D. Ala. 1961), two policies were purchased on the life of an officer-stockholder, one by the insured and the other by the corporation. Subsequently insured entered into an agreement with two key employees for the purchase of his stock at his death. The policies were transferred to a trustee for use in partially financing the agreement and the key employees took over the payment of premiums. Upon insured's death, the proceeds were applied to the purchase of his stock. The Court held, the employees were transferees for value even though they had paid no purchase price for the policies. Their agreement to make the premium payments and to purchase the stock constituted a valuable consideration. Consequently the employees were taxed on the difference between the premiums they had paid and the proceeds applied toward their purchase of the insured's stock.

For additional discussion of the transfer for value rules, see Zaritsky & Leimberg, ¶2.07. The Transfer-For-Value Rule Causing the Loss of Tax-Free Status, *Tax Planning With Life Insurance: Analysis With Forms* (WG&L).

[4126] *James F. Waters, Inc. v. Commissioner*, 160 F.2d 596 (9th Cir. 1947) (prior version of this statute).

[4127] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

[4128] Not surprisingly, Letter Ruling 200120007 treated an LLC as a partnership in applying this rule. That LLC was formed to hold stock in a C corporation. The ruling also treated as having no adverse transfer-for-value effects:

- The transfer of a second-to-die policy to a trust deemed owned by one of the insureds.
- The transfer of a policy from a trust deemed owned by husband to a trust deemed owned by wife (due to Code § 1041 make it a substituted basis transaction).

partner, or where the new owner's basis is determined in whole or in part by reference to the transferor's basis.[4129] This exception looks at the deemed owner of a grantor trust.[4130] A gift subject to a policy loan

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Letter Ruling 9347016 applied this exception when shareholders bought a policy from a corporation (to facilitate a future cross-purchase of that corporation), triggering the transfer-for-value rule, but the investment partnership the shareholders owned triggered the exception. Same with Letter Ruling 9045004, which had the following facts:

> Corp. X, a C corporation, sells musical instruments. The stock of Corp. X is owned by A (42.85%), B (7.15%), C (42.85%), and D (7.15%). A, B, C, and D also are partners in Partnership. Partnership is involved in rental real estate activities and oil and gas production. A and C each have a 49% interest and B and D each have a 1% interest in Partnership. Corp. X is the owner and beneficiary of two life insurance policies on each of the lives of A and C. Premiums for the policies are paid for by Corp. X.
>
> Corp. X proposes to transfer the ownership and change the beneficiaries on the policies it owns as follows. The two policies currently insuring A will be transferred to B with B as the primary beneficiary and C and D as secondary beneficiaries.
>
> The two policies currently insuring C will be transferred to D with D as the primary beneficiary and A and B as secondary beneficiaries. It is represented that the secondary beneficiaries would be the beneficiaries should the primary beneficiary predecease the insured. It is further represented that Corp. X will retain the cash value portion of the policies and will continue to pay the premiums for that portion representing the cash value. The new owners of the policies will pay the premiums representing the life insurance portion of the policies.
>
> It is represented that the purpose of the transaction is to facilitate a buy-sell agreement. Upon the death of one or more of the insureds of the insurance policies, the financial means will be available for the remaining shareholders to secure control of Corp. X by purchasing the decedent's share from his estate.

4129 Code § 101(a)(2)(A), (B).

4130 Rev. Rul. 2007-13 posited the following situations:

> Situation 1. TR1 and TR2 are grantor trusts, both of which are treated as wholly owned by G under subpart E of Part I of subchapter J of the Internal Revenue Code. TR2 owns a life insurance contract upon the life of G. TR2 transfers the life insurance contract to TR1 in exchange for cash.
>
> Situation 2. The facts are the same as in Situation 1, except that TR2 is not a grantor trust.

It held:

> The grantor who is treated for federal income tax purposes as the owner of a trust that owns a life insurance contract on the grantor's life is treated as the owner of the contract for purposes of applying the transfer for value limitations of § 101(a)(2). Accordingly, in Situation 1, the transfer of a life insurance contract between two grantor trusts that are treated as wholly owned by the same grantor is not a transfer for a valuable consideration within the meaning of § 101(a)(2); in Situation 2, the transfer of a life insurance contract to a grantor trust that is treated as wholly owned by the insured is a transfer to the insured within the meaning of § 101(a)(2)(B) and is therefore excepted from the transfer for value limitations under § 101(a)(2).

Note that Rev. Proc. 2019-3, Section 3.01(14) states that the IRS will not issue letter rulings on:

> Section 101.—Certain Death Benefits.—Whether there has been a transfer for value for purposes of § 101(a) in situations involving a grantor and a trust when (i) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (iv) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§ 673 to 677.

However, that did not stop the IRS from issuing Letter Ruling 201423009, which including the following facts and conclusions:

> Individual A and his spouse, Individual B, are the grantors of the AC Trust. The AC Trust, as amended, is represented to be a grantor trust for federal income tax purposes owned by Individual A and Individual B. The AC Trust, as amended, owns and is currently the beneficiary of Number Y life insurance contracts on the joint lives of Individual A and Individual B and the Number X policy on Individual B (collectively, the life insurance contracts which total Number Z policies).
>
> The movement of the life insurance contracts from the AC Trust to the AB Trust has two aspects. The first aspect is that, pursuant to the rationale of Rev. Rul. 85-13, Individual A, as a grantor of the AC Trust, as amended, proposes to transfer the life insurance contracts to the AB Trust of which Individual A is the grantor. Thus, this aspect of the transaction cannot be recognized as a sale or exchange for tax purposes because Individual A is treated for income tax purposes as owning the purported consideration both before and after the transaction. The second aspect of the transaction is that Individual B's interest in the AC Trust (in which she is a grantor) is being moved to the AB Trust in which Individual B's husband, Individual A, is the grantor. This action has the result, under § 1041(a), as being

that is not in excess of basis is a substituted basis transaction that does not trigger the transfer-for-value rule.[4131] A transfer of an interest in a partnership that owns a life insurance policy is not subject to the transfer for value rules if the transfer does not constitute a termination of the partnership.[4132] Similarly, contributing a life insurance policy to a partnership in a Code § 721 nontaxable transfer[4133] is a substituted basis transaction that is not subject to the original transfer for value rules[4134] but may need to be checked under the reportable policy sale rule under part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

II.Q.4.b.ii. The Impact of Reportable Policy Sale on Transfer for Value Rule

Special rules apply to a "reportable policy sale," which is "the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract."[4135] "Indirectly" includes "the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract."[4136] Special rules for a reportable policy sale include:

- The exceptions to the transfer for value rule described above, all of which are Code § 101(a)(2)(A) or (B), do not apply.[4137] Thus, the death benefit generally is taxable, to the extent described in fn 4122.

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treated as a gift to her husband, Individual A, who pursuant to § 1041(b) receives a carryover basis in the life insurance contracts from his wife, Individual B.

[4131] Rev. Rul. 69-187 involved the following facts:

> *A* was the owner of a life insurance policy on his life under which his estate was designated as the beneficiary. The policy was in the face amount of 2,000x dollars, and had a value of approximately 860x dollars. Approximately 845x dollars had been advanced to *A* as a policy loan, on the security of the value of the policy and without personal liability on the part of *A*.
>
> *A* transferred the policy, subject to the indebtedness, to his wife, *B*. The transfer was made by the execution by *A* of a form that designated the new owner as *B*, and on her death, then to the executors, administrators, or assigns of *B*. *B* did not assume any personal liability with respect to the indebtedness.

Rev. Rul. 69-187 held:

> In the instant case the transferee's interest in the life insurance policy was acquired in part for a valuable consideration and in part by gift. Thus, upon the insured's death the insurance proceeds will be received under a policy that has a basis with respect to the transferee determinable in part by reference to the basis of the policy in the hands of the transferor. Accordingly, the limitation provided in section 101(a)(2) of the Code is not applicable. Upon the death of the insured, the proceeds of the policy are paid to *B* solely by reason of the death of the insured and are excludable from her gross income, as provided in section 101(a)(1) of the Code, except to the extent that section 101(d) of the Code is applicable by reason of payment of the proceeds at a date later than the death of the insured.

See also Letter Rulings 8628007 and 8951056, the latter pointing out that the transaction was substituted basis because basis exceeded debt.

[4132] Letter Ruling 200826009. Note, however, that Rev. Proc. 2011-3, Section 3.01(8) states that the IRS will not issue letter rulings on:

> Sections 101, 761, and 7701.—Definitions. — Whether, in connection with the transfer of a life insurance policy to an unincorporated organization, (i) the organization will be treated as a partnership under §§ 761 and 7701, or (ii) the transfer of the life insurance policy to the organization will be exempt from the transfer for value rules of § 101, when substantially all of the organization's assets consists or will consist of life insurance policies on the lives of the members.

[4133] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

[4134] Letter Ruling 201308019.

[4135] Code § 101(a)(3)(B).

[4136] Code § 101(a)(3)(B).

[4137] Code § 101(a)(3)(A).

- Various reporting requirements apply when the death benefit is paid.[4138]

The relevant committee report provides:

> **In general**
>
> The provision imposes reporting requirements in the case of the purchase of an existing life insurance contract in a reportable policy sale and imposes reporting requirements on the payor in the case of the payment of reportable death benefits. The provision sets forth rules for determining the basis of a life insurance or annuity contract. Lastly, the provision modifies the transfer for value rules in a transfer of an interest in a life insurance contract in a reportable policy sale.
>
> **Reporting requirements for acquisitions of life insurance contracts**
>
> *Reporting upon acquisition of life insurance contract*
>
> The reporting requirement applies to every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the taxable year. A reportable policy sale means the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer's interest in the life insurance contract). An indirect acquisition includes the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.
>
> Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase is (1) the buyer's name, address, and taxpayer identification number ("TIN"), (2) the name, address, and TIN of each recipient of payment in the reportable policy sale, (3) the date of the sale, (4) the name of the issuer, and (5) the amount of each payment. The statement the buyer provides to any issuer of a life insurance contract is not required to include the amount of the payment or payments for the purchase of the contract.
>
> *Reporting of seller's basis in the life insurance contract*
>
> On receipt of a report described above, or on any notice of the transfer of a life insurance contract to a foreign person, the issuer is required to report to the IRS and to the seller (1) the name, address, and TIN of the seller or the transferor to a foreign person, (2) the basis of the contract (*i.e.*, the investment in the contract within the meaning of section 72(e)(6)), and (3) the policy number of the contract. Notice of the transfer of a life insurance contract to a foreign person is intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract.
>
> *Reporting with respect to reportable death benefits*
>
> When a reportable death benefit is paid under a life insurance contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports (1) the name, address and TIN of the person making the payment, (2) the name, address, and TIN of each recipient of a payment, (3) the date of each

[4138] Code § 6050Y, which is reproduced in part II.Q.4.b.ii.(f) Reporting Requirements for Reportable Policy Sales.

such payment, (4) the gross amount of the payment, and (5) the payor's estimate of the buyer's basis in the contract. A reportable death benefit means an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.

For purposes of these reporting requirements, a payment means the amount of cash and the fair market value of any consideration transferred in a reportable policy sale…

Scope of transfer for value rules

The provision provides that the exceptions to the transfer for value rules do not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income.

The last paragraph above, consistent with the statutory language, does not say that a reportable policy sale is an additional type of transfer that is subject to the transfer for value rule; rather, it says that the exceptions to the transfer for value rule do not apply when the transfer is also a reportable policy sale. Notwithstanding this lack of income tax effect of a reportable policy sale that is not a transfer for value, a reportable policy may be subject to additional reporting obligations, which are purely informational.[4139]

II.Q.4.b.ii.(a). Income Tax Effect of a Reportable Policy Sale

Below is a discussion of Reg. § 1.101-1, overhauled by REG-103083-18.

Part 6 of the preamble to the proposed regulations, REG-103083-18 (3/25/2019), "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death," explains:

Generally, amounts received under a life insurance contract that are paid by reason of the death of the insured are excluded from federal income tax under section 101(a)(1). However, if a life insurance contract is sold or otherwise transferred for valuable consideration, the "transfer for value rule" set forth in section 101(a)(2) limits the excludable portion of the amount paid by reason of the death of the insured. Section 101(a)(2) provides that the excludable amount following a transfer for valuable consideration generally may not exceed the sum of (1) The actual value of the consideration paid by the transferee to acquire the life insurance contract and (2) the premiums and other amounts subsequently paid by the transferee. Section 101(a)(2) provides two exceptions to this transfer for value rule. Specifically, the limitation set forth in section 101(a)(2) does not apply if (1) The transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

Section 13522 of the Act added section 101(a)(3) to the Code. Section 101(a)(3)(A) provides that these two exceptions shall not apply in the case of a transfer of a life insurance contract, or any interest therein, that is a reportable policy sale. Section 101(a)(3)(B) defines the term "reportable policy sale" to mean the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract. For purposes of the preceding sentence,

[4139] For more about these nuances, see part II.Q.4.b.ii.(g) Transfer of Interest in an Entity Holding Life Insurance, especially fn 4184.

> the term "indirectly" applies to the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.
>
> The proposed regulations update § 1.101-1(a)(1) of the existing regulations to reflect the repeal of section 101(b) (treatment of employees' death benefits) in 1996, and the addition of section 7702 (definition of life insurance contract) in 1984, section 101(j) (treatment of certain employer-owned life insurance contracts) in 2006, and section 101(a)(3) (exception to valuable consideration rules for reportable policy sales) in 2017. The proposed regulations remove the second and third sentences of § 1.101-1(a)(1) of the existing regulations and add a sentence at the end of § 1.101-1(a)(1) to address the earlier changes in law. To address the changes in law made by the Act, the proposed regulations under section 101 provide updated rules for determining the amount of death benefits excluded from gross income following a transfer for value or gratuitous transfer, including a reportable policy sale, and provide definitions applicable under section 101. The proposed regulations under section 6050Y adopt the relevant definitions by cross-reference.

Part 6 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(a) of the Proposed Regulations," explains:

> The proposed regulations would remove the second sentence of § 1.101-1(a)(1) of the existing regulations, which states: "Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, are covered by this provision." As noted in the preamble to the proposed regulations, this update reflects the addition of section 7702 to the Code in 1984. See 84 FR 11015.
>
> One commenter stated that it is important that no changes be made with respect to the second sentence because the benefits described therein were written into older policies, some of which are still in effect, and changing the rules would negatively impact policyholders who have long relied on the appropriate exclusion of these death benefits from income. The commenter further stated that there is a longstanding and extensive body of court decisions and IRS rulings that establish the conditions under which such benefits qualify for treatment as life insurance proceeds.
>
> In response to these comments, the final regulations revise, rather than remove, the second sentence of § 1.101-1(a)(1) of the existing regulations to clarify that the sentence only applies to contracts issued on or before December 31, 1984, the effective date of section 7702.

Reg. § 1.101-1(a)(1) was changed by "Revising the second sentence of paragraph (a)(1), removing the third sentence of paragraph (a)(1), and adding a sentence at the end of paragraph (a)(1), as follows:

> … Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, issued on or before December 31, 1984, are covered by this provision…. If the life insurance contract is an employer-owned life insurance contract within the definition of section 101(j)(3), the amount to be excluded from gross income may be affected by the provisions of section 101(j).

Thus, Reg. § 1.101-1(a) now reads:

> (1) *In general*. Section 101(a)(1) states the general rule that the proceeds of life insurance policies, if paid by reason of the death of the insured, are excluded from the gross income of the

recipient. Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, issued on or before December 31, 1984, are covered by this provision. For provisions relating to death benefits paid by or on behalf of employers, see section 101(b) and § 1.101-2. The exclusion from gross income allowed by section 101(a) applies whether payment is made to the estate of the insured or to any beneficiary (individual, corporation, or partnership) and whether it is made directly or in trust. The extent to which this exclusion applies in cases where life insurance policies have been transferred for a valuable consideration is stated in section 101(a)(2) and in paragraph (b) of this section. In cases where the proceeds of a life insurance policy, payable by reason of the death of the insured, are paid other than in a single sum at the time of such death, the amounts to be excluded from gross income may be affected by the provisions of section 101(c) (relating to amounts held under agreements to pay interest) or section 101(d) (relating to amounts payable at a date later than death). See §§ 1.101-3 and 1.101-4. However, neither section 101(c) nor section 101(d) applies to a single sum payment which does not exceed the amount payable at the time of death even though such amount is actually paid at a date later than death. If the life insurance contract is an employer-owned life insurance contract within the definition of section 101(j)(3), the amount to be excluded from gross income may be affected by the provisions of section 101(j).[4140]

(2) *Cross references*. For rules governing the taxability of insurance proceeds constituting benefits payable on the death of an employee -

(i) Under pension, profit-sharing, or stock bonus plans described in section 401(a) and exempt from tax under section 501(a), or under annuity plans described in section 403(a), see section 72(m)(3) and paragraph (c) of § 1.72-16;

(ii) Under annuity contracts to which § 1.403(b)-3 applies, see § 1.403(b)-7. For the definition of a life insurance company, see section 801; or

(iii) Under eligible State deferred compensation plans described in section 457(b), see paragraph (c) of § 1.457-1.

Part 1.B. of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Applicability Date for Section 101 Regulations," explains:

Section 1.101-6(b) of the proposed regulations provides that, for purposes of section 6050Y, § 1.101-1(b), (c), (d), (e), (f), and (g) apply to reportable policy sales made after December 31, 2017, and to reportable death benefits paid after December 31, 2017. Section 1.101-6(b) of the proposed regulations further provides that, for any other purpose, § 1.101-1(b), (c), (d), (e), (f), and (g) apply to transfers of life insurance contracts, or interests therein, made after the date the Treasury decision adopting the proposed regulations as final regulations is published in the Federal Register.

Several commenters requested clarification regarding the applicability dates set forth in § 1.101-6(b) of the proposed regulations. Two of these commenters requested that the Treasury Department and the IRS clarify that the rules issued with respect to section 101(a)(3) apply to all transfers of life insurance contracts, or interests therein, made after December 31, 2017, or alternatively, that

[4140] [my footnote:] For Code § 101(j), see part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

the Treasury Department and the IRS allow taxpayers to rely upon the rules in § 1.101-1 of the proposed regulations for transactions undertaken after December 31, 2017, and before the date that the Treasury Department adopts final rules. Another commenter recommended that application of the rules under section 101 (as well as the reporting obligations under section 6050Y) be delayed until 60 days after the date the final regulations are published in the Federal Register, but suggested that language should be included in the preamble to the final regulations to provide that taxpayers may rely on the proposed regulations for the period prior to the effective date of the final regulations.

> Because the final regulations provide that the reporting obligations under section 6050Y apply to reportable policy sales and payments of reportable death benefits occurring after December 31, 2018, for purposes of determining whether a transfer of an interest in a life insurance contract is a reportable policy sale or a payment of death benefits is a payment of reportable death benefits subject to the reporting requirements of section 6050Y and §§ 1.6050Y-1 through 1.6050Y-4 of the final regulations, the definitions and rules set forth in § 1.101-1(b) through (g) of the final regulations apply to reportable policy sales made after December 31, 2018, and to reportable death benefits paid after December 31, 2018. See §§ 1.101-6(b) and 1.6050Y-1(b) of the final regulations.

> The final regulations provide that, for other purposes, specifically for purposes of determining the amount of the proceeds of life insurance contracts payable by reason of death excluded from gross income under section 101, § 1.101-1(b) through (g) of the final regulations apply to amounts paid by reason of the death of the insured under a life insurance contract, or interest therein, transferred after October 31, 2019. However, under section 7805(b)(7), a taxpayer may apply the rules set forth in § 1.101-1(b) through (g) of the final regulations, in their entirety, with respect to all amounts paid by reason of the death of the insured under a life insurance contract, or interest therein, transferred after December 31, 2017, and on or before October 31, 2019.

Reg. § 1.101-6(b) provides:

> Notwithstanding paragraph (a) of this section, for purposes of determining whether a transfer of an interest in a life insurance contract is a reportable policy sale or a payment of death benefits is a payment of reportable death benefits subject to the reporting requirements of section 6050Y and §§ 1.6050Y-1 through 1.6050Y-4, § 1.1011(b) through (g) apply to reportable policy sales made after December 31, 2018, and to reportable death benefits paid after December 31, 2018. For any other purpose, including for purposes of determining the amount of the proceeds of life insurance contracts payable by reason of death excluded from gross income under section 101, § 1.101-1(b) through (g) apply to amounts paid by reason of the death of the insured under a life insurance contract, or interest therein, transferred after October 31, 2019. However, under section 7805(b)(7), a taxpayer may apply the rules set forth in § 1.101-1(b) through (g) of the final regulations, in their entirety, with respect to all amounts paid by reason of the death of the insured under a life insurance contract, or interest therein, transferred after December 31, 2017, and on or before October 31, 2019.

Reg. § 1.101-1(b)(1)(i), "In general," (under (b)(1), "Transfer of an interest in a life insurance contract for valuable consideration") provides:

> In the case of a transfer of an interest in a life insurance contract for valuable consideration, including a reportable policy sale for valuable consideration, the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited

under section 101(a)(2) to the sum of the actual value of the consideration for the transfer paid by the transferee and the premiums and other amounts subsequently paid by the transferee with respect to the interest. For exceptions to this general rule for certain transfers for valuable consideration that are not reportable policy sales, see paragraph (b)(1)(ii) of this section. The application of section 101(d), (f) or (j), which is not addressed in paragraph (b) of this section, may further limit the amount of the proceeds excludable from gross income.

Before getting into the exceptions to the transfer-for-value rule, let's address the last sentence of Reg. § 1.101-1(b)(1)(i). Code § 101(d) provides that payments other than simply the death benefit on the date of death will be taxable. Code § 101(f) relates to "a flexible premium life insurance contract issued before January 1, 1985." Code § 101(j) relates to a policy owned by an employer of or business entity owned by an insured; see part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

Part 1.B.2 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(b) of the Proposed Regulations," explains:

> Generally, amounts received under a life insurance contract that are paid by reason of the death of the insured are excluded from gross income for Federal income tax purposes under section 101(a)(1). However, if a life insurance contract or interest therein is sold or otherwise transferred for valuable consideration, the "transfer for value rule" set forth in section 101(a)(2) limits the excludable portion of the amount received by reason of the death of the insured to the sum of the consideration paid for the contract or interest therein and any premiums and other amounts subsequently paid by the transferee with respect to the contract or interest therein. Section 101(a)(2)(A) and (B) provide two exceptions to this transfer for value rule. One exception (the "certain person exception") applies to transfers to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer ("certain persons"). See section 101(a)(2)(B). The other exception (the "carryover basis exception") applies if the transferee's basis for determining gain or loss in the life insurance contract or interest therein is determined in whole or in part by reference to the transferor's basis in the contract or interest therein. See section 101(a)(2)(A). Under section 101(a)(3), which was added by section 13522 of the TCJA, neither of these exceptions to the transfer for value rule apply in the case of a transfer of a life insurance contract, or any interest therein, that is a reportable policy sale.
>
> Section 1.101-1(b)(1)(i) of the proposed regulations provides the general transfer for value rule set forth in section 101(a)(2). Section 1.101-1(b)(1)(ii) of the proposed regulations sets forth the exceptions from this general rule for transfers for valuable consideration that are not reportable policy sales (the certain person exception and carryover basis exception provided in section 101(a)(2)). Section 1.101-1(b)(2) of the proposed regulations provides rules regarding gratuitous transfers of interests in life insurance contracts, as well as transfers of only a part of an interest in a life insurance contract and bargain sales of an interest in a life insurance contract (that is, transfers that are in part gratuitous and in part transfers for valuable consideration). This section of this Summary of Comments and Explanation of Revisions discusses comments received on § 1.101-1(b) of the proposed regulations.
>
> **A. Transfers to certain persons**
>
> One commenter on the proposed regulations described a life insurance policy subject to the section 101(a)(2) transfer for value rule as "tainted," in that death benefits paid under the policy are no longer fully excluded from income under section 101(a)(1). The commenter asked that the

final regulations provide for removal of the "taint" by a transfer to the insured, as was permitted before the TCJA, and asked for clarification regarding whether a transfer of a policy to the insured must be a sale for fair market value to remove the "taint" of a transfer for valuable consideration. The commenter suggested that mistakes happen, including the mistake of not seeking tax advice from a professional who knows the section 101 rules, and that taxpayers should be able to take corrective measures to remove this "taint." The commenter noted that the insured may no longer have a business or other need for the current transferee to own the policy and may wish to hold the policy to protect the insured's family, or the insured may regret selling the policy and wish to buy the policy back after the policy was transferred in a reportable policy sale. The commenter pointed out that § 1.101-1(b)(3)(ii) of the existing regulations (not yet revised to reflect TCJA changes to section 101) currently provides such a corrective measure, allowing the "taint" to be removed by a transfer of the policy to certain persons. However, § 1.101-1(b)(1)(ii)(B)(2) of the proposed regulations makes this corrective measure unavailable to the extent that the transfer to those certain persons was preceded by a transfer of the policy for valuable consideration in a reportable policy sale. The commenter also noted that § 1.101-1(b)(3)(ii) of the existing regulations does not require the corrective transfer to be a sale for fair market value, and that § 1.101-1(b)(1)(ii)(B)(/) of the proposed regulations does not impose such a requirement. The commenter suggested that Example 1, Example 2, and Example 3 in § 1.101-1(g)(1), (2), and (3) of the proposed regulations, read together, however, appear to require that the transfer to the insured be a sale for fair market value to clear the "taint" of a prior transfer for valuable consideration. The commenter asked for clarification on this point. The commenter suggested that the transfer to the insured be available as a corrective measure even if that transfer was preceded by a reportable policy sale, and, to prevent any possible abuse, that the insured be required to pay fair market value if the policy previously had been transferred in a reportable policy sale.[4141]

Section 1.101-1(b)(1)(ii)(B)(/) of the proposed regulations does not explicitly require that the valuable consideration for a transfer of an interest in a life insurance contract be equal to the interest's fair market value, but, in the case of a bargain sale, the rules implementing the provisions of section 101 are applied separately to the sale and gift portions of the transferred interest. Under § 1.101-1(b)(2)(iii) of the proposed regulations, part of the transfer in a bargain sale is treated as a gratuitous transfer subject to § 1.101-1(b)(2)(i) of the proposed regulations. Example 1, Example 2, and Example 3 in § 1.101-1(g)(1), (2), and (3) of the proposed regulations are intended to illustrate the application of the rules implementing the changes made by the TCJA. For the sake of simplicity, the consideration in these examples equals fair market value, so the bargain sale rules do not apply. The final regulations include an example that illustrates the application of the bargain sale rules. See Example 7 in § 1.101-1(g)(7) of the final regulations.

In response to the comments received, the final regulations provide for a fresh start with respect to an interest gratuitously transferred to the insured, provided the interest has not previously been transferred for value in a reportable policy sale. See § 1.101-1(b)(2)(i) of the final regulations. Example 2 in § 1.101-1(g)(2) of the final regulations illustrates the application of this rule. The final regulations also provide for a fresh start with respect to an interest (or portion thereof) that is transferred to the insured following a reportable policy sale of the interest for valuable consideration, but only to the extent that the insured pays fair market value for the interest and only with respect to the interest (or relevant portion thereof) transferred to the insured that is not subsequently transferred in a transfer for valuable consideration or in a reportable policy sale. See § 1.101-1(b)(1)(ii)(B)(3) of the final regulations. The application of this rule is illustrated in

[4141] [My footnote:] I was that commenter.

revised Example 6, new Example 7, new Example 8, and new Example 9 in § 1.101-1(g)(6), (g)(7), (g)(8), and (g)(9) of the final regulations.

B. Gratuitous Transfers

Under § 1.101-1(b)(2)(i) of the proposed regulations, the amount of the policy proceeds attributable to a gratuitously transferred interest in a life insurance policy that is excludable from gross income under section 101(a)(1) is limited to the sum of the amount attributable to the gratuitously transferred interest that would have been excludable by the transferor if the transfer had not occurred, and the premiums and other amounts subsequently paid by the transferee with respect to the interest. Unlike the existing regulations, the proposed regulations do not provide a special rule for a gratuitous transfer made by or to certain persons.[1] As explained in the preamble to the proposed regulations, such a rule is not required by section 101(a), and a special rule for these transfers could be subject to abuse. *See* 84 FR 11009, 11017.

[1] Under § 1.101-1(b)(2) of the existing regulations, in the case of a gratuitous transfer, by assignment or otherwise, of a life insurance policy or any interest therein, the amount of the proceeds attributable to such policy or interest that is excludable from the transferee's gross income under section 101(a) is, as a general rule, limited to the sum of the amount which would have been excludable by the transferor if no such transfer had taken place and any premiums and other amounts subsequently paid by the transferee with respect to the interest. However, if the gratuitous transfer in question is made by or to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, the entire amount of the proceeds attributable to the policy or interest transferred is excludable from the transferee's gross income.

Section 1.101-1(b)(2)(i) of the proposed regulations applies to any gratuitous transfer of an interest in a life insurance contract, "including a reportable policy sale that is not for valuable consideration." One commenter requested that this language be deleted, asserting that including gratuitous transfers within the definition of reportable policy sales is not consistent with section 101.[2] The commenter noted that the title of section 101(a)(3) is "Exception to valuable consideration rules for commercial transactions," which the commenter asserted makes clear that a reportable policy sale can occur only if there has been a transfer for valuable consideration. The commenter further asserted that the provisions of section 101(a)(3)(A) and (B) limit the relevance of reportable policy sales to those situations in which a taxpayer needs to determine whether one of the section 101(a)(2) exceptions applies and, because those exceptions are never relevant for gratuitous transfers, reportable policy sales are never relevant for gratuitous transfers.

[2] The commenter also asserted that this language creates unnecessary and confusing reporting requirements under section 6050Y for gift transfers and is inconsistent with the statutory language, which, according to the commenter, indicates that a reportable policy sale must be a transfer for value. The commenter's concerns about reporting are discussed in section 10.A of this Summary of Comments and Explanation of Revisions.

The TCJA added section 101(a)(3)(A) to provide that the two pre-existing exceptions to the transfer for value rules no longer apply if the transfer is a reportable policy sale. Section 101(a)(3)(B) defines a reportable policy sale as any acquisition of an interest in a life insurance contract in the absence of the described relationship between the acquirer and insured. Although the availability of exceptions from the transfer for value rules is not directly relevant to a gratuitous transfer standing alone, the acquisition of an interest in a contract by an acquirer that does not have the described relationship with the insured, including a gratuitous transfer, may affect the exclusion of the policy proceeds from gross income under section 101(a) and the regulations thereunder if there are subsequent transfers. Consistent with the statutory language, the definition of a reportable policy sale in the final regulations does not exclude gratuitous transfers.

Reg. § 1.101-1(b)(2), "Other transfers," provides:

(i) *Gratuitous transfer of an interest in a life insurance contract*. To the extent that a transfer of an interest in a life insurance contract is gratuitous, including a reportable policy sale that is not for valuable consideration, the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of the amount of the proceeds attributable to the gratuitously transferred interest that would have been excludable by the transferor if the transfer had not occurred and the premiums and other amounts subsequently paid by the transferee with respect to the interest. However, if an interest in a life insurance contract is transferred gratuitously to the insured, and that interest has not previously been transferred for value in a reportable policy sale, the entire amount of the proceeds attributable to the interest transferred to the insured is excludable from gross income.

(ii) *Partial transfers*. When only part of an interest in a life insurance contract is transferred, the transferor's exclusion is ratably apportioned between or among the several parts. If multiple parts of an interest are transferred, the transfer of each part is treated as a separate transaction, with each transaction subject to the rule under paragraph (b) of this section that is applicable to the type of transfer involved.

(iii) *Bargain sales*. When the transfer of an interest in a life insurance contract is in part a transfer for valuable consideration and in part a gratuitous transfer, the transfer of each part is treated as a separate transaction for purposes of determining the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1). Each separate transaction is subject to the rule under paragraph (b) of this section that is applicable to the type of transfer involved.

"Gratuitous" is not defined anywhere, but the context of Reg. § 1.101-1(b)(2) suggests that it means any transfer that is not for valuable consideration. Reg. § 1.101-1(f)(5), reproduced in the text accompanying fn 4123, refers to "cash or other consideration reducible to a money value." Reg. § 1.101-1(g)(9), Example (9)(i) treats a nontaxable exchange – a contribution to a partnership in exchange for a partnership interest under Code § 721(a)[4142] – as a transfer for valuable consideration.

The last sentence of Reg. § 1.101-1(b)(2)(i) is an important cleansing rule that the final regulations added after I asked for it. See part II.Q.4.b.ii.(e) Cleansing by Transfer Back to Insured.[4143]

Reg. § 1.101-1(b)(3), "Determination of amounts paid by the transferee," provides:

For purposes of paragraphs (b)(1) and (2) of this section, in determining the amounts, if any, of consideration paid by the transferee for the transfer of an interest in a life insurance contract and premiums and other amounts subsequently paid by the transferee with respect to that interest, the amounts paid by the transferee are reduced, but not below zero, by amounts received by the

[4142] See part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.
[4143] Especially text accompanying fn 4179, as well as Example (2) that is discussed in the text accompanying fn 4173.

transferee under the life insurance contract that are not received as an annuity, to the extent excludable from gross income under section 72(e).

II.Q.4.b.ii.(b). Interest in a Life Insurance Contract

The preamble to the proposed regulations explains:[4144]

> The proposed regulations provide that any transfer of an interest in a life insurance contract for cash or other consideration reducible to a money value is a transfer for valuable consideration. See § 1.101-1(f)(5) of the proposed regulations; see also § 25.2512-8 ("[a] consideration not reducible to a value in money or money's worth, as love and affection, promise of marriage, etc., is to be wholly disregarded"). An interest in a life insurance contract (also referred to as a life insurance policy) is held by any person that has taken title to or possession of the life insurance contract, in whole or part, for state law purposes, including any person that has taken title or possession as nominee for another person, or by any person that has an enforceable right to receive all or a part of the proceeds of the life insurance contract or to any other economic benefits of the insurance policy as described in § 20.2042-1(c)(2). See § 1.101-1(e)(1) of the proposed regulations. The enforceable right to designate a contract beneficiary is an interest in a life insurance contract. *Id.* Any person named as the owner in a life insurance contract generally is the owner (or an owner) of the contract and holds an interest in the contract. *Id.*
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> The transfer of an interest in a life insurance contract includes the transfer of any interest in the life insurance contract as well as any transfer of the life insurance contract itself (meaning a transfer of title to, possession of, or legal or beneficial ownership of the life insurance contract). See § 1.101-1(e)(2) of the proposed regulations. For instance, the creation of an enforceable right to receive all or a part of the proceeds of a life insurance contract constitutes the transfer of an interest in the life insurance contract. *Id.* However, the revocable designation of a beneficiary of the policy proceeds does not constitute a transfer of an interest in a life insurance contract to the beneficiary until the designation becomes irrevocable other than by reason of the death of the insured. *Id.* For purposes of this rule, a beneficiary designation is not revocable if the person with the right to designate the beneficiary of the contract has an enforceable contractual obligation to designate a particular contract beneficiary. The pledging or assignment of a policy as collateral security also is not a transfer of an interest in a life insurance contract. *Id.* In response to comments received on Notice 2018-41 suggesting that the initial owner of a life insurance contract should not be considered an "acquirer" for purposes of section 6050Y(a), § 1.101-1(e)(2) of the proposed regulations clarifies that the issuance of a life insurance contract to a policyholder, other than the issuance of a policy in an exchange pursuant to section 1035, is not a transfer of an interest in a life insurance contract.

Part 1.B.4 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(e) of the Proposed Regulations," explains:

> Section 1.101-1(e) of the proposed regulations defines the terms used to determine whether there has been an acquisition of an interest in a life insurance contract. This section of this Summary of Comments and Explanation of Revisions discusses comments that generally relate to the definitions in § 1.101-1(e) of the proposed regulations.

[4144] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

A. Interest in a Life Insurance Contract

Under § 1.101-1(e)(1) of the proposed regulations, an "interest in a life insurance contract" is generally defined as the interest held by any person that has taken title to or possession of the life insurance contract, in whole or part, for state law purposes, and the interest held by any person that has an enforceable right to receive all or a part of the proceeds of the life insurance contract or to any other economic benefits of the policy as described in § 20.2042-1(c)(2). Section 1.101-1(e)(2) of the proposed regulations provides that the term "transfer of an interest in a life insurance contract" means the transfer of any interest in the life insurance contract, including any transfer of title to, possession of, or legal or beneficial ownership of the life insurance contract itself. Under § 1.101-1(e)(3) of the proposed regulations, the acquisition of an interest in a life insurance contract may be direct or indirect, as described in § 1.101-1(e)(3)(i) (defining "direct acquisition of an interest in a life insurance contract") and (ii) (defining "indirect acquisition of an interest in a life insurance contract").

One commenter on the proposed regulations suggested that, in a life settlement transaction in which a securities intermediary holds legal title to the acquired life insurance contract as nominee for the new beneficial owner of the life insurance contract pursuant to a securities account agreement, the new beneficial owner does not acquire an interest in the life insurance contract under § 1.101-1(e)(3) of the proposed regulations, even though the new beneficial owner controls and enjoys all of the benefits of the life insurance policy, because the new beneficial owner neither acquires legal title to the life insurance policy nor holds an ownership interest in the securities intermediary holding legal title. However, under the proposed regulations, the new beneficial owner acquires an interest in the life insurance contract because it acquires control of all of the benefits of the life insurance policy. Any person that acquires an enforceable right to receive all or a part of the proceeds of the life insurance contract or to any other economic benefits of the policy as described in § 20.2042-1(c)(2) acquires an interest in the life insurance contract under § 1.101-1(e)(1) of the proposed regulations. In the situation described in the comment, after the life settlement transaction, there are two persons who have an interest in the life insurance contract at issue: the legal title holder and the new beneficial owner. Example 16 of § 1.101-1(g)(16) of the final regulations illustrates a reportable policy sale in which one acquirer acquires legal title and another acquires beneficial ownership.

B. Section 1035 Exchanges[4145]

Section 1.101-1(e)(2) of the proposed regulations provides that the issuance of a life insurance contract to a policyholder, other than the issuance of a policy in an exchange pursuant to section 1035, is not a transfer of an interest in a life insurance contract. The preamble to the proposed regulations requests comments on whether the proposed regulations should include additional provisions regarding the treatment of section 1035 exchanges of life insurance contracts. *See* 84 FR 11009, 11019.

One commenter on the proposed regulations recommended that no additional provisions be added to the proposed regulations for this circumstance. The commenter stated that the acquirer of a life insurance contract in a reportable policy sale would be unlikely to meet the requirements for an insurable interest in the insured and, consequently, would not be able to make a section 1035 exchange. In support of this position, the commenter explained that, in order for an exchange of

[4145] [My footnote – not in the preamble:] For why this exception may be perceived to be too narrow, see text accompanying fn 4156 in part II.Q.4.b.ii.(c) "Reportable Policy Sale".

policies to qualify as a section 1035 exchange, the owner of the new contract must be the same person who owned the old contract at the time of the exchange. The commenter also stated that an insurer can issue a new policy only when that new policy will meet state insurance laws requiring an insurable interest in the insured, and an insurable interest is generally based on a close familial relationship with the insured or a lawful and substantial financial interest in the continued life of the insured.

Another commenter recommended that the statement in § 1.101-1(e)(2) of the proposed regulations regarding section 1035 exchanges be deleted or amended to eliminate any suggestion that such transactions, by themselves, can lead to reportable policy sales. The commenter indicated that the statement suggests that the mere issuance of a new life insurance policy in a section 1035 exchange could (or perhaps would) give rise to a reportable policy sale and asserted that such treatment is unnecessary and would be inappropriate.

In support of this position, the commenter explained that, mechanically, a section 1035 exchange typically involves the assignment by the policyholder of the existing policy to the carrier, followed by the surrender of the policy and the application of the cash proceeds as a premium under a new policy issued to the same owner on the same insured's life. The commenter remarked that, although the new carrier acquires an interest in the old policy, that interest is immediately extinguished. The commenter also remarked that treating the exchange as a reportable policy sale is not necessary to serve any information collection purpose in the case of an exchange involving a new, different carrier, because the exchange must be reported to the IRS and the policyholder on a Form 1099-R. Additionally, the commenter suggested that, even if an exchange were viewed as potentially meeting the definition of a reportable policy sale, the new carrier should be viewed as having a substantial business or financial relationship with the insured, considering that the carrier just issued a new policy on that individual's life.

The commenter suggested that, if there are specific transactions involving section 1035 exchanges that fall outside the normal situation described by the commenter, and the Treasury Department and the IRS determine that such atypical scenarios might give rise to reportable policy sales, the scope of any provision addressing those transactions should be limited to those particular transactions, so that doubt will not be cast on everyday policy exchanges.

The reference in § 1.101-1(e)(2) of the proposed regulations to section 1035 exchanges was not intended to imply that the transfer of a policy to an insurance company in a section 1035 exchange would be a reportable policy sale. In response to the comments received on section 1035 exchanges, § 1.101-1(c)(2)(iv) of the final regulations provides that the acquisition of a life insurance contract by an insurance company in an exchange pursuant to section 1035 (such as the acquisition that would result from the assignment by the policyholder of the existing policy to the insurance company in exchange for the issuance of a new life insurance contract) is not a reportable policy sale.

The concern prompting the reference in § 1.101-1(e)(2) of the proposed regulations to section 1035 exchanges related to the possibility that a policy transferred in a reportable policy sale subsequently could be exchanged for a new policy in an exchange pursuant to section 1035 and that, absent the reference in § 1.101-1(e)(2), the death benefits paid under the new policy might not be reported under section 6050Y(c). Under the final regulations, which adopt § 1.101-1(e)(2) of the proposed regulations as proposed, the issuance of a new life insurance contract to a policyholder in an exchange pursuant to section 1035 is a transfer of an interest in a life insurance contract (the newly issued life insurance contract) to the policyholder, which results in a direct acquisition of an interest in a life insurance contract (the newly issued life insurance contract) by the policyholder. *See* § 1.101-1(e)(2) and (3)(i) of the final regulations. The tax treatment of the newly issued life insurance contract under section 101 is not affected by the tax treatment of the policy for which it was exchanged. However, if the policyholder's acquisition of the newly issued contract constitutes a reportable policy sale, the rules generally applicable to reportable policy sales under section 101 and the regulations thereunder apply to determine the effect of the reportable policy sale on the tax treatment of the newly issued policy under section 101, and the rules generally applicable to reportable policy sales under section 6050Y and the regulations thereunder apply to determine whether section 6050Y reporting is required with respect to the reportable policy sale. The final regulations provide that the acquisition of a newly issued life insurance contract by a policyholder in an exchange pursuant to section 1035 is not a reportable policy sale, if the policyholder has a substantial family, business, or financial relationship with the insured, apart from its interest in the life insurance contract, at the time of the exchange. *See* § 1.101-1(c)(2)(v) of the final regulations. If no such relationship exists at the time of the section 1035 exchange, the exchange is a reportable policy sale under § 1.101-1(c)(1) of the final regulations. The Treasury Department and the IRS have determined that no exception from the definition of reportable policy sale should apply in this situation. Based on comments received, this situation should rarely arise due to state law insurable interest requirements.

Should this situation arise, however, the policyholder, as an acquirer, must furnish the statement to the issuer required by section 6050Y(a)(2) and § 1.6050Y-2(d)(2) of the final regulations (the reportable policy sale statement or "RPSS"). *See* § 1.6050Y-2(f)(3) of the final regulations. In this case, the statement must be furnished to the issuer that issues the new life insurance contract. *See* § 1.6050Y-1(8)(ii) of the final regulations. However, the policyholder is not required to file the information return required by section 6050Y(a)(1) and § 1.6050Y-2(a) of the final regulations. *See* § 1.6050Y-2(f)(3). Also, because the policyholder is not only the acquirer, but is also the reportable policy sale payment recipient and the seller with respect to the reportable policy sale, the policyholder is not required to furnish the statement generally required to be furnished to the reportable policy sale payment recipient under § 1.6050Y-2(d)(1) of the final regulations. See § 1.6050Y-1(a)(15), (16), and (18) of the final regulations; § 1.6050Y-2(f)(3) of the final regulations. Additionally, although the issuer that issues the new life insurance contract receives an RPSS, it is not required to file a return or furnish a statement to the seller under section 6050Y(b) and § 1.6050Y-3 because the seller does not need the information that would be provided on the statement to properly report a section 1035 exchange. See § 1.6050Y-3(f)(3) of the final regulations.

However, if the issuer makes a payment of reportable death benefits under the newly issued life insurance contract, the issuer must report that payment under section 6050Y(c) and § 1.6050Y-4 of the final regulations, unless an exception under § 1.6050Y-4 applies.

C. Ordinary Course Trade or Business Acquisitions

Several commenters on Notice 2018-41 suggested that acquisitions of life insurance contracts, or interests therein, in ordinary course business transactions in which one trade or business acquires another trade or business that owns life insurance on the lives of former employees or directors should not be reportable policy sales. The proposed regulations include provisions that exclude certain of these transactions from the definition of reportable policy sales. These provisions include the definition of substantial business relationship in § 1.101-1(d)(2) of the proposed regulations, the special rule for indirect acquisitions in § 1.101-1(d)(4)(i) of the proposed regulations, and the definition of the term "indirect acquisition of an interest in a life insurance contract" in § 1.101-1(e)(3)(ii) of the proposed regulations.

Two commenters on the proposed regulations suggested that ordinary course business transactions (such as mergers or acquisitions) involving businesses that own life insurance contracts were not intended by Congress to fall within the meaning of a reportable policy sale and noted that the rules describing a reportable policy sale in the proposed regulations are very helpful in confirming that narrow intent. Another commenter stated that, although the legislative history does not elaborate on the intent of section 101(a)(3)(A) (which limits the carryover basis exception to transfers for value that fall outside the definition of reportable policy sale in section 101(a)(3)(B)), it is widely understood to be aimed at ensuring enforcement of the transfer for value rule with respect to newer forms of speculative transfers involving life insurance policies, rather than imposing new restrictions on legitimate business uses of life insurance. The commenter asserted that the preamble to the proposed regulations implicitly acknowledges this by stating that some provisions are meant to ensure that "certain ordinary course business transactions" will not be treated as reportable policy sales. In response to these comments supporting the ordinary course exclusions from the definition of reportable policy sales in the proposed regulations, those provisions are retained in the final regulations.

One commenter on the proposed regulations requested that the proposed regulations be revised to provide that any transfer of an interest in a life insurance contract as part of a tax-free reorganization conducted in the ordinary course of business is eligible for an exception to being treated as a reportable policy sale under section 101(a)(3)(B), regardless of whether the target survives the reorganization transaction. In this regard, the commenter recommended revising § 1.101-1(e)(3)(ii) of the proposed regulations, which defines the term "indirect acquisition of an interest in a life insurance contract," to specifically cover all transactions involving the acquisition of a C corporation that qualify for tax-free reorganization treatment unless, immediately prior to the acquisition, more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts. The commenter also recommended adding an example to illustrate this point. The commenter concluded that § 1.101-1(e)(3)(ii) of the proposed regulations applies in the case of acquisition transactions in which the corporate existence of the target survives the acquisition (for instance, a taxable stock sale with no section 338 election, a reverse subsidiary merger structured to qualify as a tax-free reorganization under section 368(a)(2)(E), or a tax-free reorganization under section 368(a)(1)(B)) and appears not to apply in the case of acquisition transactions in which the target corporation is merged with and into the acquiring corporation and the target's separate corporate existence is terminated as of the merger date (for instance, a tax-free reorganization under section 368(a)(1)(A), (C), or (D) or section 368(a)(2)(D)).

Under § 1.101-1(e)(3)(ii) of the proposed regulations, an indirect acquisition of an interest in a life insurance contract occurs when a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (whether directly or indirectly) the interest in the life insurance contract. However, for this purpose, the term "other entity" does not include a C corporation, unless more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts immediately before the indirect acquisition. Accordingly, the acquisition of ownership of a C corporation that owns an interest in a life insurance contract is not an indirect acquisition of such an interest, and therefore is not a reportable policy sale, if no more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts. The commenter thus is correct that § 1.101-1(e)(3)(ii) of the proposed regulations applies only in the case of indirect acquisitions of life insurance contracts (which include a tax-free reorganization in which the corporate existence of the target that holds an interest in a life insurance contract survives the acquisition), and not direct acquisitions of life insurance contracts (which include a tax-free reorganization in which the separate corporate existence of a target that holds an interest in a life insurance contract is terminated).

The commenter asserted that this disparate treatment (between policies transferred directly in tax-free asset reorganizations and indirectly in stock reorganizations) is inappropriate and not warranted as a matter of good tax policy. The commenter further asserted that all tax-free reorganizations should be eligible for an exception similar to the exception provided in § 1.101-1(e)(3)(ii) of the proposed regulations. The commenter noted that the proposed regulations provide certain exceptions that could apply to tax-free mergers in which the target goes out of existence and the surviving corporation continues to hold the life insurance contract, but asserted that having to determine in these types of tax-free mergers whether a particular exception applies on a contract-by-contract basis is unduly complex and a trap for the unwary. The commenter further asserted that this burdensome exercise does not appear to serve the purpose of the change in the statute, which is to address abusive transactions and a failure to report income when appropriate.

The final regulations do not adopt the commenters recommendation regarding amendments to § 1.101-1(e)(3)(ii). The exception in § 1.101-1(e)(3)(ii) of the proposed regulations is not targeted to acquisitions of C corporation stock in tax-free reorganizations, but instead is a relatively broad exception that applies to the acquisition of any interest in a C corporation, provided that no more than 50 percent of the C corporation's gross asset value consists of life insurance contracts. This exception is one of a number of exceptions in the proposed regulations intended to provide relief for indirect acquisitions in which acquisition of the underlying life insurance contract interest likely was not a significant motivating factor for the acquisition. The final regulations preserve the different results for stock and asset reorganizations because there are significant differences between these two types of reorganizations, and the Treasury Department and the IRS have concluded that those distinctions justify different treatment for purposes of sections 101 and 6050Y. In addition, no exception is provided in the final regulations that excludes reorganizations from the definition of a reportable policy sale. Rather, there are exclusions based on the application of the definitions of substantial relationships as mandated by the statute and exceptions for certain indirect acquisitions that may produce different results in different types of reorganizations.

One reason for treating indirect and direct acquisitions of life insurance contract interests differently is that an acquirer of an interest in an entity may have limited ability to determine what types of assets an entity owns, or to obtain from the entity information necessary to report on the entity's assets. Thus, for example, the proposed regulations provide a reportable policy sale exception for the acquisition of a small (five percent or less) interest in any entity, unless more than 50 percent of the entity's gross asset value consists of life insurance contracts. See § 1.101-1(c)(2)(iii)(B) of the proposed regulations. In addition, in the case of a C corporation, a corporate level income tax applies to corporate earnings in addition to income tax on distributions at the shareholder level. As a result, C corporations are not frequently used as vehicles for investing in life insurance contracts covering insureds with respect to which the corporation does not have a substantial business, financial, or family relationship at the time the contract is issued. For this reason, the proposed regulations provide a more generous exception for acquisitions of interests in a C corporation, provided that no more than 50 percent of the C corporation's gross asset value consists of life insurance contracts, as determined under § 1.101-1(f)(4) of the proposed regulations. *See* § 1.101-1(e)(3)(ii) of the proposed regulations.[4]

[4] Section 1.101-1(f)(4) of the final regulations clarifies that the gross value of assets means, with respect to any entity, the fair market value of the entity's assets, including assets beneficially owned by the entity under § 1.101-1(f)(1) of the final regulations as a beneficial owner of a partnership, trust, or other entity. Accordingly, the 50 percent test in § 1.101-1(e)(3)(ii) of the final regulations applies to a C corporation's assets and the assets held by any partnership, trust, or other entity beneficially owned by the C corporation.

After the TCJA amendments to section 101, the fact that the transfer of a life insurance contract occurs in a carryover basis transaction qualifying under section 101(a)(2)(A) (such as a tax-free reorganization) is no longer sufficient to avoid the limit on the amount of life insurance policy proceeds that are excludable from gross income under the section 101(a)(1) transfer for value rule. Rather, Congress provided that the carryover basis exception in section 101(a)(2)(A) does not apply unless the transferee also has a substantial family, business, or financial relationship with the insured. Under the proposed regulations, in the case of life insurance contracts transferred in an asset reorganization, the surviving corporation could, for example, establish that a substantial business relationship exists by determining that the life insurance policies transferred in the reorganization cover insureds who are key persons of, or materially participate in, an active trade or business of the acquirer as owners, employees, or contractors. *See* § 1.101-1(d)(2)(i) of the proposed regulations. The surviving corporation could also establish that a substantial business relationship exists by determining that the life insurance contracts cover insureds who either (i) are officers, directors or employees of the business being acquired immediately before the acquisition or (ii) previously were directors, highly compensated employees or highly compensated individuals within the meaning of section 101(j)(2)(A)(ii) and the surviving corporation will have ongoing financial obligations with respect to these individuals after the acquisition (such as retirement obligations). *See* § 1.101-1(d)(2)(ii) of the proposed regulations. Corporations must track this data annually for purposes of section 101(j) corporate owned life insurance (COLI) reporting obligations and related recordkeeping, so it should not be overly burdensome to obtain this information. Additionally, in an asset reorganization, it would in any case be necessary to review the life insurance contracts directly acquired on a contract-by-contract basis in order to update insurance contract ownership and beneficiary information with the relevant insurance company.

It is possible that an asset acquisition could result in the loss of the complete exclusion of death benefits from income with respect to some COLI policies that cover insureds who are not employed by the target immediately before the acquisition or employed by the acquirer after the acquisition and with respect to whom the acquirer has no ongoing obligations to pay retirement or other benefits. However, the Treasury Department and the IRS have not identified any clear policy reason why that tax benefit should carry over when ownership of the insurance policy is transferred. The indirect transfer exceptions in the proposed regulations that could permit COLI benefits to be retained with respect to some policies covering no-longer-connected officers, directors, and employees apply only when ownership of the insurance policy is not transferred, such as in a stock reorganization. These exceptions reflect a weighing by the Treasury Department and the IRS of information collection burdens versus potential for abuse in indirect acquisition scenarios.

The commenter also recommended modifying the language in Example 8 of § 1.101-1(g)(8) of the proposed regulations to clarify that the example is intended only to illustrate application of the rule under § 1.101-1(d) of the proposed regulations and is not intended to imply that, without the insured's current employment by the acquired corporation, the transaction would be treated as a reportable policy sale. Example 8 of § 1.101-1(g)(8) of the proposed regulations describes a tax-free reorganization in which a corporation transfers to an acquiring corporation its active trade or business and a life insurance policy on the life of a current employee that was acquired from the employee. The example concludes that, because the insured was an employee of the target corporation at the time of the tax-free reorganization, and the acquiring corporation carries on the acquired trade or business, the transfer in the tax-free reorganization is not a reportable policy sale because the acquirer has a substantial business relationship with the insured under § 1.101-1(d)(2)(ii) of the proposed regulations. The commenter observed that the example suggests that the transfer of the policy as part of the tax-free reorganization described in the example would not have qualified for an exception from being treated as a reportable policy sale under the proposed regulations absent the existence of the substantial business relationship. The commenter's understanding of the example is correct. The substantial business relationship is necessary for the tax-free reorganization in the example to avoid being treated as a reportable policy sale. As discussed in this section of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have not adopted the commenter's recommendation regarding amendments to § 1.101-1(e)(3)(ii), and therefore have not revised the example in the final regulations.

This commenter also recommended a related change to § 1.101-1(d)(4)(i) of the proposed regulations. Under § 1.101-1(d)(4)(i) of the proposed regulations, an indirect acquirer is deemed to have a substantial business or financial relationship with the insured if the direct holder of the interest in the life insurance contract has a substantial business or financial relationship with the insured immediately before and after the date the indirect acquirer acquires its interest. Section 1.101-1(d)(4)(i) of the proposed regulations provides relief for acquirers who do not hold their interest in the relevant life insurance contracts directly, when the direct holder of those interests has a substantial business or financial relationship with the insured before and after the acquisition. The Department of Treasury and the IRS have determined that it is not appropriate to treat an indirect acquisition of an interest in a life insurance contract as a reportable policy sale when the direct owner of the interest in the life insurance contract does not change and the direct owner has a substantial family, business, or financial relationship with the insured. The commenter recommended modification of § 1.101-1(d)(4)(i) of the proposed regulations to eliminate what the commenter describes as disparate treatment that arises depending on the type of merger transaction the acquirer undertakes or whether after the merger the insured remains with the company or retains the right to retirement or other post-employment benefits.

First, the commenter observed that, in a tax-free merger in which the target goes out of existence, the direct holder of the life insurance contract no longer exists, and therefore would no longer have any relationship with the insured. Accordingly, the acquirer cannot be deemed to have a substantial business or financial relationship with the insured under § 1.101-1(d)(4)(i) of the proposed regulations. However, in a tax-free merger in which the target does not survive, § 1.101-1(d)(4)(i) of the proposed regulations would not apply because the acquirer would own the insurance contract directly. An acquirer that holds its interest in the relevant life insurance contract directly must determine whether it has a substantial family, business, or financial relationship with the insured under § 1.101-1(d) of the proposed regulations at the time of the acquisition.

Second, the commenter suggested that there are situations in which the insured's employment with the target company is terminated as a result of a merger or acquisition, and the insured has no continuing relationship with the surviving company that retains the life insurance contract. The commenter observed that, in such cases, the "after the date of the acquisition" prong of § 1.101-

> 1(d)(4)(i) of the proposed regulations cannot be satisfied. The commenter recommended modifying § 1.101-1(d)(4)(i) of the proposed regulations to provide that the acquirer of an interest in a life insurance contract in a tax-free merger is deemed to have a substantial business or financial relationship with the insured if the target has a substantial business or financial relationship with the insured immediately prior to the merger, provided the acquirer does not otherwise transfer any interest in the life insurance contract in a transaction treated as a reportable policy sale. The commenter also recommended that the rule specifically state that the fact that the surviving company continues to hold, after the merger, the contract on the life of an individual with whom the target had a substantial financial or business relationship is the determinative factor under this modified rule.
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> The proposed modification is not adopted because, although § 1.101-1(d)(4)(i) of the proposed regulations generally would not apply to the situations referenced by the commenter, the proposed regulations already include exceptions that may apply in the situations referenced by the commenter. In a tax-free merger in which the target does not survive, § 1.101-1(d)(4)(i) of the proposed regulations would not apply because the acquirer would have a direct acquisition of any interest in a life insurance contract acquired from the target. However, the acquirer does not have a reportable policy sale if the acquirer has a substantial family, business, or financial relationship with the insured. Under § 1.101-1(d)(2)(ii) of the proposed regulations, the surviving company has a substantial business relationship with the insured, and therefore has not acquired its interest in the life insurance contract on the insured's life in a reportable policy sale, if: (1) the insured is an employee within the meaning of section 101(j)(5)(A) of the acquired trade or business immediately preceding the acquisition, and (2) the surviving company either carries on the acquired trade or business or uses a significant portion of the acquired business assets in an active trade or business that does not include investing in interests in life insurance contracts. Accordingly, the proposed regulations already include a rule similar to the one requested by the commenter that is applicable to direct acquisitions of interests in life insurance contracts (such as acquisitions resulting from tax-free mergers in which the target does not survive).

Reg. § 1.101-1(e)(1), "Definition," provides:[4146]

> For purposes of this section and section 6050Y, the term interest in a life insurance contract means the interest held by any person that has taken title to or possession of the life insurance contract (also referred to as a life insurance policy), in whole or part, for state law purposes, including any person that has taken title or possession as nominee for another person, and the interest held by any person that has an enforceable right to receive all or a part of the proceeds of a life insurance contract or to any other economic benefits of the policy as described in § 20.2042-1(c)(2) of this chapter, such as the enforceable right to designate a contract beneficiary. Any person named as the owner in the life insurance contract generally is the owner (or an owner) of the contract and holds an interest in the contract.

Reg. § 20.2042-1(c)(2) is reproduced in part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity.

[4146] Part II.Q.4.b.ii.(g) Transfer of Interest in an Entity Holding Life Insurance discusses an interest in a life insurance contact under Reg. § 1.101-1(e)(1) in the text accompanying fn 4183.

What happens when more than one person is named in a contract/policy as holding title or has possession? How does one define each person's interest? Presumably, one would review part II.Q.4.f Split-Dollar Arrangements.

Reg. § 1.101-1(e)(2), "Transfer of an interest in a life insurance contract," provides:

> For purposes of this section and section 6050Y, the term transfer of an interest in a life insurance contract means the transfer of any interest in the life insurance contract, including any transfer of title to, possession of, or legal or beneficial ownership of the life insurance contract itself. The creation of an enforceable right to receive all or a part of the proceeds of a life insurance contract constitutes the transfer of an interest in the life insurance contract. The following events are not a transfer of an interest in a life insurance contract: the revocable designation of a beneficiary of the policy proceeds (until the designation becomes irrevocable other than by reason of the death of the insured); the pledging or assignment of a policy as collateral security; and the issuance of a life insurance contract to a policyholder, other than the issuance of a policy in an exchange pursuant to section 1035.

The preamble to the proposed regulations explains:[4147]

> Under § 1.101-1(e)(3)(i) of the proposed regulations, the transfer of an interest in a life insurance contract results in the direct acquisition of the interest by the transferee (acquirer). Under § 1.101-1(e)(3)(ii) of the proposed regulations, an indirect acquisition of an interest in a life insurance contract occurs when a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (directly or indirectly) an interest in the life insurance contract. For this purpose, the term "other entity" does not include a C corporation (as that term is defined in section 1361(a)(2)), unless more than 50 percent of the gross value of the assets of the C corporation (as determined under § 1.101-1(f)(4)) consists of life insurance contracts immediately before the indirect acquisition. Under § 1.101-1(f)(1) of the proposed regulations, a "beneficial owner" of a partnership, trust, or other entity is an individual or C corporation with an ownership interest in that partnership, trust, or other entity. The beneficial owner's interest may be held directly or indirectly, through one or more other partnerships, trusts, or other entities.
>
> Accordingly, under § 1.101-1(e)(3)(ii) of the proposed regulations, persons that acquire shares in a C corporation that holds an interest in a life insurance contract generally will not be considered to have an indirect acquisition of an interest in such contract. However, if the C corporation primarily owns life insurance contracts (or interests therein), any person that acquires shares in the C corporation will be considered to have an indirect acquisition of an interest in any life insurance contract held by the C corporation.

Reg. § 1.101-1(e)(3), "Acquisition of an interest in a life insurance contract," provides:[4148]

> For purposes of this section and section 6050Y, the acquisition of an interest in a life insurance contract may be direct or indirect.

[4147] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

[4148] For the significance of indirect acquisitions under Reg. § 1.101-1(e)(3)(ii), see text accompanying fn 4185 in part II.Q.4.b.ii.(g) Transfer of Interest in an Entity Holding Life Insurance. Certain indirect acquisitions that are not treated as reportable policy sales are described in Reg. § 1.101-1(c)(2)(iii), which is reproduced in the text accompanying fn 4155 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

(i) *Direct acquisition of an interest in a life insurance contract*. For purposes of this section and section 6050Y, the transfer of an interest in a life insurance contract results in the direct acquisition of the interest by the transferee (acquirer).

(ii) *Indirect acquisition of an interest in a life insurance contract*. For purposes of this section and section 6050Y, an indirect acquisition of an interest in a life insurance contract occurs when a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (whether directly or indirectly) the interest (whether legal or beneficial) in the life insurance contract. For purposes of this paragraph (e)(3)(ii), the term other entity does not include a C corporation, unless more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts (as determined under paragraph (f)(4) of this section) immediately before the indirect acquisition.

Elaborating on clause (ii) above, the preamble to the proposed regulations explains:[4149]

> Finally, in response to comments received on Notice 2018-41, certain indirect acquisitions of life insurance contracts, or interests in life insurance contracts, are excepted from the definition of a reportable policy sale. The limited definition of "indirect acquisition" under § 1.101-1(e)(3)(ii) of the proposed regulations means that shareholders acquiring an interest in a C corporation that holds an interest in one or more life insurance contracts will not be considered to have an indirect acquisition or reportable policy sale unless the C corporation primarily owns life insurance contracts (or interests therein). The proposed regulations also provide an exception from the definition of a reportable policy sale for an indirect acquisition of an interest in a life insurance contract if the direct holder of the interest acquired the interest in a reportable policy sale and reported the acquisition in compliance with section 6050Y(a) and § 1.6050Y-2 of the proposed regulations. See § 1.101-1(c)(2)(iii)(A) of the proposed regulations. Also, the indirect acquisition of an interest in a life insurance contract is not a reportable policy sale if (1) Immediately before the acquisition, no more than 50 percent of the gross value of the assets of the entity that directly holds the interest in the life insurance contract consists of life insurance contracts, and (2) the acquirer and his or her family members own five percent or less of the ownership interests in the entity that directly holds the interest in the life insurance contract. See § 1.101-1(c)(2)(iii)(B) of the proposed regulations. Section 1.101-1(f)(4) of the proposed regulations provides rules regarding the determination of the gross value of assets for this purpose.

Reg. § 1.101-1(f)(2), "C corporation," provides:

> The term C corporation has the meaning given to it in section 1361(a)(2).

Code § 1361(a)(2) is reproduced in fn 1734.

Reg. § 1.101-1(f)(4), "Gross value of assets," provides:

(i) *Determination of gross value of assets*. Except as provided in paragraph (f)(4)(ii) or (iii) of this section, for purposes of paragraphs (c)(2)(iii)(B) and (e)(3)(ii) of this section, the term gross value of assets means, with respect to any entity, the fair market value of the entity's assets, including assets beneficially owned by the entity under paragraph (f)(1) of this section as a beneficial owner of a partnership, trust, or other entity.

[4149] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

(ii) *Determination of gross value of assets of publicly traded entity*. For purposes of determining the gross value of assets of an entity that is publicly traded, if the entity's annual Form 10-K filed with the United States Securities and Exchange Commission (or equivalent annual filing if the entity is publicly traded in a non-U.S. jurisdiction) for the period immediately preceding a person's acquisition of an ownership interest in the entity does not contain information demonstrating that more than 50 percent of the gross value of the entity's assets consist of life insurance contracts, that person may assume that no more than 50 percent of the gross value of the entity's assets consists of life insurance contracts, unless that person has actual knowledge or reason to know that more than 50 percent of the gross value of the entity's assets consists of life insurance contracts.

(iii) *Safe harbor definition of gross value of assets*. An entity may choose to determine the gross value of all the entity's assets for purposes of this section using the following alternative definition of gross value of assets:

(A) In the case of assets that are life insurance policies or annuity or endowment contracts that have cash values, the cash surrender value as defined in section 7702(f)(2)(A); and

(B) In the case of assets not described in paragraph (f)(4)(iii)(A) of this section, the adjusted bases (within the meaning of section 1016) of such assets.

II.Q.4.b.ii.(c). "Reportable Policy Sale" Defined

What is a "reportable policy sale" is important to determine whether a transfer for valuable consideration will cause a policy's death benefit to lose its income tax exclusion[4150] and for whether certain reporting must be done.[4151]

The preamble to the proposed regulations explains:[4152]

> Section 1.101-1(c) of the proposed regulations defines the term "reportable policy sale," which was introduced in section 101(a)(3). The proposed regulations provide that, as a general matter, any direct or indirect acquisition of an interest in a life insurance contract is a "reportable policy sale" if the acquirer has, at the time of the acquisition, no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in that life insurance contract. See § 1.101-1(c)(1) of the proposed regulations.

Reg. § 1.101-1(c) describes what is a reportable policy sale.

Reg. § 1.101-1(c)(1), "In general," provides:[4153]

> Except as provided in paragraph (c)(2) of this section, a reportable policy sale for purposes of this section and section 6050Y is any direct or indirect acquisition of an interest in a life insurance contract if the acquirer has, at the time of the acquisition, no substantial family, business, or

[4150] See part II.Q.4.b.ii.(a) Income Tax Effect of a Reportable Policy Sale, as well as most of the rest of this part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.
[4151] See part II.Q.4.b.ii.(f) Reporting Requirements for Reportable Policy Sales.
[4152] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."
[4153] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 4148 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

financial relationship with the insured apart from the acquirer's interest in the life insurance contract.

The preamble to the proposed regulations explains exceptions:[4154]

> The proposed regulations also provide several exceptions from the definition of reportable policy sale. The proposed regulations provide that the transfer of an interest in a life insurance contract between certain related entities is not a reportable policy sale. Specifically, a transfer between entities with the same beneficial owners is not a reportable policy sale if the ownership interest of each beneficial owner in each entity does not vary by more than a 20 percent ownership interest. See § 1.101-1(c)(2)(i) and (g)(10) of the proposed regulations. Also, a transfer between corporations that are members of an affiliated group (as defined in section 1504(a)) that files a consolidated U.S. tax return for the taxable year in which the transfer occurs is not a reportable policy sale. See § 1.101-1(c)(2)(ii) of the proposed regulations.

Part 1.B.3 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(c) of the Proposed Regulations," explains:

> Under section 101(a)(3)(B) and § 1.101-1(c)(1) of the proposed regulations, a reportable policy sale is, as a general matter, any direct or indirect acquisition of an interest in a life insurance contract if the acquirer has, at the time of the acquisition, no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance contract. Exceptions to the definition of reportable policy sale for transfers between certain related entities are provided in § 1.101-1(c)(2)(i) and (ii) of the proposed regulations. Section 1.101-1(c)(2)(iii) of the proposed regulations sets forth exceptions from the definition of reportable policy sales for certain indirect acquisitions. This section of this Summary of Comments and Explanation of Revisions discusses comments received on § 1.101-1(c) of the proposed regulations.
>
> **A. Pre-TCJA Acquisitions**
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> Two commenters on the proposed regulations requested clarification regarding the application of § 1.101-1(c)(2)(iii)(A) with respect to the indirect acquisition of an interest in a life insurance contract if the entity that directly holds the interest acquired the interest before January 1, 2018 (that is, before the existence of any reporting requirements under section 6050Y(a)). Both commenters recommended that an exception from the definition of reportable policy sale be provided with respect to the indirect acquisition of an interest in a life insurance contract by a person if the partnership, trust, or other entity that directly holds the interest in the life insurance contract acquired the interest before January 1, 2018. One commenter recommended that, if the requested exception is not provided, the partnership, trust, or other entity in which the investment interest is purchased should be permitted to undertake the applicable reporting, instead of requiring the investor to navigate the complexities of the reporting requirements. This commenter also suggested that, if the requested exception is provided, the partnership, trust, or other entity could file an information return with the IRS for its portfolio of policies acquired prior to January 1, 2018, as a transition solution. However, the other commenter suggested that the partnership, trust, or other entity may not have tracked or retained information sufficient to satisfy

[4154] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

the reporting requirements under section 6050Y with respect to interests acquired before January 1, 2018.

In response to these comments, § 1.101-1(c)(2)(iii)(A) of the final regulations provides an exception from the definition of reportable policy sale with respect to the indirect acquisition of an interest in a life insurance contract by a person if a partnership, trust, or other entity in which an ownership interest is being acquired directly or indirectly holds the interest in the life insurance contract and acquired that interest before January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2.[3]

[3] As discussed in section 1.A of this Summary of Comments and Explanation of Revisions, the final regulations provide that the reporting obligations under section 6050Y apply to reportable policy sales and payments of reportable death benefits occurring after December 31, 2018. See § 1.6050Y-1(b) of the final regulations. Section 3.B of this Summary of Comments and Explanation of Revisions describes changes adopted in § 1.101-1(c)(2)(iii)(A) of the final regulations in response to other comments requesting expanded indirect acquisition exceptions.

B. Additional Requests for Expanded Indirect Acquisition Exceptions

One commenter on the proposed regulations identified the existence of a possible technical issue with § 1.101-1(c)(2)(iii)(A) of the proposed regulations, which provides an exception from reportable policy sale status for certain indirect acquisitions. The commenter noted that, under this provision, the indirect acquisition of an interest in a life insurance contract is not a reportable policy sale if the partnership, trust, or other entity that directly holds the interest in the life insurance contract acquired the interest in a reportable policy sale that was reported in compliance with section 6050Y(a) and the regulations thereunder. The commenter described a fact pattern in which legal title to a life insurance contract is held by a nominee (for example, a securities intermediary) on behalf of a partnership, trust, or other entity (for example, an investment fund). The commenter concluded that, in this fact pattern, the exception in § 1.101-1(c)(2)(iii)(A) of the proposed regulations cannot apply to an investor in the partnership, trust, or other entity because the investor's ownership interest is in the partnership, trust, or other entity (which does not hold a direct interest in the life insurance contract), not in the nominee (which directly holds the legal interest in the life insurance contract). The commenter also recommended that § 1.101-1(c)(2)(iii)(A) be revised to clarify that the exception applies if reporting under section 6050Y is done by either the legal owner of the life insurance contract (such as a securities intermediary holding legal title as a nominee) or the beneficial owner of the life insurance policy that controls the life insurance contract under a securities account agreement (such as an investment fund).

In the fact pattern described in the comment letter, the partnership, trust, or other entity in which the investor acquires an ownership interest holds an interest in the life insurance contract. An interest in a life insurance contract is not limited to legal ownership of the contract. Instead, any person that acquires an enforceable right to receive all or a part of the proceeds of the life insurance contract or acquires the right to any other economic benefits of the policy as described in § 20.2042-1(c)(2) acquires an interest in the life insurance contract under § 1.101-1(e)(1) of the proposed regulations.

The partnership, trust, or other entity described by the commenter presumably would hold such an interest directly, even though legal title to the life insurance contract is held by a nominee or other intermediary. By acquiring an interest in the partnership, trust, or other entity, the investor indirectly would acquire a beneficial interest in the life insurance contract. The exception in

§ 1.101-1(c)(2)(iii)(A) of the proposed regulations would apply to this indirect acquisition if the partnership, trust, or other entity reported its acquisition of the beneficial interest in the contract in compliance with section 6050Y(a). The commenter's recommended revision to § 1.101-1(c)(2)(iii)(A) of the proposed regulations therefore is not adopted in the final regulations.

The commenter also proposed that § 1.101-1(c)(2)(iii)(A) of the proposed regulations be modified to apply if "the partnership, trust, or other entity that directly or indirectly holds the interest in the life insurance contract acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2."

This change is adopted in the final regulations, which also clarify that the partnership, trust, or other entity must be a partnership, trust, or other entity in which an ownership interest is being acquired. As modified, the exception applies to the indirect acquisition of an interest in a life insurance contract by a person acquiring an ownership interest in a partnership, trust, or other entity that holds the interest in the life insurance contract, regardless of whether the person's ownership interest in the partnership, trust, or other entity that reported its acquisition of the interest in the life insurance contract is direct or indirect and regardless of whether that partnership, trust, or other entity acquired its interest in a direct or indirect acquisition, provided the partnership, trust, or other entity acquired its interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2 or, as discussed in section 3.A of this Summary of Comments and Explanation, acquired its interest before January 1, 2019.

One commenter on the proposed regulations reiterated its previous request, made in comments on Notice 2018-41, that an exception from the reporting requirements of section 6050Y be provided with respect to an indirect acquisition of an interest in a life insurance contract by any investor that acquires a 5 percent or less economic and voting interest in an investment vehicle that holds, directly or indirectly, life insurance policies, with the added proviso that the investor must not be an officer or director of the investment vehicle. Section 1.101-1(c)(2)(iii)(B) of the proposed regulations provides that the indirect acquisition of an interest in a life insurance contract is not a reportable policy sale if the acquirer and his or her family members own, in the aggregate, 5 percent or less of the partnership, trust, or other entity that directly holds the interest in the life insurance contract, but this exception applies only if, immediately before the acquisition, no more than 50 percent of the gross value of the assets of the partnership, trust, or other entity that directly holds the interest in the life insurance contract consists of life insurance contracts.

The final regulations do not adopt the proposed change because, if more than 50 percent of an entity's asset value is life insurance contracts, investment in life insurance contracts is likely the entity's primary business activity, and it is reasonable to expect even small investors to be able to determine the primary activity of the business they are investing in, regardless of whether they are also officers or directors of the entity. In addition, any investor that does not qualify for the exception set forth in § 1.101-1(c)(2)(iii)(B) of the final regulations because more than 50 percent of the gross value of the assets of the partnership, trust, or other entity that directly holds the interest in the life insurance contract consists of life insurance contracts may still qualify for the exception set forth in § 1.101-1(c)(2)(iii)(A) of the final regulations if a partnership, trust, or other entity that directly or indirectly holds the interest in the life insurance contract acquired the interest before January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2.

Separately, § 1.101-1(c)(2)(iii)(B) of the final regulations clarifies that, if the partnership, trust, or other entity in which the acquirer is directly acquiring an ownership interest indirectly holds an interest in one or more life insurance contracts, (i) the assets of the partnership, trust, or other entity in which the ownership interest is being acquired are tested to determine whether more than 50 percent of the gross value of the assets of that partnership, trust, or other entity consists of life insurance contracts, and (ii) the ownership interest in that partnership, trust, or other entity held by the acquirer and his or her family members after the acquisition is tested to determine whether they hold more than a 5 percent ownership interest in the entity. The assets of the partnership, trust, or other entity that directly holds the interest in the life insurance contract and the interest in that partnership, trust, or other entity held by the acquirer and his or her family member are tested only if the acquirer is directly acquiring an ownership interest in that partnership, trust, or other entity.

Reg. § 1.101-1(c)(2), "Exceptions," provides:

None of the following transactions is a reportable policy sale:[4155]

(i) A transfer of an interest in a life insurance contract between entities with the same beneficial owners, if the ownership interest of each beneficial owner in the transferor entity does not vary by more than a 20 percent ownership interest from that beneficial owner's ownership interest in the transferee entity. In a series of transfers, the prior sentence is applied by comparing the beneficial owners' ownership interest in the first transferor entity and the last transferee entity. For purposes of this paragraph (c)(2)(i), each beneficial owner of a trust is deemed to have an ownership interest determined by the broadest possible exercise of a trustee's discretion in that beneficial owner's favor. Paragraph (g)(13) (Example 13) of this section provides an illustration of the application of this paragraph (c)(2)(i).

(ii) A transfer between corporations that are members of an affiliated group (as defined in section 1504(a)) that files a consolidated U.S. income tax return for the taxable year in which the transfer occurs.

(iii)The indirect acquisition of an interest in a life insurance contract by a person if—

(A) A partnership, trust, or other entity in which an ownership interest is being acquired directly or indirectly holds the interest in the life insurance contract and acquired that interest before January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2; or

(B) Immediately before the acquisition, no more than 50 percent of the gross value of the assets (as determined under paragraph (f)(4) of this section) of the partnership, trust, or other entity that directly or indirectly holds the interest in the life insurance contract, and in which an ownership interest is being directly acquired, consists of life insurance contracts, provided that, after the acquisition, with respect to that partnership, trust, or other entity, the person indirectly acquiring the interest in the life insurance contract and his or her family members own, in the aggregate-

(1) With respect to an S corporation, stock possessing 5 percent or less of the total combined voting power of all classes of stock entitled to vote and 5 percent or less of the total value of shares of all classes of stock of the S corporation;

[4155] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 4148 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

(2) With respect to a trust or decedent's estate, 5 percent or less of the corpus and 5 percent or less of the annual income (taking into account, for the purpose of determining any person's ownership interest, the maximum amount of income and corpus that could be distributed to or held for the benefit of that person); or

(3) With respect to a partnership or other entity that is not a corporation or a trust, 5 percent or less of the capital interest and 5 percent or less of the profits interest.

(iv) The acquisition of a life insurance contract by an insurance company that issues a life insurance contract in an exchange pursuant to section 1035.

(v) The acquisition of a life insurance contract by a policyholder in an exchange pursuant to section 1035, if the policyholder has a substantial family, business, or financial relationship with the insured, apart from its interest in the life insurance contract, at the time of the exchange.

Reg. § 1.101-1(c)(2)(v) requires the holder of a policy on the insured who does a Code § 1035 exchange for a replacement policy on the insured to have a substantial family, business, or financial relationship with the insured or risk its interest in the replacement policy being tainted as having been transferred in a reportable policy sale.[4156] This creates concerns when an employer uses a cash value life insurance policy to fund its payments of post-retirement benefits for a living former employee. (It would not create a concern when funding the post-mortem purchase of the retiree's interest in the employer or any other obligations that mature by reason of the employee's death.)[4157]

Reg. § 1.101-1(c)(2)(i) refers to Reg. § 1.101-1(g)(13),[4158] which provides:

> *Example 13*. Partnership X and Partnership Y are owned by individuals A, B, and C. A holds 40% of the capital and profits interest of Partnership X and 20% of the capital and profits interest of Partnership Y. B holds 35% of the capital and profits interest of Partnership X and 40% of the capital and profits interest of Partnership Y. C holds 25% of the capital and profits interest of Partnership X and 40% of the capital and profits interest of Partnership Y. Partnership X is the initial policyholder of a $100,000 insurance policy on the life of A. Partnership Y purchases the policy from Partnership X. Under paragraph (c)(2)(i) of this section, this transfer is not a reportable policy sale because the ownership interest of each beneficial owner in Partnership X does not vary from that owner's interest in Partnership Y by more than a 20% ownership interest. A's ownership varies by a 20% interest, B's ownership varies by a 5% interest, and C's ownership varies by a 15% interest.

[4156] For the preamble discussing this issue, see fn 4145 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract.

[4157] See Reg. § 1.101-1(d)(2)(ii).

[4158] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

Reg. § 1.101-1(g)(15)[4159] elaborates on Reg. § 1.101-1(c)(2)(iii)(B), providing:

> *Example 15*. The facts are the same as in Example 14[4160] in paragraph (g)(14) of this section, except that A is no longer an employee of Partnership X, and Partnership X has no substantial family, business, or financial relationship with A, when B acquires the profits interest in Partnership X. Also, B acquires only a 5% profits interest in exchange for a cash payment of $500,000. Partnership X does not own an interest in any other life insurance policies, and the gross value of its assets is $10 million. Although neither Partnership X nor B has a substantial family, business, or financial relationship with A at the time of B's indirect acquisition of an interest in the policy covering A's life, because B's profits interest in Partnership X does not exceed 5%, and because no more than 50% of Partnership X's asset value consists of life insurance contracts, the exception in paragraph (c)(2)(iii)(B) of this section applies, and B's indirect acquisition of an interest in the policy covering A's life is not a reportable policy sale.

Reg. § 1.101-1(c)(1) above stated that a reportable policy sale can apply only if, at the time of the acquisition, the acquirer has "no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance contract." Reg. § 1.101-1(d) describes these substantial relationships.

The preamble to the proposed regulations explains:[4161]

> Section 1.101-1(d) of the proposed regulations defines the terms "substantial family relationship," "substantial business relationship," and "substantial financial relationship." Under section 1.101-1(d)(1) of the proposed regulations, a "substantial family relationship" is the relationship between an individual and any family member of that individual as defined in § 1.101-1(f)(3) of the proposed regulations. A substantial family relationship also exists between an individual and his or her former spouse with regard to a transfer of an interest in a life insurance contract to (or in trust for the benefit of) that former spouse incident to divorce. See § 1.101-1(d)(1) of the proposed regulations. Additionally, a substantial family relationship exists between the insured and an entity if all of the entity's beneficial owners have a substantial family relationship with the insured. *Id.*
>
> Section 1.101-1(d)(2) describes the two situations in which a substantial business relationship exists between the acquirer and insured: (1) The insured is a key person (as defined in section 264) of, or materially participates (as defined in section 469 and the corresponding regulations) in, an active trade or business as an owner, employee, or contractor, and at least 80% of that trade or business is owned (directly or indirectly, through one or more partnerships, trusts, or other entities) by the acquirer or the beneficial owners of the acquirer, and (2) the acquirer acquires an active trade or business and acquires the interest in the life insurance contract either as part of that acquisition or from a person owning significant property leased to the acquired trade or business

[4159] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

[4160] [Not in the regulation - click to go to:] Example 14.

[4161] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

> or life insurance policies held to facilitate the succession of the ownership of the business, if certain requirements are met. See § 1.101-1(d)(2)(i) and (ii) of the proposed regulations.
>
> Comments received on Notice 2018-41 suggested that acquisitions of life insurance contracts, or interests therein, in certain ordinary course business transactions involving the acquisition of a trade or business should not be considered reportable policy sales, including ordinary course business transactions whereby one trade or business acquires another trade or business that owns life insurance on the lives of former employees or directors. The definition of substantial business relationship in § 1.101-1(d)(2) of the proposed regulations, as well as certain other provisions in the proposed regulations, are intended to exclude certain of these transactions from the definition of reportable policy sales.
>
> Section 1.101-1(d)(3) of the proposed regulations describes the three situations in which a substantial financial relationship exists between the insured and the acquirer: (1) The acquirer (directly or indirectly, through one or more partnerships, trusts, or other entities of which it is a beneficial owner) has, or the beneficial owners of the acquirer have, a common investment (other than the interest in the life insurance contract) with the insured and a buy-out of the insured's interest in the common investment by the co-investor(s) after the insured's death is reasonably foreseeable; (2) the acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets or satisfy liabilities following the death of the insured; or (3) the acquirer is an organization described in sections 170(c), 2055(a), and 2522(a) that previously received financial support in a substantial amount or significant volunteer support from the insured. See § 1.101-1(d)(3)(i) through (iii) of the proposed regulations.
>
> The proposed regulations also specify that the fact that an acquirer is a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer (all relationships that are covered by an exception from the transfer for value rule) is not sufficient to establish a substantial business or financial relationship, nor is such status required to establish a substantial business or financial relationship. See § 1.101-1(d)(4)(ii) of the proposed regulations. The proposed regulations also clarify that, for purposes of determining whether the acquirer in an indirect acquisition of an interest in a life insurance contract has a substantial business or financial relationship with the insured, the acquirer will be deemed to have a substantial business or financial relationship with the insured if the direct holder of the interest in the life insurance contract has a substantial business or financial relationship with the insured immediately before and after the date the acquirer acquires its interest. See § 1.101-1(d)(4)(i) of the proposed regulations. Accordingly, the acquirer in an indirect acquisition may establish a substantial business or financial relationship with the insured based on the acquirer's own relationship with the insured or the relationship between the insured and the direct holder of the interest in the life insurance contract.

Part 1.B.3 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to § 1.101-1(d) of the Proposed Regulations," explains:

> Section 1.101-1(d) of the proposed regulations defines the terms substantial family relationship, substantial business relationship, and substantial financial relationship, and provides special rules for applying these definitions. This section of this Summary of Comments and Explanation of Revisions discusses comments that generally relate to the definitions and special rules in § 1.101-1(d) of the proposed regulations.

A. Beneficial Owners With a Combination of Substantial Relationships

Under § 1.101-1(d)(1) of the proposed regulations, a substantial family relationship exists between the insured and a partnership, trust, or other entity if all of the beneficial owners of that partnership, trust, or other entity have a substantial family relationship with the insured. A partnership, trust, or other entity may itself have a substantial business or financial relationship with the insured under § 1.101-1(d)(2) or (3) of the proposed regulations.

One commenter on the proposed regulations recommended that a transfer to a trust, partnership, or other entity not be a reportable policy sale within the meaning of section 101(a)(3) if all of the beneficial owners of the trust, partnership, or other entity have a substantial family, business, or financial relationship with the insured.[4162] The Treasury Department and the IRS have determined it would be appropriate to expand the definition of substantial family, business, or financial relationship to include the relationship between the insured and a trust, partnership, or other entity, every beneficial owner of which has a substantial family, business, or financial relationship with the insured. Accordingly, § 1.101-1(d)(4)(iii) of the final regulations provides this expanded definition.

The commenter also suggested that the definition of "family member" under § 1.101-1(f)(3) should include charities to which the insured has given substantial financial support or significant volunteer support. Another commenter suggested that a trust with beneficiaries that include both individual family members and a charity with a substantial financial relationship to the insured should qualify as a "family member."[4163] Under § 1.101-1(d)(3)(iii) of the proposed regulations, a substantial financial relationship exists between the insured and acquirer if the acquirer is an organization described in sections 170(c), 2055(a), and 2522(a) that previously received financial support in a substantial amount or significant volunteer support from the insured. Under either of the approaches suggested by the commenters, the acquisition of an interest in a life insurance contract by a trust with beneficiaries that include both individuals who are family members of the insured and a charity described in § 1.101-1(d)(3)(iii) of the proposed regulations would not be a reportable policy sale. The Treasury Department and the IRS agree that the existence of a trust beneficiary that is a charity described in § 1.101-1(d)(3)(iii) of the proposed regulations should not cause a transfer to that trust to be a reportable policy sale. However, rather than expanding the definition of "family member" under § 1.101-1(f)(3) of the proposed regulations as suggested by the commenters, the Treasury Department and the IRS have adopted a more direct and expansive approach to address the commenters' concerns by adding a new rule in the final regulations providing that any combination of the described substantial relationships between a trust's beneficiaries and the insured is sufficient to qualify the transfer to that trust for the reportable policy sale exclusion. See § 1.101-1(d)(4)(iii) of the final regulations. As a result, under the final regulations, there is no need to also expressly treat a trust established and maintained for the primary benefit of the insured or one or more of the insured's family members as a family member of the insured. Therefore, the final regulations do not include such a trust in the definition of family member.

[4162] [my footnote:] I was that commenter (one of only 12 comments submitted); see https://www.thompsoncoburn.com/docs/default-source/blog-documents/gorin-transfer-for-value-comments.pdf. Discussing with ACTEC Fellow Michael Van Cise's the comment he was making below got me thinking more about this issue.

[4163] [my footnote:] ACTEC Fellow Michael Van Cise was that commenter.

B. Substantial Financial Relationships With Charities

Under § 1.101-1(d)(3)(iii) of the proposed regulations, the acquirer of an interest in a life insurance contract has a substantial financial relationship with the insured if the acquirer is an organization described in sections 170(c), 2055(a), and 2522(a) that previously received financial support in a substantial amount or significant volunteer support from the insured. One commenter on the proposed regulations suggested that this provision be expanded to include any other such organization with which the insured has substantial personal ties, such as the donor or a family member having benefitted from the charitable organization's services in some manner.[4164] The commenter stated that it is not uncommon for a donor to both (i) contribute very modestly, if at all, to a charity during life because the donor is concerned about having sufficient retirement income, and (ii) want to benefit the charity when the donor no longer needs to preserve retirement income sources. The commenter also stated that donors often benefit charities through either a split interest trust described in section 170(f)(2) or a bargain sale described in § 1.1011-2.

The Treasury Department and IRS have not adopted this suggestion in the final regulations because it would be challenging to determine when personal ties with a charity are substantial enough to constitute a substantial financial relationship with the insured, in the absence of a significant donation of time or property. Also, there generally will be little detriment to a charity as a result of an acquisition (whether gratuitous or for value) of an interest in a life insurance contract in a reportable policy sale. Nevertheless, as discussed later in this section, the final regulations provide that the category of charities considered to have a substantial financial relationship with an insured may be expanded in the future in guidance published in the Internal Revenue Bulletin.

Treating a gratuitous transfer of an interest in a life insurance contract (or the part of the transfer that is gratuitous, in the case of a bargain sale) as a reportable policy sale does not affect the amount of proceeds excludable by the gratuitous transferee. Section 1.101-1(b)(2)(i) of the final regulations applies to all gratuitous transfers of interests in life insurance contracts and generally provides that the transferee in a gratuitous transfer of an interest in a life insurance contract steps into the shoes of the transferor and may exclude death benefits paid under the contract from gross income to the same extent that the transferor would have been able to exclude the benefits, in addition to the premiums and other amounts paid by the transferee. Furthermore, treatment of a gratuitous transfer as a reportable policy sale does not result in reporting obligations for the gratuitous transferee because the gratuitous transferor is not a reportable policy sale payment recipient. See §§ 1.6050Y-1(a)(16) and 1.6050Y-2(a) of the final regulations.

Even if a charity purchased some or all of its interest in a life insurance contract for valuable consideration, a charity generally is not subject to Federal income tax on its income (including insurance policy proceeds) unless the income arises from an unrelated trade or business. Thus, the charity's obligation in case of a purchase generally would be limited to acquirer reporting under § 1.6050Y-2, which merely requires providing on Form 1099-LS information that should be readily available to the charity. This reporting provides important information regarding the sale to reportable policy sale payment recipients and the IRS.

In response to the commenters concerns, however, the final regulations provide that the IRS may publish guidance in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) describing other situations in which a substantial financial relationship exists between the insured and an

[4164] [my footnote:] I was that commenter; see fn 4162.

acquirer that is an organization described in sections 170(c), 2055(a), and 2522(a). See § 1.101-1(d)(3)(iii) of the final regulations.

C. Substantial Financial Relationships and BOLI Pooling Transactions

One commenter on the proposed regulations requested confirmation that a reportable policy sale will not arise when a life insurance policy is involved in a transaction that pools bank-owned life insurance (BOLI). The commenter explained that businesses, such as banks, commonly promise certain pre-and post-retirement benefits to their employees, such as retiree health care benefits, which can result in substantial liabilities for the businesses that must be reflected on their financial statements. The commenter described BOLI as permanent, cash value life insurance coverage on the lives of a bank's officers, directors, and employees purchased by the bank to fund such obligations informally and to establish assets on its financial statements to offset liabilities for the promised benefits. The commenter stated that BOLI owners typically hold the policies until the death benefits become payable and use the benefits to fund the costs of the employee benefits or to recover such costs after the fact. The commenter described BOLI pooling transactions as transactions that pool the BOLI policies of multiple banks for the continued purpose of funding each bank's employee benefits, but in a more effective, centralized way. The commenter described the initial step of a BOLI pooling transaction as the transfer by multiple unrelated banks of their pre-existing BOLI policies to a partnership, in return for which each bank receives a partnership interest proportional to the value of its contributed policies. The commenter explained that the partnership holds and manages the contributed policies and distributes death benefits among the bank-partners pro rata based on their respective partnership interests, which is expected to help normalize cash flows from the policies.

The commenter asserted that BOLI pooling transactions are ordinary course business transactions that should not be treated as reportable policy sales because they are not speculative and can be distinguished from sales of policies to third parties because the intent and result is to pool the policies among all the original policyholders for the continued purpose of funding their employee benefit liabilities. The commenter noted that the IRS has issued private letter rulings that confirm, directly or indirectly, that the carryover basis exception to the transfer for value rule in section 101(a)(2) applies to a bank's contribution of BOLI policies to the partnership in a BOLI pooling transaction, thereby preserving the tax-free character of the death benefits when paid to the partnership. These rulings pre-date the addition of section 101(a)(3) to the Code. The reportable policy sale rules of section 101(a)(3) are in addition to the carryover basis exception of section 101(a)(2). As a result, policy transfers are ineligible for the carryover basis exception if no substantial family, business, or financial relationship exists between the acquirer of an interest in a life insurance contract and the insured under that contract at the time of the acquisition.

The commenter asserted that the proposed regulations support the requested treatment of BOLI pooling transactions because a substantial financial relationship exists between the acquirer and insured. A substantial financial relationship exists under § 1.101-1(d)(3)(ii) of the proposed regulations if the acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets or satisfy liabilities following the death of the insured. The commenter asserted that this provision applies in BOLI pooling transactions with respect to both the bank and the partnership as follows: (1) the partnership has a direct acquisition of life insurance policies, which it maintains to satisfy liabilities following the death of the insured, namely, the employee benefit liabilities of the bank-partners for which they originally purchased the policies; (2) the bank has an indirect acquisition of life insurance policies contributed by other banks to the partnership; and (3) the bank maintains its indirect interest in those policies to continue funding the same employee benefit liabilities. The commenter recommended clarification of the regulations to confirm this treatment, either by adding additional language to the definition of substantial financial relationship, or by adding an example that applies that provision to the BOLI pooling transaction. Alternatively, the commenter suggested a separate exception to the reportable policy sale definition.

The final regulations do not adopt the commenters requested changes because the changes would be inconsistent with the statute. The proposed regulations do not support, and were not intended to support, the requested treatment of BOLI pooling transactions.

First, the partnership described by the commenter does not have a substantial family, business, or financial relationship with the insureds under the proposed regulations. Specifically, it does not have a substantial financial relationship with any insured under § 1.101-1(d)(3)(ii) of the proposed regulations because it does not maintain the life insurance contract on the life of the insured to provide funds for the partnership to purchase assets or satisfy liabilities following the insured's death. As described by the commenter, the partnership maintains the life insurance contracts to provide its partners, the banks, with funds to satisfy the banks' employee benefit liabilities. Accordingly, the partnership's acquisition of the life insurance contracts in the circumstances described is a reportable policy sale that must be reported under section 6050Y and § 1.6050Y-2 of the proposed regulations.

Second, the definition of a substantial financial relationship in § 1.101-1(d)(3)(ii) of the proposed regulations was not intended to cover relationships as tenuous as those existing between the indirect acquirers (the banks) and the insureds in the BOLI pooling transactions described by the commenter. Section 1.101-1(d)(3)(ii) of the proposed regulations was intended to cover situations in which the life insurance contract is held to provide funds to purchase assets or satisfy liabilities, when the need for the asset purchases or liability payments results from the insured's death. In the situation described by the commenter, a bank does not have this kind of relationship with the insureds under life insurance contracts contributed to the partnership by other banks. However, in the circumstances described, because the partnership acquires the life insurance contracts in a reportable policy sale that must be reported under section 6050Y(a) and § 1.6050Y-2 of the proposed regulations, the bank's indirect acquisition of the life insurance contracts is not a reportable policy sale, provided the partnership complies with the reporting requirements. See § 1.101-1(c)(2)(iii)(A) of the proposed regulations.

D. Substantial Financial Relationships Under § 1.101-1(d)(3)(ii)

A substantial financial relationship exists under § 1.101-1(d)(3)(ii) of the proposed regulations if the acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets or satisfy liabilities following the death of the insured. As described in section 5.0 of this Summary of Comments and Explanation of Revisions, this definition was intended to apply in situations in which the life insurance contract is held to provide funds to purchase assets or satisfy liabilities following the death of the insured, when the need for the asset purchases or liability payments results from the insured's death. Accordingly, § 1.101-1(d)(3)(ii) of the final regulations revises the definition to provide that a substantial financial relationship exists between the acquirer and insured if the acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets of or to satisfy liabilities of the insured or the insured's estate, heirs, legatees, or other successors in interest, or to satisfy other liabilities arising upon or by reason of the death of the insured.

Reg. § 1.101-1(d)(1), "Substantial family relationship," provides:

> For purposes of this section, a substantial family relationship means the relationship between an individual and any family member of that individual as defined in paragraph (f)(3) of this section. In addition, a substantial family relationship exists between an individual and his or her former spouse with regard to the transfer of an interest in a life insurance contract to (or in trust for the benefit of) that former spouse incident to divorce.

Reg. § 1.101-1(f)(3), "Family member," provides:

> With respect to any individual, the term family member refers to any person described in paragraphs (f)(3)(i) through (vi) of this section. For purposes of this paragraph (f)(3), full effect is given to a legal adoption, and a step-child is deemed to be a descendant. The family members of an individual include:
>
> (i) The individual;
>
> (ii) The individual's spouse or a person with whom the individual is in a registered domestic partnership, civil union, or other similar relationship established under state law;
>
> (iii) Any parent, grandparent, or great-grandparent of the individual or of the person described in paragraph (f)(3)(ii) of this section and any spouse of such parent, grandparent, or great-grandparent, or person with whom the parent, grandparent, or great-grandparent is in a registered domestic partnership, civil union, or other similar relationship established under state law;
>
> (iv) Any lineal descendant of the individual or of any person described in paragraph (f)(3)(ii) or (iii) of this section;
>
> (v) Any spouse of a lineal descendant described in paragraph (f)(3)(iv) of this section and any person with whom such a lineal descendant is in a registered domestic partnership, civil union, or other similar relationship established under state law; and
>
> (vi) Any lineal descendant of a person described in paragraph (f)(3)(v) of this section.

Reg. § 1.101-1(d)(2), "Substantial business relationship," provides:

> For purposes of this section, a substantial business relationship between the insured and the acquirer exists in each of the following situations:
>
> (i) The insured is a key person (as defined in section 264) of, or materially participates (within the meaning of section 469) in, an active trade or business as an owner, employee, or contractor, and at least 80 percent of that trade or business is owned (directly or indirectly, through one or more partnerships, trusts, or other entities) by the acquirer or the beneficial owners of the acquirer.
>
> (ii) The acquirer acquires an active trade or business and acquires the interest in the life insurance contract either as part of that acquisition or from a person owning significant property leased to the acquired trade or business or life insurance policies held to facilitate the succession of the ownership of the business if--

(A) The insured—

(1) Is an employee within the meaning of section 101(j)(5)(A) of the acquired trade or business immediately preceding the acquisition; or

(2) Was a director, highly compensated employee, or highly compensated individual within the meaning of section 101(j)(2)(A)(ii) of the acquired trade or business, and the acquirer, immediately after the acquisition, has ongoing financial obligations to the insured with respect to the insured's employment by the trade or business (for example, the life insurance contract is maintained by the acquirer to fund current or future retirement, pension, or survivorship obligations based on the insured's relationship with the entity or to fund a buy-out of the insured's interest in the acquired trade or business); and

(B) The acquirer either carries on the acquired trade or business or uses a significant portion of the acquired business assets in an active trade or business that does not include investing in interests in life insurance contracts.

For the above references to Code § 264, see fns 4111-4113 in part II.Q.4.a Funding the Buy-Sell. Under that provision, generally a key person is an officer or 20% owner, but the number of individuals who may be treated as key persons may be as few as five people.

For the above references to material participation under Code § 469, see part II.K.1.a.ii Material Participation and various other discussion in part II.K.1 Passive Loss Rules Generally.

For the above references to Code § 101(j), see part II.Q.4.g.i Analysis of Code § 101(j).

Reg. § 1.101-1(d)(2), "Substantial financial relationship," provides:

> For purposes of this section, a substantial financial relationship between the insured and the acquirer exists in each of the following situations:
>
> (i) The acquirer (directly or indirectly, through one or more partnerships, trusts, or other entities of which it is a beneficial owner) has, or the beneficial owners of the acquirer have, a common investment (other than the interest in the life insurance contract) with the insured and a buy-out of the insured's interest in the common investment by the co-investor(s) after the insured's death is reasonably foreseeable.
>
> (ii) The acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets of or to satisfy liabilities of the insured or the insured's estate, heirs, legatees, or other successors in interest, or to satisfy other liabilities arising upon or by reason of the death of the insured.
>
> (iii) The acquirer is an organization described in sections 170(c), 2055(a), and 2522(a) that previously received from the insured either financial support in a substantial amount or significant volunteer support or that meets other requirements prescribed in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) for establishing that a substantial financial relationship exists between the insured and the organization.

Neither the proposed regulations nor their preamble defines "common investment." Presumably this provides full latitude for buy-sell agreements among owners of a business entity.

Reg. § 1.101-1(d)(4), "Special rules," provides:

> Paragraphs (d)(4)(i), (ii), and (iii) of this section apply for purposes of determining whether a substantial relationship (whether family, business, or financial) exists under paragraph (d)(1), (2), or (3) of this section, respectively.
>
> (i) *Indirect acquisitions*. The acquirer of an interest in a life insurance contract in an indirect acquisition is deemed to have a substantial business or financial relationship with the insured if the direct holder of the interest in the life insurance contract has a substantial business or financial relationship with the insured immediately before and after the date the acquirer acquires its interest.
>
> (ii) *Acquisitions by certain persons*. The sole fact that an acquirer is a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, is not sufficient to establish a substantial business or financial relationship with the insured. In addition, an acquirer need not be a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer to have a substantial business or financial relationship with the insured.
>
> (iii) *Acquisitions by those with differing types of substantial relationships*. A substantial family, business, or financial relationship exists between the insured and a partnership, trust, or other entity if each beneficial owner of that partnership, trust, or other entity has a substantial family, business, or financial relationship with the insured. For example, a substantial family, business, or financial relationship exists between the insured and a trust if each trust beneficiary is a family member of the insured or an organization described in paragraph (d)(3)(iii) of this section.

Reg. § 1.101-1(f)(1), "Beneficial owner," provides:

> A beneficial owner of a partnership, trust, or other entity is an individual or C corporation with an ownership interest in that entity. The interest may be held directly or indirectly, through one or more other partnerships, trusts, or other entities. For instance, an individual that directly owns an interest in a partnership (P1), which directly owns an interest in another partnership (P2), is an indirect beneficial owner of P2 and any assets or other entities owned by P2 directly or indirectly. For purposes of this paragraph (f)(1), the beneficial owners of a trust include those who may receive current distributions of trust income or corpus and those who could receive distributions if the trust were to terminate currently.

Note that the beneficial owners of a trust ***include*** those persons named above [emphasis added]. My understanding is that, in federal tax regulations, "includes" means "includes without limitation." Query whether that expansion of the definition means that one or more persons beyond the current potential distributees and immediate remaindermen need to be considered.

Reg. § 1.101-1(g)(14)[4165] elaborates on Reg. § 1.101-1(d)(4), providing:

> *Example 14*. Partnership X conducts an active trade or business and is the initial policyholder of a $100,000 insurance policy on the life of its full-time employee, A. A materially participates in

[4165] Reg. § 1.101-1(g), "Examples," begins with:

Partnership X's active trade or business in A's capacity as an employee. Individual B acquires a 10% profits interest in Partnership X in exchange for a cash payment of $1,000,000. Under paragraphs (d)(1) through (3) of this section, B does not have a substantial family, business, or financial relationship with A. Under paragraph (d)(4)(i) of this section, however, B is deemed to have a substantial business relationship with A because, under paragraph (d)(2)(i) of this section, Partnership X (the direct policyholder) has a substantial business relationship with A. Accordingly, although the acquisition of the 10% partnership interest by B is an indirect acquisition of a 10% interest in the insurance policy covering A's life, the acquisition is not a reportable policy sale.

Reg. § 1.101-1(g)(16)[4166] elaborates on Reg. § 1.101-1(d), providing:

> *Example 16*. A is the initial policyholder of a $100,000 insurance policy on A's life. A sells the policy for its fair market value. As a result of the sale, Bank X holds legal title to the life insurance contract as the nominee of Partnership B, and Partnership B has the enforceable right to designate the contract beneficiary. Under paragraphs (d)(1) through (4) of this section, neither Bank X nor Partnership B has a substantial family, business, or financial relationship with the insured, A, at the time of the sale. Accordingly, the transfer of legal title to the policy to Bank X is a reportable policy sale under paragraph (c)(1) of this section, unless an exception set forth in paragraph (c)(2) of this section applies. The same is true of the transfer of the economic benefits of the policy to Partnership B. At a later date, Partnership B sells its economic interest in the policy to Partnership C for fair market value. Bank X continues to hold legal title to the life insurance contract, but now holds it as Partnership C's nominee. Partnership C has no substantial family, business, or financial relationship with the insured, A, under paragraphs (d)(1) through (4) of this section at the time of the transfer. Accordingly, Partnership C's acquisition of the economic interest in the policy from Partnership B is a reportable policy sale under paragraph (c)(1) of this section, unless an exception set forth in paragraph (c)(2) of this section applies.

II.Q.4.b.ii.(d). Transfer With Substituted Basis or To Permitted Transferee When Not a Reportable Policy Sale

Code § 101(a)(2) provides that the transfer for value rule does not apply:

> (A) if such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or
>
> (B) if such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

[4166] Reg. § 1.101-1(g), "Examples," begins with:

The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

Thus, either, the substituted basis rule of Code § 101(a)(2)(A) or the permitted transferee rule of Code § 101(a)(2)(B) suffices to exclude from the transfer for value rules any transfer that is not a reportable policy sale.

The preamble to the proposed regulations explains:[4167]

> Section 1.101-1(b)(1)(i) of the proposed regulations provides that, in the case of a transfer of an interest in a life insurance contract for valuable consideration, the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited under section 101(a)(2) to the sum of the actual value of the consideration for the transfer paid by the transferee and the premiums and other amounts subsequently paid by the transferee with respect to that interest. Consistent with section 101(a)(3), this general rule applies to all transfers of interests in life insurance contracts for valuable consideration that are reportable policy sales. Consistent with section 101(a)(2), this general rule also continues to apply to transfers of interests in life insurance contracts for valuable consideration that are not reportable policy sales, unless an exception set forth in section 101(a)(2) applies. See § 1.101-1(b)(1)(i) and (ii) of the proposed regulations. Section 1.101-1(b)(1)(ii)(A) of the proposed regulations applies to carryover basis transfers that are not also subject to § 1.101-1(b)(1)(ii)(B) of the proposed regulations. Section 1.101-1(b)(1)(ii)(B) of the proposed regulations applies to transfers to certain persons.
>
> Under § 1.101-1(b)(1)(ii)(A) of the proposed regulations, the limitation described in section 101(a)(2) and § 1.101-1(b)(1)(i) of the proposed regulations does not apply to the transfer of an interest in a life insurance contract for valuable consideration if (1) The transfer is not a reportable policy sale, (2) the basis of the interest transferred, for the purpose of determining gain or loss with respect to the transferee, is determinable in whole or in part by reference to the basis of that interest in the hands of the transferor, and (3) § 1.101-1(b)(1)(ii)(B) of the proposed regulations does not apply to the transfer. The amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is, however, limited to the sum of (1) The amount that would have been excludable by the transferor, and (2) the premiums and other amounts subsequently paid by the transferee.
>
> This limitation applies without regard to whether the interest previously has been transferred or to the nature of any prior transfer of the interest. For instance, it is irrelevant whether a prior transfer was gratuitous or for value, whether section 101(a)(2)(A) or (B) applied to a prior transfer, whether any prior transfer was a reportable policy sale, or whether the prior transfer was of the same interest or a larger interest in a life insurance contract that included the same interest. If the full amount of the proceeds would have been excludable by the transferor, as would generally be the case if the original policyholder is the transferor, § 1.101-1(b)(1)(ii)(A) of the proposed regulations will, as a practical matter, impose no limitation on the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1).
>
> Under § 1.101-1(b)(1)(ii)(B)(1) of the proposed regulations, the limitation on the excludable amount of the proceeds described in section 101(a)(2) and § 1.101-1(b)(1)(i) of the proposed regulations will not apply to an interest in a life insurance contract that is transferred for valuable consideration if (1) The transfer is not a reportable policy sale and the interest was not previously transferred for valuable consideration in a reportable policy sale, and (2) the transfer is to the

[4167] Part 6 of the preamble REG-103083-18, "Section 1.101-1: Exclusion from Gross Income of Proceeds of Life Insurance Contracts Payable by Reason of Death."

> insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer (a (B)(1) person).
>
> Under § 1.101-1(b)(1)(ii)(B)(2) of the proposed regulations, if a transfer of an interest in a life insurance contract to a (B)(1) person follows a transfer for valuable consideration in a reportable policy sale (whether in the immediately preceding transfer or an earlier transfer), the amount of the proceeds attributable to that interest that is excludable from gross income under section 101(a)(1) is limited to the sum of (1) The higher of the amount that would have been excludable by the transferor if the transfer to the (B)(1) person had not occurred or the actual value of the consideration for the transfer to the (B)(1) person paid by the (B)(1) person, and (2) the premiums and other amounts subsequently paid by the transferee. Thus, in determining the excludable amount of the proceeds attributable to an interest in a life insurance contract that is transferred to a (B)(1) person in a transfer that is not a reportable policy sale, the limitation described in section 101(a)(2) and § 1.101-1(b)(1)(i) of the proposed regulations is inapplicable unless the interest previously had been transferred in a reportable policy sale. Additionally, because of the alternative in the formula for computing the limitation, a (B)(1) person will not be subject to a less favorable limitation than the limitation applicable to a transferee in a carryover basis transfer eligible for the exception set forth in § 1.101-1(b)(1)(ii)(A) of the proposed regulations.
>
> The proposed regulations provide a single rule applicable to all gratuitous transfers of interests in life insurance contracts, including reportable policy sales that are not for valuable consideration: the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of (1) The amount of the proceeds attributable to the gratuitously transferred interest that would have been excludable by the transferor if the transfer had not occurred, and (2) the premiums and other amounts subsequently paid by the transferee. See § 1.101-1(b)(2)(i) of the proposed regulations. Although § 1.101-1(b)(2) of the existing regulations provides a special rule for gratuitous transfers made by or to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, such a rule is not required by section 101(a), and the proposed regulations do not contain a special rule for these transfers because it could be subject to abuse.
>
> Section 1.101-1(b)(3) of the proposed regulations clarifies that, for purposes of § 1.101-1(b)(1) and (2) of the proposed regulations, in determining the amounts, if any, of consideration paid by the transferee for the transfer of an interest in a life insurance contract and premiums and other amounts subsequently paid by the transferee with respect to that interest, the amounts paid by the transferee are reduced, but not below zero, by amounts received by the transferee under the life insurance contract that are not received as an annuity, to the extent excludable from gross income under section 72(e). This provision is necessary to prevent an exclusion from gross income based on a double-counting of consideration paid.

Reg. § 1.101-1(b)(1)(ii), "Exceptions," explains in (A), "Exception for carryover basis transfers," when the substituted basis rule of Code § 101(a)(2)(A) causes the transfer for value rule under Code § 101(a)(2) not to apply:

> The limitation described in paragraph (b)(1)(i) of this section does not apply to the transfer of an interest in a life insurance contract for valuable consideration if each of the following requirements are satisfied. First, the transfer is not a reportable policy sale. Second, the basis of the interest, for the purpose of determining gain or loss with respect to the transferee, is determinable in whole or in part by reference to the basis of the interest in the hands of the transferor (see

section 101(a)(2)(A)). Third, paragraph (b)(1)(ii)(B) of this section does not apply. In the case of a transfer described in this paragraph (b)(1)(ii)(A), the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of the amount that would have been excludable by the transferor if the transfer had not occurred and the premiums and other amounts subsequently paid by the transferee with respect to the interest. The preceding sentence applies without regard to whether the interest previously has been transferred and the nature of any prior transfer of the interest.

Thus, the substituted basis rule of Code § 101(a)(2)(A) applies when the permitted transferee rule of Code § 101(a)(2)(B), which is elaborated upon in Reg. § 1.101-1(b)(1)(ii)(B), does not apply. Reg. § 1.101-1(b)(1)(ii)(B), "Exception for transfers to certain persons," provides:

(1) *In general*. The limitation described in paragraph (b)(1)(i) of this section does not apply to the transfer of an interest in a life insurance contract for valuable consideration if both of the following requirements are satisfied. First, the transfer is not a reportable policy sale and the interest was not previously transferred for valuable consideration in a reportable policy sale. Second, the interest is transferred to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer (see section 101(a)(2)(B)).

(2) *Transfers to certain persons subsequent to a reportable policy sale*. Except as provided in paragraph (b)(1)(ii)(B)(3) of this section, if a transfer of an interest in a life insurance contract would be described in paragraph (b)(1)(ii)(B)(/) of this section, but for the fact that the interest previously was transferred for valuable consideration in a reportable policy sale (whether in the immediately preceding transfer or an earlier transfer), then the amount of the proceeds attributable to the interest that is excludable from gross income under section 101(a)(1) is limited to the sum of -

(i) The higher of the amount that would have been excludable by the transferor if the transfer had not occurred or the actual value of the consideration for the transfer paid by the transferee; and

(ii) The premiums and other amounts subsequently paid by the transferee with respect to the interest.

(3) *Transfers to the insured subsequent to a reportable policy sale*.

(i) Except as provided in paragraph (b)(1)(ii)(B)(3)(ii) of this section, to the extent that an interest (or portion of an interest) in a life insurance contract that was transferred for valuable consideration in a reportable policy sale subsequently is transferred to the insured for valuable consideration, the limitations described in paragraph (b)(1)(i) of this section and paragraph (b)(1)(ii)(B)(2) of this section do not apply. To the extent that fair market value is not paid by the insured for the transferred interest, the transfer of the portion of the interest with a value in excess of the consideration paid will be treated as a gift under the bargain sale rule in paragraph (b)(2)(iii) of this section.

(ii) This paragraph (b)(1)(ii)(B)(3)(ii) applies with respect to an interest described in paragraph (b)(1)(ii)(B)(3)(i) of this section (or portion of such an interest) that subsequently is transferred by the insured to any other person. If all subsequent transfers of the interest (or portion of the interest) are gratuitous transfers that are not reportable policy sales, the amount of the proceeds excluded from gross income is determined under paragraph (b)(2)(i) of this section, taking into account the application of paragraph (b)(1)(ii)(B)(3)(i) of this section to the insured's acquisition of the interest. If any subsequent transfer of the interest (or portion of the interest) is for valuable consideration or is a reportable policy sale, the amount of the policy proceeds excludable from gross income is determined in accordance with paragraph (b) of this section; if the amount that would have been excludable from gross income by the insured following the transaction described in paragraph (b)(1)(ii)(B)(3)(i) of this section if no subsequent transfer had occurred is relevant, that amount is determined under paragraph (b)(1)(ii)(B)(2) of this section. Paragraph (g)(8) (Example 8) of this section and paragraph (g)(9) (Example 9) of this section illustrate the application of this paragraph (b)(1)(ii)(B)(3)(ii).

Reg. § 1.101-1(b)(1)(ii)(B)(1) above continues the policy of the prior regulations that a transfer to a permitted transferee cleanses a prior transfer for value, but it adds in the requirement that the transfer not be a reportable policy and removes the requirement that the transfer be the final transfer before the insured's death.[4168]

Reg. § 1.101-1(b)(1)(ii)(B)(3) was added in response to my comments requesting cleansing if the insured buys the policy after a reportable policy sale. See part II.Q.4.b.ii.(e) Cleansing by Transfer Back to Insured.[4169]

Examples (10) through (12) in Reg. § 1.101-1(g)(10) through(12)[4170] shed some light on this rule (other than the cleansing aspects, which are discussed later:

(10) *Example 10*. A is the initial policyholder of a $100,000 insurance policy on A's life. A contributes the policy to Corporation X in exchange for stock. Corporation X's basis in the policy is determinable in whole or in part by reference to A's basis in the policy. Corporation X conducts an active trade or business that it wholly owns, and A materially participates in that active trade or business as an employee of Corporation X. Corporation X receives the proceeds of $100,000 on A's death. A's contribution of the policy to Corporation X is not a reportable policy sale because Corporation X has a substantial business relationship with A under paragraph (d)(2)(i) of this section. Although Corporation X's basis in the policy is determinable in whole or in part by reference to A's basis in the policy, paragraph (b)(1)(ii)(A) of this section does not apply because the insured, A, is a shareholder of Corporation X and the other requirements under paragraph (b)(1)(ii)(B) of this section are satisfied. Accordingly, paragraph (b)(1)(ii)(B) of this section applies, and paragraph (b)(1)(ii)(A) of this section is inapplicable. Under paragraph (b)(1)(ii)(B)(/) of this section, Corporation X's exclusion is not limited by paragraph (b) of this section.

[4168] Reg. § 1.101-1(b)(1)(ii)(B)(1) is applied is Example (3), which is discussed in the text accompanying fn 4174 in part II.Q.4.b.ii.(e) Cleansing by Transfer Back to Insured.
[4169] Especially text accompanying fn 4178.
[4170] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

(11) *Example 11*. The facts are the same as in Example 10 in paragraph (g)(10) of this section, except that Corporation X transfers its active trade or business and the policy on A's life to Corporation Y in a tax-free reorganization at a time when A is still employed by Corporation X, but is no longer a shareholder of Corporation X. Corporation Y's basis in the policy is determinable in whole or in part by reference to Corporation X's basis in the policy, and Corporation Y carries on the trade or business acquired from Corporation X. Corporation Y receives the proceeds of $100,000 on A's death. The transfer from Corporation X to Corporation Y is not a reportable policy sale because Corporation Y has a substantial business relationship with A under paragraph (d)(2)(ii) of this section. The amount of the proceeds that Corporation Y may exclude from gross income is limited under paragraph (b)(1)(ii)(A) of this section to the sum of the amount that would have been excludable by Corporation X had the transfer to Corporation Y not occurred, plus any premiums and other amounts paid by Corporation Y with respect to the policy subsequent to the transfer. Accordingly, because Corporation X's exclusion is not limited by paragraph (b) of this section, as described in Example 10 in paragraph (g)(10) of this section, Corporation Y's exclusion is not limited by paragraph (b) of this section.

(12) *Example 12*. A is the initial policyholder of a $100,000 insurance policy on A's life. A contributes the policy to a C corporation, Corporation W, in exchange for stock. After the acquisition, A owns less than 20% of the outstanding stock of Corporation W and owns stock possessing less than 20 % of the total combined voting power of all stock of Corporation W and is therefore not a key person with respect to Corporation W under section 264(e)(3). Corporation W's basis in the policy is determinable in whole or in part by reference to A's basis in the policy. However, no substantial family, business, or financial relationship exists between A and Corporation W, so A's contribution of the policy to Corporation W is a reportable policy sale. Corporation W receives the proceeds of $100,000 on A's death. Under paragraph (b)(1)(i) of this section, the amount of the proceeds Corporation W may exclude from gross income is limited to the actual value of the stock exchanged for the policy, plus any premiums and other amounts paid by Corporation W with respect to the policy subsequent to the transfer. The exceptions in paragraph (b)(1)(ii) of this section do not apply because the transfer to Corporation W is a reportable policy sale.

Example (10) meets each element of the 3-prong test of Reg. § 1.101-1(b)(1)(ii). Example (11) meets the substituted basis and not-a-reportable-sale elements but not the qualified transferee element. However, Example (11) concludes that, because the transferor would have excluded the proceeds from gross income, the substituted-basis transferee may also do so. Thus, Reg. § 1.101-1(b)(1) is essentially imprinting on to the substituted basis rule of Code § 101(a)(2)(A) the idea that a policy's taint under the transfer-for-value rule continues when the policy is transferred in a substituted basis transaction without being cleansed. Conventional wisdom had been that a transfer to the insured would cleanse the taint. However, Reg. § 1.101-1 seems to suggest limitations on which transfers to the insured would cleanse the taint; see part II.Q.4.b.ii.(e) Cleansing by Transfer Back to Insured.

Example (12) points out that a substituted basis transfer that is a reportable policy sale is subject to the transfer-for-value rules, which is consistent with Code § 101(a)(3).

II.Q.4.b.ii.(e). Cleansing by Transfer Back to Insured or Permitted Transferee

For a sale that is ***not*** a reportable policy sale, Examples (1), (2) and (3) in Reg. § 1.101-1(g)(1), (2), and (3)[4171] describe how to cleanse a policy:

(1) *Example 1*. A is the initial policyholder of a $100,000 insurance policy on A's life. A sells the policy to B, A's child, for $6,000, its fair market value. B is not a partner in a partnership in which A is a partner. B receives the proceeds of $100,000 upon the death of A. Because the transfer to B was for valuable consideration, and none of the exceptions in paragraph (b)(1)(ii) of this section applies, the amount of the proceeds B may exclude from B's gross income under this section is limited under paragraph (b)(1)(i) of this section to $6,000 plus any premiums and other amounts paid by B with respect to the policy subsequent to the transfer.

(2) *Example 2*. The facts are the same as in Example 1 in paragraph (g)(1) of this section except that, before A's death, B gratuitously transfers the policy back to A. A's estate receives the proceeds of $100,000 on A's death. Because the transfer from B to A is a gratuitous transfer to the insured, and the preceding transfer from A to B was not a reportable policy sale, the amount of the proceeds A's estate may exclude from gross income under this section is not limited by paragraph (b)(2)(i) of this section.

(3) *Example 3*. The facts are the same as in Example 1 in paragraph (g)(1) of this section except that, before A's death, B sells the policy back to A for its fair market value. A's estate receives the proceeds of $100,000 on A's death. The transfer from A to B is not a reportable policy sale because the acquirer B has a substantial family relationship with the insured, A. The transfer from B to A also is not a reportable policy sale because the acquirer A has a substantial family relationship with the insured, A. Accordingly, paragraph (b)(1)(ii)(B)(/) of this section applies to the transfer to A, and the amount of the proceeds A's estate may exclude from gross income is not limited by paragraph (b) of this section.

Before discussing cleansing, let's discuss Example (1). If A had given the policy to B, then the gift would have qualified for the substituted basis exception to the transfer for value rule. If A had sold the policy to an irrevocable grantor trust that A had previously established for B, the sale would have been disregarded and the rule would not have applied.[4172]

Example (2) cleansed the policy by a gratuitous transfer to the insured under Reg. § 1.101-1(b)(2)(i).[4173]

Example (3) applies the exception for a transfer for valuable consideration to a permitted transferee in Reg. § 1.101-1(b)(1)(ii)(B)(1).[4174] Unlike Example (2), it was a transfer for valuable consideration, so it also had to avoid being a reportable policy sale.

[4171] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

[4172] See Rev. Rul. 2007-13, reproduced in fn 4130 in part II.Q.4.b.i Transfer for Value Rule Generally.

[4173] Fn 4179 reproduces the relevant part of . § 1.101-1(b)(2)(i), and Reg. § 1.101-1(b)(2) is reproduced in the text preceding fn 4143 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

[4174] See text accompanying and preceding fn 4168 in part II.Q.4.b.ii.(d) Transfer With Substituted Basis or To Permitted Transferee When Not a Reportable Policy Sale.

For a sale that ***is*** a reportable policy sale, the Examples in Reg. § 1.101-1(g)(4), (5), and (6)[4175] in the proposed regulations asserted that no transfer back to the insured will cleanse the policy from the transfer for value rules, but the final regulations allow a fair market value sale to the insured to cleanse the policy:

(4) *Example 4*. A is the initial policyholder of a $100,000 insurance policy on A's life. A transfers the policy for $6,000, its fair market value, to an individual, C, who does not have a substantial family, business, or financial relationship with A. The transfer from A to C is a reportable policy sale. C receives the proceeds of $100,000 on A's death. The amount of the proceeds C may exclude from C's gross income under this section is limited under paragraph (b)(1)(i) of this section to $6,000 plus any premiums and other amounts paid by C with respect to the policy subsequent to the transfer.

(5) *Example 5*. The facts are the same as in Example 4 in paragraph (g)(4) of this section, except that before A's death, C transfers the policy to D, a partner of A who co-owns real property with A, for $8,000, the policy's fair market value. D receives the proceeds of $100,000 on A's death. The transfer from C to D is not a reportable policy sale because the acquirer D has a substantial financial relationship with the insured, A. However, because that transfer follows a reportable policy sale (the transfer from A to C), the amount of the proceeds that D may exclude from gross income under this section is limited by paragraph (b)(1)(ii)(B)(2) of this section to the sum of--

(i) The higher of the amount C could have excluded had the transfer to D not occurred ($6,000 plus any premiums and other amounts paid by C with respect to the policy subsequent to the transfer to C, as described in Example 4 in paragraph (g)(4) of this section) or the actual value of the consideration for that transfer paid by D ($8,000); and

(ii) Any premiums and other amounts paid by D with respect to the policy subsequent to the transfer to D.

(6) *Example 6*. The facts are the same as in Example 4 in paragraph (g)(4) of this section, except that before A's death, C transfers the policy back to A for $8,000, its fair market value. A's estate receives the proceeds of $100,000 on A's death. The transfer from C to A is not a reportable policy sale because the acquirer A has a substantial family relationship with the insured, A. Although the transfer follows a reportable policy sale (the initial transfer from A to C), A's estate may exclude all of the policy proceeds from gross income because paragraph (b)(1)(ii)(B)(3)(i) of this section applies and, therefore, the amount of the proceeds that A may exclude from gross income is not limited by paragraph (b)(1)(i) of this section or (b)(1)(ii)(B)(2) of this section.

[4175] Reg. § 1.101-1(g), "Examples," begins with:

The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

Reg. § 1.101-1(g)(7), Example (7)[4176] applies the bargain sale rule to Example (6):

> (7) *Example 7*. The facts are the same as in Example 6 in paragraph (g)(6) of this section, except that C transfers the policy back to A for $4,000, rather than its fair market value of $8,000. A's estate receives the proceeds of $100,000 on A's death. Because A did not pay fair market value for the policy, the transfer is bifurcated and treated as a bargain sale under paragraph (b)(2)(iii) of this section. A therefore is treated as having purchased 50% of the policy interest for valuable consideration equal to fair market value and as having received 50% of the policy interest in a gratuitous transfer. The transfer from C to A is not a reportable policy sale because the acquirer, A, has a substantial family relationship with the insured, A, but the transfer from C to A follows a reportable policy sale (the transfer from A to C).
>
> (i) *Treatment of policy interest purchased by A*. A's estate may exclude from income all of the policy proceeds related to the 50% policy interest transferred for valuable consideration ($50,000) because, under paragraph (b)(1)(ii)(B)(3)(i) of this section, the amount of the proceeds that may be excluded from gross income is not limited by paragraph (b)(1)(i) of this section or (b)(1)(ii)(B)(2) of this section.
>
> (ii) *Treatment of policy interest gratuitously transferred to A*. The amount of the policy proceeds related to the 50% policy interest transferred gratuitously that A's estate may exclude from income is limited under paragraph (b)(2)(i) of this section to the sum of the amount C could have excluded with respect to 50% of the policy had the transfer back to A not occurred (that is, 50% of the $6,000 that C paid A for the policy, plus 50% of any premiums and other amounts paid by C with respect to the policy subsequent to the transfer to C), plus 50% of any premiums and other amounts paid by A with respect to the policy subsequent to the transfer to A.

Additional cleansing examples are in Reg. § 1.101-1(g)(8) and (9), Examples (8) and (9)[4177]:

> (8) *Example 8*. The facts are the same as in Example 6 in paragraph (g)(6) of this section, except that, before A's death, A gratuitously transfers 50% of the policy interest to B, A's child, and sells 50% of the policy interest for its fair market value to an individual, E, who does not have a substantial family, business, or financial relationship with A. B and E each receive $50,000 of the proceeds on A's death. Paragraph (b)(1)(ii)(B)(3)(ii) of this section applies to determine the amount of the proceeds that B and E may exclude from gross income because the policy interests transferred to B and E were first transferred for valuable consideration in a reportable policy sale (the transfer by A to C) and then transferred to the insured, A, for fair market value.

[4176] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

[4177] Reg. § 1.101-1(g), "Examples," begins with:

> The application of this section is illustrated by the following examples. Each example assumes that the transferee did not receive any amounts under the life insurance contract other than the amounts described in the examples. With the exception of paragraph (g)(7) (Example 7) of this section, the bargain sale rules set forth in paragraph (b)(2)(iii) of this section do not apply in the examples because the consideration paid for the policy transferred is fair market value....

(i) *Treatment of policy interest transferred to B*. With respect to the portion of the policy interest transferred to B, because the transfer to B was the only transfer subsequent to the transfer to A and the transfer to B was gratuitous and not a reportable policy sale, under paragraph (b)(1)(ii)(B)(3)(ii) of this section, the amount of the policy proceeds excludable from gross income by B is determined under paragraph (b)(2)(i) of this section, taking into account the application of paragraph (b)(1)(ii)(B)(3)(i) of this section to A's acquisition of the interest. Under paragraph (b)(2)(i) of this section, the amount of the proceeds B may exclude is limited to the sum of the amount A could have excluded had the transfer to B not occurred, and any premiums and other amounts paid by B with respect to the policy subsequent to the transfer to B. As described in Example 6 in paragraph (g)(6) of this section, under paragraph (b)(1)(ii)(B)(3)(i) of this section, the amount of the proceeds that A may exclude from gross income is not limited by paragraph (b)(1)(i) of this section or (b)(1)(ii)(B)(2) of this section. Accordingly, the amount of the proceeds that B may exclude from gross income is not limited by paragraph (b) of this section.

(ii) *Treatment of policy interest transferred to E*. With respect to the portion of the policy interest transferred to E, because the transfer to E was not gratuitous and was a reportable policy sale, under paragraph (b)(1)(ii)(B)(3)(ii) of this section, the amount of the policy proceeds excludable from gross income by E is determined in accordance with paragraph (b) of this section. Accordingly, because the transfer to E was for valuable consideration, the amount excludable from gross income by E is limited by paragraph (b)(1)(i) of this section unless an exception in paragraph (b)(1)(ii) of this section applies. Because the transfer from A to E is a reportable policy sale, none of the exceptions in paragraph (b)(1)(ii) of this section apply. Therefore, the amount of the proceeds E may exclude from gross income under this section is limited by paragraph (b)(1)(i) of this section to the sum of the consideration paid by E and the premiums and other amounts paid by E with respect to the policy subsequent to the transfer to E.

(9) *Example 9*. The facts are the same as in Example 8 in paragraph (g)(8) of this section, except that, before A's death, B transfers B's policy interest to Partnership F, whose partners are A and other family members of A, in exchange for a partnership interest in Partnership F. Partnership F receives $50,000 of the proceeds on A's death. With respect to the policy interest transferred to Partnership F, paragraph (b)(1)(ii)(B)(3)(ii) of this section applies to determine the amount of the proceeds that Partnership F may exclude from gross income for the reasons described in Example 8 in paragraph (g)(8) of this section.

(i) *Treatment of policy interest transferred to Partnership F*. The transfer to Partnership F was not a reportable policy sale. However, because the transfer to Partnership F was not gratuitous, the amount of the policy proceeds excludable from gross income by Partnership F is determined in accordance with paragraph (b) of this section as if the amount that would have been excludable from gross income by A following the transfer to A, if no subsequent transfer had occurred, was determined under paragraph (b)(1)(ii)(B)(2) of this section. Because B's transfer to Partnership F was a transfer for valuable consideration to a partnership in which the insured is a partner that was preceded by a reportable policy sale (the transfer to C), the amount of the proceeds Partnership F may exclude from gross income under this section is limited under paragraph (b)(1)(ii)(B)(2) of this section to the higher of the amount that would have been excludable by B if the transfer to Partnership F had not occurred or the actual value of the consideration for the policy paid by Partnership F, plus any premiums and other amounts paid by Partnership F with respect to the policy subsequent to the transfer to Partnership F.

(ii) *Amount that B could have excluded*. Because the transfer from A to B was a gratuitous transfer, the amount of the proceeds B could have excluded from gross income under this section if the transfer to Partnership F had not occurred is limited under paragraph (b)(2)(i) of this section to the sum of the amount A could have excluded had the transfer to B not occurred, and any premiums and other amounts paid by B with respect to the policy subsequent to the transfer to B.

(iii) *Amount that A could have excluded*. As described in paragraph (g)(9)(i) of this section, the amount of the proceeds A could have excluded under this section if the transfer to B had not occurred must be determined under paragraph (b)(1)(ii)(B)(2) of this section in accordance with paragraph (b)(1)(ii)(B)(3)(ii) of this section. Under paragraph (b)(1)(ii)(B)(2) of this section, the amount that would have been excludable by A is limited to the higher of the amount that would have been excludable by C if the transfer to A had not occurred ($6,000 plus premiums and other amounts subsequently paid by C) or the actual value of the consideration for the policy paid by A ($8,000), plus any premiums and other amounts paid by A with respect to the policy subsequent to the transfer to A.

These Examples helpfully illustrate that reportable policy sale can be completely cleansed through a sale to the insured for fair market value, and a subsequent transferee may (if appropriate) inherit the policy's cleansed status.[4178] A bargain sale is broken into its separate components of a sale plus a gratuitous transfer. A gratuitous transfer back to the insured does not cleanse the policy after a reportable policy sale. Furthermore, Reg. § 1.101-1(b)(2) also provides cleansing: "if an interest in a life insurance contract is transferred gratuitously to the insured, and that interest has not previously been transferred for value in a reportable policy sale, the entire amount of the proceeds attributable to the interest transferred to the insured is excludable from gross income."[4179] And that cleansing can apply to subsequent transferees, when appropriate. I am delighted that, in response my comments, the final regulations provide both of these cleansing opportunities.

Contrast this to what was in effect before the reportable policy sale rules were enacted, Reg. § 1.101-1(b)(3), which had provided:

> In the case of a series of transfers, if the last transfer of a life insurance policy or an interest therein is for a valuable consideration -
>
> (i) The general rule is that the final transferee shall exclude from gross income, with respect to the proceeds of such policy or interest therein, only the sum of—
>
> (a) The actual value of the consideration paid by him, and
>
> (b) The premiums and other amounts subsequently paid by him;

[4178] Reg. § 1.101-1(b)(1)(ii)(B)(3) is reproduced in the text preceding fn 4169.

[4179] Reg. § 1.101-1(b)(2) is reproduced in the text preceding fn 4143 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

(ii) If the final transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer, the final transferee shall exclude the entire amount of the proceeds from gross income;

(iii) Except where subdivision (ii) of this subparagraph applies, if the basis of the policy or interest transferred, for the purpose of determining gain or loss with respect to the final transferee, is determinable, in whole or in part, by reference to the basis of such policy or interest therein in the hands of the transferor, the amount of the proceeds which is excludable by the final transferee is limited to the sum of—

(a) The amount which would have been excludable by his transferor if no such transfer had taken place, and

(b) Any premiums and other amounts subsequently paid by the final transferee himself.

Thus, under prior regulations, cleansing applied only to a transfer to the insured for valuable consideration and then only if the insured or a permitted transferee was the final transferee. The prior regulations were much more narrow than what the 2019 regulations adopted.

II.Q.4.b.ii.(f). Reporting Requirements for Reportable Policy Sales

See "About Form 1099-LS, Reportable Life Insurance Sale," at https://www.irs.gov/forms-pubs/about-form-1099-ls.

Code § 6050Y, "Returns relating to certain life insurance contract transactions," starts with subsection (a), "Requirements of reporting of certain payments":

(1) *In general*. Every person who acquires a life insurance contract or any interest in a life insurance contract in a reportable policy sale during any taxable year shall make a return for such taxable year (at such time and in such manner as the Secretary shall prescribe) setting forth—

(A) the name, address, and TIN of such person,

(B) the name, address, and TIN of each recipient of payment in the reportable policy sale,

(C) the date of such sale,

(D) the name of the issuer of the life insurance contract sold and the policy number of such contract, and

(E) the amount of each payment.

(2) *Statement to be furnished to persons with respect to whom information is required*. Every person required to make a return under this subsection shall furnish to each person whose name is required to be set forth in such return a written statement showing—

(A) the name, address, and phone number of the information contact of the person required to make such return, and

(B) the information required to be shown on such return with respect to such person, except that in the case of an issuer of a life insurance contract, such statement is not required to include the information specified in paragraph (1)(E).

Code § 6050Y(b), "Requirement of reporting of seller's basis in life insurance contracts," provides:

(1) *In general*. Upon receipt of the statement required under subsection (a)(2) or upon notice of a transfer of a life insurance contract to a foreign person, each issuer of a life insurance contract shall make a return (at such time and in such manner as the Secretary shall prescribe) setting forth—

(A) the name, address, and TIN of the seller who transfers any interest in such contract in such sale,

(B) the investment in the contract (as defined in section 72(e)(6)) with respect to such seller, and

(C) the policy number of such contract.

(2) *Statement to be furnished to persons with respect to whom information is required*. Every person required to make a return under this subsection shall furnish to each person whose name is required to be set forth in such return a written statement showing—

(A) the name, address, and phone number of the information contact of the person required to make such return, and

(B) the information required to be shown on such return with respect to each seller whose name is required to be set forth in such return.

Code § 6050Y(c), "Requirement of reporting with respect to reportable death benefits," provides:

(1) In general. Every person who makes a payment of reportable death benefits during any taxable year shall make a return for such taxable year (at such time and in such manner as the Secretary shall prescribe) setting forth—

(A) the name, address, and TIN of the person making such payment,

(B) the name, address, and TIN of each recipient of such payment,

(C) the date of each such payment,

(D) the gross amount of each such payment, and

(E) such person's estimate of the investment in the contract (as defined in section 72(e)(6)) with respect to the buyer.

(2) Statement to be furnished to persons with respect to whom information is required. Every person required to make a return under this subsection shall furnish to each person whose name is required to be set forth in such return a written statement showing—

(A) the name, address, and phone number of the information contact of the person required to make such return, and

(B) the information required to be shown on such return with respect to each recipient of payment whose name is required to be set forth in such return.

Code § 6050Y(d), "Definitions," provides that, for purposes of Code § 6050Y:

(1) *Payment*. The term "payment" means, with respect to any reportable policy sale, the amount of cash and the fair market value of any consideration transferred in the sale.

(2) *Reportable policy sale*. The term "reportable policy sale" has the meaning given such term in section 101(a)(3)(B).

(3) *Issuer*. The term "issuer" means any life insurance company that bears the risk with respect to a life insurance contract on the date any return or statement is required to be made under this section.

(4) *Reportable death benefits*. The term "reportable death benefits" means amounts paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.

For details on the definition of "reportable policy sale" in Code § 101(a)(3)(B), see part II.Q.4.b.ii.(c) "Reportable Policy Sale".

Part 1.A.3 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Applicability Date for Section 6050Y Regulations," explains:

> Section 1.6050Y-1 of the proposed regulations provides that the rules in § 1.6050Y-1 through 1.6050Y-4 of the proposed regulations apply to reportable policy sales made and reportable death benefits paid after December 31, 2017, and provides transition relief with respect to reporting required on reportable policy sales and payments of reportable death benefits occurring after December 31, 2017, and before the date final regulations under section 6050Y are published in the Federal Register.
>
> One commenter recommended that reporting obligations under section 6050Y (as well as application of the rules under section 101 relating to section 6050Y) be delayed until 60 days after the date the final regulations are published in the Federal Register. Informal comments also were received requesting transition relief (such as delayed reporting) or permanent relief with respect to the reporting obligations under section 6050Y for reportable policy sales and payments of reportable death benefits occurring after December 31, 2017, and before January 1, 2019 (such as waiving the reporting obligations for this period). One commenter requested that at least an additional 30 days be added to the 90-day relief period provided in § 1.6050Y-1(b)(2) and (3) of the proposed regulations for filing returns and furnishing statements required under section 6050Y(b) and (c) and § 1.6050Y-3 and 1.6050Y-4 of the proposed regulations, to give issuers at least 60 days to complete their reporting after the 60-day extension period provided to acquirers of an interest in a life insurance contract under § 1.6050Y-1(b)(1) of the proposed regulations. The commenter asserted that issuers require significantly more time than the 30 days effectively provided to complete Forms 1099-SB, "Seller's Investment in Life Insurance Contract," and 1099-R "Distributions From Pensions, Annuities, Retirement or Profit-Sharing

> Plans, IRAs, Insurance Contracts, etc.", and to add new forms (such as Form 1099-SB) to their systems. The commenter stated that issuers must identify policies that are subject to reporting once the Forms 1099-LS, "Reportable Life Insurance Sale," are received as well as enhance systems to track these policies over their life and transmit data between various systems in order to accurately report under sections 6050Y(b) and (c).
>
> In response to these comments, and to give acquirers and issuers ample time to develop and implement reporting systems, the final regulations provide that the rules in §§ 1.6050Y-1 through 1.6050Y-4 of the final regulations apply to reportable policy sales made and reportable death benefits paid after December 31, 2018. See § 1.6050Y-1(b) of the final regulations. As a result, no reporting is required under section 6050Y for reportable policy sales made and reportable death benefits paid after December 31, 2017, and before January 1, 2019.
>
> Section 1.6050Y-1(a)(12) of the final regulations defines "reportable death benefits" as "amounts paid by reason of the death of the insured under a life insurance contract that are attributable to an interest in the contract that was transferred in a reportable policy sale." Accordingly, because the definition of "reportable policy sale" under § 1.6050Y-1(a)(14) of the final regulations applies only to transfers of interests in life insurance contracts made after December 31, 2018, death benefits are "reportable death benefits" under § 1.6050Y-1(a)(12) of the final regulations and are subject to the reporting requirements of § 1.6050Y-4 of the final regulations only if the death benefits are paid by reason of the death of the insured under a life insurance contract transferred after December 31, 2018, in a reportable policy sale.
>
> The final regulations also provide transition relief as set forth in the proposed regulations with two modifications. First, the transition relief applies with respect to reportable policy sales made and reportable death benefits paid after December 31, 2018, and on or before October 31, 2019. Second, as requested by one of the commenters, § 1.6050Y-1(b)(3), (4), and (5) of the final regulations provide issuers with at least 120 days after the final regulations are published in the Federal Register to file returns and furnish statements under section 6050Y(b) and (c) and §§ 1.6050Y-3 and 1.6050Y-4 of the final regulations. These features of the final regulations are intended to give acquirers and issuers ample time to develop and implement reporting systems.
>
> Noting that 250 or more information returns of a single taxpayer must be filed electronically, one commenter requested waivers from electronic filing for 2018 and 2019 issuer reporting under section 6050Y(b) and (c). The Treasury Department and the IRS have determined not to provide the requested waiver in the final regulations under section 6050Y because procedures already exist for any person required to file 250 or more returns during the calendar year to request a waiver from the requirement to file electronically by showing hardship. See § 301.6011-2(c).

Part 7 of the preamble to the final regulations, T.D. 9879 (10/31/2019), "Comments and Changes Relating to Sec. 1.6050Y-1 of the Proposed Regulations," explains:

> Section 1.6050Y-1 of the proposed regulations provides that the rules in § 1.6050Y-1 through 1.6050Y-4 of the proposed regulations apply to reportable policy sales made and reportable death benefits paid after December 31, 2017, and provides transition relief with respect to reporting required on reportable policy sales and payments of reportable death benefits occurring after December 31, 2017, and before the date final regulations under section 6050Y are published in the Federal Register.

I have not reproduced the rest of the preamble explaining various changes to these regulations.

Reg. § 1.6050Y-2, "Information reporting by acquirers for reportable policy sale payments," provides:

(a) *Requirement of reporting*. Except as provided in paragraph (f) of this section, every person that is an acquirer in a reportable policy sale during any calendar year must file a separate information return with the Internal Revenue Service (IRS) in the form and manner as required by the IRS for each reportable policy sale payment recipient, including any seller that is a reportable policy sale payment recipient. Each return must include the following information with respect to the seller or other reportable policy sale payment recipient to which the return relates:

(1) The name, address, and taxpayer identification number (TIN) of the acquirer;

(2) The name, address, and TIN of the seller or other reportable policy sale payment recipient to which the return relates;

(3) The date of the reportable policy sale;

(4) The name of the 6050Y(a) issuer of the life insurance contract acquired and the policy number of the life insurance contract;

(5) The aggregate amount of reportable policy sale payments made, or to be made, to the seller or other reportable policy sale payment recipient to which the return relates with respect to the reportable policy sale; and

(6) Any other information that is required by the form or its instructions.

(b) *Unified reporting*. The information reporting requirement of paragraph (a) of this section applies to each acquirer in a series of prearranged transfers of an interest in a life insurance contract, as well as each acquirer in a simultaneous transfer of different interests in a single life insurance contract. In either case, an acquirer's reporting obligation is deemed satisfied if the information required by paragraph (a) of this section with respect to that acquirer is timely reported on behalf of that acquirer in a manner that is consistent with forms, instructions, and other IRS guidance by one or more other acquirers or by a third party information reporting contractor.

(c) *Time and place for filing*. Returns required to be made under paragraph (a) of this section must be filed with the Internal Revenue Service Center designated on the prescribed form or in its instructions on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the reportable policy sale occurred. However, see § 1.6050Y-1(b)(5) for transition rules.

(d) *Requirement of and time for furnishing statements*.

(1) *Statements to reportable policy sale payment recipients*.

(i) *Requirement of furnishing statement*. Every person required to file an information return under paragraph (a) of this section with respect to a reportable policy sale payment recipient must furnish in the form and manner prescribed by the IRS to the reportable policy sale payment recipient whose name is set forth in that return a written statement showing the information required by paragraph (a) of this section with respect to the reportable policy sale payment recipient and the name, address, and phone number of the information contact of the person furnishing the written statement. The contact information of the person furnishing the written statement must provide direct access to a person that can answer questions about the statement. The statement is not required to include information with respect to any other reportable policy sale payment recipient in the reportable policy sale or information about reportable policy sale payments to any other reportable policy sale payment recipient.

(ii) *Time for furnishing statement*. Each statement required by paragraph (d)(1)(i) of this section to be furnished to any reportable policy sale payment recipient must be furnished on or before February 15 of the year following the calendar year in which the reportable policy sale occurred. However, see § 1.6050Y-1(b)(2) for transition rules.

(2) *Statements to 6050Y(a) issuers*.

(i) *Requirement of furnishing RPSS*.

(A) *In general*. Except as provided in paragraph (d)(2)(i)(B) of this section, every person required to file a return under paragraph (a) of this section must furnish in the form and manner prescribed by the IRS to the 6050Y(a) issuer whose name is required to be set forth in the return an RPSS with respect to each reportable policy sale payment recipient that is also a seller. Each RPSS must show the information required by paragraph (a) of this section with respect to the seller named therein, except that the RPSS is not required to set forth the amount of any reportable policy sale payment. Each RPSS must also show the name, address, and phone number of the information contact of the person furnishing the RPSS. This contact information must provide direct access to a person that can answer questions about the RPSS.

(B) *Exception from reporting*. An RPSS is not required to be furnished to the 6050Y(a) issuer by an acquirer acquiring an interest in a life insurance contract in an indirect acquisition.

(ii) *Time for furnishing RPSS*. Except as provided in this paragraph (d)(2)(ii), each RPSS required by paragraph (d)(2)(i) of this section to be furnished to a 6050Y(a) issuer must be furnished by the later of 20 calendar days after the reportable policy sale, or 5 calendar days after the end of the applicable state law rescission period. However, if the later date is after January 15 of the year following the calendar year in which the reportable policy sale occurred, the RPSS must be furnished by January 15 of the year following the calendar year in which the reportable policy sale occurred. However, see § 1.6050Y-1(b)(1) for transition rules.

(3) *Unified reporting*. The information reporting requirements of paragraphs (d)(1)(i) and (d)(2)(i) of this section apply to each acquirer in a series of prearranged transfers of an interest in a life insurance contract, as well as each acquirer in a simultaneous transfer of different interests in a single life insurance contract, as described in paragraph (b) of this section. In either case, an acquirer's obligation to furnish statements is deemed satisfied if the information required by paragraphs (d)(1)(i) and (d)(2)(i) of this section with respect to that acquirer is timely reported on behalf of that acquirer consistent with forms, instructions, and other IRS guidance by one or more other acquirers or by a third party information reporting contractor.

(e) *Notice of rescission of a reportable policy sale*. Any person that has filed a return required by section 6050Y(a)(1) and this section with respect to a reportable policy sale must file a corrected return within 15 calendar days of the receipt of notice of the rescission of the reportable policy sale. Any person that has furnished a written statement under section 6050Y(a)(2) and this section with respect to the reportable policy sale must furnish the recipient of that statement with a corrected statement within 15 calendar days of the receipt of notice of the rescission of the reportable policy sale.

(f) *Exceptions to requirement to file*.

(1) An acquirer that is a foreign person is not required to file an information return under paragraph (a) of this section with respect to a reportable policy sale unless -

(i) The life insurance contract (or interest therein) transferred in the sale is on the life of an insured who is a United States person at the time of the sale; or

(ii) The sale is subject to the laws of one or more States of the United States that pertain to acquisitions or sales of life insurance contracts (or interests therein).

(2) An acquirer is not required to file an information return under paragraph (a) of this section with respect to a reportable policy sale payment to a reportable policy sale payment recipient other than the seller if the reportable policy sale payment is reported by the acquirer under section 6041 or 6041A.

(3) An acquirer is not required to file an information return under paragraph (a) of this section with respect to the issuance of a life insurance contract in an exchange pursuant to section 1035. However, the acquirer is required to furnish the 6050Y(a) issuer with the statement required under paragraph (d)(2) of this section as if the acquirer were required to file an information return under paragraph (a) of this section.

(g) *Cross-reference to penalty provisions*.

(1) *Failure to file correct information return*. For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6050Y(a)(1) and this section, see section 6721 and § 301.6721-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(2) *Failure to furnish correct statement*. For provisions relating to the penalty provided for failure to furnish timely a correct statement to identified persons under section 6050Y(a)(2) and this section, see section 6722 and § 301.6722-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

Reg. § 1.6050Y-6, "Information reporting by 6050Y(b) issuers for reportable policy sales and transfers of life insurance contracts to foreign persons," provides:

(a) *Requirement of reporting*. Except as provided in paragraph (f) of this section, each 6050Y(b) issuer that receives an RPSS or any notice of a transfer to a foreign person must file an information return with the Internal Revenue Service (IRS) with respect to each seller in the form and manner prescribed by the IRS. The return must include the following information with respect to the seller:

(1) The name, address, and taxpayer identification number (TIN) of the seller;

(2) The investment in the contract with respect to the seller;

(3) The amount the seller would have received if the seller had surrendered the life insurance contract on the date of the reportable policy sale or the transfer of the contract to a foreign person, or if the date of the transfer to a foreign person is not known to the 6050Y(b) issuer, the date the 6050Y(b) issuer received notice of the transfer; and

(4) Any other information that is required by the form or its instructions.

(b) *Unified reporting*. Each 6050Y(b) issuer subject to the information reporting requirement of paragraph (a) of this section must satisfy that requirement, but a 6050Y(b) issuer's reporting obligation is deemed satisfied if the information required by paragraph (a) of this section with respect to that 6050Y(b) issuer is timely reported on behalf of that 6050Y(b) issuer in a manner that is consistent with forms, instructions, and other IRS guidance by one or more other 6050Y(b) issuers or by a third party information reporting contractor.

(c) *Time and place for filing*. Except as provided in this paragraph (c), returns required to be made under paragraph (a) of this section must be filed with the Internal Revenue Service Center designated on the prescribed form or in its instructions on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the reportable policy sale or the transfer to a foreign person occurred. If the 6050Y(b) issuer does not receive notice of a transfer to a foreign person until after January 31 of the calendar year following the year in which the transfer occurred, returns required to be made under paragraph (a) of this section must be filed by the later of February 28 (March 31 if filed electronically) of the calendar year following the year in which the transfer occurred or thirty days after the date notice is received. However, see § 1.6050Y-1(b)(5) for transition rules.

(d) *Requirement of and time for furnishing statements*.

(1) *Requirement of furnishing statement*. Every 6050Y(b) issuer filing a return required by paragraph (a) of this section must furnish to each seller that is a reportable policy sale payment recipient or makes a transfer to a foreign person and whose name is required to be set forth in the return a written statement showing the information required by paragraph (a) of this section with respect to that seller and the name, address, and phone number of the information contact of the person filing the return. This contact information must provide direct access to a person that can answer questions about the statement.

(2) *Time for furnishing statement*. Except as provided in this paragraph (d)(2), each statement required by paragraph (d)(1) of this section to be furnished to any seller must be furnished on or before February 15 of the year following the calendar year in which the reportable policy sale or transfer to a foreign person occurred. If a 6050Y(b) issuer does not receive notice of a transfer to a foreign person until after January 31 of the calendar year following the year in which the transfer occurred, each statement required to be made under paragraph (d) of this section must be furnished by the date thirty days after the date notice is received. However, see § 1.6050Y-1(b)(3) for transition rules.

(3) *Unified reporting*. Each 6050Y(b) issuer subject to the information reporting requirement of paragraph (d)(1) of this section must satisfy that requirement, but a 6050Y(b) issuer's reporting obligation is deemed satisfied if the information required by paragraph (d)(1) of this section with respect to that 6050Y(b) issuer is timely reported on behalf of that 6050Y(b) issuer consistent with forms, instructions, and other IRS guidance by one or more other 6050Y(b) issuers or by a third party information reporting contractor.

(e) *Notice of rescission of a reportable policy sale or transfer of an insurance contract to a foreign person*. Any 6050Y(b) issuer that has filed a return required by section 6050Y(b)(1) and this section with respect to a reportable policy sale or transfer of an insurance contract to a foreign person must file a corrected return within 15 calendar days of the receipt of notice of the rescission of the reportable policy sale or transfer of the insurance contract to a foreign person. Any 6050Y(b) issuer that has furnished a written statement under section 6050Y(b)(2) and this section with respect to the reportable policy sale or transfer of the insurance contract to a foreign person must furnish the recipient of that statement with a corrected statement within 15 calendar days of the receipt of notice of the rescission of the reportable policy sale or transfer of the insurance contract to a foreign person.

(f) *Exceptions to requirement to file*. A 6050Y(b) issuer is not required to file an information return under paragraph (a) of this section if paragraph (f)(1), (2), or (3) of this section applies.

(1) Except as provided in this paragraph (f)(1), the 6050Y(b) issuer obtains documentation upon which it may rely to treat a seller of a life insurance contract or interest therein as a foreign beneficial owner in accordance with § 1.1441-1(e)(1)(ii), applying in such case the provisions of § 1.1441-1 by substituting the term "6050Y(b) issuer" for the term "withholding agent" and without regard to the fact that that these provisions apply only to amounts subject to withholding under chapter 3 of subtitle A of the Internal Revenue Code. A 6050Y(b) issuer may also obtain from a seller that is a partnership or trust, in addition to documentation establishing the entity's foreign status, a written certification from the entity that no beneficial owner of any portion of the proceeds of the sale is a United States person. In such a case, the issuer may rely upon the written certification to treat the partnership or trust as a foreign beneficial owner for purposes of this paragraph (f)(1) provided that the seller does not have actual knowledge that a United States person is the beneficial owner of all or a portion of the proceeds of the sale. See § 1.1441-1(c)(6)(ii) for the definition of beneficial owner that applies for purposes of this paragraph (f)(1). Additionally, for certifying its status as a foreign beneficial owner (as applicable) for purposes of this paragraph (f)(1), a seller that is required to report any of the income from the sale as effectively connected with the conduct of a trade or business in the United States under section 864(b) is required to provide to the 6050Y(b) issuer a Form W-8ECI, Certificate of Foreign Person's Claim that Income is Effectively Connected with the Conduct of a Trade or Business in the United States. If a 6050Y(b) issuer obtains a Form W-8ECI from a seller with respect to the sale or has reason to know that income from the sale is effectively connected with the conduct of a trade or business in the United States under section 864(b), the exception to reporting described in this paragraph (f)(1) does not apply.

(2) The 6050Y(b) issuer receives notice of a transfer to a foreign person, but does not receive an RPSS with respect to the transfer, provided that, at the time the notice is received -

(i) The 6050Y(b) issuer is not a United States person;

(ii) The life insurance contract (or interest therein) transferred is not on the life of a United States person; and

(iii) The 6050Y(b) issuer has not classified the seller as a United States person in its books and records.

(3) The RPSS received by the 6050Y(b) issuer is with respect to the 6050Y(b) issuer's issuance of a life insurance contract to a policyholder in an exchange pursuant to section 1035.

(g) *Cross-reference to penalty provisions*.

(1) *Failure to file correct information return*. For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6050Y(b)(1) and this section, see section 6721 and § 301.6721-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(2) *Failure to furnish correct statement*. For provisions relating to the penalty provided for failure to furnish timely a correct statement to identified persons under section 6050Y(b)(2) and this section, see section 6722 and § 301.6722-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

Reg. § 1.6050Y-7, "Information reporting by payors for reportable death benefits," provides:

(a) *Requirement of reporting*. Except as provided in paragraph (e) of this section, every person that is a payor of reportable death benefits during any calendar year must file a separate information return for such calendar year with the Internal Revenue Service (IRS) for each reportable death benefits payment recipient in the form and manner prescribed by the IRS. The return must include the following information with respect to the reportable death benefits payment recipient to which the return relates:

(1) The name, address, and taxpayer identification number (TIN) of the payor;

(2) The name, address, and TIN of the reportable death benefits payment recipient;

(3) The date of the payment;

(4) The gross amount of reportable death benefits paid to the reportable death benefits payment recipient during the taxable year;

(5) The payor's estimate of investment in the contract with respect to the buyer, limited to the payor's estimate of the buyer's investment in the contract with respect to the interest for which the reportable death benefits payment recipient was paid; and

(6) Any other information that is required by the form or its instructions.

(b) *Time and place for filing*. Returns required to be made under this section must be filed with the Internal Revenue Service Center designated in the instructions for the form on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the payment of reportable death benefits was made. However, see § 1.6050Y-1(b)(5) for transition rules.

(c) *Requirement of and time for furnishing statements*.

(1) *Requirement of furnishing statement*. Every person required to file an information return under paragraph (a) of this section must furnish to each reportable death benefits payment recipient whose name is required to be set forth in that return a written statement showing the information required by paragraph (a) of this section with respect to that reportable death benefits payment recipient and the name, address, and phone number of the information contact of the payor. This contact information must provide direct access to a person that can answer questions about the statement.

(2) *Time for furnishing statement*. Each statement required by paragraph (c)(1) of this section to be furnished to any reportable death benefits payment recipient must be furnished on or before January 31 of the year following the calendar year in which the payment of reportable death benefits was made. However, see § 1.6050Y-1(b)(4) for transition rules.

(d) *Notice of rescission of a reportable policy sale*. Any person that has filed a return required by section 6050Y(c) and this section with respect to a payment of reportable death benefits must file a corrected return within 15 calendar days of recovering any portion of the reportable death benefits payment from the reportable death benefits payment recipient as a result of the rescission of the reportable policy sale. Any person that has furnished a written statement under section 6050Y(c)(2) and this section with respect to a payment of reportable death benefits must furnish the recipient of that statement with a corrected statement within 15 calendar days of recovering any portion of the reportable death benefits payment from the reportable death benefits payment recipient as a result of the rescission of the reportable policy sale.

(e) *Exceptions to requirement to file*. A payor is not required to file an information return under paragraph (a) of this section with respect to a payment of reportable death benefits if paragraph (e)(1), (2), or (3) of this section applies.

(1) Except as provided in this paragraph (e)(1), the payor obtains documentation in accordance with § 1.1441-1(e)(1)(ii) upon which it may rely to treat the reportable death benefits payment recipient as a foreign beneficial owner of the reportable death benefits, applying in such case the provisions of § 1.1441-1 by substituting the term "payor" for the term "withholding agent" and without regard to the fact that the provisions apply only to amounts subject to withholding under chapter 3 of subtitle A of the Internal Revenue Code. A payor may also obtain from a partnership or trust that is a reportable death benefits recipient, in addition to documentation establishing the entity's foreign status, a written certification from the entity that no beneficial owner of any portion of the reportable death benefits payment is a United States person. In such a case, a payor may rely upon the written certification to treat the partnership or trust as a foreign beneficial owner for purposes of this paragraph (e)(1) provided that the payor does not have actual knowledge that a United States person is the beneficial owner of all or a portion of the reportable death benefits payment. See § 1.1441-1(c)(6)(ii) for the definition of beneficial owner that applies for purposes of this paragraph (e)(1). Other due diligence or reporting requirements may, however, apply to a payor that relies on the exception set forth in this paragraph (e)(1). See § 1.1441-5(c) and (e) (determination of payees of foreign partnerships and certain

foreign trusts for amounts subject to withholding under § 1.1441-2(a)) and § 1.1461-1(b) and (c) (amounts subject to reporting for chapter 3 purposes).

(2) The buyer obtained the life insurance contract (or interest therein) under which reportable death benefits are paid in a reportable policy sale to which the exception to reporting described in § 1.6050Y-3(f)(2) applies.

(3) The payor never received, and has no knowledge of any issuer having received, an RPSS with respect to the interest in a life insurance contract with respect to which the reportable death benefits are paid.

(f) *Cross-reference to penalty provisions*.

(1) *Failure to file correct information return*. For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6050Y(c)(1) and this section, see section 6721 and § 301.6721-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(2) *Failure to furnish correct statement*. For provisions relating to the penalty provided for failure to furnish timely a correct statement to identified persons under section 6050Y(c)(2) and this section, see section 6722 and § 301.6722-1 of this chapter. See section 6724(a) and § 301.6724-1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

II.Q.4.b.ii.(g). Transfer of Interest in an Entity Holding Life Insurance

Under pre-2018 law, a transfer of an interest in an entity did not constitute a transfer of the entity's life insurance under the transfer for value rule. Letter Ruling 9410039, involving a general partnership, held:

> … the admittance of new partners to Taxpayer and/or the withdrawal of partners from Taxpayer will not result in a transfer for valuable consideration under section 101(a)(2) of the life insurance contract on Managing Director, provided there is no termination of the partnership under section 708(b). We express no opinion about the application of section 101(a)(2) in the event that there is a termination of the partnership under section 708(b).[4180]

For an LLC taxed as a partnership, Letter Ruling 200826009 similarly ruled:

> … the sale or exchange of membership interests in X either by N or any of the Investors will not result in a transfer for a "valuable consideration" under § 101(a)(2), provided there is no termination of the partnership under § 708(b)(1)(B).[4181]

2017 tax reform did not change the language that what triggers the transfer for value rules is "a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein."[4182] Code § 101(a)(3)(A) added that the permitted transfer and permitted transferee exceptions

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[4180] [My footnote:] See part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).
[4181] [My footnote:] See part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform).
[4182] Code § 101(a)(2).

to the transfer for value rule "shall not apply in the case of a transfer of a life insurance contract, or any interest therein, which is a reportable policy sale." Code § 101(a)(3)(B) defines a "reportable policy sale" as "the acquisition of an interest in a life insurance contract, directly or indirectly," if the acquirer does not have a required connection to the insured.

As described in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract, Reg. § 1.101-1(e)(1), "Definition," [4183] an "interest" refers to taking "title to or possession of the life insurance contract (also referred to as a life insurance policy), in whole or part, for state law purposes," as well as holding "an enforceable right to receive all or a part of the proceeds of a life insurance contract or to any other economic benefits of the policy" as described in Reg. § 20.2042-1(c)(2) (incidents of ownership).

Applying the above definition of an "interest" in a contract, it appears that for purposes of testing whether a transfer for value has occurred that may affect the exclusion of a death benefit from income, direct ownership of a policy (in whole or in part) must be subjected to a "transfer for a valuable consideration."[4184] Therefore, the conclusion of Letter Rulings 9410039 and 200826009 - that a transfer of a partnership interest does not constitute a deemed transfer of the partnership's insurance policies - would seem to continue to apply. Presumably the same analysis would apply to the transfer of an interest in any other type of entity.

Through this lens, let's consider that a transfer of an interest in an entity may cause the acquirer to have an "indirect acquisition" that constitutes a reportable policy sale.[4185] Although such a transfer does not appear to trigger the transfer for value rule's income taxation of death benefits, it may trigger reporting requirements, given that the rules in part II.Q.4.b.ii.(f) Reporting Requirements for Reportable Policy Sales refer to the definition in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

If the required connection with the insured exists, one does not need to worry about an "indirect acquisition." Also, the "indirect acquisition" rule does not apply if:[4186]

> A partnership, trust, or other entity in which an ownership interest is being acquired directly or indirectly holds the interest in the life insurance contract and acquired that interest before January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with section 6050Y(a) and § 1.6050Y-2.

So, if the entity acquired each life insurance contract before January 1, 2019, one does not need worry about the transfer of any interest in the entity (but, for policies issued after August 17, 2006, see part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance). One also need not worry when dealing with an interest of no more than 5%, if the entity does not hold mainly life insurance contracts.[4187] Otherwise, one may need to file Form 1099-LS for each policy, to qualify for the exception for a reportable policy sale reported in compliance with Code § 6050Y(a) and Reg. § 1.6050Y-2.

[4183] Reg. § 1.101-1(e)(1) is reproduced in the text accompanying fn 4146.

[4184] For a discussion of legislative history supporting this idea, see fn 4139 in part II.Q.4.b.ii The Impact of Reportable Policy Sale on Transfer for Value Rule.

[4185] Reg. § 1.101-1(e)(3)(ii) defines "indirect acquisition" and is reproduced in the text accompanying fn 4148 in part II.Q.4.b.ii.(b) Interest in a Life Insurance Contract. Certain indirect acquisitions that are not treated as reportable policy sales are described in Reg. § 1.101-1(c)(2)(iii), which is reproduced in the text accompanying fn 4155 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

[4186] Reg. § 1.101-1(c)(2)(iii)(A), which is reproduced along with the rest of Reg. § 1.101-1(c)(2) in the text accompanying fn 4155 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

[4187] Reg. § 1.101-1(c)(2)(iii)(B), which is reproduced along with the rest of Reg. § 1.101-1(c)(2) in the text accompanying fn 4155 in part II.Q.4.b.ii.(c) "Reportable Policy Sale" Defined.

Although I feel comfortable taking the position that the rule regarding indirect acquisitions does not cause the transfer of an interest in a business entity to be a transfer for value, the IRS might assert that such a position makes the reportable policy sale rule toothless for income tax purposes, because all one needs to do to protect a life insurance contract from the income tax consequences is to put the life insurance in a partnership wrapper. Thus, the IRS' might argue that an "indirect acquisition" constitutes a "a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein."[4188]

Therefore, when in doubt regarding whether the transfer of an interest in a business entity might constitute an "indirect acquisition," one should consider reporting on Form 1099-LS any policy where the requisite relationship with the insured might not exist, to avoid any argument by the IRS that the policy's death benefit might be subjected to income tax.

II.Q.4.b.iii. Basis in Purchased Life Insurance Contract

Rev. Rul. 2009-13 took the position that the basis of a policy that is sold to a person other than the issuer is not equal to the premiums paid.[4189] Effective for transactions entered into after August 25, 2009 (coinciding with the effective date of the IRS' position), section 13521 of the 2017 tax reform act reversed the IRS' position,[4190] adding Code § 1016(a)(1)(B), which provides:

> Proper adjustment in respect of the property shall in all cases be made for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract.

Rev. Rul. 2020-5 modifies Rev. Ruls. 2009-13 and 2009-14 to effectuate Code § 1016(a)(1)(B).[4191]

For basis step-up when an owner who is not the insured dies and for an analysis of "investment in the contract" (which governs distributions from a policy) generally, see part II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies.

II.Q.4.c. Income Tax Issues in Transferring Life Insurance; Code § 1035

Generally, income tax applies when buying, selling, or swapping policies. However, Code § 1035, "Certain exchanges of insurance policies," provides:

> (a) *General rules*. No gain or loss shall be recognized on the exchange of -
>
> > (1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract or for a qualified long-term care insurance contract;
> >
> > (2) a contract of endowment insurance (A) for another contract of endowment insurance which provides for regular payments beginning at a date not later than the date payments would have

[4188] Code § 101(a)(2).
[4189] See Rev. Ruls. 2009-13 and 2009-14. Commentators disagreed with the IRS' position.
[4190] The Senate report stated:
> The provision provides that in determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract (known as "cost of insurance"). This reverses the position of the IRS in Revenue Ruling 2009-13 that on sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance.

[4191] For details on Rev. Rul. 2020-5, see text accompanying fn 4196.

begun under the contract exchanged, or (B) for an annuity contract, or (C) for a qualified long-term care insurance contract;

(3) an annuity contract for an annuity contract or for a qualified long-term care insurance contract; or

(4) a qualified long-term care insurance contract for a qualified long-term care insurance contract.

(b) *Definitions*. For the purpose of this section -

(1) *Endowment contract*. A contract of endowment insurance is a contract with an insurance company which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life.

(2) *Annuity contract*. An annuity contract is a contract to which paragraph (1) applies but which may be payable during the life of the annuitant only in installments. For purposes of the preceding sentence, a contract shall not fail to be treated as an annuity contract solely because a qualified long-term care insurance contract is a part of or a rider on such contract.

(3) *Life insurance contract*. A contract of life insurance is a contract to which paragraph (1) applies but which is not ordinarily payable in full during the life of the insured. For purposes of the preceding sentence, a contract shall not fail to be treated as a life insurance contract solely because a qualified long-term care insurance contract is a part of or a rider on such contract.

(c) *Exchanges involving foreign persons*. To the extent provided in regulations, subsection (a) shall not apply to any exchange having the effect of transferring property to any person other than a United States person.

(d) *Cross references*.

(1) For rules relating to recognition of gain or loss where an exchange is not solely in kind, see subsections (b) and (c) of section 1031.

(2) For rules relating to the basis of property acquired in an exchange described in subsection (a), see subsection (d) of section 1031.

Reg. § provides, "section 1035 does not apply to such exchanges if the policies exchanged do not relate to the same insured."[4192] Rev. Rul. 90-109 examined a contract that allowed the insured to change (highlighting added):

> A change in contractual terms effected through an option provided in the original contract is treated as an exchange under section 1001 if there is a sufficiently fundamental or material change that the substance of the original contract is altered through the exercise of the option. Under such circumstances, the old contract is treated as if it were actually exchanged for a new one. *Cf.* Rev. Rul. 69-135, 1969-1 C.B. 198 (recognition of realized gain or loss under former section 1002 where bonds of one corporation are converted into stock of another corporation pursuant to an option contained in the bonds). See also Rev. Rul. 79-155, 1979-1 C.B. 153 (addition of new parent as obligor is a change which, together with other changes, constitutes a material change for purposes of section 1001).
>
> In the present situation, X exercised an option in its key person insurance policy that permitted it to change the insured from A, the original insured under the policy, to B, the new insured. This resulted in a change in the fundamental substance of the original contract because the essence of a life insurance contract is the

[4192] Some tax research services make this clause look like part of subsection (c) only, but T.D. 6211 (11/14/56) clearly indents (a), (b), and (c) without indenting this part.

> life that is insured under the contract. Thus, X's exercise of the change-of-insureds option is substantively the same as an actual exchange of contracts and is a sale or other disposition for purposes of section 1001.
>
> Section 1.1035-1 of the regulations expressly excludes from the application of section 1035 exchanges of policies that do not relate to the same insured and thus prevents policy owners from deferring indefinitely recognition of gain with respect to the policy value. Had X actually assigned a life insurance policy on A to the insurance company as consideration for a new life insurance policy on B, any gain realized on the exchange would have been ineligible for nonrecognition treatment under section 1035 of the Code. X cannot avoid the same-insured limitations of section 1035 simply by placing terms in its original documents that obviate the need for an actual exchange but nevertheless effect a de facto exchange of the original contract for a new contract on a different insured. For example, the result would be the same if X insured a person holding a particular position and, thus, no formal substitution is made when a new person occupies that position.

It held:

> The exercise of an option in an insurance policy to change the insured constitutes a sale or other disposition under section 1001 of the Code, and this disposition does not qualify as a tax-free exchange of insurance policies under section 1035.

A taxpayer may roll over part of a policy into another policy. Notice 2011-68, § 2.05 states:

> In *Conway v. Commissioner*, 111 T.C. 350 (1998), *acq.*, 1999-2 C.B. xvi, the Tax Court held that the direct exchange by an insurance company of a portion of an existing annuity contract to an unrelated insurance company for a new annuity contract was a tax-free exchange under § 1035. Such a transaction is sometimes referred to as a "partial exchange." See also Rev. Rul. 2003-76, 2003-2 C.B. 355 (direct transfer of a portion of an annuity contract for a new annuity contract treated as a tax-free exchange under § 1035); Rev. Rul. 2002-75, 2002-2 C.B. 812 (assignment of an entire annuity contract for deposit into a preexisting annuity contract treated as a tax-free exchange under § 1035).

Similarly, Rev. Rul. 92-43 held that a taxpayer's exchange of an annuity contract issued by a life insurance company that has become subject to a rehabilitation, conservatorship, or similar state proceeding, for an annuity contract issued by another life insurance company qualify as tax-free under Code § 1035 if the new contract is funded by a series of two or more payments from the old annuity contract, even in the case of serial funding of a new life insurance contract. Its facts were:

> L1 is a life insurance company within the meaning of section 816(a) of the Code. L1 is domiciled in state O. A owns an annuity contract (Old Contract) issued by L1.
>
> L1 is subject to a O rehabilitation, conservatorship, or similar state proceeding under the jurisdiction and control of the O insurance commissioner and a O court. Under the terms imposed by any O authorities pursuant to the proceeding, L1 is permitted to distribute no more than X percent of the full cash value of the annuity contract. A wishes to terminate all of A's rights in Old Contract and acquire a new annuity contract (New Contract) from L2. L2 is a life insurance company within the meaning of section 816(a) of the Code.
>
> A assigns Old Contract to L2 in exchange for a New Contract. Pursuant to the assignment, L1 pays cash to L2 in an amount that represents X percent of the cash value of Old Contract, and is required to pay L2 an amount equal to any residual value of Old Contract when it is permitted to do so by the O authorities. L2 must credit to New Contract all amounts received from L1.

Rev. Rul. 92-43 reasoned:

> Section 1035(a)(3) of the Code provides that no gain or loss is recognized on the exchange of one annuity contract solely for another annuity contract. Neither the statute nor the regulations contain a time limit for completion of the exchange. In addition, nonrecognition treatment under section 1035 is not expressly conditioned upon the relative policy values of the contracts exchanged, so long as no other property or cash is distributed as part of the exchange.
>
> Under the facts described, A has effected an exchange of annuity contracts. Because section 1035(a)(3) of the Code does not require that an exchange be completed concurrently where the issuer is precluded from distributing the full cash value of the contract, the transaction is a nontaxable exchange of an annuity contract for an annuity contract under that section.

Rev. Rul. 92-43 held:

> Under section 1035 of the Code, A does not recognize gain or loss on the exchange of Old Contract for New Contract even though New Contract will be funded through a series of payments from L1 that may extend over a period of time. The same holding applies in the case of serial funding of an exchange of a life insurance contract for a life insurance, endowment, or annuity contract.

Letter Ruling 200323012 held that a revocable trust could swap tax-free under Code § 1035 two annuity contracts it owned on the life of its deemed owner for one annuity contract that owner owned on her life.[4193]

A life insurance contract may be swapped into another life insurance, endowment, annuity, or qualified long-term care insurance contract. Notice 2011-68, § 3 describes certain changes made by the Pension Protection Act of 2006, P.L. 109-280 (the "PPA"):

> .04. Section 844(b) of the PPA expanded the categories of exchanges that are treated as tax-free under § 1035 to include certain exchanges that involve a qualified long-term care insurance contract. Accordingly, § 1035 now applies to the exchange of a life insurance contract for another life insurance, endowment, annuity, or qualified long-term care insurance contract; an endowment contract for another endowment, annuity, or qualified long-term care insurance contract; an annuity contract for another annuity or qualified long-term care insurance contract; or a qualified long-term care insurance contract for another qualified long-term care insurance contract. The PPA also amended § 1035(b)(2) and (3) to provide that, for purposes of § 1035, a contract does not fail to be treated as a life insurance contract or an annuity contract solely because a qualified long-term care insurance contract is a part of or a rider on the contract.
>
> .05. Just as the direct transfer of a portion of the cash surrender value of an existing deferred annuity contract for a second annuity contract may be treated as a tax-free exchange under § 1035, the direct transfer of a portion of the cash surrender value of an existing deferred annuity contract for a qualified long-term care insurance contract may be treated as a tax-free exchange, provided the requirements of § 1035 are otherwise met. See, *e.g.*, Rev. Proc. 2011-38, 2011-30 I.R.B. 66 (setting forth conditions under which such a transfer will be treated as a tax-free exchange under § 1035); but see, Rev. Rul. 2007-24, 2007-21 I.R.B. 1282 (receipt of a check under a nonqualified annuity contract and endorsement of the check to a second company as consideration for a second annuity contract treated as a distribution under § 72(e), rather than as a tax-free exchange under § 1035).
>
> .06. Although § 7702B(b)(1)(D) and (E) limit the extent to which a qualified long-term care insurance contract may have a cash value or premium refund feature, § 7702B(b)(2)(C) permits the refund of premiums in the event of a complete surrender or cancellation of the contract, provided the amount does

[4193] Letter Ruling 200323012 is discussed (including large excerpts) in part II.J.19.a.v Annuity Contract Issued to Grantor Trust in the text before and after fn 2921.

> not exceed the aggregate premiums paid under the contract. Such a refund is includible in gross income to the extent that any deduction or exclusion was allowable with respect to the premiums. Moreover, § 1031(d) provides that if property is acquired in an exchange described in § 1035(a), then the acquired property's adjusted basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. Accordingly, Treasury and the IRS believe that, under § 1031(d), the adjusted basis of a qualified long-term care insurance contract received in a tax-free exchange under § 1035(a) generally carries over from the life insurance, endowment, annuity, or qualified long-term care insurance contract exchanged.

If one insured in a second-to-die policy has died, Code § 1035 may apply to the exchange of that policy for a policy on the life of only the surviving insured. Consistent with Letter Ruling 9248013, Letter Ruling 9330040 reasoned and held:

> The legislative history of section 1035 of the Code indicates that Congress viewed nonrecognition treatment as appropriate for "individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954).
>
> Trust's proposed assignment of Policy to the issuer of New Policy and its receipt of New Policy will qualify as an exchange of one contract of life insurance for another contract of life insurance under section 1035(a)(1) of the Code. At the time of the proposed exchange, the sole remaining insured on Policy will be A. The sole insured on New Policy will also be A. Therefore, the proposed exchange does not involve a change of insured, which would disqualify the transaction from nonrecognition treatment under section 1035.
>
> Accordingly, under section 1035 of the Code no gain or loss will be recognized by Trust upon the exchange of Policy solely for New Policy. Further, the basis of New Policy in the hands of Trust will, as provided in section 1031(d), be the same as Trust's basis in Policy.
>
> We express no opinion on whether section 1035 of the Code applies to the exchange of a survivorship or "second to die" life insurance contract for a single life insurance contract prior to the death of either of the insureds under the survivorship contract. We also express no opinion on whether Policy or New Policy qualifies as a life insurance contract under section 7702(a).

However, Code § 1035 does not apply to changing from having two insureds under a second-to-die policy to one insured under a policy or from one insured under a policy to two insureds under a second-to-die policy. Letter Ruling 9542037 rejected the application of Code § 1035 in all of the following situations:

> Taxpayer has inquired as to several situations involving exchanges by Taxpayer's policyholders who are spouses. In Situation 1, Spouse A exchanges a life insurance contract insuring solely his own life for a second-to-die life insurance contract covering the lives of both Spouse A and Spouse B. In Situation 2, Spouse A exchanges two life insurance contracts, one of which insures the life of Spouse A and one of which insures the life of Spouse B, for a second-to-die life insurance contract which covers the lives of both Spouse A and Spouse B. In Situation 3, Spouse A and Spouse B jointly exchange separate life insurance contracts each of which insures solely the life of one spouse for a jointly owned second-to-die life insurance contract which covers the lives of both Spouse A and Spouse B. In Situations 4A and 4B respectively, the facts are the same as in Situations 1 and 2 except that a trust is the owner and exchanger of the life insurance contracts involved. In none of the Situations do Spouse A, Spouse B or the trust receive any money or other property not permitted to be transferred without the recognition of gain or loss.

It held:

> In each of the Situations described above, the individual insured under each contract given up in the exchange is not the sole individual insured under the contract received in the exchange. As the contracts do not relate to the same insured, any gain realized on the exchange is ineligible for nonrecognition under section 1035 of the Code.

The transfer for value rule might cause the death benefit to be subject to income tax. see part II.Q.4.a Funding the Buy-Sell.

When life insurance is sold in a taxable transaction, the IRS' position was that:[4194]

[4194] Rev. Rul. 2009-13, Situation 2 provides the following facts and analysis, which works from Situation 1:

> **Situation 1**
> On January 1 of Year 1, A, an individual, entered into a life insurance contract (as defined in § 7702 of the Internal Revenue Code (Code)) with cash value. Under the contract, A was the insured, and the named beneficiary was a member of A's family. A had the right to change the beneficiary, take out a policy loan, or surrender the contract for its cash surrender value. The contract in A's hands was not property described in § 1221(a)(1)-(8).
> On June 15 of Year 8, A surrendered the contract for its $78,000 cash surrender value, which reflected the subtraction of $10,000 of cost-of-insurance charges collected by the issuer for periods ending on or before the surrender of the contract. Through that date, A had paid premiums totaling $64,000 with regard to the life insurance contract. A had neither received any distributions under the contract nor borrowed against the contract's cash surrender value.
> A determines taxable income using the cash method of accounting and files income tax returns on a calendar year basis. As of June 15 of Year 8, A was not a terminally ill individual, nor a chronically ill individual, within the meaning of § 101(g)(4).
> **Situation 2**
> The facts are the same as in Situation 1, except that on June 15 of Year 8, A sold the life insurance contract for $80,000 to B, a person unrelated to A and who would suffer no economic loss upon A's death.
> ….
> **Law and Analysis**
> ….
> In Situation 2, A paid total premiums of $64,000 under the life insurance contract through the date of sale, and $10,000 was subtracted from the contract's cash surrender value as cost-of-insurance charges. Accordingly, A's adjusted basis in the contract as of the date of sale under §§ 1011 and 1012 and the authorities cited above was $54,000 ($64,000 premiums paid less $10,000 expended as cost of insurance).
> Accordingly, A must recognize $26,000 on the sale of the life insurance contract to B, which is the excess of the amount realized on the sale ($80,000) over A's adjusted basis of the contract ($54,000).
> [above two paragraphs were superseded by Rev. Rul. 2020-5, as described in fn 4196.]
> **Character of income recognized on sale of the life insurance contract**
> Unlike Situation 1, which involves the surrender of the life insurance contract to the issuer of the contract, Situation 2 involves an actual sale of the contract. Nevertheless some or all of the gain on the sale of the contract may be ordinary if the substitute for ordinary income doctrine applies.
> The Supreme Court has held, under the so-called substitute for ordinary income doctrine, that property within the meaning of § 1221 does not include claims or rights to ordinary income. Instead, the Court has consistently construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income. *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965). *See also Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958) (consideration received on the sale of a working interest in an oil well represented a substitute for what would have been received in the future as ordinary income, therefore taxable as ordinary income and not capital gain); *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 217, n. 5 (1988) (noting that the substitute for ordinary income doctrine had no application to that case). Thus, ordinary income that has been earned but not recognized by a taxpayer cannot be converted into capital gain by a sale or exchange. *See also Prebola v. Commissioner*, 482 F.3d 610 (2d Cir. 2007); *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004); *Davis v. Commissioner*, 119 T.C. 1 (2002) (applying the substitute for ordinary income doctrine after the Arkansas Best decision).

1. The taxpayer's gain is:

   - Ordinary income to the extent that it does not exceed the excess of the policy's cash value over the taxpayer's "investment in the contract" (this excess referred to later as the "inside build-up"),[4195] and

   - Capital gain to the extent of the balance.

2. The selling taxpayer's basis is reduced by the cost of insurance.

However, as mentioned above, Congress retroactively repealed the IRS' position that the selling taxpayer's basis is reduced by the cost of insurance.[4196]

If the policy is a term policy, then the IRS asserts that the basis is any unexpired premiums and the gain is purely capital gain.[4197] Rev. Rul. 2009-14 discusses tax consequences to the purchaser of a term life insurance policy but must be read in light of the modification to Situation 2 made by Rv. Rul. 2020-5.

The substitute for ordinary income doctrine has been applied to characterize the profit on a sale of an annuity contract or life insurance contract as ordinary income. For example, in *Gallun*, 327 F.2d 809, 811 (7th Cir. 1964), the court stated:

> The question presented has been considered by other courts. Uniformly, they have held that the assignment of income doctrine . . . should be applied and the profits realized from the sale or the surrender value of an annuity or life insurance contract should be treated as ordinary income rather than capital gain. These cases are: *First Nat'l Bank of Kansas City v. Commissioner*, 309 F.2d 587 (8th Cir. 1962); *Rolf v. Commissioner*, 304 F.2d 450 (3d Cir. 1962); *Commissioner v. Phillips*, 275 F.2d 33 (4th Cir. 1960); *Arnfeld v. United States*, 163 F.Supp. 865, 143 Ct. Cl. 277 (1958).

Application of the substitute for ordinary income doctrine is limited to the amount that would be recognized as ordinary income if the contract were surrendered (i.e., to the inside build-up under the contract). Hence, if the income recognized on the sale or exchange of a life insurance contract exceeds the inside build-up under the contract, the excess may qualify as gain from the sale or exchange of a capital asset. *See*, *e.g.*, *Commissioner v. Phillips*, 275 F.2d 33, 36 n. 3 (4th Cir. 1960).

In Situation 2, the inside build-up under A's life insurance contract immediately prior to the sale to B was $14,000 ($78,000 cash surrender value less $64,000 aggregate premiums paid). Hence, $14,000 of the $26,000 of income that A must recognize on the sale of the contract is ordinary income under the substitute for ordinary income doctrine. Because the life insurance contract in A's hands was not property described in § 1221(a)(1)-(8) and was held by A for more than one year, the remaining $12,000 of income is long-term capital gain within the meaning of § 1222(3).

[4195] Although the IRS did not expressly say so, this policy result is required to preserve the integrity of the system described in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy), which also explains why this policy result is required in the text preceding fn. 4211.

[4196] See text accompanying fn 4191 in part II.Q.4.b.iii Basis in Purchased Life Insurance Contract. Thus, Rev. Rul. 2020-5 modifies the analysis of fn 4194:

> In Situations 2 and 3 in Rev. Rul. 2009-13, under § 1016(a)(1)(B), as added by the TCJA, A is not required to reduce A's basis in the contract by the cost of insurance. Accordingly, in Situation 2 of Rev. Rul. 2009-13, A's adjusted basis in the contract equals the premiums paid. A must recognize $16,000 of income on the sale of the contract ($80,000 amount realized on sale less $64,000 adjusted basis). In Situation 3 of Rev. Rul. 2009-13, A's adjusted basis in the contract equals the premiums paid. A will recognize a $25,000 loss on the sale of the contract ($20,000 amount realized on the sale less $45,000 adjusted basis). A will not be permitted to deduct the loss unless the loss is incurred under § 165(c)(1) or (2).

However, Rev. Rul. 2020-5, fn 1 provides:

> Section 13521 of the TCJA only applies to determine a taxpayer's adjusted basis in a life insurance contract under § 1016. Section 13521 of the TCJA does not affect the analysis in Situations 2 and 3 of Rev. Rul. 2009-13 and Situation 2 of Rev. Rul. 2009-14 with respect to the character of any income or loss recognized by a taxpayer on the sale of a life insurance contract.

[4197] Rev. Rul. 2009-13, Situation 1.

Using a life insurance LLC might solve most or all of these issues.[4198]

II.Q.4.d. Income Tax on Distributions or Loans from Contract (Including Surrender of Policy)

To the extent that the distributions are nontaxable death benefits,[4199] the rules described below do not apply.[4200]

Generally, distributions (other than tax-free death benefits) from life insurance contracts are not taxable "the extent allocable to the investment in the contract."[4201] Dividends used to pay premiums are not taxable.[4202] Furthermore, loans generally are also not subject to income tax (without reference to the investment in the contract) while the borrower continues to hold the policy[4203] and are treated as distributions when those exceptions apply.[4204] However, distributions and loans generally are taxable if the policy is a "modified endowment contract," which generally applies when a policy's premiums are paid too quickly in its initial years.[4205]

Any distributions in excess of "investment in the contract" constitute ordinary income.[4206] However, Code § 1234A might be used to argue that income on surrender should be all capital gain.[4207]

"Investment in the contract":[4208]

> as of any date is-
>
> (A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus
>
> (B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

4198 See parts II.Q.4.i Life Insurance LLC, II.M.3 Buying into or Forming a Partnership, and II.Q.8 Exiting From or Dividing a Partnership.

4199 Code § 101(a)(1).

4200 Reg. § 1.72-2(b)(1)(i) provides:

> In general, the amounts to which section 72 applies are any amounts received under the contracts described in paragraph (a)(1) of this section. However, if such amounts are specifically excluded from gross income under other provisions of chapter 1 of the Code, section 72 shall not apply for the purpose of including such amounts in gross income. For example, section 72 does not apply to amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured and are excludable from gross income under section 101(a). See also sections 101(d), relating to proceeds of life insurance paid at a date later than death, and 104(a)(4), relating to compensation for injuries or sickness.

4201 Code §§ 72(e)(1), 72(e)(2)(B)(ii).

4202 Code § 72(e)(4)(B).

4203 Code § 72(e)(4)(A) includes various exceptions.

4204 Code § 72(e)(4)(A) includes various exceptions.

4205 Code § 72(e)(10), using the definition of modified endowment contract in Code § 7702A.

4206 Code § 72(e)(2).

4207 At the 2015 Heckerling Institute, Larry Brody reported having settled a Tax Court case on this basis. See part II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy. Rev. Rul. 2009-13 asserted, without explanation, that Code § 1234A does not apply to a surrender.

4208 Code § 72(e)(6).

However, charges relating to a long-term insurance component of a policy may reduce "investment in the contract."[4209]

What constitutes "other consideration paid for the contract"? Code § 72(g) tells us what to do when the policy is sold:

> (g) **Rules for transferee where transfer was for value**. Where any contract (or any interest therein) is transferred (by assignment or otherwise) for a valuable consideration, to the extent that the contract (or interest therein) does not, in the hands of the transferee, have a basis which is determined by reference to the basis in the hands of the transferor, then—
>
> (1) for purposes of this section, only the actual value of such consideration, plus the amount of the premiums and other consideration paid by the transferee after the transfer, shall be taken into account in computing the aggregate amount of the premiums or other consideration paid for the contract;
>
> (2) for purposes of subsection (c)(1)(B), there shall be taken into account only the aggregate amount received under the contract by the transferee before the annuity starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and
>
> (3) the annuity starting date is January 1, 1954, or the first day of the first period for which the transferee received an amount under the contract as an annuity, whichever is the later.
>
> For purposes of this subsection, the term "transferee" includes a beneficiary of, or the estate of, the transferee.

Code § 72(g)(2) does not apply, because our income is based on Code § 72(e)(6), not Code § 72(c)(1)(B).

Consider the following potential abuse:

1. Policy owner sells the policy and receives capital gain treatment.

2. Buyer receives a new "investment in the contract" under Code § 72(g).

[4209] Notice 2011-68, § 3 describes certain changes made by the Pension Protection Act of 2006, P.L. 109-280 (the "PPA"):
.02. Section 844(a) of the PPA amended § 72(e) by adding a new paragraph, § 72(e)(11). Section 72(e)(11) provides that a charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract made as payment for coverage under a qualified long-term care insurance contract that is part of or a rider on the annuity or life insurance contract is not includible in income. The investment in the contract is reduced (but not below zero) by the charge.
.03. The PPA did not otherwise amend the definition of "investment in the contract" in § 72(c)(1) and 72(e)(6). Accordingly, the Treasury Department and the IRS believe that all premiums paid for a combination contract that is an annuity and also provides long-term care insurance are generally included in investment in the contract under § 72 if (i) the premiums are credited to the contract's cash value (rather than directly to the long-term care insurance contract that is part of or a rider to the contract), and (ii) coverage under the long-term care insurance contract is paid for by charges against the cash value of the contract. Consistently, a waiver of premiums under such a contract, such as on account of disability or because the annuitant has become chronically ill, should be accounted for in the same manner as a waiver of premiums under other contracts for which "investment in the contract" is determined under § 72(c)(1) or 72(e)(6). See, *e.g.*, *Estate of Wong Wing Non v. Commissioner*, 18 T.C. 205 (1952) (waived premiums not treated as constructively received as disability benefits, and therefore not included as part of premium paid for endowment life insurance policy).

3. Buyer cashes in the policy, tax-free.

Given that the buyer has no risk, a policy owner could easily find a straw man to help the policy owner cash in the policy and receive capital gain treatment, avoiding the ordinary income treatment provided by Code § 72(e)(1). Rev. Rul. 2009-13, [4210] Situation 2,[4211] prevents this potential abuse.

Thus, if one sells a policy in a taxable transaction:

1. If and to the extent one has gain, the first tier of this gain is ordinary income.[4212]
2. All of the gain on the sale translates into increased "investment in the contract" against which distributions can be taken tax-free.
3. Be careful to fit within an exception to the transfer for value rules[4213] if the buyer expects to receive death benefit in excess of investment in the contract.

II.Q.4.e. Income Tax Issues When the Owner Who Is Not the Insured Dies

Generally, property an individual owns (including indirectly through a partnership[4214]) receives a new tax basis when that individual dies if that property is included in that individual's estate for estate tax purposes.[4215]

The discussion below focuses on if and the extent to which a life insurance might not get a basis adjustment on the death of an owner who is not insured and then explores practical issues in implementing any basis adjustment that is available.

II.Q.4.e.i. Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured

However, "annuities described in section 72" do not receive a new basis.[4216] Although Code § 72 governs distributions from life insurance companies to policy owners, this provision appears to be aimed at annuity contracts and not life insurance contracts.

Of greater concern is whether the internal build-up in a cash value life insurance contract constitutes "income in respect of a decedent" (IRD) ineligible for a basis adjustment.[4217] Regulations provide:[4218]

> **General definition.** In general, the term "income in respect of a decedent" refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a

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[4210] See fn 4190 in part II.Q.4.b Transfer for Value Rule; Basis for the fact that Rev. Rul. 2009-13 does not apply to basis determinations.
[4211] See fn. 4194.
[4212] See text accompanying fn. 4194.
[4213] Code § 101(a)(2).
[4214] Generally, the partnership need to have a Code § 754 election in place for the partnership's taxable year in which the individual dies or in certain situations when that person's interest in the partnership is later transferred. See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.
[4215] Code § 1014, which applies to more than just what this sentence describes.
[4216] Code § 1014(b)(9); Reg. § 1.1014-2(b)(3)(i).
[4217] Code § 1014(c).
[4218] Reg. § 1.691(a)-1(b).

previous taxable year under the method of accounting employed by the decedent. See the regulations under section 451. Thus, the term includes-

(1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;

(2) Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting; and

(3) Income to which the decedent had a contingent claim at the time of his death.

Income is "accrued" when "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."[4219] 2017 tax reform modified this test; a brief explanation is in the "SUPPLEMENTARY INFORMATION" portion of the preamble to T.D. 9941 (1/6/2021):

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 451(b) and (c) of the Internal Revenue Code (Code).

On December 22, 2017, section 451(b) and (c) were amended by section 13221 of Public Law 115-97 (131 Stat. 2054), commonly referred to as the Tax Cuts and Jobs Act (TCJA). Section 451(b) was amended to provide that, for a taxpayer using an accrual method of accounting (accrual method taxpayer), the all events test for an item of gross income, or portion thereof, is met no later than when the item, or portion thereof, is included in revenue for financial accounting purposes on an applicable financial statement (AFS). Section 451(c) was amended to provide that an accrual method taxpayer may use the deferral method of accounting provided in section 451(c) for advance payments. Unless otherwise indicated, all references to section 451(b) and section 451(c) hereinafter are references to section 451(b) and section 451(c), as amended by the TCJA.

I. Section 451(b)

In general, section 451(a) provides that the amount of any item of gross income is included in gross income for the taxable year in which it is received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period. Under § 1.451-1(a), accrual method taxpayers generally include items of income in gross income in the taxable year when all the events occur that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy (all events test). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. Revenue Ruling 2003-10, 2003-1 C.B. 288; Revenue Ruling 84-31, 1984-1 C.B. 127; Revenue Ruling 80-308, 1980-2 C.B. 162.

[4219] Reg. § 1.451-1(a). On the deduction side, see *U.S. v. General Dynamics Corp.*, 481 U.S. 239 (1987); *U.S. v. Hughes Properties, Inc.*, 476 U.S. 593 (1986); Rev. Rul. 78-212; *Giant Eagle, Inc. v. Commissioner*, 822 F.3d 666 (3rd Cir. 2016), *rev'g* T.C. Memo. 2014-146. In addition to the all events test, the Code § 461(h) economic performance rules may defer deductions.

Section 451(b)(1)(A) provides that, for an accrual method taxpayer, the all events test for an item of gross income, or portion thereof, is met no later than when the item, or portion thereof, is included as revenue in an AFS (AFS Income Inclusion Rule).

Section 451(b)(1)(B) lists exceptions to the AFS Income Inclusion Rule. The AFS Income Inclusion Rule does not apply to taxpayers that do not have an AFS for a taxable year or to any item of gross income from a mortgage servicing contract.

Section 451(b)(1)(C) codifies the all events test, stating that the all events test is met for any item of gross income if all the events have occurred which fix the right to receive such income and the amount of such income can be determined with reasonable accuracy.

Section 451(b)(2) provides that the AFS Income Inclusion Rule does not apply for any item of gross income the recognition of which is determined using a special method of accounting, "other than any provision of part V of subchapter P (except as provided in clause (ii) of paragraph (1)(B))."

Section 451(b)(3) defines an AFS, as referenced in section 451(b)(1)(A)(i), by providing a hierarchical list of financial statements.

Section 451(b)(4) provides that for purposes of section 451(b), in the case of a contract which contains multiple performance obligations, the allocation of the transaction price to each performance obligation is equal to the amount allocated to each performance obligation for purposes of including such item in revenue in the taxpayer's AFS.

Section 451(b)(5) provides that, if the financial results of a taxpayer are reported on the AFS for a group of entities, the group's financial statement shall be treated as the AFS of the taxpayer.

II. Section 451(c)

Section 451(c) provides special rules for the treatment of advance payments. Section 451(c)(1)(A) provides the general rule requiring an accrual method taxpayer to include an advance payment in gross income in the taxable year of receipt. However, section 451(c)(1)(B) permits a taxpayer to elect to include any portion of the advance payment in gross income in the taxable year following the year of receipt to the extent income is not included in revenue in the AFS in the year of receipt. Section 451(c)(1)(B) generally codifies Revenue Procedure 2004-34, 2004-22 I.R.B. 991, which provided for a similar deferral period.

Section 451(c)(2)(A) provides the Secretary of the Treasury or his delegate (Secretary) with the authority to provide the time, form and manner for making the election under section 451(c)(1)(B), and the categories of advance payments for which an election can be made. Under section 451(c)(2)(B), the election is effective for the taxable year that it is first made and for all subsequent taxable years, unless the taxpayer receives the consent of the Secretary to revoke the election. Section 451(c)(3) provides that the deferral election does not apply to advance payments received in the taxable year that the taxpayer ceases to exist.

Section 451(c)(4)(A) defines advance payment for purposes of section 451(c). Under section 451(c)(4)(A), the term advance payment means any payment that meets the following three requirements: (1) The full inclusion of the payment in gross income in the year of receipt is a permissible method of accounting; (2) any portion of the advance payment is included in revenue

> in an AFS for a subsequent tax year; and (3) the advance payment is for goods, services, or such other items that the Secretary has identified. Section 451(c)(4)(B) lists certain payments that are excluded from the definition of advance payment and gives the Secretary the authority to identify other payments to be excluded from the definition. Section 451(c)(4)(C) provides a special definition of the term "receipt" for purposes of the definition of advance payment, and section 451(c)(4)(D) states that rules similar to those for allocating the transaction price among performance obligations in section 451(b)(4) also apply for purposes of section 451(c).

IRD does not include "items which are excluded from gross income under subtitle A."[4220]

When the owner who is not the insured dies, we do not know whether the policy's value in excess of "investment in the contract" (such excess, the "inside build-up") is going to be includible in income (if taken out before the insured dies)[4221] or excluded from income (if received as a nontaxable death benefit).[4222] In other words, it is not true that "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Therefore, the inside build-up has not "accrued" upon that owner's death and cannot constitute IRD.

This analysis is consistent with a test the Tax Court formulated for determining whether proceeds from a sale contract are IRD. The test considers:[4223]

4220 Reg. § 1.691(a)-1(c).

4221 Code § 72(e).

4222 See fns. 4199-4200.

4223 *Estate of Peterson v. Commissioner*, 667 F.2d 675 (8th Cir. 1981), summarizing the Tax Court's holding. Although the Eighth Circuit agreed with the Tax Court's holding and pointed out that the IRS agreed with the test when it appealed, it held that lack of delivery of the sold goods sufficed to prevent IRD treatment:

> Here, the task remaining to be performed by the estate was performance of the contract. We agree with the conclusion of the Tax Court that performance of the contract, which, under the circumstances, involved care and feeding of livestock and delivery, cannot be characterized as a ministerial or minor act. However, we think that characterization of the tasks which remain after the death of the decedent should not necessarily depend upon the nature of the subject matter of the sales transaction. For example, the subject matter of the sales transaction in the present case was livestock, which obviously required care and feeding. What if the subject matter was not livestock but logs or refrigerators? It would still be the task of the decedent's transferee to deliver or otherwise dispose of the logs or refrigerators, even though that type of property does not require the care that livestock does.
>
> We recognize that the analysis followed by the Tax Court emphasizes delivery or disposal of the subject matter of the sales transaction and, to a certain degree, discounts the significance of the sales contract. Compare Gordon, Income in Respect of a Decedent and Sales Transactions, 1961 Wash. U.L.Q. 30, 37-38 (proposing that §691 should apply to sales proceeds if the contract of sale is incomplete at death "only as to delivery of the res and receipt of the purchase price"). Nonetheless, this analysis is not inconsistent with *Trust Co. v. Ross*, *supra*, 392 F.2d at 697, where the contract of sale was executed and the stock was placed in escrow before the death of the decedent and the tasks remaining for the estate were "minor," and *Commissioner v. Linde*, *supra*, 213 F.2d at 4-8, where the decedent had delivered the property before death to the marketing cooperative, thus "converting" the property into a right to receive income. Moreover, "while the death of a decedent can be a fortuitous event tax-wise, it is certainly hard to visualize death as a tax avoidance scheme." Note, Sales Transactions and Income in Respect of a Decedent, *supra*, 3 Ga. L. Rev. at 615. After all, the decedent in a sales case does not prearrange his death in order to shift the responsibility for delivering the subject matter of the sale transaction to his executor or to take advantage of the fair market value basis rule of § 1014(a) and thus avoid the reach of § 691.

However, the IRS does not appear to agree with the Eighth Circuit's emphasis on delivery. Rev. Rul. 82-1 involved the following facts:

> A taxpayer, who used the cash receipts and disbursements method of accounting, held title to a personal residence solely in the taxpayer's name. The taxpayer met all the age, use, and holding requirements of section 121 of the Code relating to the treatment of gain from sale or exchange of a principal residence by an individual who has attained age 55. The taxpayer had not previously made an election under section 121 with respect to any prior sale.

(1) whether the decedent entered into a legally significant arrangement regarding the subject matter of the sale,[5]

(2) whether the decedent performed the substantive (nonministerial) acts required as preconditions to the sale,[6]

(3) whether there existed at the time of the decedent's death any economically material contingencies which might have disrupted the sale,[7] and

(4) whether the decedent would have eventually received the sale proceeds if he or she had lived.[8]

74 T.C. at 639-41.

[5] As noted by the Tax Court, "[t]his arrangement may take a variety of forms: an express executory contract of sale [as in *Trust Co. v. Ross*, *supra*, 392 F.2d 694]; an implied contract for sale [A delivers apples to Y, Y accepts the apples, A dies before Y can pay for them]; or a contractual arrangement with a cooperative marketing association [as in *Commissioner v. Linde*, *supra*, 213 F.2d 1 (no contract or sale, just delivery of grapes to marketing cooperative; proceeds held income in respect of a decedent when received)]." *Estate of Peterson v. Commissioner*, 74 T.C. 630, 639 (1980) (parentheticals substituted and expanded). *See also Halliday v. United States*, 655 F.2d 68, 72 (5th Cir. 1981) (the right to income need not be legally enforceable).

[6] "One indicium of whether a decedent has performed the applicable substantive acts is whether he has delivered, or somehow placed, the subject matter of the sale beyond his control prior to his death." *Estate of Peterson v. Commissioner*, *supra*, 74 T.C. at 640. *Compare* M. Ferguson, J. Freeland & R. Stephens, *Federal Income Taxation of Estates and Beneficiaries*, *supra*, 180-84 ("[E]vend where the property has been made the subject of a binding, executory contract of sale, if the benefits and hazards of ownership are still possessed by the decedent at his death, the property is entitled to a § 1014(a) basis in the hands of his estate, and his negotiated profit will not be taxed to his estate (or to anyone) under § 691 when the sale is completed after his death.") (footnote omitted), with Gordon, Income in Respect of a Decedent and Sales Transactions,

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> The taxpayer entered into a binding executory contract to sell the residence and accepted a down payment. The terms of the contract called for delivery of the deed and possession of the property upon receipt of the balance of the purchase price. After substantial fulfillment of the prerequisites to consummation of the sale and with only ministerial obligations remaining to be performed under the contract, but prior to closing the sale, the taxpayer died and the sale was completed when the executor of the taxpayer's estate received payment in full and delivered the deed.

Rev. Rul. 82-1 held:

> Consistent with the extension of rights and privileges accorded a fiduciary under section 6903, the executor may "stand in the shoes" of the decedent for purposes of making the election under section 121, with respect to the sale of the residence described herein. However, if the executor chooses not to make the election under section 121, or to the extent that the gain exceeds the amount excludable under section 121, the provisions of section 691(a), relating to income in respect of a decedent, will apply. Rev. Rul. 78-32.

In *Trust Co. of Ga. v. Ross*, 392 F.2d 694 (5th Cir. 1967), *aff'g* 262 F.Supp. 900 (N.D. Ga. 1966), cert. denied 393 U.S. 830 (1968), the decedent had fully performed, but the buyer had not met financing contingencies and other contingencies out of the decedent's control remained. The Fifth Circuit found IRD:

> When the facts in these cases are all viewed, it is readily apparent that the proceeds in issue were realized as a consequence of negotiations and an enforceable contract made by Mr. Dinkler, Sr., during his lifetime, and not the result of any material acts or activities by the estate. The right to the proceeds was acquired by the plaintiffs solely by virtue of the death of the decedent and not through their own efforts. Had Mr. Dinkler lived through the closing date, the proceeds would have been income to him and, consequently, they constitute income in respect of a decedent when received by the estate.

> 1961 *Wash. U.L.Q.* 30, 37 (§ 691 should apply to sale proceeds from sales which at the time of the decedent's death are incomplete "only as to delivery of the *res* and receipt of the purchase price").
>
> [7] *Cf. Keck v. Commissioner*, *supra* 415 F.2d at 534 (sale of stock was contingent upon Interstate Commerce Commission approval; proceeds held not income in respect of decedent where ICC approval not granted at time of the decedent's death).
>
> [8] *See* 26 C.F.R. § 1.691(a)-2(b) (Ex. 4) (buy-sell agreement effective at date of death; proceeds not income in respect of a decedent because the decedent could not have received the proceeds if he had lived).

The Tax Court in that case held:[4224]

> Although three of the four requirements tend to support a conclusion opposite to the one reached, all four elements are necessary to support a finding that the decedent possessed a right to the sale proceeds as of his date of death. [fn. omitted] Accordingly, the absence of one of these requirements precludes the applicability of section 691.

In analyzing the requirement that was missing, the Tax Court said:[4225]

> The fourth requirement is that the decedent, himself, would have eventually received (actually or constructively) the sale proceeds if he had lived. This situation may be best exemplified by a typical date-of-death buy-sell agreement between a decedent and his corporation; since, by its terms, the sale is only effective upon the decedent's death, the decedent could not have received the sale proceeds if he had lived. Therefore, the proceeds from such a sale are not income in respect of a decedent.

(Related to this is the "open transaction" doctrine. See part II.A.1.d.ii Monetizing Founder's Remaining Shares After Going Public, discussing the prepaid variable forward Tax Court case of *Estate of Andrew J. McKelvey v. Commissioner* (see fn 56)).

Applying the Tax Court's fourth requirement to the insurance policy analysis, would the decedent have received taxable income from the policy if the decedent/policy owner had lived? The answer is not necessarily – if the insured died while the policy owner was living, the policy owner would have received a tax-free death benefit. The answer would be different if the policy owner had submitted the appropriate forms to cash out the policy before the policy owner died and the insurance company simply had not cut the check before the policy owner died. Thus, if the policy owner has not, before the policy owner's death, submitted whatever documentation is required to cash in the policy, then the events fixing the policy's tax consequences have not occurred before the policy owner's death and the internal cash build-up obtains a basis step-up because it does not constitute IRD.

Insurance companies remain concerned because they view the inside build-up as vested untaxed earnings. Although this argument seems untenable for contracts whose cash value might later decrease, for fully paid whole-life they understandably view it as absolute earnings that will never decrease. Rev. Rul. 2009-

[4224] 74 T.C. at 643-44.

[4225] 74 T.C. at 641. In a case involving a similar issue, farm inputs deducted on the decedent's final returns received a basis step-up at death and could be deducted by his widow on her return, even though their expected use was obvious. See *Backemeyer*, discussed in part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

13[4226] took the position that, on the sale of a life insurance contract, the gain on sale is ordinary income to the extent that it does not exceed the inside build-up.[4227] The substitute-for-income doctrine, under which the IRS states that the asset is not a capital asset to the extent that the doctrine applies, makes them view the inside build-up as IRD. What they do not take into account is that assets that generate ordinary income on sale, such as inventory (which is not a capital asset),[4228] do not constitute IRD unless actually sold before death; an asset's character as an ordinary income asset has nothing to do with IRD characterization unless the income is "accrued"[4229] or is a specified class of assets subject to IRD, neither of which applies to a life insurance contract. If and to the extent that a policy might not constitute a capital asset, that classification is irrelevant, because the Code § 1014 basis step-up rules apply to more than just capital assets.[4230] Furthermore, Rev. Rul. 2009-13 did not say that inside build-up creates gain; it merely said that inside build-up recharacterizes part or all of the gain on sale of the policy as ordinary income. Of course, Rev. Rul. 2009-13 has been retroactively repealed, [4231] so my mention of it simply provides context in which to analyze these issues.

Thus, although the potential ordinary income taxation of inside build-up might make one inclined to view it as IRD, that view has no basis in the law, although I found one probably irrelevant and unsound source that the IRS might try to seize upon in the event of an audit.[4232]

[4226] See fn 4190 in part II.Q.4.b Transfer for Value Rule; Basis for the fact that Rev. Rul. 2009-13 does not apply to basis determinations.

[4227] See fn. 4194.

[4228] Code § 1221(a)(1) provides:

> For purposes of this subtitle, the term capital asset means property held by the taxpayer (whether or not connected with his trade or business), but does not include … stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Note that real estate might or might not constitute inventory. See part II.G.14 Future Development of Real Estate, especially fn. 1553.

[4229] Rev. Rul. 58-436. However, crop shares or livestock received as rent by a decedent, who had employed the cash method of accounting, before the decedent's death, and owned by the decedent at the time of the decedent's death, as well as crop shares or livestock which the decedent had a right to receive as rent at the time of the decedent's death for economic activities occurring before the decedent's death, constitute income in respect of a decedent which is required to be included in gross income, for Federal income tax purposes, in the year in which the crop shares or livestock are sold, or otherwise disposed of. Rev. Rul. 64-289. *Friedman v. Commissioner*, 41 T.C. 428 (1965), *aff'd* 346 F.2d 506 (6th Cir. 1965) and Rev. Rul. 69-102 were disturbed when a taxpayer sought a charitable deduction for the full value of life insurance policies and therefore taxed the taxpayer on ordinary income on the policies' inside build-up based on a combination of the assignment-of-income principle and the taxpayers realizing a benefit (charitable deduction) for that income; Code § 170(e) and Reg. § 1.170A-4(a) address this issue by not permitting a deduction on the portion of the policy that would constitute ordinary income if the policy were sold, so presumably these authorities are obsolete in light of Rev. Rul. 2009-13. Rev. Rul. 69-102 involved an endowment policy, which typically provides for a payout of the accrued income on a specified maturity date, so before the gift all events had occurred that would require the payout of the inside build-up. Once a policy has been annuitized, an assignment triggers the assignment of income doctrine, *Jones v U.S.*, 395 F.2d 938 (6th Cir. 1968), but that should not apply to a policy passing by reason of death to the extent that the policy had not been annuitized.

[4230] For example, nobody has ever suggested that a depreciable building used in a business is not eligible for a new basis under Code § 1014, even though Code § 1221(a)(2) provides that such a building is not a capital asset. See*, e.g.*, Reg. §§ 1.1245-2(c)(1)(iv) and 1.1250-3(b)(2)(i), providing that Code § 1014 can wipe out depreciation recapture when such property is included in the deceased owner's estate. See also the quotes from the U.S. Supreme Court and Tax Court in the text accompanying fn. 2028, found in part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[4231] See fn 4190 in part II.Q.4.b Transfer for Value Rule; Basis for the fact that Rev. Rul. 2009-13 does not apply to basis determinations.

[4232] Rev. Rul. 75-125 (which the Rev. Rul. 92-47 cited as being good law) took the position that stock, which has net unrealized appreciation (NUA) that was not taxed when distributed from a qualified retirement plan, does not receive a basis step-up at death to the extent of that NUA. This ruling preceded *Peterson* (fn. 4223), and I believe it is simply wrong in light of *Peterson*,

II.Q.4.e.ii. Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured

The only direct immediate practical use of a stepped-up basis is avoiding gain on sale. After all, the death benefit is tax-free if one avoids the transfer for value rules (see part II.Q.4.a Funding the Buy-Sell). The remaining big question is any effect on distributions of inside build-up, the taxation of which depends on the "investment in the contract" under Code § 72(g).

The estate of the decedent who is not the insured does not appear to receive a new "investment in the contract" because the contract was not transferred to it "for a valuable consideration." However, if that estate later sold the policy for full value to a different taxpayer:

- The estate would have a stepped-up basis.
- The transferee would have a new "investment in the contract."
- The transferee would need to make sure that the "transfer for value" rules[4233] do not make the death benefit taxable.[4234]

Before buying a cash value policy to be includible in the estate of a person who is not the insured or that might be transferred in a taxable sale (perhaps one that avoids the transfer for value rules), consider asking the insurance company its procedures in this area. Results from that inquiry include the following:

- "We never undertake to make a Code § 72(g) adjustment, because we don't want to be bothered with it." If the insurance company answers that way, ask whether they will honor a request to check the box "taxable amount not determined" so that the taxpayer is not required to disprove what otherwise would be an incorrect Form 1099.
- "We don't want to undertake to make a Code § 72(g) adjustment, but we will do it if a sale violates the transfer for value rules; in that case, we need to tell the IRS the taxable amount at death, so it is worth it to track this." To obtain that Form 1099 reporting, the policy owner's estate might sell the policy in a transaction that violates the transfer for value rules. One might follow that transfer by a transfer to the insured, which would cleanse the transfer for value taint (perhaps other cleansing opportunities are available as well). For example, Dad owns policy on Daughter's life. Dad dies. Dad's estate sells the policy to Son, violating the transfer for value rules (unless an exception applies) and triggering the insurance company tracking the new "investment in the contract." Then Son sells the policy to Daughter (the insured); this transaction would not generate any gain to the extent of Son's basis due to his purchase from Dad's estate, and Daughter's purchase cleanses the transfer-for-value taint because she is the insured. However, one might decide that taking all these steps is not worth the effort and simply ask whether the insurance company will honor a request to check the box "taxable amount not determined."

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because there is no assurance that the gain will ever be realized, and the ruling did not cite any particular support in reaching the conclusion it did. It is also philosophically inconsistent with the IRS' failure to assert assignment of income principles or otherwise impose any taint when NUA property was given to charitable remainder trusts in Letter Rulings 200038050, 200202078, 200215032, 200302048, and 200335017.

[4233] See part II.Q.4.a Funding the Buy-Sell, especially fns. 4122-4134.

[4234] Nothing in Code § 72(g) or Reg. § 1.72-10 suggests that an exception to the transfer for value rules (other than a substituted basis transaction) would make the contract not transferred for a valuable consideration.

II.Q.4.f. Split-Dollar Arrangements

II.Q.4.f.i. Split-Dollar Generally

A split-dollar arrangement is an arrangement in which one party pays part or all of the premiums and one or more of the economic rights to the policy (cash value, death benefits, etc.) are divided. An employer cannot bundle together a number of such arrangements and call them deductible welfare benefit plans; doing so subjects the employer to penalties.[4235] If an employer buys insurance on an employee's life and allows the employee to designate the beneficiary, that arrangement may constitute an ERISA plan.[4236] The IRS has an audit techniques guide on split-dollar arrangements.[4237]

The IRS created split-dollar rules before the U.S. Supreme Court found that interest could be imputed on loans and before Code § 7872 was enacted. During that period, the employer would retain the premiums it paid when the arrangement terminated (whether by death or by unwinding the arrangement – the latter referred to as a "rollout"), and the employee's beneficiary (or employee on rollout) would receive the death benefit (or cash value in the case of a rollout) after reimbursing the premiums paid.[4238] It needed a mechanism to tax long-term interest-free loans, which is what split-dollar was essentially at that time, but without a promissory note. Under that system, the employer was treated as owning the policy and providing taxable economic benefits to the employee each year equal to the value of one year of life insurance protection. This treatment applied whether the employer or employee owned the policy. To avoid estate tax on the death benefit, an irrevocable life insurance trust ("ILIT") would own the policy, so that each year's imputed income to the employee was also a gift to the trust. Eventually, the arrangement would be undone before the employee's death, whether because the annual life insurance protection became too high as the employee got older, because the parties wanted to simplify the arrangement, or termination of employment. Often, the policy's cash value exceeded the premiums paid; and some taxpayers took the position that receipt of the life insurance policy, which had a cash value in excess of the premiums reimbursed to the employer on rollout, was not a taxable event, because the employee (or life insurance trust) already had legal title to the policy. The government was not happy with the taxpayer using the tax fiction of the employer owning the policy before rollout and then ignoring that tax fiction at rollout and responded by promulgating the regulatory regime described below.

Now split-dollar arrangements are governed by Reg. § 1.7872-15, under which premium payments generally are treated as loans, or Reg. § 1.61-22, the "economic benefit regime," under which generally one person is treated as owning all of the policy's cash value and the other person pays, or is treated as paying, for one-year term life insurance to the extent of the death benefit not allocated to the owner or deemed owner.

[4235] *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015). This case involved seven taxpayers, and the parties in approximately 40 other cases agreed to be bound by the result of this case. Notice 2007-83 announced that the IRS would target welfare benefit plans funded by life insurance. Notice 2007-84 announced that the IRS would target certain multi-employer welfare benefit plans. Program Manager Technical Advice 2015-11 explains how to apply the 30% accuracy-related penalty under Code § 6662A(c), to taxpayers who didn't follow the requirement of Notice 2007-83 to disclose participation in a listed transaction that used cash value life insurance policies to provide welfare benefits in a purported Code § 419 plan. The IRS successfully penalized Keller Tank Services II, Inc., one of the employers in the *Our Country Home Enterprises* case, for failure to report its participation in the plan as a "listed transaction" on its tax return. *Keller Tank Services II, Inc. v. Commissioner*, 854 F3d 1192 (10th Cir. 2017).

[4236] And it did in *Alberth v. Southern Lakes Plumbing & Heating, Inc.*, 2020 WL 1082775, 2020 Employee Benefits Cas. 84,566 (E.D. Wis. 3/6/2020) (Docket No. 19-CV-62).

[4237] See http://www.irs.gov/Businesses/Corporations/Split-Dollar-Life-Insurance-Audit-Technique-Guide-(03-2005) and www.irs.gov/businesses/corporations/article/0,id=136548,00.html.

[4238] The reimbursement obligation was nonrecourse – paid only out of the policy and not personally by the employee.

In the economic benefit regime, generally the owner and non-owner receive tax-free death benefits. The owner applies Code § 72 to any distributions that are not death benefits; even a deemed owner is treated as the real owner under Code § 72. See part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement. The other version involves the premium payor being treated as making loans to the policy owner. Generally, interest is actually paid when the insured dies but treated as paid every year,[4239] and the parties need to make an election to give effect to the loan for income and gift tax purposes.[4240] See part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

For the treatment of the economic benefit regime before Reg. § 1.61-22 was promulgated, agreements entered into on or before September 17, 2003 are instead subject to IRS Notices 2001-10 and 2002-8[4241] and Rev. Rul. 2003-105, so long as they are not "materially modified." Reg. § 1.61-22(j) lists some unenlightening safe harbors for what does not constitute a material modification. "Material modification" for this purpose includes changes that would not constitute a material modification under Code § 101(j) (employer-owned life insurance)[4242] or 264(f) (limiting deductions for interest expense allocable to unborrowed policy cash value).[4243]

The economic benefit regime might also trigger the harsh nonqualified deferred compensation rules of Code § 409A.[4244] Although the Code § 409A risk described in fn. 4244 is much smaller under Reg. § 1.61-22 than under prior law, be careful to consider it in either case.[4245]

All split-dollar arrangements require an exit strategy. For the loan regime, somehow the loans must be repaid; however, they do not need to be repaid until the insured's death, so the exit strategy might be easy. For the economic benefit regime, the deemed term portion becomes prohibitively expensive when the

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[4239] Stated interest that is not payable annually triggers the Code § 1272 original issue discount (OID) rules. See text accompanying fns 4289-4294 in part Split-Dollar Loans under Reg. § 1.7872-15.

[4240] See text accompanying fns 4303-4304 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4241] Notice 2002-8 discusses the extent to which changes in the IRS' view might affect arrangements then in effect:

> **VI. Effect On Other Documents**
>
> Notice 2001-10 is revoked. Notwithstanding that revocation, Rev. Rul. 55-747 remains revoked, and Rev. Rul. 64-328, 1964-2 C.B. 11, and Rev. Rul. 66-110 remain modified to the extent that those rulings indicate that an employer's premium payments under a split-dollar life insurance arrangement may not be treated as loans.
>
> Except for Part III (Revised Standards for Valuing Current Life Insurance Protection), no inference should be drawn from this notice regarding the appropriate Federal income, employment and gift tax treatment of split-dollar life insurance arrangements entered into before the date of publication of final regulations. However, taxpayers may rely on this notice (including a reasonable application of the rules to be proposed as described in Part II) or Notice 2001-10 for split-dollar life insurance arrangements entered into before the date of publication of final regulations.

I am aware of a taxpayer who took the position of no income or gift on rollout, filed Form 8275, received a brief question from the IRS, and then heard nothing before the statute of limitations passed. See Thompson Coburn doc. 6348842 (email from an outside lawyer to that effect).

[4242] See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance, especially part II.Q.4.g.i Analysis of Code § 101(j).

[4243] Notice 2008-42.

[4244] See text accompanying fns. 4098-4099.

[4245] Reg. § 1.409A-1(b)(1) provides:

> A legally binding right to an amount that will be excluded from income when and if received does not constitute a deferral of compensation, unless the service provider has received the right in exchange for, or has the right to exchange the right for, an amount that will be includible in income….

Generally, for post-2003 split-dollar agreements, the employee will have to pay for the policy's value under part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22; however, one might want to clarify that the employee will need to pay the greater of the amount provided under the regulations or the policy's fair market value, which as a practical matter would likely to be the value on Form 712. For pre-2003 agreements that are not materially modified, the employee paying the cash surrender value would suffice. Given that these older arrangements might not require the employee to pay the cash surrender value, one should look to Notice 2007-34 to try to make the policy qualify for being grandfathered from Reg. § 1.61-22 and comply with Code § 409A.

insured reaches a certain age, and it is not unusual for the parties not to have planned for how the non-owner obtains ownership for tax purposes (even though they should have). For split-dollar agreements entered into on or before September 17, 2003, when the policy is rolled out with the non-owner merely repaying the premiums:

- The equity (excess of policy value over amount owed the owner) may be taxable, but the no-inference language in fn 4241 supports a reasonable basis argument that lets one take a tax return reporting position that the equity is not taxable, so a taxpayer can take the position, file Form 8275, and see what happens. *Neff v. Commissioner*, T.C. Memo. 2012-244, accepted the IRS' position that the taxpayer had taxable income to the extent that the amount the taxpayer owed the employer on rollout exceeded the amount the employee paid the employer (rather than the employee's argument that the present value of the amount payable at death was the proper measure). It appears that nobody considered whether the employee should have been taxable on the policy's value, which exceeded the amount owed to the employer.

- However, if I can find a way to avoid doing that, I will. For example, if the employer can use the deduction (or is a pass-through entity whose owners can use the deduction), then the employer can afford to gross them up for taxes, because the employer is saving taxes by taking that reporting position. A classic example: Employer and employee are both in the federal and state combined 40% bracket, and the amount of equity is $100. The employer pays the employee a $67 bonus so that the employee can pay the employee's taxes. The employee's taxes are $67, which is 40% of $167, the latter being the sum of the $100 policy value and the $67 bonus. The employer saves $67 taxes by reporting the same $167 compensation value, so the employer is not out-of-pocket anything.

- I successfully use the above strategy most of the time. However, the paradigm falls apart when the employer's tax benefit is less than the employee's tax cost, which often happens when the employer has little taxable income from operations against which to use the deduction. And my solution does not address estate/gift tax issues. So sometimes we need to fall back to the taxpayer taking the position that the equity is not taxable. And I have not heard any war stories about the IRS auditing this issue.

The loan regime can be somewhat unwieldy, in that each year's premium requires a separate loan. Furthermore, the economic benefit regime tends to be most beneficial to the non-owner in the policy's early years, in which the premiums paid tend to exceed the policy's cash value. Considering these issues, one might consider starting with the economic benefit regime and the switching to the loan regime when cash value approaches premium paid. This switching approach avoids administering and accruing interest on multiple loans in the policy's early years and allow cash value increases after that point to benefit the party that originally was the non-owner. By the time the switch occurs, the policy might very well be earning enough dividends to pay premiums, perhaps avoiding the need to administer multiple loans to pay for those future premiums. If the original non-owner is an irrevocable trust, during the economic benefit phase (and of course later) the grantor can make annual exclusion gifts to the trust and perhaps even use leveraged estate planning techniques[4246] to grow the trust so that the trust can afford to pay future premiums and perhaps even retire the split-dollar loans.

[4246] See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.

II.Q.4.f.ii. Technical Details of the Split-Dollar Economic Benefit Regime

II.Q.4.f.ii.(a). Is the Arrangement a Split-Dollar Arrangement?

Generally, in the split-dollar economic benefit regime, the idea is give only pure term protection to the "non-owner" and all other right to the actual or deemed "owner."

Reg. § 1.61-22(b)(1) provides:

> *In general*. A split-dollar life insurance arrangement is any arrangement between an owner and a non-owner of a life insurance contract that satisfies the following criteria -
>
> (i) Either party to the arrangement pays, directly or indirectly, all or any portion of the premiums on the life insurance contract, including a payment by means of a loan to the other party that is secured by the life insurance contract;
>
> (ii) At least one of the parties to the arrangement paying premiums under paragraph (b)(1)(i) of this section is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract; and
>
> (iii) The arrangement is not part of a group-term life insurance plan described in section 79 unless the group-term life insurance plan provides permanent benefits to employees (as defined in § 1.79-0).

Even if the above requirements are not met, any arrangement between an owner and a non-owner of a life insurance contract is treated as a split-dollar life insurance arrangement if it qualifies as a certain compensatory arrangement or shareholder arrangement.[4247]

The following constitutes a split-dollar compensatory arrangement:[4248]

> (A) The arrangement is entered into in connection with the performance of services and is not part of a group-term life insurance plan described in section 79;[4249]

[4247] Reg. § 1.61-22(b)(2)(i).

[4248] Reg. § 1.61-22(b)(2)(ii).

[4249] *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015), discussed this requirement in depth, including the requirement of Reg. § 1.79-1(a)(4) that a group term arrangement not involve individual selection:

> Guardian and Minnesota Life required that the Our Country and Environmental shareholder/employees tender information on their health, traveling tendencies, and/or driving traits. The need to submit that type of personal information as a condition to receiving the insurance strongly suggests, and we find, that the insurers were exercising underwriting judgment with respect to at least the Our Country and Environmental shareholder/employees in connection with the issuance of the life insurance related to them. This finding is further strengthened by the fact that, in the case of Guardian at least, Guardian specifically rated each of Our Country's participating employees for purposes of setting the premiums payable on their policies and offered to try to find a way to reduce the premium attributable to the Blake policy. The mere fact that an insurer such as Guardian or Minnesota Life may add up the premiums that apply to separate policies that it sells on a specific group of insureds and then tender the total as the amount due on a group policy does not necessarily recharacterize the separate policies as part of a single group term life insurance plan. Instead, as we have stated, the exercise of underwriting judgment with respect to the specific persons in a group is indicative of the issuance of individual insurance policies rather than group policies. We hold that the insurance policies at hand are not group term life insurance policies for Federal income tax purposes.

(B) The employer or service recipient pays, directly or indirectly, all or any portion of the premiums; and

(C) Either-

(1) The beneficiary of all or any portion of the death benefit is designated by the employee or service provider or is any person whom the employee or service provider would reasonably be expected to designate as the beneficiary; or[4250]

(2) The employee or service provider has any interest in the policy cash value of the life insurance contract.[4251]

De Los Santos v. Commissioner, T.C. Memo. 2018-155, followed *Our Country Home*. In contrast, if a group-term policy allows employees to buy additional pure term insurance on an after-tax basis without any such purchases affecting the employer-provided group plan, the employees' independent choices do not affect the employer-provided group plan's qualification as such. Letter Ruling 201542003.

[4250] *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015), discussed this requirement in depth:

> The shareholder/employees named the beneficiaries of the death benefits payable under their insurance policies by designating through the Sterling Plan the individuals who would receive the death benefits under the plan, which, in turn were the death benefits under the policy. In addition, those shareholder/employees were assured that their designated beneficiaries would receive any death benefits payable on those policies to the extent that the shareholder/employees died while participants in the plan. Petitioners seek a contrary holding essentially by looking at the life insurance policies through the wider end of a telescope towards its narrower end and seeing that the Sterling Plan is named as the beneficiary on the policies. They conclude from this view that none of the individuals who the participating employees designate to receive the death benefits payable by the Sterling Plan is [t]he beneficiary of all or any portion on the death benefit for purposes of section 1.61-22(b)(2)(ii)(C), Income Tax Regs. We, on the other hand, look telescopically at the life insurance benefit from the narrower end towards the wider end, as one commonly does, and see the ultimate recipient of the death proceeds as the person designated by the shareholder/employees. The fact that the death proceeds from the life insurance policies are funneled through the Sterling Plan to each of the ultimate recipients does not blur our view (or our conclusion) that each of those recipients is the beneficiary of the death benefit for purposes of section 1.61-22(b)(2)(ii)(C), Income Tax Regs. *Cf. Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (To permit the true nature of a transaction to be disguised by mere formalisms *** would seriously impair the effective administration of the tax policies of Congress.); *Minn. Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) (A given result at the end of a straight path is not made a different result because reached by following a devious path.). The light at the end of the tunnel brightly illuminates our conclusion, given that the Sterling Plan would pay no death benefit were it not for the life insurance policies, and the employee to whom a policy relates, rather than the Sterling Plan, is assured of receiving the entire amount that is payable under the terms of the policy.

[4251] *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015), discussed this requirement in depth:

> We also conclude that the shareholder/employees of Our Country and Environmental had interests in the their life insurance policies and the cash values thereof. This conclusion is supported by at least five facts. First, each life insurance policy and any funds related thereto were intended to be received by the corresponding employee or his or her designee(s) and no one else, and those employees were the only ones who had the right to receive or otherwise to redirect to someone else the cash value of the life insurance policies related to them. Second, the employees could elect to receive their policies upon retiring from employment with the employer. Third, the funds in the Sterling Plan could not be accessed by either the employer or by the employer's creditors, and Our Country and the Environmental employees, upon retiring or alternatively upon their employers' ceasing participation in the Sterling Plan, were certain to get those funds in the form of the policies that then passed to the employees. Fourth, a participating employee, before actually receiving the funds in his or her account, could be allowed to direct the investment of those funds and thus enjoy the benefit of any investment gain or suffer the detriment of any investment loss. Fifth, if the participating employee were to die while his or her insurance policy was in force, then the death benefit under that policy would ultimately be paid to his or her beneficiary in accordance with the terms of the policy.
>
> We also find important to our just-stated conclusion that the plan benefits were set to be fully vested either when a shareholder/employee satisfied the vesting requirements that he or she chose (or possibly could choose) in the name of the employer or when the employer terminated the plan. And as to vesting, the shareholder/employees were not

If an employer funds a split-dollar arrangement using a Code § 419(e) welfare benefit fund, the employer and employee retain their status as such under the split-dollar arrangement notwithstanding the fund's role and notwithstanding any delay in the fund remitting premiums to the insurance company.[4252]

The following constitutes a split-dollar shareholder arrangement:[4253]

(A) The arrangement is entered into between a corporation and another person in that person's capacity as a shareholder in the corporation;

(B) The corporation pays, directly or indirectly, all or any portion of the premiums; and

(C) Either-

(1) The beneficiary of all or any portion of the death benefit is designated by the shareholder or is any person whom the shareholder would reasonably be expected to designate as the beneficiary; or

(2) The shareholder has any interest in the policy cash value of the life insurance contract.

II.Q.4.f.ii.(b). Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22

The rules below apply for purposes of the income tax, the gift tax, the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), the Railroad Retirement Tax Act (RRTA), and the Self-Employment Contributions Act of 1954 (SECA).[4254] Generally, the split-dollar economic benefit regime[4255] applies to any arrangement that is not subject to the split-dollar loan regime.[4256] It also applies to a loan arrangement if the following requirements of Reg. § 1.61-22(b)(3)(ii) apply:

(A) The arrangement is entered into in connection with the performance of services, and the employer or service recipient is the owner of the life insurance contract (or is treated as the owner of the contract under paragraph (c)(1)(ii)(A)(1) of this section); or

necessarily bound by the vesting requirements that were initially set in their plans. Instead, at their whim they could accelerate or otherwise change the vesting requirements to their preference. In the case of Mr. Blake, for example, he executed an adoption agreement on July 30, 2006, retroactive to January 1, 2005, that lowered the normal retirement age for the employee participants in the Our Country plan and accelerated his complete vesting to the then-present time.

[4252] *De Los Santos v. Commissioner*, T.C. Memo. 2018-155.

[4253] Reg. § 1.61-22(b)(2)(iii).

[4254] Reg. § 1.61-22(a)(1) provides:

In general. This section provides rules for the taxation of a split-dollar life insurance arrangement for purposes of the income tax, the gift tax, the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), the Railroad Retirement Tax Act (RRTA), and the Self-Employment Contributions Act of 1954 (SECA). For the Collection of Income Tax at Source on Wages, this section also provides rules for the taxation of a split-dollar life insurance arrangement, other than a payment under a split-dollar life insurance arrangement that is a split-dollar loan under § 1.7872-15(b)(1). A split-dollar life insurance arrangement (as defined in paragraph (b) of this section) is subject to the rules of paragraphs (d) through (g) of this section, § 1.7872-15, or general tax rules. For rules to determine which rules apply to a split-dollar life insurance arrangement, see paragraph (b)(3) of this section.

Noticeably absent from the list in the first sentence is estate tax, the consequences of which are provided in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.

[4255] The regulatory framework for the split-dollar economic benefit regime is valid. *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015).

[4256] Reg. § 1.61-22(b)(3)(i).

(B) The arrangement is entered into between a donor and a donee (for example, a life insurance trust) and the donor is the owner of the life insurance contract (or is treated as the owner of the contract under paragraph (c)(1)(ii)(A)(2) of this section).

Generally, "with respect to a life insurance contract, the person named as the policy owner of such contract generally is the owner of such contract.[4257]

However:[4258]

(1) An employer or service recipient is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into in connection with the performance of services if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in paragraph (d)(3) of this section; and

(2) A donor is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into between a donor and a donee (for example, a life insurance trust) if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in paragraph (d)(3) of this section.

Note that (1) above does not prevent an employee from setting up an endorsement arrangement with the employer, in which the employee owns the policy (including cash surrender value) and pays the premiums and the employer pays for some current life insurance protection. In such an arrangement, the employee's interest in the cash value means that current life insurance protection is not the employee's only interest in the policy; therefore, the employee's being named as the policy owner also makes the employee the owner for tax purposes.

Similarly, in a donor-donee economic benefit split-dollar agreement, if the donee is designated the owner of the life insurance policy, then the donee will be treated as the owner for tax purposes if the donee has any interest other than current life insurance protection. Although the donee having actual ownership of the policy would seem risky for this reason, such an arrangement might save estate tax if the donor is not the insured, as described in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.[4259]

For these purposes, Reg. § 1.61-22(d)(3)(i) provides:

> the amount of the current life insurance protection provided to the non-owner for a taxable year (or any portion thereof in the case of the first year or the last year of the arrangement) equals the excess of the death benefit of the life insurance contract (including paid-up additions thereto) over the total amount payable to the owner (including any outstanding policy loans that offset amounts otherwise payable to the owner) under the split-dollar life insurance arrangement, less the portion of the policy cash value actually taken into account under paragraph (d)(1) of this section or paid

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[4257] Reg. § 1.61-22(c)(1)(i), which further provides:

> If two or more persons are named as policy owners of a life insurance contract and each person has, at all times, all the incidents of ownership with respect to an undivided interest in the contract, each person is treated as the owner of a separate contract to the extent of such person's undivided interest. If two or more persons are named as policy owners of a life insurance contract but each person does not have, at all times, all the incidents of ownership with respect to an undivided interest in the contract, the person who is the first-named policy owner is treated as the owner of the entire contract.

[4258] Reg. § 1.61-22(c)(1)(ii)(A).

[4259] Especially fns. 4325-4327.

> for by the non-owner under paragraph (d)(1) of this section for the current taxable year or any prior taxable year.

Reg. § 1.61-22(d)(1) provides:

> In the case of a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section, economic benefits are treated as being provided to the non-owner of the life insurance contract. The non-owner (and the owner for gift and employment tax purposes) must take into account the full value of all economic benefits described in paragraph (d)(2) of this section, reduced by the consideration paid directly or indirectly by the non-owner to the owner for those economic benefits. Depending on the relationship between the owner and the non-owner, the economic benefits may constitute a payment of compensation, a distribution under section 301, a contribution to capital, a gift, or a transfer having a different tax character. Further, depending on the relationship between or among a non-owner and one or more other persons (including a non-owner or non-owners), the economic benefits may be treated as provided from the owner to the non-owner and as separately provided from the non-owner to such other person or persons (for example, as a payment of compensation from an employer to an employee and as a gift from the employee to the employee's child).

Machacek v. Commissioner, T.C. Memo. 2016-55, held that a split-dollar agreement benefitting a shareholder-employee was a compensatory plan, causing income inclusion to the shareholder-employee. The Sixth Circuit reversed, 906 F.3d 429 (2018),[4260] ignoring both parties' briefs and instead citing Reg. § 1.301-1(q)(1), "Split-dollar life insurance arrangements," which provides:

> (i) *Distribution of economic benefits*. The provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement, as defined in § 1.61-22(b)(1) or (2), of economic benefits described in § 1.61-22(d) or of amounts described in § 1.61-22(e) is treated as a distribution of property, the amount of which is determined under § 1.61-22(d) and (e), respectively.
>
> (ii) *Distribution of entire contract or undivided interest therein*. A transfer (within the meaning of § 1.61-22(c)(3)) of the ownership of a life insurance contract (or an undivided interest therein) that is part of a split-dollar life insurance arrangement is a distribution of property, the amount of which is determined pursuant to § 1.61-22(g)(1) and (2).

The Sixth Circuit stated that Reg. § 1.301-1(q)(1)(i) did not differentiate between compensatory and non-compensatory split-dollar arrangements and noted that this was not inconsistent with Reg. § 1.61-22(d)(1), which specifically contemplates that Code § 301 may apply to a split-dollar arrangement. Although such a disproportionate distribution should be cured if an S election is in place, it almost never will cause the corporation to violate the single-class-of-stock rule.[4261]

However, in a unanimous reviewed decision, *De Los Santos v. Commissioner*, 156 T.C. No. 9 (2021), refused to accept this reversal outside the Sixth Circuit, commenting on the enactment of Code § 301(a):

> This provision, Congress explained, "has applicability only to distributions of property to shareholders in their capacity as such." S. Rept. No. 83-1622, at 231 (1954), 1954 U.S.C.C.A.N.

[4260] The Sixth Circuit denied the Government's petition for rehearing on December 9, 2020. 2021-21 I.R.B. 1156 nonacquiesced to the Sixth Circuit's decision.

[4261] See part II.A.2.i Single Class of Stock Rule, especially parts II.A.2.i.ii Temporary Timing Differences; Other Varying Differences (especially fn 259, citing Reg. § 1.1361-1(l)(2)(i)) and II.A.2.i.iii Disproportionate Distributions.

4621, 4868. “For example, a distribution of property to a shareholder who is a creditor of the corporation in satisfaction of his claim against the corporation is not within the scope of section 301.” *Ibid.*

The regulations issued under section 301 must (and can) be interpreted to be consistent with this statutory mandate. Section 1.301-1(a) describes the statute as setting forth “the general rule for treatment of distributions … by a corporation to a shareholder with respect to its stock.” Section 1.301-1(c) states that “[s]ection 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such.”

These general rules, unambiguously stated at the outset of the section 301 regulations, necessarily apply to (and limit) the subsequent, more granular provisions. Those subsequent provisions often refer to “distributions to shareholders” or “property transferred by a corporation to a shareholder,” without explicitly saying-each and every time-that the distribution or transfer is being made to the shareholder “in his capacity as such.”[5] But there was no need for Treasury to include that verbiage in these more granular provisions because the general rules stated at the outset limit the scope of the regulations to distributions by a corporation with respect to its stock.

[5] *See, e.g.*, sec. 1.301-1(b), Income Tax Regs. (specifying time for inclusion in gross income of “[a] distribution made by a corporation to its shareholders,” without specifically stating that the distribution was made to shareholders in their capacity as such); *id*. para. (d)(3) (specifying consequences for “a distribution of property … by a foreign corporation to a shareholder,” without specifically stating that the distribution was made to the shareholder in its capacity as such); *id*. para. (f), Examples (1), (2), and (3) (specifying consequences of various distributions to stockholders, without specifically stating that the distributions were made to them in their capacity as such); *id*. para. (j) (specifying consequences where “property is transferred by a corporation to a shareholder which is not a corporation for an amount less than its fair market value in a sale or exchange,” without specifically stating that the distribution was made to a shareholder in his capacity as such); id. para. (m) (providing that “[t]he cancellation of indebtedness of a shareholder by a corporation shall be treated as a distribution of property,” without specifically stating that this benefit is conferred on the shareholder in his capacity as such).

The same analysis applies to section 1.301-1(q)(1)(i), Income Tax Regs. It says that “[t]he provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement ... of economic benefits … is treated as a distribution of property.” *Ibid*. This sentence necessarily applies only to the provision of economic benefits to a shareholder “in his capacity as such,” because that is the only type of transfer to which section 301 applies. Interpreting “shareholder” to mean “shareholder in his capacity as such” - when used here and in comparable paragraphs of the regulation-is not only justified but is required by the statutory text and by the regulation’s introductory provisions.[6]

[6] The Sixth Circuit suggested that there was “no alternative interpretation that gives meaning to the inclusion of compensatory arrangements in § 1.301-1(q)(1)(i).” *Machacek*, 906 F.3d at 436. Again we respectfully disagree. The “alternative interpretation” that renders this provision consistent with the statute and the rest of the regulation is to interpret “to its shareholder,” as used in sec. 1.301-1(q)(1)(i), to mean “to its shareholder in his capacity as such.” That is the clear meaning of this phrase throughout sec. 1.301-1, Income Tax Regs. See supra note 5.

When proposing and finalizing the split-dollar regulations, Treasury made clear that the manner in which economic benefits are taxed depends on whether the arrangement is a compensatory arrangement or a shareholder arrangement. "[I]f the arrangement were in a compensatory context," Treasury advised, "the employee … would account for the amount as compensation." Sec. 1.61-22, Proposed Income Tax Regs., 67 Fed. Reg. 45417 (July 9, 2002). The final regulations similarly state that the manner in which economic benefits are taxed "[d]epend[s] on the relationship between the owner and the non-owner." Sec. 1.61-22(d)(1), Income Tax Regs. Depending on the capacity in which the non-owner receives the transfer, it "may constitute a payment of compensation, a distribution under section 301, a contribution to capital, a gift, or a transfer having a different tax character." *Ibid*. Under the Sixth Circuit's approach in *Machacek*, economic benefits received by a shareholder would invariably constitute a distribution under section 301, regardless of the relationship that accounts for the payment. We are unable to reconcile that approach either with the text of section 301(a) or with the split-dollar regulations.

Notably, the split-dollar regulations govern the taxation of such arrangements, not only for income and gift tax purposes, but also for employment tax purposes. See sec. 1.61-22(a)(1), Income Tax Regs. ("This section provides rules for the taxation of a split-dollar life insurance arrangement for purposes of … the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), … and the Self-Employment Contributions Act[.]"). It is well established that an S corporation "cannot avoid Federal employment taxes by characterizing compensation … as distributions of the corporation's net income." *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 141, 145-146 (2001), *aff'd sub nom. Yeagle Drywall Co. v. Commissioner*, 54 F. App'x 100 (3d Cir. 2002).

But if a corporate employer could characterize benefits paid to employees under compensatory arrangements as section 301 "distributions," the employer could avoid paying a substantial amount of taxes that fund programs like Medicare and Social Security. An S corporation might even offer its rank-and-file employees a few shares of stock. By converting each employee into a "shareholder," the employer could avoid paying employment taxes on split-dollar insurance benefits, contrary to Treasury's evident purpose in promulgating these rules.

For these reasons, we conclude that the economic benefits received by petitioner husband under the split-dollar arrangement cannot be characterized as "distributions" under section 301. In the notice of deficiency respondent determined that these benefits, having been received under a compensatory arrangement, are taxable as "compensation for services" under section 61(a)(1) and thus as ordinary income. Although we agree that the benefits are taxable as ordinary income, we think the path to that conclusion requires a few additional steps.

Subchapter S governs the tax treatment of S corporations and their share-holders. Section 1372, one of its provisions, is captioned "Partnership Rules to Apply for Fringe Benefit Purposes." Section 1372(a) provides that, "[f]or purposes of applying the provisions of this subtitle [*viz*., subtitle A, dealing with income taxes] which relate to employee fringe benefits - (1) the S corporation shall be treated as a partnership, and (2) any 2-percent shareholder of the S corporation shall be treated as a partner of such partnership." A "2-percent shareholder" is defined to include "any person who owns … more than 2 percent of the outstanding stock of such corporation." Sec. 1372(b).

In *Our Country Home Enterprises*, 145 T.C. at 51, we ruled that an employer's provision of economic benefits to its employees under a compensatory split-dollar arrangement "generally is deemed to be the payment of compensation." But we noted that this general rule is subject to an exception "where the employer is an S corporation that provides the benefits to a 2% shareholder in consideration for services rendered." Ibid. "In the case of such an S corporation," we reasoned, "the 2% shareholder is treated as a partner for purposes of applying the employee fringe benefit rules, the economic benefits are categorized as guaranteed payments under section 707(c), and the 2% shareholder must recognize the amount of the guaranteed payments as gross income under section 61(a)." *Ibid.*; see *Hurst v. Commissioner*, 124 T.C. 16, 35 (2005) (treating an S corporation's payment of insurance premiums on behalf of a 2% shareholder as "guaranteed payments" under section 707(c)).

> Petitioner husband owned 100% of the S Corp.'s stock at all relevant times. Under section 1372(a), the S Corp. is treated as a partnership, and he is treated as a partner, for purposes of determining the taxation of employee fringe benefits. The life insurance benefits petitioner husband received under the split-dollar arrangement are "employee fringe benefits" within the meaning of section 1372. *Our Country Home Enters., Inc.*, 145 T.C. at 51; see *Hurst*, 124 T.C. at 35. Those economic benefits are thus taxed to petitioner husband as "guaranteed payments" under section 707(c) and hence as ordinary income under section 61.

The Tax Court explained its interpretation of "fringe benefit" for the purposes of Code § 1372:[4262]

> The term "fringe benefit" is commonly understood to mean "any form of employee compensation provided in addition to wages or base salary, as a pension, insurance coverage, vacation time, etc." Webster's New World Collegiate Dictionary 568 (4th ed. 2010); see Black's Law Dictionary (11th ed. 2019) (defining "fringe benefit" as a "benefit (other than direct salary or compensation) received by an employee from an employer, such as insurance"); see also Internal Revenue Manual pt. 4.23.5.15(1) (Nov. 22, 2017) (defining "fringe benefit" as a benefit "that an employee receives in addition to regular taxable wages").

> Although the term "fringe benefit" is not defined in the Code, all available evidence suggests that Congress intended to adopt the common understanding of this term, *i.e.*, that a "fringe benefit" includes any employer-provided benefit that supplements an employee's salary, specifically including life insurance benefits. Because the Code "is broad enough to include in taxable income any … benefit conferred on the employee as compensation," *Commissioner v. Smith*, 324 U.S. 177, 181 (1945), any fringe benefit is taxable unless "excluded by § 132 or some other explicit exclusionary rule," Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Employee Compensation*, para. 5.1, at *1 (2020), Westlaw WGL-COMP. Section 132, captioned "Certain fringe benefits," specifically excludes from gross income eight types of fringe benefits, but split-dollar insurance benefits are not among those so excluded.

> Congress codified section 1372 as part of the Subchapter S Revision Act of 1982 (Act), Pub. L. No. 97-354, 96 Stat. at 1682. In the section of the Act governing effective dates Congress provided that, in the case of "existing fringe benefits," section 1372 shall apply "only with respect to taxable years beginning after December 31, 1987." Act sec. 6(d)(1), 96 Stat. at 1699. Congress defined "existing fringe benefit" to mean "any employee fringe benefit of a type which the corporation provided to its employees as of September 28, 1982." *Id*. para. (3). By referring to "any employee fringe benefit," Congress evidently intended to give this term broad scope.

[4262] Code § 132 is referred to in the paragraph accompanying fn 3781 in part II.P.2 C Corporation Advantage Regarding Fringe Benefits.

The Act's legislative history expressed Congress' understanding that "fringe benefits" within the meaning of section 1372 included various insurance benefits, such as death benefits, group term life insurance benefits, and benefits received under accident and health plans. See S. Rept. No. 97-640, at 22 (1982), 1982-2 C.B. 718, 728; H.R. Rept. No. 97-826, at 21 (1982), 1982-2 C.B. 730, 739. Both reports state, without exceptions, that "the treatment of fringe benefits of any person owning more than two percent of the stock of the corporation will be treated in the same manner as a partner in partnership." Ibid. Petitioners offer no plausible explanation why the death benefits they received under the Legacy Plan, unlike all other employer-provided insurance benefits, should be excluded from "fringe benefits" that are subject to this rule.[7]

[7] Notably, the IRS has consistently characterized split-dollar life insurance benefits as "fringe benefits" for purposes of subchapter S. See Priv. Ltr. Rul. 200441023 (Oct. 8, 2004); Priv. Ltr. Rul. 9248019 (Nov. 27, 1992). Petitioners seek to differentiate such benefits from other insurance benefits on the theory that "split-dollar arrangements represent more of a co-ownership of an asset for income tax purposes which benefits both parties." This statement is factually incorrect, at least as applied to the Legacy Plan: The Trust owned the Policy, and the S Corp. was simply deemed "the owner" for purposes of the split-dollar regulations. See sec. 1.61-22(c)(1)(ii)(A)(1), Income Tax Regs. In any event all employee benefit programs may be said to "benefit both parties." Otherwise employers presumably would not offer them to their employees.

Besides pointing us to the correct technical analysis, section 1372 confirms the error of petitioners' reliance on section 1.301-1(q), Income Tax Regs. For purposes of taxing the economic benefits at issue here, section 1372 requires that the S Corp. be treated as a partnership. Although partnerships can distribute property, see secs. 731-737, they cannot make "distributions" covered by section 301, see sec. 301(a) (specifying taxability of distributions of property "made by a corporation to a shareholder"). The regulation on which petitioners rely accordingly has no application to this case. See sec. 1.301-1(q)(1)(i), Income Tax Regs. (addressing the provision of economic benefits "by a corporation to its share-holder"). Thus, even if petitioners were correct in contending that split-dollar insurance benefits received by an employee-shareholder of a C corporation would necessarily be treated as a distribution under section 301, sections 1372 and 707(c) dictate that the result is different for an employee-shareholder of an S corporation who owns 2% or more of its stock. These provisions therefore supply a distinct and independently sufficient basis for denying petitioners' motion for partial summary judgment.[8]

[8] Although the employer in *Machacek*, 906 F.3d at 430, was an S corporation, the Sixth Circuit in its opinion did not address sec. 1372, and neither party appears to have brought that provision to the court's attention.

The opinion says that the compensation is taxable as a Code § 707(c) guaranteed payment. Presumably the IRS will use the logic of Rev. Rul. 91-26 and Announcement 92-16 (both reaffirmed in Notice 2005-8) and reported on Form W-2.

The requirement that the non-owner receive only current life insurance protection means that the non-owner cannot have any other economic benefits, such as current or future access to cash value.[4263] Policy

[4263] Reg. § 1.61-22(d)(2) provides:

Value of economic benefits. The value of the economic benefits provided to a non-owner for a taxable year under the arrangement equals—

cash value excludes surrender charges or other similar charges or reductions and includes policy cash value attributable to paid-up additions.[4264] A non-owner has current access to that portion of the policy cash value (A) to which the non-owner has a current or future right and (B) that currently is directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner's general creditors.[4265] Note that the policy's being inaccessible to the owner is not enough to attribute cash value to the non-owner; the non-owner must also have a current or future right to the cash value.[4266]

(i) The cost of current life insurance protection provided to the non-owner as determined under paragraph (d)(3) of this section;

(ii) The amount of policy cash value to which the non-owner has current access within the meaning of paragraph (d)(4)(ii) of this section (to the extent that such amount was not actually taken into account for a prior taxable year); and

(iii) The value of any economic benefits not described in paragraph (d)(2)(i) or (ii) of this section provided to the non-owner (to the extent not actually taken into account for a prior taxable year).

[4264] Reg. § 1.61-22(d)(4)(i).

[4265] Reg. § 1.61-22(d)(4)(ii). *De Los Santos v. Commissioner*, T.C. Memo. 2018-155, held:

Petitioners had a "future right" to the Policy cash value because they had the exclusive right to designate who would receive death benefits under the Policy. *See Our Country Home Enters.*, Inc., 145 T.C. at 45-46, 53-54. Moreover, once a participating employer had made contributions to the Legacy/Flex Trust, those contributions were irrevocable and were inaccessible to the employer and its creditors. Employers and their creditors likewise had no access to the income or assets (including insurance contracts) held by the Legacy/Flex Trust. Thus, although petitioners during 2011-2012 could not withdraw funds from the Policy or the Legacy/Flex Plan, the Policy cash value, in its entirety, was "inaccessible to the owner" (*i.e.*, the S Corp.) and was "inaccessible to the owner's general creditors." See sec. 1.61-22(d)(4)(ii)(B), Income Tax Regs.[4]

[4] Petitioners insist that they enjoyed no economic benefit beyond the cost of current insurance protection—i.e., $178 for 2011 and $213 for 2012—because they could not withdraw cash from the Policy or from the Legacy/Flex Plan currently. This argument ignores the governing regulation, which explicitly states that a non-owner possessing future rights "has current access to that portion of the policy cash value" that is "inaccessible to the owner" or "inaccessible to the owner's general creditors." Sec. 1.61-22(d)(4)(ii)(B), Income Tax Regs.

Although the Legacy/Flex Plan documents make clear that the Policy cash value was not subject to the claims of any participating employer or its creditors, petitioners assert that a clawback provision in the bankruptcy code could lead to a different outcome. Under 11 U.S.C. sec. 548(e)(1) (2012), a bankruptcy trustee may claw back any transfers made by a debtor within 10 years of the petition date if the transfer (among other things) was made to a self-settled trust or to a similar device whose beneficiary was the debtor. This provision is irrelevant here. The Legacy and Flex Trusts were not self-settled trusts. And the S Corp., the debtor in the scenario petitioners imagine, was not a beneficiary of the Legacy or Flex Trust. We accordingly hold that petitioners had "current access" to the entire cash value of the Policy during 2011 and 2012.

[4266] See fns. 4325-4327, in which the cash value seemed to be as inaccessible to the donor as it could possibly be, and the court dismissed out-of-hand arguments about inaccessibility because the non-owner had no current or future right to any part of the cash value. The split-dollar agreement provided:

Section 2.01. Policy Ownership.

(a) The Trust be the sole and absolute owner of the Policy. and may exercise all ownership rights granted to the owner thereof under the term of the Policy, except as otherwise provided in and limited by this Agreement.

(b) It is the intention of the parties to this Agreement and the purpose of the Collateral Assignment that the Trust shall retain all rights that the Policy grants to the owner thereof, except as otherwise provided in and provided by this Agreement. The sole right of the Donor under this Agreement and under the Collateral Assignment shall be to be repaid the amount due to Donor under this Agreement. Specifically, but without limitation, the Donor shall neither have nor exercise any right as collateral assignee of the Policy that could in any way defeat or impair the Trust's right to receive the Policy Cash Value or the death benefit of the Policy in excess of the total amount due to the Donor under this Agreement. All provisions of this Agreement and of the Collateral Assignment shall be construed so as to carry out such intention and purpose.

Section 2.02. Dividends. All dividends declared and paid on the Policy shall be applied as the Trust shall deem appropriate.

Section 6.01 of the split-dollar agreement said that the agreement is to be interpreted such that the only economic benefit is the current life insurance protection. Query whether the IRs and court assumed that this savings clause meant that the

Now that we have established that the non-owner receives only the term portion and the owner receives everything else, let's discuss how to treat money received with respect to the subject life insurance contract.

For death benefits (noting that Code § 101(a) exempts death benefits from income taxation except to the extent that the transfer for value or rules apply, if at all, or to the extent that the policy's issuance violates the employer-owned life insurance rules):[4267]

(i) *Death benefit proceeds to beneficiary (other than the owner).* Any amount paid to a beneficiary (other than the owner) by reason of the death of the insured is excluded from gross income by such beneficiary under section 101(a) as an amount received under a life insurance contract to the extent such amount is allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

(ii) *Death benefit proceeds to owner as beneficiary.* Any amount paid or payable to an owner in its capacity as a beneficiary by reason of the death of the insured is excluded from gross income of the owner under section 101(a) as an amount received under a life insurance contract to the

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dividends could not be paid to the trust – rather that the trust merely had discretion how to apply the dividends to the policy's cash value; I do not recall them addressing the issue. Note that the trust having a right to be receive dividends itself would have violated the Reg. § 1.61-22(c)(1)(ii)(A)(2) rule that the only right to the policy be current life insurance protection and the consequence of violating that rule would have been that the trust would be deemed the owner for gift tax purposes.

Paragraph 2 of the collateral assignment (also not mentioned in the court's opinion) provided as follows:

> 2. It is expressly agreed that the Assignee's interest in the Policy under and by virtue of this Assignment shall be limited to die following specific rights, and no others: (a) the right to be paid the amount due to the Assignee under the Agreement by recovering said amount directly from the Insurer out of the net death proceeds of the Policy; upon the death of the Insured; and (b) the right to be paid the amount due to the Assignee under the Agreement by recovering said amount from the Assignor out of the Policy Cash Value (as defined in the Agreement), in the event the Policy is surrendered or cancelled by the Assignor or m the event the Agreement is terminated during the Insured's lifetime. The Assignee shall have no other rights or powers in and to the Policy as a result of the assignment of the Policy to the Assignee hereunder, and specifically shall not have the right or power to borrow against or obtain loans or advances on the Policy, make withdrawals from the Policy, nor cancel or surrender the Policy.
>
> 3. Except as otherwise provided in this Assignment and the Agreement, the Assignor shall specifically retain all incidents of ownership in and to the Policy, .including, but not limited to: (a) the sole right to cancel or surrender the Policy at any time provided by the terms of the Policy and at such other times as the Insurer may allow; (b) the sole right to collect and receive all distributions or shares of surplus, dividend deposits or additions to the Policy now or hereafter made or apportioned thereto, and to exercise any and all options contained in the Policy with respect thereto; (c) the sole right to exercise all non forfeiture rights permitted by the return of the Policy or allowed by the Insurer and to receive all benefits and advantages derived therefrom; (d) the sole right to designate and change the beneficiary of the Policy (for any amount in excess of the amount to the .Assignee under the Agreement); (e) the sole right to elect any optional mode of settlement permitted by the Policy or allowed by the Insurer; and (c) the sole right to collect directly from the Insurer that portion of the net death proceeds of the Policy in excess of those proceeds payable to the Assignee under the Agreement; *provided, however,* in no event shall the Assignor possess the right or power to receive loans or other advances respecting the Policy from the Insurer or any other lender; *provided, further,* all of the foregoing rights retained by the Assignor in the Policy hereunder shall be subject to the terms and conditions of the Agreement.

I view the collateral assignment as being limited by the split-dollar agreement.

Notwithstanding any of the above possible interpretations, I recommend making it clear that the donee is not entitled to dividends. This particular policy was variable life insurance but paid dividends presumably because it was a mutual insurance company.

[4267] Reg. § 1.61-22(f)(3). These exceptions are found in parts II.Q.4.b Transfer for Value Rule; Basis and II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

> extent such amount is not allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

Except for death benefits:[4268]

> Any amount received under a life insurance contract that is part of a split-dollar life insurance arrangement … is treated, to the extent provided directly or indirectly to a non-owner of the life insurance contract, as though such amount had been paid to the owner of the life insurance contract and then paid by the owner to the non-owner. The amount received is taxable to the owner in accordance with the rules of section 72. The non-owner (and the owner for gift tax and employment tax purposes) must take the amount described in paragraph (e)(3) of this section into account as a payment of compensation, a distribution [from a corporation],[4269] a contribution to capital, a gift, or other transfer depending on the relationship between the owner and the non-owner.

The owner is the only party who is credited with "investment in the contract" under Code § 72(e)(6).[4270]

If the employee or donee is provided only current life insurance protection so that a policy owned by the that person for state law purposes is treated as owned by the employer or donor for income tax purposes,[4271] then any modification that causes the employer or donor not to be treated as the donor for income tax purposes has the following consequences:[4272]

> (1) If, immediately after such modification, the employer, service recipient, or donor is the owner of the life insurance contract under the split-dollar life insurance arrangement (determined without regard to paragraph (c)(1)(ii)(A) of this section), the employer, service recipient, or donor continues to be treated as the owner of the life insurance contract.
>
> (2) If, immediately after such modification, the employer, service recipient, or donor is not the owner of the life insurance contract under the split-dollar life insurance arrangement (determined without regard to paragraph (c)(1)(ii)(A) of this section), the employer, service recipient, or donor is treated as having made a transfer of the entire life insurance contract to the employee, service provider, or donee under the rules of paragraph (g) of this section as of the date of such modification.
>
> (3) For purposes of this paragraph (c)(1)(ii)(B), entering into a successor split-dollar life insurance arrangement that has the effect of providing any economic benefit in addition to that described

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[4268] Reg. § 1.61-22(e)(1).

[4269] The actual text refers to Code § 301.

[4270] Reg. § 1.61-22(f)(2)(ii) provides:

> *To owner*. Any premium paid by an owner under a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section is included in the owner's investment in the contract under section 72(e)(6). No premium or amount described in paragraph (d) of this section is deductible by the owner (except as otherwise provided in § 1.83-6(a)(5)). Any amount paid by a non-owner, directly or indirectly, to the owner of the life insurance contract for current life insurance protection or for any other economic benefit under the life insurance contract is included in the owner's gross income and is included in the owner's investment in the life insurance contract for purposes of section 72(e)(6) (but only to the extent not otherwise so included by reason of having been paid by the owner as a premium or other consideration for the contract).

[4271] Reg. § 1.61-22(c)(1)(ii)(A), reproduced in the text accompanying fn 4258.

[4272] Reg. § 1.61-22(c)(1)(ii)(B).

> in paragraph (d)(3) of this section is treated as a modification of the prior split-dollar life insurance arrangement.

A transfer of the ownership of a life insurance contract (or an undivided interest in such contract) that is part of a split-dollar life insurance arrangement occurs on the date that a non-owner becomes the owner (within the meaning of Reg. § 1.61-22(c)(1)) of the entire contract or of an undivided interest in the contract.[4273] After a transfer of an entire life insurance contract,[4274] the transferee generally becomes the owner for Federal income, employment, and gift tax purposes, including for purposes of Reg. § 1.61-22.[4275]

Reg. § 1.61-22(g) provides rules for unwinding the arrangement so that the non-owner becomes the owner. Unwinding the agreement before the insured's death would have the following consequences:

1. <u>If the non-owner buys the policy</u> (outside of an employment setting – see footnote):[4276]

    - The buyer (and the seller for gift tax and employment tax purposes) takes into account the excess of the life insurance contract's fair market value at that time over the sum of:[4277]

        - The amount the buyer pays to the seller; and

        - The amount of all economic benefits (cash value and other policy features other than term insurance protection)[4278] actually taken into account by the buyer (and the seller for gift tax and employment tax purposes), plus certain consideration[4279] paid or treated as having been paid by the buyer for such economic benefits, to the extent that it was not previously applied to such economic benefits.[4280]

    The life insurance contract's fair market value used above is the policy's cash value and the value of all other rights under the contract (including any supplemental agreements thereto and whether or not guaranteed), other than the value of current life insurance protection; however, a life

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4273 Reg. § 1.61-22(c)(3).

4274 Reg. § 1.61-22(c)(4), "Undivided interest," provides:

> An undivided interest in a life insurance contract consists of an identical fractional or percentage interest or share in each right, benefit, and obligation with respect to the contract. In the case of any arrangement purporting to create undivided interests where, in substance, the rights, benefits or obligations are shared to any extent among the holders of such interests, the arrangement will be treated as a split-dollar life insurance arrangement.

4275 Preamble to T.D. 9092, which further explains:

> Thus, if the transferor pays premiums after the transfer, the payment of those premiums may be includible in the transferee's gross income if the payments are not split-dollar loans under § 1.7872-15. Alternatively, the arrangement will be subject to the loan regime if the payments constitute split-dollar loans under § 1.7872-15.

4276 Reg. § 1.61-22(g)(3) provides:

> *Exception for certain transfers in connection with the performance of services*. To the extent the ownership of a life insurance contract (or undivided interest in such contract) is transferred in connection with the performance of services, paragraph (g)(1) of this section does not apply until such contract (or undivided interest in such contract) is taxable under section 83. For purposes of paragraph (g)(1) of this section, fair market value is determined disregarding any lapse restrictions and at the time the transfer of such contract (or undivided interest in such contract) is taxable under section 83.

4277 Reg. § 1.61-22(g)(1).

4278 Referring to benefits described in Reg. § 1.61-22(d)(2)(ii) and (iii), which are reproduced in fn. 4263 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

4279 Referring to consideration described in Reg. § 1.61-22(d)(1), which is reproduced in the text following fn 4259 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

4280 Referring to accounting for benefits under Reg. § 1.61-22(e)(3)(ii) or (g)(1)(ii).

insurance contract's fair market value for gift tax purposes is determined under Reg. § 25.2512-6(a).

- Presumably, for income tax purposes the transferor treats the transaction as a sale (to the extent of sale proceeds) or a gift. The transferor's basis would be the fair market value of the split-dollar receivable at the original owner's death plus any premiums paid by the current owner.[4281] The IRS' position is that any part of the gain attributable to cash value inside the policy is ordinary income and the rest of the gain would be capital gain.[4282]

- After a transfer of an life insurance contract (except when such transfer is in connection with the performance of services and the transfer is not yet taxable under Code § 83), the buyer is treated as the owner of such contract for all purposes.[4283] Furthermore, the buyer's investment in the contract[4284] treats as premiums paid the greater of the fair market value of the contract or certain amounts accounted for under the split-dollar rules.[4285] Generally, the buyer does not get credit

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[4281] See part II.Q.4.e.i Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured.
[4282] See fn 4194 in part II.Q.4.c Income Tax Issues in Transferring Life Insurance; Code § 1035.
[4283] Reg. § 1.61-22(g)(4)(i), which applies to a transfer of an entire policy, referring to Reg. §§ 1.61-22(b) and 1.61-2(d)(2)(ii)(A), and continues:

> After the transfer of an undivided interest in a life insurance contract (or, if later, at the time such transfer is taxable under section 83), the person who previously had been the non-owner is treated as the owner of a separate contract consisting of that interest for all purposes, including for purposes of paragraph (b) of this section and for purposes of § 1.61-2(d)(2)(ii)(A).

[4284] For the significance of the "investment in the contract," see part II.Q.4.e.ii Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured.
[4285] Reg. § 1.61-22(g)(4)(ii), "Investment in the contract after transfer," provides:

> (A) *In general*. The amount treated as consideration paid to acquire the contract under section 72(g)(1), in order to determine the aggregate premiums paid by the transferee for purposes of section 72(e)(6)(A) after the transfer (or, if later, at the time such transfer is taxable under section 83), equals the greater of the fair market value of the contract or the sum of the amounts determined under paragraphs (g)(1)(i) and (ii) of this section.
>
> (B) *Transfers between a donor and a donee*. In the case of a transfer of a contract between a donor and a donee, the amount treated as consideration paid by the transferee to acquire the contract under section 72(g)(1), in order to determine the aggregate premiums paid by the transferee for purposes of section 72(e)(6)(A) after the transfer, equals the sum of the amounts determined under paragraphs (g)(1)(i) and (ii) of this section except that—
>
> (1) The amount determined under paragraph (g)(1)(i) of this section includes the aggregate of premiums or other consideration paid or deemed to have been paid by the transferor; and
>
> (2) The amount of all economic benefits determined under paragraph (g)(1)(ii) of this section actually taken into account by the transferee does not include such benefits to the extent such benefits were excludable from the transferee's gross income at the time of receipt.
>
> (C) *Transfers of an undivided interest in a contract*. If a portion of a contract is transferred to the transferee, then the amount to be included as consideration paid to acquire the contract is determined by multiplying the amount determined under paragraph (g)(4)(ii)(A) of this section (as modified by paragraph (g)(4)(ii)(B) of this section, if the transfer is between a donor and a donee) by a fraction, the numerator of which is the fair market value of the portion transferred and the denominator of which is the fair market value of the entire contract.
>
> (D) *Example*. The following example illustrates the rules of this paragraph (g)(4)(ii):
>
> (i) In year 1, donor D and donee E enter into a split-dollar life insurance arrangement as defined in paragraph (b)(1) of this section. D is the owner of the life insurance contract under paragraph (c)(1) of this section. The life insurance contract is not a modified endowment contract as defined in section 7702A. In year 5, D gratuitously transfers the contract, within the meaning of paragraph (c)(3) of this section, to E. At the time of the transfer, the fair market value of the contract is $200,000 and D had paid $50,000 in premiums under the arrangement. In addition, by the time of the transfer, E had current access to $80,000 of policy cash value which was excludable from E's gross income under section 102.
>
> (ii) E's investment in the contract is $50,000, consisting of the $50,000 of premiums paid by D. The $80,000 of policy cash value to which E had current access is not included in E's investment in the contract because such amount was excludable from E's gross income when E had current access to that policy cash value.

toward "investment in the contract" for the economic benefit of any term portion previously taken into account.[4286]

2. If the owner cashes in the policy. The owner reports ordinary income to the extent that the cash received exceeds the premiums paid, without regard to basis, so long as the policy has not been sold (including transfer by pecuniary bequest).[4287]

Reg. § 1.61-22(g), "Examples," provides:

> The following examples illustrate the rules of this section. Except as otherwise provided, each of the examples assumes that the employer (R) is the owner (as defined in paragraph (c)(1) of this section) of a life insurance contract that is part of a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section, that the employee (E) is not provided any economic benefits described in paragraph (d)(2)(iii) of this section, that the life insurance contract is not a modified endowment contract under section 7702A, that the compensation paid to E is reasonable, and that E makes no premium payments. The examples are as follows:
>
> *Example (1)*.
>
> (i) In year 1, R purchases a life insurance contract on the life of E. R is named as the policy owner of the contract. R and E enter into an arrangement under which R will pay all the premiums on the life insurance contract until the termination of the arrangement or E's death. Upon termination of the arrangement or E's death, R is entitled to receive the greater of the aggregate premiums or the policy cash value of the contract. The balance of the death benefit will be paid to a beneficiary designated by E.
>
> (ii) Because R is designated as the policy owner of the contract, R is the owner of the contract under paragraph (c)(1)(i) of this section. In addition, R would be treated as the owner of the contract regardless of whether R were designated as the policy owner under paragraph (c)(1)(i) of this section because the split-dollar life insurance arrangement is described in paragraph (c)(1)(ii)(A)(1) of this section. E is a non-owner of the contract. Under the arrangement between R and E, a portion of the death benefit is payable to a beneficiary designated by E. The arrangement is a split-dollar life insurance arrangement under

[4286] Reg. § 1.61-22(g)(4)(ii), "No investment in the contract for current life insurance protection," provides:

> Except as provided in paragraph (g)(4)(ii)(B) of this section, no amount allocable to current life insurance protection provided to the transferee (the cost of which was paid by the transferee or the value of which was provided to the transferee) is treated as consideration paid to acquire the contract under section 72(g)(1) to determine the aggregate premiums paid by the transferee for purposes of determining the transferee's investment in the contract under section 72(e) after the transfer.

The above preceded the 2017 enactment of Code § 1016(a)(1)(B), which is described in the text accompanying fn 4190 in part II.Q.4.b.iii Basis in Purchased Life Insurance Contract, which perhaps might affect the regulation's validity? However, the regulation discusses "investment in the contract," whereas the statutory change address basis.

[4287] See part II.Q.4.e.ii Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured. Reg. § 1.61-22(f)(2)(ii) provides:

> *To owner*. Any premium paid by an owner under a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section is included in the owner's investment in the contract under section 72(e)(6). No premium or amount described in paragraph (d) of this section is deductible by the owner (except as otherwise provided in § 1.83-6(a)(5)). Any amount paid by a non-owner, directly or indirectly, to the owner of the life insurance contract for current life insurance protection or for any other economic benefit under the life insurance contract is included in the owner's gross income and is included in the owner's investment in the life insurance contract for purposes of section 72(e)(6) (but only to the extent not otherwise so included by reason of having been paid by the owner as a premium or other consideration for the contract).

paragraph (b)(1) or (2) of this section. Because R pays all the premiums on the life insurance contract, R provides to E the entire amount of the current life insurance protection E receives under the arrangement. Therefore, for each year that the split-dollar life insurance arrangement is in effect, E must include in gross income under paragraph (d)(1) of this section the value of current life insurance protection described in paragraph (d)(2)(i) of this section provided to E in each year.

Example (2).

(i) The facts are the same as in Example 1 except that, upon termination of the arrangement or E's death, R is entitled to receive the lesser of the aggregate premiums or the policy cash value of the contract. Under the terms of the arrangement and applicable state law, the policy cash value is fully accessible by R and R's creditors but E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R.

(ii) Because R is designated as the policy owner, R is the owner of the contract under paragraph (c)(1)(i) of this section. E is a non-owner of the contract. For each year that the split-dollar life insurance arrangement is in effect, E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R. Thus, under paragraph (d)(4)(ii) of this section, E has current access to such portion of the policy cash value for each year that the arrangement is in effect. In addition, because R pays all the premiums on the life insurance contract, R provides to E all the economic benefits that E receives under the arrangement. Therefore, for each year that the split-dollar life insurance arrangement is in effect, E must include in gross income under paragraph (d)(1) of this section, the value of all economic benefits described in paragraph (d)(2)(i) and (ii) of this section provided to E in each year.

Example (3).

(i) The facts are the same as in Example 1 except that in year 5, R and E modify the split-dollar life insurance arrangement to provide that, upon termination of the arrangement or E's death, R is entitled to receive the greater of the aggregate premiums or one-half the policy cash value of the contract. Under the terms of the modified arrangement and applicable state law, the policy cash value is fully accessible by R and R's creditors but E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R.

(ii) For each year that the split-dollar life insurance arrangement is in effect, E must include in gross income under paragraph (d)(1) of this section the value of the economic benefits described in paragraph (d)(2)(i) of this section provided to E under the arrangement during that year. In year 5 (and subsequent years), E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the amount payable to R. Thus, under paragraph (d)(4)(ii) of this section, E has current access to such portion of the policy cash value. Thus, in year 5 (and each subsequent year), E must also include in gross income under paragraph (d)(1) of this section the value of the economic benefits described in paragraph (d)(2)(ii) of this section provided to E in each year.

(iii) The arrangement is not described in paragraph (c)(1)(ii)(A)(1) of this section after it is modified in year 5. Because R is the designated owner of the life insurance contract, R continues to be treated as the owner of the contract under paragraph (c)(1)(ii)(B)(1) of this section after the arrangement is modified. In addition, because the modification made by

R and E in year 5 does not involve the transfer (within the meaning of paragraph (c)(3) of this section) of an undivided interest in the life insurance contract from R to E, the modification is not a transfer for purposes of paragraph (g) of this section.

Example (4).

(i) The facts are the same as in Example 2 except that in year 7, R and E modify the split-dollar life insurance arrangement to provide that, upon termination of the arrangement or E's death, R will be paid the lesser of 80 percent of the aggregate premiums or the policy cash value of the contract. Under the terms of the modified arrangement and applicable state law, the policy cash value is fully accessible by R and R's creditors but E has the right to borrow or withdraw at any time the portion of the policy cash value exceeding the lesser of 80 percent of the aggregate premiums paid by R or the policy cash value of the contract.

(ii) Commencing in year 7 (and in each subsequent year), E must include in gross income the economic benefits described in paragraph (d)(2)(ii) of this section as provided in this Example 4(ii) rather than as provided in Example 2(ii). Thus, in year 7 (and in each subsequent year) E must include in gross income under paragraph (d) of this section, the excess of the policy cash value over the lesser of 80 percent of the aggregate premiums paid by R or the policy cash value of the contract (to the extent E did not actually include such amounts in gross income for a prior taxable year). In addition, in year 7 (and each subsequent year) E must also include in gross income the value of the economic benefits described in paragraph (d)(2)(i) of this section provided to E under the arrangement in each such year.

Example (5).

(i) The facts are the same as in Example 3 except that in year 7, E is designated as the policy owner. At that time, E's rights to the contract are substantially vested as defined in § 1.83-3(b).

(ii) In year 7, R is treated as having made a transfer (within the meaning of paragraph (c)(3) of this section) of the life insurance contract to E. E must include in gross income the amount determined under paragraph (g)(1) of this section.

(iii) After the transfer of the contract to E, E is the owner of the contract and any premium payments by R will be included in E's income under paragraph (b)(5) of this section and § 1.61-2(d)(2)(ii)(A) (unless R's payments are split-dollar loans as defined in § 1.7872-15(b)(1)).

Example (6).

(i) In year 1, E and R enter into a split-dollar life insurance arrangement as defined in paragraph (b)(2) of this section. Under the arrangement, R is required to make annual premium payments of $10,000 and E is required to make annual premium payments of $500. In year 5, a $500 policy owner dividend payable to E is declared by the insurance company. E directs the insurance company to use the $500 as E's premium payment for year 5.

(ii) For each year the arrangement is in effect, E must include in gross income the value of the economic benefits provided during the year, as required by paragraph (d)(2) of this section, over the $500 premium payments paid by E. In year 5, E must also include in gross income as compensation the excess, if any, of the $500 distributed to E from the proceeds of the policy owner dividend over the amount determined under paragraph (e)(3)(ii) of this section.

(iii) R must include in income the premiums paid by E during the years the split-dollar life insurance arrangement is in effect, including the $500 of the premium E paid in year 5 with proceeds of the policy owner dividend. R's investment in the contract is increased in an amount equal to the premiums paid by E, including the $500 of the premium paid by E in year 5 from the proceeds of the policy owner dividend. In year 5, R is treated as receiving a $500 distribution under the contract, which is taxed pursuant to section 72.

Example (7).

(i) The facts are the same as in Example 2 except that in year 10, E withdraws $100,000 from the cash value of the contract.

(ii) In year 10, R is treated as receiving a $100,000 distribution from the insurance company. This amount is treated as an amount received by R under the contract and taxed pursuant to section 72. This amount reduces R's investment in the contract under section 72(e). R is treated as paying the $100,000 to E as cash compensation, and E must include that amount in gross income less any amounts determined under paragraph (e)(3)(ii) of this section.

Example (8).

(i) The facts are the same as in Example 7 except E receives the proceeds of a $100,000 specified policy loan directly from the insurance company.

(ii) The transfer of the proceeds of the specified policy loan to E is treated as a loan by the insurance company to R. Under the rules of section 72(e), the $100,000 loan is not included in R's income and does not reduce R's investment in the contract. R is treated as paying the $100,000 of loan proceeds to E as cash compensation. E must include that amount in gross income less any amounts determined under paragraph (e)(3)(ii) of this section.

II.Q.4.f.iii. Split-Dollar Loans under Reg. § 1.7872-15

For purposes of Reg. § 1.7872-15, "split-dollar life insurance arrangement," "owner," and "non-owner" have the same meanings as provided in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.[4288]

Reg. § 1.7872-15(a)(2) provides:[4289]

(i) *General rule*. A payment made pursuant to a split-dollar life insurance arrangement is treated as a loan for Federal tax purposes, and the owner and non-owner are treated, respectively, as the borrower and the lender, if—

[4288] Reg. § 1.7872-15(b), referring to Reg. § 1.61-22(b) and (c).

[4289] Reg. § 1.7872-15(a)(1) provides, "This section applies to split-dollar loans as defined in paragraph (b)(1) of this section." Reg. § 1.7872-15(b)(1) provides, "A split-dollar loan is a loan described in paragraph (a)(2)(i) of this section." Thus, Reg. § 1.7872-15(a)(2)(i) is our starting point.

(A) The payment is made either directly or indirectly by the non-owner to the owner (including a premium payment made by the non-owner directly or indirectly to the insurance company with respect to the policy held by the owner);

(B) The payment is a loan under general principles of Federal tax law or, if it is not a loan under general principles of Federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest); and

(C) The repayment is to be made from, or is secured by, the policy's death benefit proceeds, the policy's cash surrender value, or both.

(ii) *Payments that are only partially repayable*. For purposes of § 1.61-22 and this section, if a non-owner makes a payment pursuant to a split-dollar life insurance arrangement and the non-owner is entitled to repayment of some but not all of the payment, the payment is treated as two payments: one that is repayable and one that is not. Thus, paragraph (a)(2)(i) of this section refers to the repayable payment.

(iii) *Treatment of payments that are not split-dollar loans*. See § 1.61-22(b)(5) for the treatment of payments by a non-owner that are not split-dollar loans.

(iv) *Examples*. The provisions of this paragraph (a)(2) are illustrated by the following examples:

Example (1). Assume an employee owns a life insurance policy under a split-dollar life insurance arrangement, the employer makes premium payments on this policy, there is a reasonable expectation that the payments will be repaid, and the repayments are secured by the policy. Under paragraph (a)(2)(i) of this section, each premium payment is a loan for Federal tax purposes.

Example (2).

(i) Assume an employee owns a life insurance policy under a split-dollar life insurance arrangement and the employer makes premium payments on this policy. The employer is entitled to be repaid 80 percent of each premium payment, and the repayments are secured by the policy. Under paragraph (a)(2)(ii) of this section, the taxation of 20 percent of each premium payment is governed by § 1.61-22(b)(5). If there is a reasonable expectation that the remaining 80 percent of a payment will be repaid in full, then, under paragraph (a)(2)(i) of this section, the 80 percent is a loan for Federal tax purposes.

(ii) If less than 80 percent of a premium payment is reasonably expected to be repaid, then this paragraph (a)(2) does not cause any of the payment to be a loan for Federal tax purposes. If the payment is not a loan under general principles of Federal tax law, the taxation of the entire premium payment is governed by § 1.61-22(b)(5).

Reg. § 1.7872-15(a)(1) provides:

If a split-dollar loan is not a below-market loan, then, except as provided in this section, the loan is governed by the general rules for debt instruments (including the rules for original issue discount (OID) under sections 1271 through 1275 and the regulations thereunder). If a split-dollar loan is a below-market loan, then, except as provided in this section, the loan is governed by section 7872. The timing, amount, and characterization of the imputed transfers between the lender and borrower of a below-market split-dollar loan depend upon the relationship between the parties and upon whether the loan is a demand loan or a term loan. For additional rules relating to the treatment of split-dollar life insurance arrangements, see § 1.61-22.

The OID rules referred to above provide that, if adequate stated interest is not paid annually, payments will be deemed made from the borrower to the lender each year, generating interest income[4290] and generally nondeductible interest,[4291] even though no cash changes hands.[4292] If the split-dollar agreement is between a donor and a donee, consider making the donee be an irrevocable grantor trust, so that no interest income is recognized while the trust is deemed owned by the donor.[4293] Presumably any accrued interest at the time that grantor trust treatment is turned off will be considered principal for income tax purposes; perhaps the promissory note might be drafted so that any accrued but unpaid interest is added to principal on the note's anniversary to further support that treatment.

Generally, a split-dollar loan will bear and accrue interest at the long-term applicable federal rate, so that making the loan does not constitute a gift in a donor-donee setting or compensation in an employer-employee setting. This accrued interest can be ignored for two reasons (in addition to possibly being ignored under general tax principals. First, Reg. § 1.7872-15(a)(4), "Certain interest provisions disregarded," provides:

(i) *In general*. If a split-dollar loan provides for the payment of interest and all or a portion of the interest is to be paid directly or indirectly by the lender (or a person related to the lender), then the requirement to pay the interest (or portion thereof) is disregarded for purposes of this section. All of the facts and circumstances determine whether a payment to be made by the lender (or a person related to the lender) is sufficiently independent from the split-dollar loan for the payment to not be an indirect payment of the interest (or a portion thereof) by the lender (or a person related to the lender).

(ii) *Examples*. The provisions of this paragraph (a)(4) are illustrated by the following examples:

[4290] Code § 1272.

[4291] Reg. § 1.7872-15(c) provides:

Interest deductions for split-dollar loans. The borrower may not deduct any qualified stated interest, OID, or imputed interest on a split-dollar loan. See sections 163(h) and 264(a). In certain circumstances, an indirect participant may be allowed to deduct qualified stated interest, OID, or imputed interest on a deemed loan. See paragraph (e)(2)(iii) of this section (relating to indirect loans).

[4292] Reg. § 1.7872-15(f), "Treatment of stated interest and OID for split-dollar loans," provides:

(1) *In general*. If a split-dollar loan provides for stated interest or OID, the loan is subject to this paragraph (f), regardless of whether the split-dollar loan has sufficient interest. Except as otherwise provided in this section, split-dollar loans are subject to the same Internal Revenue Code and regulatory provisions for stated interest and OID as other loans. For example, the lender of a split-dollar loan that provides for stated interest must account for any qualified stated interest (as defined in § 1.1273-1(c)) under its regular method of accounting (for example, an accrual method or the cash receipts and disbursements method). See § 1.446-2 to determine the amount of qualified stated interest that accrues during an accrual period. In addition, the lender must account under § 1.1272-1 for any OID on a split-dollar loan. However, § 1.1272-1(c) does not apply to any split-dollar loan. See paragraph (h) of this section for a subsequent waiver, cancellation, or forgiveness of stated interest on a split-dollar loan.

(2) *Term, payment schedule, and yield*. The term of a split-dollar term loan determined under paragraph (e)(4)(iii) of this section (other than paragraph (e)(4)(iii)(C) of this section) applies to determine the split-dollar loan's term, payment schedule, and yield for all purposes of this section.

[4293] Rev. Rul. 85-13, referred to in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation.

Example (1).

(i) On January 1, 2009, Employee B issues a split-dollar term loan to Employer Y. The split-dollar term loan provides for five percent interest, compounded annually. Interest and principal on the split-dollar term loan are due at maturity. On January 1, 2009, B and Y also enter into a fully vested non-qualified deferred compensation arrangement that will provide a payment to B in an amount equal to the accrued but unpaid interest due at the maturity of the split-dollar term loan.

(ii) Under paragraph (a)(4)(i) of this section, B's requirement to pay interest on the split-dollar term loan is disregarded for purposes of this section, and the split-dollar term loan is treated as a loan that does not provide for interest for purposes of this section.

Example (2).

(i) On January 1, 2004, Employee B and Employer Y enter into a fully vested non-qualified deferred compensation arrangement that will provide a payment to B equal to B's salary in the three years preceding the retirement of B. On January 1, 2009, B and Y enter into a split-dollar life insurance arrangement and, under the arrangement, B issues a split-dollar term loan to Y on that date . The split-dollar term loan provides for five percent interest, compounded annually. Interest and principal on the split-dollar term loan are due at maturity. Over the period in which the non-qualified deferred compensation arrangement is effective, the terms and conditions of B's non-qualified deferred compensation arrangement do not change in a way that indicates that the payment of the non-qualified deferred compensation is related to B's requirement to pay interest on the split-dollar term loan. No other facts and circumstances exist to indicate that the payment of the non-qualified deferred compensation is related to B's requirement to pay interest on the split-dollar term loan.

(ii) The facts and circumstances indicate that the payment by Y of non-qualified deferred compensation is independent from B's requirement to pay interest under the split-dollar term loan. Under paragraph (a)(4)(i) of this section, the fully vested non-qualified deferred compensation does not cause B's requirement to pay interest on the split-dollar term loan to be disregarded for purposes of this section. For purposes of this section, the split-dollar term loan is treated as a loan that provides for stated interest of five percent, compounded annually.

Thus, one should avoid bequeathing the split-dollar note receivable until long after the funds are advanced.[4294]

Second, interest (or any other payment) needs to be reasonably expected to be repaid or must be deemed expected to be repaid. As mentioned above,[4295] to be a split-dollar loan, among other requirements the payment of premiums must be "a loan under general principles of Federal tax law or, if it is not a loan under general principles of Federal tax law (for example, because of the nonrecourse nature of the obligation or otherwise), a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest)." Split-dollar loans are commonly nonrecourse, and

[4294] See text accompanying fns 4320-4321 in part II.Q.4.f.iv.(b) Loan Regime After Initial Owner Has Died.
[4295] Reg. § 1.7872-15(a)(2)(i)(B), quoted in full in the text accompanying fn 4289.

if the policy does not perform then typically the lender eats the loss. Reg. § 1.7872-15(d), (j) discuss nonrecourse or contingent payments.[4296]

Reg. § 1.7872-15(j) controls over the usual rules governing contingent payments in making loans at the applicable federal rate (AFR).[4297] The lender puts together a projected payment schedule, which everyone directly or indirectly involved in the loan must use.[4298] The term of a split-dollar loan payable on the death of an individual is the individual's life expectancy as determined under the appropriate table in Reg. § 1.72-9 on the day the loan is made;[4299] if the insured outlives his or her life expectancy, the split-dollar loan is treated as retired and reissued as a split-dollar demand loan at that time for an amount of cash equal to the loan's adjusted issue price on that date.[4300] Although a payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances, if any payment on a split-dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes unless the parties to the arrangement make the written representation provided for in Reg. § 1.7872-15(d)(2).[4301] Treating a nonrecourse payment as contingent may cause that payment to assigned a zero value,[4302] which would mean that the usual nonrecourse split dollar loan would be assigned a zero value.

Thus, the written representation provided for in Reg. § 1.7872-15(d)(2) is critically important in making sure that a nonrecourse loan is respected. An otherwise noncontingent payment on a split-dollar loan that

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[4296] Reg. § 1.7872-15(d)(1) provides:

> (1) *In general*. Except as provided in paragraph (d)(2) of this section, if a payment on a split-dollar loan is nonrecourse to the borrower, the payment is a contingent payment for purposes of this section. See paragraph (j) of this section for the treatment of a split-dollar loan that provides for one or more contingent payments.

[4297] Reg. § 1.7872-15(j)(1) provides:

> (1) *In general*. Except as provided in paragraph (j)(2) of this section, this paragraph (j) provides rules for a split-dollar loan that provides for one or more contingent payments. This paragraph (j), rather than § 1.1275-4, applies to split-dollar loans that provide for one or more contingent payments.

[4298] Reg. § 1.7872-15(j)(3)(ii)(E) provides:

> *Borrower/lender consistency*. Contrary to § 1.1275-4(b)(4)(iv), the lender rather than the borrower is required to determine the projected payment schedule and to provide the schedule to the borrower and to any indirect participant as described in paragraph (e)(2) of this section. The lender's projected payment schedule is used by the lender, the borrower, and any indirect participant to compute interest accruals and adjustments.

[4299] Reg. § 1.7872-15(e)(5)(ii)(C), which further provides:

> If a split-dollar loan is payable on the earlier of the individual's death or another term determined under paragraph (e)(4)(iii) of this section, the term of the loan is whichever term is shorter.

If the split-dollar loan is payable on the later of the individual's death or a term certain, the term certain is used. Reg. § 1.7872-15(e)(5)(v)(A), (B)(2).

The contingent payment rules look to the above regulations. Reg. § 1.7872-15(j)(3)(ii)(B) provides:

> *Split-dollar term loans payable upon the death of an individual*. If a split-dollar term loan described in paragraph (e)(5)(ii)(A) or (v)(A)(1) of this section provides for one or more contingent payments, the projected payment schedule is determined based on the term of the loan as determined under paragraph (e)(5)(ii)(C) or (v)(B)(2) of this section, whichever is applicable.

Closing the loop, Reg. § 1.7872-15(e)(5)(ii)(A) provides:

> *Applicability*. This paragraph (e)(5)(ii) applies to a split-dollar term loan payable not later than the death of an individual.

[4300] Reg. § 1.7872-15(e)(5)(ii)(D), which further provides:

> However, the loan is not retested at that time to determine whether the loan provides for sufficient interest. For purposes of determining forgone interest under paragraph (e)(5)(ii)(B) of this section, the appropriate AFR for the reissued loan is the AFR determined under paragraph (e)(5)(ii)(B) of this section on the day the loan was originally made.

[4301] Reg. § 1.7872-15(j)(2)(ii).

[4302] When the lender determines the projected payment schedule, Reg. § 1.7872-15(j)(3)(ii)(A) provides:

> The projected payment for a contingent payment is the lowest possible value of the payment. The projected payment schedule, however, must produce a yield that is not less than zero. If the projected payment schedule produces a negative yield, the schedule must be reasonably adjusted to produce a yield of zero.

is nonrecourse to the borrower is not deemed a contingent payment if the parties to the split-dollar life insurance arrangement represent in writing that a reasonable person would expect that all payments under the loan will be made.[4303] Unless the IRS provides otherwise, "both the borrower and the lender must sign the representation not later than the last day (including extensions) for filing the Federal income tax return of the borrower or lender, whichever is earlier, for the taxable year in which the lender makes the first split-dollar loan under the split-dollar life insurance arrangement."[4304] If the interest actually paid on the split-dollar loan is less than the interest required to be accrued on the split-dollar loan according to the representation, "the excess of the interest required to be accrued over the interest actually paid is treated as waived, cancelled, or forgiven by the lender."[4305]

Once we have figured out the payment schedule that the IRS will respect, Reg. § 1.7872-15(k) applies a payment made by the borrower on all direct and indirect split-dollar loans in the following order:

> (1) A payment of interest to the extent of accrued but unpaid interest (including any OID) on all outstanding split-dollar loans in the order the interest accrued;
>
> (2) A payment of principal on the outstanding split-dollar loans in the order in which the loans were made;
>
> (3) A payment of amounts previously paid by a non-owner pursuant to a split-dollar life insurance arrangement that were not reasonably expected to be repaid by the owner; and
>
> (4) Any other payment with respect to a split-dollar life insurance arrangement, other than a payment taken into account under ... (1), (2), and (3) ….

Reg. § 1.7872-15(m) describes what happens when the insurance company pays the lender:

> *Repayments received by a lender*. Any amount received by a lender under a life insurance contract that is part of a split-dollar life insurance arrangement is treated as though the amount had been paid to the borrower and then paid by the borrower to the lender. Any amount treated as received by the borrower under this paragraph (m) is subject to other provisions of the Internal Revenue Code as applicable (for example, sections 72 and 101(a)). The lender must take the amount into account as a payment received with respect to a split-dollar loan, in accordance with paragraph (k) of this section. No amount received by a lender with respect to a split-dollar loan is treated as an amount received by reason of the death of the insured.

[4303] Reg. § 1.7872-15(d)(2)(i).

[4304] Reg. § 1.7872-15(d)(2)(ii), which further provides:

> This representation must include the names, addresses, and taxpayer identification numbers of the borrower, lender, and any indirect participants. Unless otherwise stated therein, this representation applies to all subsequent split-dollar loans made pursuant to the split-dollar life insurance arrangement. Each party should retain an original of the representation as part of its books and records and should attach a copy of this representation to its Federal income tax return for any taxable year in which the lender makes a loan to which the representation applies.

Letter Ruling 201041006, summarizing the deadline as well as the issue and then granted relief.

[4305] Reg, § 1.7872-15(h)(1)(iv).

II.Q.4.f.iv. Income Taxation of Split-Dollar Agreement After Premium Payor Dies When Life Insurance Not on the Owner's Life

When the premium payor dies holding a split-dollar receivable on the payor's life, the receivable is repaid immediately and correspondingly has a basis equal to the amount of the receivable, generating no income taxation.

However, if the split-dollar receivable is not on the premium payor's life, the receivable would be valued based on when the receivable is collected. The split-dollar arrangement's long-term nature may cause the receivable to be valued at significantly less than its face amount, leading to a step-down in basis; see the cases in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.

The rest of this discussion, from part II.Q.4.f.iv, assumes that the initial owner has died and refers to the successor owner as the owner.

II.Q.4.f.iv.(a). Economic Benefit Model After Initial Owner Has Died

In the economic benefit model described in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22, the economic benefit of current life insurance protection is considered a payment from the owner to the non-owner.[4306] The payment's nature depends on the relationship between the owner and non-owner.[4307] As the insured gets older, the amount of this payment increases and may become exorbitant, and the arrangement might need to be terminated. If the insurance company distributes the cash value, the holder of the split-dollar receivable recognizes ordinary income to the extent that the amount received exceeds the holder's "investment in the contract," the latter which is described in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy). Under those rules, the change in basis by reason of death does not affect the "investment in the contract." If the policy's ownership is considered transferred from the owner to the non-owner, then the transfer may be a sale (taxable to the extent that proceeds exceed basis), a gift, a distribution, or some other appropriate arrangement.[4308] An advantage of just cashing out the policy with the insurance company is that the investment in the contract, which would generally exceed the stepped-down basis on the date of the original owner's death, would reduce income relative to the gain on sale, which the IRS would assert (not necessarily successfully)[4309] is ordinary income anyway.

If the arrangement stays in place until the insured's death, then:

- Generally, the owner's death benefit is nontaxable under Code § 101(a).[4310]

[4306] Reg. § 1.61-22(d)(1), quoted in the text following fn 4259 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4307] The part of § 1.61-22(d)(1) that follows fn 4259 in part 1.61-22(d)(1) provides:

> Depending on the relationship between the owner and the non-owner, the economic benefits may constitute a payment of compensation, a distribution under section 301, a contribution to capital, a gift, or a transfer having a different tax character. Further, depending on the relationship between or among a non-owner and one or more other persons (including a non-owner or non-owners), the economic benefits may be treated as provided from the owner to the non-owner and as separately provided from the non-owner to such other person or persons (for example, as a payment of compensation from an employer to an employee and as a gift from the employee to the employee's child).

[4308] See fns 4268 and 4276-4282 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4309] See fn 4207 in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy).

[4310] Reg. § 1.61-22(f)(3)(ii) provides:

- Generally, the non-owner's death benefit is nontaxable under Code § 101(a), if the non-owner paid for or properly took into account the value of the economic benefit of the life insurance protection.[4311]

- Generally, any death benefit not described above is taxable.[4312]

If the insured was employed by or owned at least 5% of the original owner when the policy was issued, special requirements apply to obtain the Code § 101(a) exclusion. See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance. Also, to obtain the Code § 101(a) exclusion, any transfer from the original owner to a successor owner needs to qualify for an exception from the transfer-for-value rules,[4313] which means that any distribution from a trust or estate should be pick-and-choose fractional instead of pecuniary.[4314]

II.Q.4.f.iv.(b). Loan Regime After Initial Owner Has Died

Suppose a $1 million split-dollar loan under Code § 1.7872-15 is worth $150,000 at the death of the owner who is not the insured. This valuation spread is realistic, because commercial lenders do not make long-term loans except for real estate, and even then they tend to require significant equity. Unlike other loans, payment of annual interest is not required in a split-dollar loan.[4315] A split-dollar loan does not require any equity, and the lender cannot accelerate the loan if the underlying collateral starts to lose value or otherwise fail to perform. Furthermore, a cash value life insurance policy loses value immediately, due to commissions and other start-up costs the insurance company incurs that are allocated to the policy. Commercial lenders who finance life insurance tend to require some combination of equity or outside collateral, use floating interest rates, and impose loan maturities much shorter than the insured's life expectancy.

Let's look at the character of the note repayment:

- Any payment from the life insurer to repay the note is treated as a payment from the insurer to the borrower and then from the borrower to the lender.[4316]

Death benefit proceeds to owner as beneficiary. Any amount paid or payable to an owner in its capacity as a beneficiary by reason of the death of the insured is excluded from gross income of the owner under section 101(a) as an amount received under a life insurance contract to the extent such amount is not allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

4311 Reg. § 1.61-22(f)(3)(i) provides:

Death benefit proceeds to beneficiary (other than the owner). Any amount paid to a beneficiary (other than the owner) by reason of the death of the insured is excluded from gross income by such beneficiary under section 101(a) as an amount received under a life insurance contract to the extent such amount is allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

4312 Reg. § 1.61-22(f)(3)(iii) provides:

Transfers of death benefit proceeds. Death benefit proceeds paid to a party to a split-dollar life insurance arrangement (or the estate or beneficiary of that party) that are not excludable from that party's income under section 101(a) to the extent provided in paragraph (f)(3)(i) or (ii) of this section, are treated as transferred to that party in a separate transaction. The death benefit proceeds treated as so transferred will be taxed in a manner similar to other transfers. For example, if death benefit proceeds paid to an employee, the employee's estate, or the employee's beneficiary are not excludable from the employee's gross income under section 101(a) to the extent provided in paragraph (f)(3)(i) of this section, then such payment is treated as a payment of compensation by the employer to the employee.

4313 See part II.Q.4.b Transfer for Value Rule; Basis.

4314 See part II.J.8.d Distribution in Kind; Specific Bequests.

4315 See part II.Q.4.f.i Split-Dollar Generally, especially the text accompanying fns 4239-4240.

4316 See Reg. § 1.7872-15(m), reproduced in full near the end of part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

- To the extent of any accrued interest, the payment would have that character.[4317]

- To the extent that a payment is principal and the payment exceeds basis, the payment would probably be taxed as capital gain to the original holder of the note or to a substituted basis transferee or ordinary income for any other holder.[4318] Thus, if the decedent's estate is considered to be the issuer, then the estate and any beneficiary (except the recipient of a pecuniary bequest) should have capital gain. Otherwise, the gain would be taxed as ordinary income.

Many commentators have suggested that, because one misstep can cause the economic benefit split-dollar regime (described in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit **Arrangement under Reg. § 1.61-22**) to be unwound, resulting in potentially huge income and gift tax consequences, the loan regime is safer.[4319] However, consider *Morrissette*, in which the split-dollar receivable's owner bequeathed the receivable to the split-dollar obligor.[4320] If the arrangement had been a split-dollar loan, that bequest might have violated Reg. § 1.7872-15(a)(4) (especially Example (1)), causing the interest expected to be paid under the loan to be disregarded, eviscerating most of the loan's value for gift tax purposes.[4321]

On the other hand, the economic benefit regime would let the successor owner cash in the policy using the investment in the contract (generally premiums paid) instead of the basis that was greatly reduced when the original owner died.[4322] Furthermore, if the insured dies before the economic benefit regime is unwound and the transfer-for-value and related rules have not been violated, all benefits to everyone are received tax-free.[4323]

II.Q.4.f.v. Estate Tax Consequences of Split-Dollar Agreements

The split-dollar economic benefit regime regulations do not apply for estate tax purposes.[4324]

Apparently taking advantage of this gap, *Estate of Morrissette v. Commissioner*[4325] held that a taxpayer's entering into a heavily discounted generational split-dollar agreement[4326] did not constitute a gift, even

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[4317] See Reg. § 1.7872-15(k), reproduced in full near the end of part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15, provides that accrued interest is deemed paid first.

[4318] See fns 2098-2099 (especially the latter) in part II.H.5.b Moving Real Estate or Other Low-Basis Property from Irrevocable Trust to Grantor, discussing what if an irrevocable grantor trust sold assets to the decedent in exchange for a note from the decedent.

[4319] See fns 4263-4266 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4320] See fns 4325-4328 in part II.Q.4.f.v Estate Tax Consequences of Split-Dollar Agreements.

[4321] Reg. § 1.7872-15(a)(4) is reproduced in full in text preceding the sentence that includes fn 4294 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4322] See text accompanying fns 4308-4309 in part II.Q.4.f.iv.(a) Economic Benefit Model After Initial Owner Has Died.

[4323] See fn 4267 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4324] See fn 4254 in part II.Q.4.f.ii.(b) Split-Dollar Economic Benefit Arrangement under Reg. § 1.61-22.

[4325] 146 T.C. 171 (2016). For a complete discussion, see S. Gorin & H. Zaritsky, Tax Court Approves Some Key Issues with Intergenerational Split-Dollar Arrangements, 28 Probate Practice Reporter 1 (June 2016). For a link to various selected documents filed with the Tax Court, including the split dollar agreement and appraisal the IRS viewed as representative of the arrangements, see http://tcinstitute.com/rv/ff002894cb41394cda173f9fe7469759eae604bd. In *Estate of Levine v. Commissioner*, Tax Court docket no. 9345-15, a July 13, 2016 order granted summary judgment to the taxpayer because the parties agreed that *Morrissette* controlled, with the IRS preserving its right to appeal, indicating that it continued to disagree with *Morrissette*.

[4326] Under the split-dollar rules, the decedent was the deemed owner of policies on younger insureds. Such an arrangement is referred to as generational because the insured is expected to outlive the decedent by a significant number of years. That the decedent's estate has to wait for many years to collect what it is owed and must also continue to expend funds during that time might cause the value of the decedent's economic rights to be discounted. However, the decedent's estate would benefit from though the decedent bequeathed her interest to the other party in the split-dollar arrangement.[4327] In that case, the mother funded life insurance owned by irrevocable life insurance trusts ("ILITs") to fund cross purchase buy-sell obligations that her children had to each other. Because the mother had to wait until her children died to receive cash on the split-dollar receivables and the ILITs had full control over the policies, the mother's estate tax return reported that her right to receive the almost $30 million she invested was worth only approximately $7.5 million. Because the split-dollar receivable would have a low basis, repayment would have generated significant income tax; by bequeathing the receivable to the other party the agreement, the mother might have prevented that result.[4328] However, in a similar situation, *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84, held that Code §§ 2036, 2038, and 2703[4329] may very well

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the growth in the policy's cash value and would not bear the mortality charge (except to the extent that the mortality charge exceeded the rates under the IRS' Table 2001 rates), so it is unclear how much the policy should be discounted.

[4327] The IRS apparently argued that bequeathing the decedent's split-dollar interest to the other party to the contract made the restrictions illusory. From the opinion:

> Respondent argues that the Dynasty Trusts had a direct or indirect right in the cash values of the insurance policies by virtue of the terms of the 2006 Amendment to the CMM Trust. Under that amendment, the CMM Trust's interest in the cash values of the policies would pass to the Dynasty Trusts or directly to Mrs. Morrissette's sons or their heirs upon her death. However, because the CMM Trust was a revocable trust with respect to Mrs. Morrissette, she retained an absolute right to alter the CMM Trust throughout her lifetime. Accordingly, the Dynasty Trusts did not have a legally enforceable right to the cash values of the policies during the lifetime of the grantor. Furthermore, the split-dollar life insurance arrangements did not require the CMM Trust to distribute the receivables to the Dynasty Trusts. Rather, Mrs. Morrissette retained the right to receipt of the receivables.

The decedent's ability to amend her revocable trust was pure legal fiction, which legal fiction this case takes to the extreme. From the finding of facts:

> [The decedent's sons] Arthur, Donald, and Kenneth petitioned the Circuit Court of Fairfax County, Virginia (Fairfax court) for appointment of a conservator for Mrs. Morrissette's estate and asked the conservator to transfer additional assets to the CMM Trust. On August 18, 2006, the court found Mrs. Morrissette to be permanently incapacitated and appointed Cathleen A. Hatfield, an employee of the Interstate Group, to serve as the conservator. The Fairfax court granted Ms. Hatfield broad authority to act on Mrs. Morrissette's behalf. The conservatorship expired on October 20, 2006.

The conservator did the following during that 2-month period:

1. Established Dynasty Trusts,
2. Amended the revocable trust to authorize entering into the split-dollar agreements and bequeathing the revocable trust's interest in each split-dollar agreement to the other party to the split-dollar agreement, and
3. Entered into a buy-sell agreement requiring the life insurance.

Then, the Dynasty Trusts bought the policies and, together with the revocable trust (of which the sons were co-trustees), entered into the split-dollar agreements.

The idea that this arrangement would ever be modified was ludicrous, given that the sons orchestrated this entire transaction for their benefit, using as the conservator an employee of the company that they directly or beneficially owned, to set up a multi-million dollar transaction in a compressed period of time.

The following facts might have helped the estate's case:

- The purchase of the policies was for a legitimate and significant nontax reason [my assumption that the *Bongard* test might have been in the court's mind - see fn 95 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders] – to fund a buy-sell agreement.
- The donor lived 4 years after the arrangement was made.
- The gift tax returns used the IRS' Table 2001 rates instead of any alternative term rates provided by the insurance company.

[4328] Presumably the bequest of the receivable or even a note under the loan regime would not generate income tax. Bequeathing a note (other than a note received in an installment sale) does not trigger cancellation of indebtedness income to the debtor; see fn. 6860, found in part III.B.5.b Promissory Notes. However, if *Morrissette* had used the loan regime, bequeathing the note may have caused the loan to be disregarded for gift tax purposes, which would have made the whole amount advanced constitute a gift. See fn 4294 in part II.Q.4.f.iii Split-Dollar Loans under Reg. § 1.7872-15.

[4329] The court held:

> On the basis of the undisputed facts, we conclude that under section 2703(a)(1) the split-dollar agreements, and specifically the provisions that prevent decedent from immediately withdrawing his investment, are agreements to acquire or use property at a price less than fair market value. The estate claims that decedent paid $10 million to the insurance companies for the benefit of MB Trust and in return received certain rights, namely, the termination rights

apply, probably not qualifying for the exception for a sale for adequate and full consideration that would prevent the former two[4330] from applying because the split dollar receivable was only a small fraction of the amount of money the decedent contributed to the agreement.[4331] The court failed to address Reg. § 20.2038-1(a)(2), which prevents Code § 2038 from applying "if the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law."[4332] On December 12, 2018, the parties settled the case, with the estate paying $2,123,508 in estate tax and $424,702 in Code § 6662(h) penalties (but no Code § 6662(a) penalties).

In an order entered June 21, 2018, the *Morrissette* Tax Court denied the taxpayer's motion for partial summary judgment on grounds similar to *Cahill*.[4333] On February 19, 2019, the court denied the IRS

(which the estate claims are worthless) and decedent's death benefit rights (which, according to the estate's valuation theory, are worth less than 2% of the cash surrender value). MB Trust, meanwhile, paid nothing into this arrangement and received MB Trust's death benefit rights. As best we understand the estate's valuation theory, MB Trust's death benefit rights are allegedly worth at least the cash surrender value minus the value of decedent's death benefit rights (*i.e.*, $9,611,624 – (allegedly) $183,700 = $9,427,924). Nothing in the parties' filings suggests that MB Trust ever paid, or was obligated to pay, any interest or other amount to compensate decedent for MB Trust's acquisition and use of this amount….

Next, it is clear that under section 2703(a)(2) the split-dollar agreements, and specifically MB Trust's ability to prevent termination, also significantly restrict decedent's right to use the termination rights. The split-dollar agreements, taken as a whole, clearly restrict decedent's right to terminate the agreements and withdraw his investment from these arrangements.

[4330] The court held:

… the rights to terminate and recover at least the cash surrender value were clearly rights, held in conjunction with another person (MB Trust), both to designate the persons who would possess or enjoy the transferred property under section 2036(a)(2) and to alter, amend, revoke, or terminate the transfer under section 2038(a)(1).

[4331] The court noted:

Whether a transfer was for adequate and full consideration is a question of value; *i.e.*, did what decedent transferred roughly equal the value of what he received in return? See, *e.g.*, *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278. On the basis of the undisputed facts presently before us, we conclude that it was not.

According to the estate, at decedent's date of death MB Trust's ability to veto decedent's termination of the agreements rendered the termination rights valueless. Additionally, the estate alleges that decedent's death benefit rights are worth less than 2% of the cash surrender value (i.e., $183,700 ÷ $9,611,624 < 2%). But MB Trust's veto power existed from the moment decedent entered into these split-dollar agreements, and nothing in the undisputed facts presently before us suggests that the terms of the split-dollar agreements were altered between execution of the agreements and decedent's date of death; consequently, this alleged 98% discount must have been present from the execution of these agreements. Therefore, *according to the estate's valuation theory*, the initial transfer of $10 million in value cannot have been in exchange for property worth that amount; *i.e.*, under the estate's argument, what decedent received was necessarily worth at least 98% less than what he transferred (even without taking into account the amounts used to pay commissions and fees to the insurance company). Consequently, at least according to the estate's valuation theory, the value of what decedent received (allegedly, something close to $183,700) was not even roughly equal to the $10 million decedent paid.

[4332] That exception is an alternative to the exception to which the court alluded, Reg. § 20.2038-1(a)(1), which prevents Code § 2038 from applying, "to the extent that the transfer was for an adequate and full consideration in money or money's worth (see §20.2043-1)."

[4333] The court reasoned and ruled (Docket No. 4415-14):

Petitioners argue that the decedent's only right under the split-dollar arrangements was the death benefit and that right was without restriction. They argue that the property being valued is the death benefit, the death benefit is free of any restriction as defined in section 2703(a)(2), and accordingly section 2703(a) does not apply to the valuation of the split-dollar arrangements. They argue that the split-dollar arrangements did not contain any restrictions on the decedent's rights for purposes of section 2703(a)(2). They state, without further analysis, that the termination restriction, *i.e.*, that neither party had the unilateral right to terminate the split-dollar arrangements, is not a restriction for purposes of section 2703(a)(2).

Respondent argues that the decedent's rights also include the termination right and receipt of a payout upon termination. He argues that the termination right were restricted by the split-dollar arrangements and that motion for summary judgment under Code §§ 2036(a)(2) and 2038(a)(1) and (2), finding that "there is a material factual dispute concerning the issue of full and adequate consideration" and denied the IRS motion for summary judgment under Code § 2703, stating that Code § 2703 "will apply unless the requirements of the section 2703(b) exception are satisfied" but that "there is a genuine dispute of material fact of whether the transfers were a device to transfer property to members of decedent's family for less than full an adequate consideration in money or money's worth." Ultimately, however, T.C. Memo 2021-60 held that Code § 2036 did not apply:[4334]

> Taking into account the totality of the facts and circumstances, the CMM trust had legitimate and significant nontax purposes for entering into the split-dollar agreements and funding payment of the premiums in exchange for repayment plus interest in the form of inside buildup. An important purpose of the transfer was to promote the management succession and efficiency and to protect corporate profits for the accumulation of capital to develop the business. On the basis of the record before us, we find that unrelated parties would have agreed to similar terms. Respondent has not argued otherwise….
>
> To qualify for the bona fide sale exceptions, the transfer must have been made for adequate and full consideration in money or money's worth….

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section 2703(a)(2) applies to disregard the termination restrictions. He also argues the decedent had rights under collateral assignment agreements. He contends that the CMM Trust and the Dynasty Trusts entered into agreements in which the Dynasty Trusts assigned the insurance policies to the CMM Trust as collateral for its $30 million premium prepayment, and the collateral assignments contained a restriction that should be disregarded under section 2703(a)(2). He argues that neither the termination restriction nor the collateral assignment restriction is inherent or necessary to a split-dollar agreement. See *Estate of Strangi v. Commissioner*, 115 T.C. 478, 488-489 (2000), *aff'd* in part, *rev'd* on another issue, 293 F.3d 279 (5th Cir. 2002) (holding that section 2703 did not apply to disregard partnership entity to cause partnership assets to be included in the estate); *cf. Estate of Elkins v. Commissioner*, 140 T.C. 86 (2013), *aff'd* in part, *rev'd* in part, 767 F.3d 443 (5th Cir. 2014) (applying section 2703(a) to disregard restriction on decedent's right to institute a partition action for undivided fractional interests in art work); *Holman v. Commissioner*, 130 T.C. 170 (2008) (applying section 2703 to disregard restrictions in partnership agreement on partner's right to transfer her partnership interest). He argues that we should deny summary judgment in petitioners' favor because genuine issues of material fact exist. He argues that the Court should find that section 2703 applies to the decedent's rights under the split-dollar arrangements as a matter of law, but he did not file a cross-motion for summary judgment on this issue. If section 2703 applies, respondent argues that we should disregard the termination restrictions pursuant to section 2703 and value the decedent's rights under the split-dollar arrangement as if she had the right to unilaterally terminate the agreements. He does not seek to disregard the split dollar arrangements in their entirety.

The restriction on the decedent's termination rights is a restriction for purposes of section 2703(a)(2). *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84, at *23-28. In *Estate of Cahill*, we denied the estate's motion for partial summary judgment that section 2703(a) is inapplicable to split-dollar arrangements with termination restrictions similar to those at issue here where the parties to the arrangements could mutually agree to terminate the arrangement but neither party could unilaterally terminate the arrangements. *Id.* Here the CMM Trust and the respective Dynasty Trust could mutually agree to terminate the split-dollar arrangement, but neither party could unilaterally terminate the agreement. Respondent has asserted alternative arguments that the split-dollar arrangements are includible in the decedent's gross estate pursuant to sections 2036 and 2038 relating to inter vivos transfers, which petitioners have not been addressed in their summary judgment motions and remain at issue for trial. See *Estate of Cahill v Commissioner*, T.C. Memo. 2018-84, at *15-*16 (holding the estate retained rights under the split-dollar arrangements as defined in sections 2036(a) and 2038(a) and denying summary judgment to the estate that those sections are inapplicable). As there may be facts or theories not yet presented, we decline to treat respondent's response to petitioners' motion for partial summary judgment as a cross-motion for partial summary judgment.

Accordingly, it is ORDERED that petitioners' motion for partial summary judgment, filed December 5, 2016, relating to the issue of the applicability of section 2703 is denied.

[4334] These are strategic excerpts from the full analysis that is reproduced in the text following fn 7235 in part III.C.1 Whether Code § 2036 Applies.

> Compliance with the economic benefit regime does not mean that the adequate and full consideration requirement is met. *Estate of Cahill v. Commissioner*, at *33. Under the plain text of the regulations, the economic benefit regime does not apply for estate tax purposes. The regime is set out in the income tax regulations, and the regulations state that the regime applies for income, gift, employment, and self-employment tax purposes. Sec. 1.61-22(a), Income Tax Regs. Estate tax is not listed. The economic benefit regime does not use the phrase "adequate and full consideration" or otherwise invoke the concept of adequate and full consideration….
>
> We hold that the CMM trust received adequate and full consideration on the basis of the split-dollar agreements' repayment terms that included interest earned in the form of inside buildup of the insurance policies. The minimum interest rates and the actual appreciation in the policies' cash values were higher than the interest rates that the CMM trust had been earning on the money. Respondent does not argue that the repayment terms were inadequate. The split-dollar agreements also provide the additional benefit of deferral of tax on the policies' inside buildup and the tax-exempt payout of the death benefits to the beneficiaries.
>
> Estate tax saving was not achieved through execution of the split-dollar agreements alone but rather through the undervaluation of the split-dollar rights….

The court held that Code § 2703 did not apply,[4335] which is not surprising given that it bought into the bona fide arguments for Code § 2036. However, the court did not buy into the estate's valuation, holding the split-dollar agreement would be unwound much earlier than its stated termination (thereby undermining the effect of various discounts):

> Petitioners argue that there was no prearranged plan to terminate the split-dollar agreements when the agreements were executed. We are not convinced. When the 2006 plan was implemented, the CMM trust agreement was amended to distribute the split-dollar rights to the respective dynasty trusts that owned the underlying policies. Such a distribution indicates an intent to give the dynasty trusts full control over the policies once the distribution occurred. Such control makes it appropriate to apply a maturity date, and we apply a maturity date of December 31, 2013. That is the date that respondent seeks. Accordingly, we do not apply an earlier one. We acknowledge that Ken testified that he did not intend to cancel the policies. While we find him credible, the brothers were free to choose to cancel the policies after the agreements were distributed to the dynasty trusts. From the outset, the plan was to give the dynasty trusts complete control after Mrs. Morrissette's death, and the CMM trust agreement was so amended. Respondent points to other facts to support a December 31, 2013, maturity date including the decision to purchase policies with high premiums and modest death benefits and July 2010 emails between Don, Mr. Meltzer, and Mr. McNair that discuss the possibility of canceling certain policies. Mr. McNair responded to Don that he insisted that the policies not be canceled until the three-year period of limitations on the estate return had expired. This is the basis for respondent's choosing December 31, 2013, as the maturity date. Petitioners raise valid objections to the emails including that Ken and Buddy were not involved and the discussion started out about the effect of cancellation of the policies on Mr. Meltzer's future commissions. However, on our review of all the facts and circumstances, the key factor in setting the December 31, 2013, maturity date is the brothers' complete control over the split-dollar agreements. As stated above, there are grounds for setting an earlier maturity date, but we will use respondent's date.

[4335] See text accompanying fn 7167 in part III.B.7.e Code § 2703 Overview.

The court imposed an undervaluation penalty:

> When considering reliance on an appraisal as a defense to a valuation penalty, we consider the methodology and assumptions underlying the appraisal, the appraised value, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer. *Estate of Richmond v. Commissioner*, T.C. Memo. 2014-26, at *48. In this case we place the most weight on the appraised value, less than $7.5 million. Mr. Stephanson's opined value was not reasonable, and the brothers should have known that. The brothers had the CMM trust pay $30 million and turned it into $7.5 million for estate tax reporting purposes. They should have known that the claimed value was unreasonable and not supported by the facts.
>
> While the brothers credibly testified to the business and nontax purposes for entering into the split-dollar agreements, they also knew that Mr. Meltzer and Mr. McNair were marketing the agreements as an estate tax saving strategy. Mr. Meltzer and Mr. McNair made it clear that the tax benefits of the split-dollar agreements would be obtained through the undervaluation of the split-dollar agreements, and the brothers knew from the time they decided to enter into the split-dollar agreements that any estate tax saving depended on valuing the split-dollar rights at a substantial discount from the premiums that the CMM trust paid. In July 2010, before the return's filing, Mr. McNair warned Don that the IRS would likely see problems with the values of the split-dollar rights that the estate had planned to report on the return. Nevertheless, the brothers had the estate report substantially discounted values on the return.
>
> Mrs. Morrissette had significant, nontax reasons for entering into the split-dollar agreements. However, the only purpose for the substantially discounted values of the split-dollar rights as compared to the $30 million that the CMM trust paid is estate tax saving. Knowing that any estate tax saving would be from the undervaluation of the split-dollar rights, the brothers engaged an appraiser that Mr. McNair recommended. Mr. McNair reviewed a draft of Mr. Stephanson's appraisal and asked Mr. Stephanson to make changes that reduced his opined values.
>
> Mr. Stephanson's appraisal was not reasonable, and petitioners did not rely on it in good faith. Accordingly, the estate is not entitled to rely on Mr. Stephanson's appraisal as a reasonable cause defense. The estate did not act reasonably or in good faith in the valuation of the split-dollar rights. The estate is liable for the 40% penalty for the gross valuation misstatement of the split-dollar rights.

Also consider potential estate tax inclusion when the insured controls an employer that is a party to the split-dollar agreement. Because part of the death benefit is not payable to the employer,[4336] the IRS might argue that the insured has incidents of ownership over the policy that is subjected to the split-dollar arrangement. To avoid such an argument, the split-dollar agreement and any collateral assignments might limit the employer's rights to just those provided in the split-dollar agreement.[4337] Although that approach

[4336] If all of the death benefit is payable to the employer or used for the employer's business purpose, the insurance policy is not included in the insured's estate by reasons of incidents of ownership, although the death benefit might very well affect the employer's value that is included in its deceased owner's estate. See part II.Q.4.a Funding the Buy-Sell, especially fn. 4103.

[4337] For example, Letter Ruling 9651017 held:

> Under the split-dollar agreement in the present case, X is expressly prohibited from borrowing against any part of the policy. In addition, the power to change the beneficiary, the power to surrender or cancel the policy, the power to assign the policy or to revoke an assignment, and the power to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy are vested in the trustee of Trust. Accordingly, we conclude, that X

would work for the split-dollar loan regime, it might not work so well for the economic benefit regime. The economic benefit regime provides that the non-owner is deemed to have current access to that portion of the policy cash value to which the non-owner has a current or future right and that currently is inaccessible to the owner.[4338] In other words, if the employer is generally the deemed owner but cannot access the cash value, the other party to the split-dollar agreement is deemed to benefit from that cash value if the other party has a current or future right to part of the cash value. Thus, the approach suggested in fn. 4337 risks being recharacterized as being owned by the employee (and therefore the employer's premium being considered paid to the employee to the extent not attributable to the employer's retained rights to absolutely control cash value) unless the split-dollar agreement is absolutely tight about the employer being entitled to the full cash value. For those less than absolutely confident that the agreement, when using the economic benefit regime consider making the case that the entire arrangement is for the employer's business purpose – the employer receives the employer's portion of the death benefit, and the balance of the death benefit was provided through reasonable compensation for valuable services that the insured provided to the employer or through sharing the premium. However, *Morrissette*'s approval of a split-dollar policy as being solely owned by the premium payer (other than current life insurance protection) will boost the confidence of practitioners regarding the ability to draft agreements without risking the named owner being treated as the owner for income and gift tax purposes; see fn. 4325.

For donor-donee arrangements on the life of the insured, naming the donor as owner is not available. If the donor is the insured, one must draw up an absolutely tightly woven split-dollar agreement preventing the donor from having incidents of ownership, if using the economic regime (as in fn. 4325); those who are risk averse should use the loan regime. If the donor is not the insured, preventing the donor from having incidents of ownership is not important; one can then either name the donor as owner to take a conservative approach or, using a tightly woven split-dollar to try to secure valuation discounts,[4339] name the donee as the owner.

Lee Slavutin suggests the following guidelines for drafting generational split dollar agreements:[4340]

> will possess no incidents of ownership in the policy acquired by the Trust. See Rev. Rul. 76-274, 1976-2 C.B. 278, modified by Rev. Rul. 82-145, 1982-2 C.B. 213.

Letter Ruling 9651030 had the same or similar language. Letter Ruling 9511046 elaborated:

> Under the split-dollar agreement in the present case, the corporation will, however, hold no incidents of ownership. The corporation will have no defacto ability to force the trustee to borrow against the policy because the corporation is required to make the necessary premium payments for the duration of the trust. The power to change the beneficiary, the power to surrender or cancel the policy, the power to assign the policy or to revoke an assignment, and the power to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy are vested in the third party trustee of the irrevocable trust and are not attributable to the corporation. Accordingly, although the surviving spouse will hold control of the corporation for purposes of section 20.2042-1(c)(6), the corporation will hold no incidents of ownership in the second-to-die life insurance policy, and, thus, no incidents of ownership in the policy will be attributable to the surviving spouse. Reg. § 20.2042-1(c)(6) is reproduced in part II.Q.4.i.ii.(b) Corporate Ownership of Policy.

Letter Ruling 9348009 held:

> The facts in this case indicate that the Company's economic interest in the policy is limited to that of irrevocably designated beneficiary of that portion of the proceeds that is equal to the cash surrender of the policy. Additionally, we assume that no agreement or other factors exist that would cause the value of the decedent's stock holdings in the corporation not to be taken into account for purposes of section 2031. Under these circumstance, because the Company possesses no rights the exercise of which would impact that portion of the proceeds payable to a beneficiary other than the Company, the Company cannot be said to possess any incidents of ownership in the policy of the type that would be attributable to the surviving spouse under section 20.2042-1(6) of the regulations.

[4338] Reg. § 1.61-22(d)(2)(ii) - see fns. 4263 and 4265 for text of the relevant regulations.

[4339] See fns. 4325-4327.

[4340] A Post-*Morrissette* Roadmap for Drafting Intergenerational Split Dollar Agreements, *Steve Leimberg's Estate Planning Email Newsletter* - Archive Message #2414 (5/12/2016).

1. Clearly state that the purpose of the split dollar agreement is to "fund a permanent life insurance policy for estate liquidity or business succession, for example."

2. Add a preliminary recital that the agreement is intended to qualify as an economic benefit arrangement under Reg. § 1.61-22 and that the ONLY benefit intended to be provided to the "donee" trust is life insurance protection.

3. Do NOT give the donee trust the right to borrow against the cash value.

4. At termination or death, make sure that the donor gets the GREATER of cash value or premiums paid.

5. The donor should be REQUIRED to pay all premiums. The donee has no obligation to pay premiums. If premiums are prepaid, there will be no additional benefit to the donee trust.

6. Do not mention the disposition of the receivable at death. Otherwise, it might be construed as an additional benefit to the donee trust.

II.Q.4.g. Income Tax Trap for Business-Owned Life Insurance

II.Q.4.g.i. Analysis of Code § 101(j)

Beware that an employer-owned life insurance contract might not qualify for the usual exclusion from regular income tax.[4341] An "employer-owned life insurance contract" (a term that applies to much more than one would think) does not receive the exclusion unless certain notice and consent requirements are met.[4342]

An "employer-owned life insurance contract" is a life insurance contract that (i) is owned by a person engaged in a trade or business and under which such person (or certain related party) is directly or indirectly a beneficiary under the contract, and (ii) covers the life of an insured who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.[4343] An "applicable policyholder" means, with respect to any employer-owned life insurance contract, the person described in the preceding sentence who owns the contract[4344] at the time it is issued.[4345]

[4341] Code § 101(j).
[4342] Code § 101(j)(1), (2).
[4343] Code § 101(j)(3)(A).
[4344] Code § 101(j)(3)(B)(i).
[4345] The qualification at the time it is issued is not mentioned in any particular authority but appears to be implicit in the statutory scheme. See the text accompanying fn. 4350.

"Employee" includes a "highly compensated employee" under Code § 414(q),[4346] and Code § 414(q)(1)(A) pulls in people who own at least 5% of the company.[4347] Thus, an owner who is not an employee is an "employee" for purposes of this rule by being a 5% owner.[4348]

The notice and consent requirements are met if, before the issuance of the contract, the employee (A) is notified in writing that the applicable policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued, (B) provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and (C) is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.[4349] The only way that this requirement makes any sense is if the policy was issued to the person treated as the insured's employer under these rules - this requirement would be impossible to satisfy if it was issued to the insured or someone else because the person treated as an employer might not even know about the policy. Thus, "applicable policyholder" should mean the person to whom the policy is issued when the insured is an "employee" of that person.[4350]

In addition to the notice and consent requirements, either the insured must have a qualifying relationship with the company or the death benefit must be put to certain uses:

- A qualifying relationship includes the insured being an employee, director, or 5% owner at any time during the 12-month period before the insured's death.[4351]

- Another qualifying relationship is if, when the contract is issued, the insured is a director, certain highly compensated employees, or a 5% owner.[4352] (Note that Code § 101(j) does not apply unless the insured is an employee with respect to the trade or business of the applicable policyholder when

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[4346] Code § 101(j)(5).

[4347] Code § 414(q)(1), "In general," provides:

> The term "highly compensated employee" means any employee who -
> (A) was a 5-percent owner at any time during the year or the preceding year, or
> (B) for the preceding year -
> (i) had compensation from the employer in excess of $80,000, and
> (ii) if the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for such preceding year.
>
> The Secretary shall adjust the $80,000 amount under subparagraph (B) at the same time and in the same manner as under section 415(d), except that the base period shall be the calendar quarter ending September 30, 1996.

Notice 2018-83 provides that the $80,000 amount is $125,000 for 2019.

[4348] Notice 2009-48, A-8 provides:

> Section 101(j)(4) provides no exception that would excuse a wholly-owned corporation and its employee-owner from the notice and consent requirements that otherwise apply, nor can actual knowledge alone substitute for the statutory requirement that notice and consent be 'written.' Moreover, the requirement that notice and consent be written avoids factual controversies that otherwise could result where, for example, the sole owner of a corporation delegates financial matters to an employee.

[4349] Code § 101(j)(4).

[4350] Notice 2009-48, A-1, further below, clarifies that the person to whom this sentence refers generally is the entity that employs the insured rather than an owner of the entity and that the entity is treated as owning a policy owned by a grantor trust with respect to which the entity is the deemed owner.

[4351] Code § 101(j)(2)(A)(i). The reference to director comes from Code § 101(j)(5), and a 5% owner is described in the text accompanying fns. 4346-4348.

[4352] Code § 101(j)(2)(A)(ii). The reference to a 5% owner is described in the text accompanying fns. 4346-4348. The highly compensated employees are those described in Code § 414(q) (without regard to Code § 414(q)(1)(B)(ii)) or Code § 105(h)(5) (except that 35% is substituted for "25 percent" in Code § 105(h)(5)(C). Code § 414(q)(1) is reproduced in fn 4347 in part II.Q.4.g.i Analysis of Code § 101(j).

the contract is issued, so the concern for the qualifying relationship or qualifying use applies only when the insured is an employee who does not satisfy this bullet point when the contract is issued.)[4353]

- A qualifying use is being paid to a member of the family of the insured, any individual who is the designated beneficiary of the insured under the contract (other than the applicable policyholder), a trust established for the benefit of any such member of the family or designated beneficiary, or the estate of the insured.[4354]

- Another qualifying use is the purchase of an equity (or capital or profits) interest in the applicable policyholder from any person described in the preceding bullet point.[4355] Beware of the proceeds exceeding this use.

A life insurance-funded buy-sell agreement might be structured to comply with these rules, in case the parties forget to do the required notice and consent.[4356] It also would guard against error in my suggestion that "applicable policyholder" is limited to being the person to whom the policy is issued when the insured is an "employee" of that person.

These rules impose various notice and other requirements that in most cases will not be a practical obstacle to implementing buy-sell agreements if signed <u>before</u> the application is signed.[4357] The employer might be able to cure a failure before the due date of its return for the year in which the policy was issued if the insured has not died yet.[4358] Another cure would be to transfer the policy to the insured, then the insured

[4353] See text accompanying fns. 4343-4345.

[4354] Code § 101(j)(2)(B)(i). "Family member" refers to Code § 267(b)(4).

[4355] Code § 101(j)(2)(B)(ii).

[4356] One might consider provisions such as that found in part II.Q.4.g.ii Consent Integrated into Operating Agreement. The sample is an attempt to be a catch-all in case clients do not follow the recommended procedure. Letter Ruling 201217017 approved what appears to have been a similar provision in a corporate buy-sell agreement:

> … the Agreement provides that Taxpayer will obtain life insurance on the life of each Shareholder, and that Taxpayer will be the owner and beneficiary of such life insurance. If the Agreement is terminated, or a Shareholder disposes of his interest in Taxpayer as allowed by the Agreement, a Shareholder has the right to purchase from Taxpayer any Taxpayer-owned life insurance covering his life. If the life insurance was not purchased, Taxpayer retained the right to surrender or otherwise dispose of the life insurance.

The ruling concluded:

> …considering all of Taxpayer's documentation as a whole, for the Contracts listed in the Appendix, all of the requirements of § 101(j)(4) were met before the issuance of the Contracts:
>
> a) through the Agreement and the Application, each Shareholder was notified in writing that Taxpayer intended to insure the Shareholder's life;
>
> b) through the Application, each Shareholder was notified in writing of the maximum face amount for which the Shareholder could be insured at the time the Contract was issued, in dollars;
>
> c) by signing both the Agreement and the Application, each Shareholder consented to being insured under the Contract;
>
> d) by signing the Agreement, each Shareholder consented that such coverage may continue after the Shareholder terminates employment; and
>
> e) through the Agreement and the Application, each Shareholder was informed in writing that Taxpayer will be a beneficiary of any proceeds payable upon the death of the Shareholder.

[4357] Leimberg and Zaritsky, IRS Provides New and Substantial Guidance on Employer-Owned Life Insurance, 36 *Estate Planning*, No. 8, 3 (August 2009).

[4358] Notice 2009-48, A-13 provides:

> Section 101(j) does not contain a provision for correcting an inadvertent failure to satisfy the notice and consent requirements of § 101(j)(4). The Service will not, however, challenge the applicability of an exception under § 101(j)(2) based on an inadvertent failure to satisfy the notice and consent requirements if the following conditions are met: (1) the applicable policyholder made a good faith effort to satisfy those requirements, such as by maintaining a formal system for providing notice and securing consents from new employees; (2) the failure to satisfy the

transfers the policy back to the company (generally, transfers from the insured to the company are not subject to the rule, except with respect to increases in coverage);[4359] step transaction concerns might suggest that the insured transfer the policy into a life insurance LLC[4360] instead of waiting long enough (whatever that means) to avoid an assertion of the step transaction doctrine.

The proposed policy owner should obtain the insured's written consent before the life insurance application is signed.

Consider having the maximum face amount in that consent provide a cushion in excess of the largest amount that the parties can conceive of that death benefit being (including increased death benefits due to investing the cash value very successfully).

An insurance agent might provide such a consent form, which counsel should consider reviewing, or counsel could provide his/her own consent form to the client. Although some agents understand these issues, many agents do not know (or think they know but actually misunderstand) these rules. Accordingly, tax advisors should consider warning their clients that the tax advisors need to be involved before any policy is issued.

Every applicable policyholder owning one or more employer-owned life insurance contracts issued after August 17, 2006 is required to file IRS Form 8925 each year.[4361] "Applicable policyholder" and "employer-owned life insurance contract" are defined for purposes of this reporting rule the same way they are for determining whether a policy is subject to the notice and consent rules.[4362]

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requirements was inadvertent; and (3) the failure to obtain the requisite notice and consent was discovered and corrected no later than the due date of the tax return for the taxable year of the applicable policyholder in which the employer-owned life insurance contract was issued. Because § 101(j)(4)(B) requires that the employee's consent be written, failure to obtain such consent cannot be corrected after the insured employee has died.

[4359] Notice 2009-48, Q/A-8 provides:

Q-8. Is notice and consent required with regard to an existing life insurance contract that an employee irrevocably transfers to an employer?

A-8. No. The actual transfer of an existing life insurance contract by an employee to an employer is sufficient to satisfy the requirements that the employee be notified in writing of the intention to insure and the maximum face amount of insurance, that written consent be secured, and that the employee be notified that the employer will be a beneficiary upon his or her death. In the event the employer subsequently increases the face amount of the contract, however, written notice and consent must be secured to establish the requisite notice to the employee and consent to the new face amount.

[4360] See part II.Q.4.i Life Insurance LLC.

[4361] Code § 6039I(a) is the general reporting requirement, and Reg. § 1.6039I-1 specifies the form.

[4362] Code § 6039I(c).

These rules for life insurance contracts issued or materially changed after August 17, 2006.[4363] Notice 2009-48 elaborates on the rules described above, as well as providing rules for what constitutes a material modification,[4364] including guidance on tax-free exchanges.[4365]

As to buy-sell agreements, Notice 2009-48 provides that a contract that is owned by the owner of an entity engaged in a trade or business (such as for purposes of financing the purchase of an equity interest of another owner – in other words, a cross-purchase - is not subject to these rules.[4366] However, if the business owns it,[4367] the following rules apply (emphasis added):[4368]

> **Exceptions to the Application of § 101(j)(1)**
>
> Section 101(j)(2) provides several exceptions to the application of § 101(j)(1), ***provided the notice and consent requirements of § 101(j)(4) are met***. Specifically, under § 101(j)(2)(A), § 101(j)(1) does not apply if the insured either was an employee at any time during the 12-month period before death, or was a director, highly compensated employee or highly compensated individual, as defined, at the time the contract was issued. Under § 101(j)(2)(B), § 101(j)(1) does not apply to any amount received by reason of the death of an insured to the extent the amount is paid to or used to purchase an equity (or capital or profits) interest from a family member of the insured, an individual who is a designated beneficiary, a trust established for the benefit of a family member or designated beneficiary, or the estate of the insured.

If plans do change, the Notice allows consent to be given before the death benefit exceeds the amount shown in the consent. The Notice also provides for a change in the employer.

[4363] P.L. 109-280, Sec. 863(a). Changing a split-dollar agreement without changing the underlying policy will not constitute a material modification under Code § 101(j), although it might very well affect other tax treatment. Notice 2008-42, discussed in part II.Q.4.f.i Split-Dollar Generally, especially the text accompanying fns. 4243-4245.

[4364] Notice 2009-48, A-14 provides:

> The following changes are not treated as material changes for purposes of determining whether an existing contract is treated as a new contract for purposes of § 101(j): (1) increases in death benefit that occur as a result of either the operation of § 7702 or the terms of the existing contract (provided the insurer's consent to the increase is not required); (2) administrative changes; (3) changes from general account to separate account or from separate account to general account; or (4) changes as a result of the exercise of an option or right granted under the contract as originally issued. Thus, for example, a death benefit increase does not cause a contract to be treated as a new contract if the increase is necessary to keep the contract in compliance with § 7702, or if the increase results from the application of policyholder dividends to purchase paid-up additions, or if the increase is the result of market performance or contract design with regard to a variable contract. Notice and consent are required if a contract is treated as a new contract by reason of a material increase in death benefit or other material change, unless a valid consent remains in effect with regard to the insured.

[4365] Notice 2009-48, A-15 provides:

> Section 863(d) of the PPA provides that § 101(j) generally does not apply to a contract issued after August 17, 2006 in an exchange described in § 1035 for a contract issued on or before that date. Section 863(d) also provides that, for purposes of determining when a contract is issued, a material increase in the death benefit or other material change generally causes the contract to be treated as a new contract. A § 1035 exchange that results in a material increase in death benefit or other material change (other than a change in issuer) is treated as the issuance of a new contract after August 17, 2006 for purposes of determining whether § 101(j) applies to the contract.

[4366] A-1.

[4367] Including through a grantor trust that the business established, per A-1.

[4368] After A-3 and before Q-4.

The Notice further provides:

Q-1. Can a contract be an employer-owned life insurance contract if it is owned not by a person engaged in a trade or business, but by a related person who is not engaged in a trade or business?

A-1. No. A contract is an employer-owned life insurance contract only if it is owned by a person engaged in a trade or business and is otherwise described in § 101(j)(3). Thus, a contract that is owned by the owner of an entity engaged in a trade or business (such as for purposes of financing the purchase of an equity interest of another owner), or by a qualified plan or VEBA that is sponsored by an entity engaged in a trade or business, is not an employer-owned life insurance contract. A contract, however, that is owned by a grantor trust (such as a rabbi trust), assets of which are treated as assets of a grantor that is engaged in a trade or business, is an employer-owned life insurance contract if the contract is otherwise described in § 101(j)(3).

Q-2. Can a contract be an employer-owned life insurance contract if it is subject to a split dollar arrangement?

A-2. Yes. A contract that is subject to a split dollar arrangement is an employer-owned life insurance contract if the contract is owned by a person engaged in a trade or business and is otherwise described in § 101(j)(3). See § 1.61-22(c)(1) (defining the owner of a contract subject to a split dollar arrangement to be the person named as the policy owner of the contract). Under § 101(j)(2)(B), however, the general rule of § 101(j)(1) does not apply to the extent any amount received by reason of the death of the insured is paid to a family member of the insured, an individual who is a designated beneficiary, a trust established for the benefit of a family member or designated beneficiary.

Q-3. Is a contract an employer-owned life insurance contract if it is owned by a partnership or sole proprietorship that is engaged in a trade or business; the partnership or sole proprietorship is directly or indirectly a beneficiary under the contract; and, the contract covers the life of an insured who is an employee with respect to the trade or business on the date the contract is issued?

A-3. Yes. If a life insurance contract is otherwise described in § 101(j)(3), ownership of the contract by a partnership or sole proprietorship does not prevent the contract from being treated as an employer-owned life insurance contract. A life insurance contract that is owned by a sole proprietor on his or her own life is not, however, an employer-owned life insurance contract.

Q-4. Under § 101(j)(2)(A) and (j)(4), when is a contract treated as "issued" for purposes of determining whether the notice and consent are timely, or whether the insured is a director, a highly compensated employee, or a highly compensated individual at the time the contract is issued?

A-4. Generally, the issue date of a contract is the date on the policy assigned by the insurance company, which is on or after the date the application was signed. Solely for purposes of § 101(j)(2)(A) and (j)(4), an employer-owned life insurance contract is treated as "issued" on the later of (1) the date of application for coverage, (2) the effective date of coverage, or (3) the formal issuance of the contract. Thus, if an employer-owned life insurance contract is effective for a limited period of time before formal issuance of the contract (such as to complete underwriting), the notice and consent requirements may be satisfied during the period between the effective date of coverage and formal issuance of the contract. In addition, an employer-owned life insurance contract may be treated as a new contract, and thus newly "issued," by reason of a material increase in death benefit or other material change in the contract. See A-14, this Notice.

Q-5. For purposes of § 101(j), is the term "employee" limited to common law employees?

A-5. No. Section 101(j)(5)(A) provides that the term "employee" includes an officer, director, and highly compensated employee (within the meaning of § 414(q)). A director is an independent contractor in his or her capacity as a director.

Section 414(q) contains special rules relating to certain former employees and self-employed individuals. For example, a former employee is treated as a highly compensated employee (within the meaning of § 414(q)) if the individual was a highly compensated employee when he separated from service, or was a highly compensated employee at any time after attaining age 55. In addition, the term "employee" for purposes of § 414(q) includes an individual who is a self-employed individual who is treated as an employee pursuant to § 401(c)(1).

Although policies used to fund redemptions are subject to the notice and consent rules if the insured is either an employee or holds at least 5% ownership, an exception applies if and to the extent that the company uses the policy to redeem the insured's stock shortly after death:

A-6. In order to know whether an amount received as a death benefit under an employer-owned life insurance contract is eligible for exclusion from gross income under § 101(a), or is ineligible for exclusion under the general rule of § 101(j)(1), it is necessary to determine the availability of the exception for amounts used to purchase an equity (or capital or profits) interest in the applicable policyholder. Accordingly, an amount must be so paid or used by the due date, including extensions, of the tax return for the taxable year of the applicable policyholder in which the applicable policyholder is treated as receiving a death benefit under the contract.

I insist on notice and consent - even for redemption arrangements - because the purchase might not be completed within that deadline, the parties might later all agree that the money would be better used in the business, or the death benefit might exceed the purchase price.

II.Q.4.g.ii. Consent Integrated into Operating Agreement

As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below. See fn. 4356 for authority for relying on such a provision; however, I recommend obtaining a separate notice and consent for more direct evidence to show the IRS. The rest of this part II.Q.4.g.ii is the sample:

The Company or Members may from time to time obtain life insurance policies on the lives of the Members. In the event those policies fall within the definition of "employer-owned life insurance policies" as defined in Code section 101(j), it is intended that the policies qualify for an exclusion from those rules (and thus the proceeds will be income tax-free) and that this Operating Agreement comply with the notice and consent requirements necessary to obtain that exclusion. Therefore, each Member is hereby given written notice that the Company or Members intend to insure his or her life by purchasing life insurance policy(ies) in the maximum face amount of $___________, and that the Company or Members will be the owner and beneficiary of that policy and of any proceeds payable on such Member's death. Each Member (by signing this Operating Agreement) hereby gives advance written consent to being insured under such policy(ies) and to the continuation of the policy(ies) after such Member ceases to have an Interest in the Company or otherwise terminates employment (as defined in Code section 101(j)(4)(B)) with the Company (and no inference is intended that a Member is an "employee" for any purposes other than the possible application of Code section 101(j)). The Members also agree to enter into a specific notice and consent containing these terms with regard to each policy obtained before the issuance of that policy.

II.Q.4.g.iii. Consent for Owner Who Is Not an Employee

As mentioned in part II.Q.4.g.i, a person owning at least 5% of a company is treated as an employee for purposes of this rule, even if that person not an employee. The rest of this part II.Q.4.g.iii is a sample. As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below.

Notice and Consent

For _____ Owner

Under I.R.C. Section 101(j)(4)

I acknowledge notification that ______________ (the "Employer") intends to obtain a policy insuring my life with a maximum face amount of $_______. Although the Employer does not employ me, I understand that my ownership in the Employer makes me considered an "employee" for purposes of I.R.C. Section 101(j). Therefore:

(A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.

(B) I consent to being insured under these contracts and that such coverage may continue after I no longer own an interest in the Employer or otherwise terminate employment.

(C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

[add signature line and date, dated on before policy issuance]

II.Q.4.g.iv. Consent for an Employee

The rest of this part II.Q.4.g.iv is a sample. As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below.

Notice and Consent

For _______ Employee

Under I.R.C. Section 101(j)(4)

I acknowledge notification that ____________ (the "Employer") intends to obtain a policy insuring my life with a maximum face amount of $_______, and:

(A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.

(B) I consent to being insured under these contracts and that such coverage may continue after I terminate employment.

(C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

[add signature line and date, dated on before policy issuance]

II.Q.4.h. Establishing Estate Tax Values

For estate tax purposes, fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[4369] If a decedent owns voting and nonvoting shares, the shares are valued together as a single block.[4370]

Suppose a company is worth $4M and A owns 75% of the company. Perhaps A's estate would want to be bought out for $3M, which is 75% of $4M.

Suppose the company then buys a $3M policy insuring A's life, so it could buy A's interest when A dies. On A's death, however, the company is worth $7M – the sum of its $4M normal value and $3M of life insurance. Should the company have to pay 75% of $7M for A's interest, because of this life insurance? That higher price certainly would not honor the parties' intent. If the parties agree that A's estate gets $3M instead of 75% of $7M, does that mean that A has bequeathed the difference to the company's other owners? Imposing estate tax on A's estate for money that the estate will never receive is certainly an unfair result. On the other hand, if the company's other owner was A's son or some other natural object of A's bounty, then perhaps A's goal was essentially to bequeath the difference to that other owner. In the latter case, A's estate should pay estate tax on the difference and – depending on A's intent – perhaps recover the extra estate tax from that other owner.

How does the estate tax system differentiate between these situations? Regarding buy-sell agreements, Reg. § 20.2031-2(h), "Securities subject to an option or contract to purchase," provides:

> Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the

[4369] Reg. § 20.2031-1(b). Rev. Rul. 59-60 and its progeny discuss valuation principles.
[4370] *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981).

> decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. See section 2703 and the regulations at § 25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990.

Thus, a buy-sell or similar agreement must apply during a decedent's life as well as after death before it might be given effect. Recent cases have reaffirmed this requirement.[4371] If a buy-sell agreement is held to have testamentary intent rather than a legitimate business purpose, a bargain sale may constitute a gift.[4372]

Reg. § 20.2031-2(h) is not the only hurdle. For purposes of gift, estate and GST tax, Code § 2703(a) provides that the value of any property shall be determined without regard to:

> (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or
>
> (2) any restriction on the right to sell or use such property.

Thus, when a parent transfers an equity interest to a child pursuant to a legally binding stock option or buy-sell agreement, generally for gift, estate and GST tax purposes the parent is deemed to make a taxable transfer to the extent that the equity interest's value exceeds the payment under that agreement. Reg. § 25.2703-1(a)(3) provides:

> A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement, or any other agreement. A right or restriction may be implicit in the capital structure of an entity.

A waiver of the right to partition art was disregarded under Code § 2703(a)(2).[4373]

[4371] *True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004); *Estate of Blount*, T.C. Memo. 2004-116, *aff'd* in part, *rev'd* in part, 428 F.3d 1338 (11th Cir. 2005) (life insurance included in valuing company, but the Eleventh Circuit treated the buy-sell obligation as offsetting the inclusion); *Smith III v. U.S.*, 96 A.F.T.R.2d 2005-6549 (W.D. Pa. 2005). In a case citing *True* but taking an unusual tack, in *Huber v. Commissioner*, T.C. Memo. 2006-96, the IRS tried to use a buy-sell agreement against a taxpayer, but Judge Goeke ruled that a right of first refusal in the agreement did not increase the value of the subject stock. Not mentioned in the Huber opinion is that, according to one of the taxpayer's counsel, prior gift tax audits had accepted the taxpayer's appraisals or settled very close to it, so the IRS' posture was radically different than before. In *Estate of Cartwright v. Commissioner*, 183 F.3d 1034 (9th Cir. 1999), *aff'g* in part and *rev'g* in part T.C. Memo. 1996-286, life insurance proceeds did not increase the value of the decedent's interest in the law firm to which he had belonged, except as necessary to take into account advanced client costs and work in process pursuant to the buy-sell agreement.

[4372] See quote from *Estate of Lauder v. Commissioner*, T.C. Memo. 1994-527, in the text preceding fn 3674 in part II.O.2.c Effect of Buy-Sell Agreement on Marital Deduction.

[4373] *Elkins v. Commissioner*, 140 T.C. No. 5 (2013).

However, Code § 2703(b) provides that Code § 2703(a) does not apply to any option, agreement, right, or restriction which meets each of the following requirements:

(1) It is a bona fide business arrangement.[4374]

[4374] *Holman v. Commissioner*, 130 T.C. 170 (2008) held:

> We believe that [the transfer restrictions] were designed principally to discourage dissipation by the children of the wealth that Tom and Kim had transferred to them by way of the gifts. The meaning of the term bona fide business arrangement in section 2703(b)(1) is not self-apparent. As discussed supra, in *Estate of Amlie v. Commissioner*, T.C. Memo. 2006-76, we interpreted the term bona fide business arrangement to encompass value-fixing arrangements made by a conservator seeking to exercise prudent management of his ward's minority stock investment in a bank consistent with his fiduciary obligations to the ward and to provide for the expected liquidity needs of her estate. Those are not the purposes of [the transfer restrictions]. There was no closely held business here to protect, nor are the reasons set forth in the Committee on Finance report as justifying buy-sell agreements consistent with petitioners' goals of educating their children as to wealth management and disincentivizing them from getting rid of Dell shares, spending the wealth represented by the Dell shares, or feeling entitled to the Dell shares.

The court had cited this portion of the legislative history (an informal report of the Senate Committee on Finance):

> [Buy-sell agreements] are common business planning arrangements … that … generally are entered into for legitimate business reasons…. Buy-sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an unrelated party, to provide a market for the equity interest, and to allow owners to plan for future liquidity needs in advance….

The Eighth Circuit affirmed, 601 F.3d 763 (2010):

> Here that context shows that the Tax Court correctly assessed the personal and testamentary nature of the transfer restrictions. Simply put, in the present case, there was and is no business, active or otherwise. The donors have not presented any argument or asserted any facts to distinguish their situation from the use of a similar partnership structure to hold a passbook savings account, an interest-bearing checking account, government bonds, or cash. We and other courts have held that maintenance of family ownership and control of [a] business may be a bona fide business purpose. *St. Louis County Bank*, 674 F.2d at 1207; see also *Estate of Bischoff v. Commissioner*, 69 T.C. 32, 39–40 (1977). We have not so held, however, in the absence of a business. [footnote described below]
>
> That is not to say we necessarily believe it will always be easy to apply § 2703(b)(1) or that investment-related activities cannot satisfy the subsection (b)(1) test. When the restrictions at issue, however, apply to a partnership that holds only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy, we do not view this determination as difficult. See, e.g., *Higgins v. Commissioner*, 312 U.S. 212, 217–18 (1941) (holding in another context that merely keeping records and collecting interest and dividends did not amount to carrying on a business); *Estate of Thompson v. Commissioner*, 382 F.3d 367, 380 (3d Cir. 2004) (Other than favorable estate tax treatment resulting from the change in form, it is difficult to see what benefit could be derived from holding an untraded portfolio of securities in this family limited partnership with no ongoing business operations.).

In footnote 3 discussing the *St. Louis County Ban*k case, 674 F.2d 1207 (8th Cir. 1982), the court pointed out:

> In *St. Louis County Bank*, for example, the transferred interests were shares in a family company that had started out as a moving, storage, and parcel-delivery business and evolved into a real estate management company. *St. Louis Bank*, 674 F.2d at 1208–09. When engaged in the moving and storage business, the company had created a stock-purchase agreement based on a valuation formula keyed to income. *Id*. At 1209. Later, the family exited the moving and storage business but kept the business structure as a vehicle for renting real estate. *Id*. With this new activity, the formula resulted in a dramatically lower value. *Id*. We stated, We have no problem with the District Court's findings that the stock-purchase agreement provided for a reasonable price at the time of its adoption, and that the agreement had a bona fide business purpose—the maintenance of family ownership and control of the business. Courts have recognized the validity of such a purpose. *Id*. at 1210.

Judge Beam offered a strong dissent:

> Here, the Tax Court made the express factual determination that the partnership agreement restrictions were designed principally to protect family assets from dissipation by the Holman daughters. *Holman*, 130 T.C. at 195 (emphasis added). In other words, the Tax Court determined that the restrictions were designed primarily to serve a non-tax purpose. Notably, the Tax Court did not find that the Holmans merely paid lip service to legitimate business purposes for the restrictions while, in reality, using the restrictions for the primary purpose of avoiding taxes. [footnote omitted] Additionally, the Tax Court did not find that the restrictions failed to match the partnership's legitimate, non-tax goals. [footnote omitted] The underlying purposes of § 2703 are not served where, as here, the bona fide business arrangement test is applied in a manner

(2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.[4375]

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that discourages partners in family partnerships from creating restrictions principally to achieve non-tax, economic goals. Thus, I would hold that the Holman partnership agreement restrictions are bona fide business arrangements because they were not created for the primary purpose of avoiding taxes, and they served the following legitimate business purposes: (1) maintaining family control over the right to participate as a limited partner; (2) maintaining family control over the right to receive income from the partnership's investment assets; (3) protecting partnership assets from creditors and potential future ex-spouses; and (4) preserving the partners' fundamental right to choose who may become a partner.

…Under § 2703(b)(3)'s comparable terms test, the Holman partnership restrictions' terms must be comparable to similar arrangements entered into by persons in an arms' length transaction. While the Tax Court did not decide whether the restrictions satisfied the comparable terms test, it noted that both parties' experts agree that transfer restrictions comparable to those found in [the Holman partnership agreement] are common in agreements entered into at arm's length. [footnote omitted] Holman, 130 T.C. at 198–99. The Tax Court explained that this would seem to be all that [the Holmans] need to show to satisfy section 2703(b)(3). Id. at 199. I agree, and I would hold that the Holman partnership restrictions satisfy § 2703(b)(3)'s comparable terms test. Thus, because the partnership restrictions satisfy all three of § 2703(b)'s tests, I would reverse and remand to the Tax Court for a valuation of the limited partnership interests that does not disregard the partnership restrictions.

The U.S. District Court for the Southern District of Indiana, following *Holman*, held that holding undeveloped land did not constitute a business that could qualify for the Code § 2703 safe harbor. *Fisher v. U.S.*, 106 A.F.T.R.2d 2010-6144. The court later ruled that the taxpayer could not introduce into evidence the discounts that the IRS had used on audit, ruling that the IRS' audit determination was irrelevant to determining the actual value. 106 A.F.T.R.2d 2010-6144.

For an in-depth discussion of the facts of some of these cases, see Aghdami, Mancini, & Zaritsky, *Structuring Buy-Sell Agreements*, ¶ 6.02[4] Restriction on Lifetime Transfer.

[4375] Judge Beam's dissent in *Holman v. Commissioner*, 601 F.3d 763 (2010), argued that "decedent" in Code § 2703(b)(2) means it does not apply to gifts:

Having determined that the partnership restrictions satisfy § 2703(b)(1), I now turn to § 2703(b)(2)'s device test. Under this test, the Holman partnership restrictions must not be a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth. I.R.C. § 2703(b)(2) (emphasis added). Treasury Regulation § 25.2703-1(b)(1)(ii) excises the phrase members of the decedent's family found in § 2703(b)(2) and substitutes in its place the phrase natural objects of the transferor's bounty, apparently because the Secretary of the Treasury interprets § 2703(b)(2) to apply to both inter vivos transfers and transfers at death. Holman, 130 T.C. at 195–96. Applying this regulation, the Tax Court held that the Holman partnership restrictions operate as a device to transfer property to the natural objects of the Holmans' bounty. The Holmans argue that Treasury Regulation § 25.2703-1(b)(1)(ii) is invalid because it fails to give effect to § 2703(b)(2)'s plain language. I agree. [discusses Chevron deference] The parties primarily dispute whether § 2703(b)(2) is ambiguous. The Holmans assert that the term decedent unambiguously refers to a deceased person and, therefore, § 2703(b)(2) asks only whether restrictions operate as a device to transfer property to family members at death. The Holmans point out that only the term decedent, not the broader term transferor, is used throughout § 2703(b)(2)'s legislative history. Conversely, the Commissioner argues that the term decedent is ambiguous due to § 2703's location in the Internal Revenue Code. Specifically, § 2703 is located in Subtitle B of the Code, which includes three transfer taxes—the estate, gift and generation-skipping transfer taxes. More precisely, § 2703 is located in Subtitle B, Chapter 14. In Chapter 14, § 2703 joins a set of special valuation rules targeting transfer tax avoidance schemes. It is clear that the phrase members of the decedent's family unambiguously limits § 2703(b)(2)'s application to transfers at death. First, the term decedent is itself unambiguous. *Black's Law Dictionary* 465 (9th ed. 2009) plainly defines decedent as [a] dead person. Moreover, the phrase members of decedent's family is not ambiguous when read in the greater context of Chapter 14. While Congress used the term decedent in § 2703(b)(2), it used the broader term transferor in Chapter 14's other valuation statutes. See I.R.C. §§ 2701(a)(1) & 2702(a)(1). And, as the Holmans point out, the term decedent consistently appears in § 2703(b)(2)'s legislative history. Finally, I find it telling that members of Congress have failed in their attempts to amend § 2703(b)(2) by substituting the legislative phrase members of the decedent's family with the Commissioner's phrase natural objects of the transferor's bounty. See *Smith v. United States*, No. C.A. 02-264 ERIE, 2004 WL 1879212, at 6 n.3 (W.D. Pa. June 30, 2004). Thus, although Congress enacted Chapter 14 to generally address transfer tax avoidance schemes, § 2703(b)(2) applies specifically to transfers at death. Therefore, Treasury Regulation § 25.2703-1(b)(1)(ii) is invalid because it does not give effect to the plain language of § 2703(b)(2). Since the Holmans are living persons, they are, by definition, not decedents and § 2703(b)(2)'s device test is satisfied.

Kress v. U.S., 123 AFTR 2d 2019-1224 (E.D. Wis. 3/26/2019), held that Code § 2703(b)(2) does not apply to gifts (highlighting added):

(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

One way to satisfy this exception is if the entity is not family owned, using Code § 2701 principles:[4376]

> A right or restriction is considered to meet each of the three requirements … if more than 50 percent by value of the property subject to the right or restriction is owned directly or indirectly (within the meaning of § 25.2701-6) by individuals who are not members of the transferor's family. In order to meet this exception, the property owned by those individuals must be subject to the right or restriction to the same extent as the property owned by the transferor. For purposes of this section, members of the transferor's family include the persons described in § 25.2701-2(b)(5) and any other individual who is a natural object of the transferor's bounty. Any property held by a member of the transferor's family under the rules of § 25.2701-6 (without regard to § 25.2701-6(a)(5)) is treated as held only by a member of the transferor's family.

If the entity does not satisfy this non-family-controlled test, then one must satisfy each of the above three exceptions separately. The Code § 2703(b)(3) comparability test, which is the main test that Code § 2703 added to pre-1990 law, uses the following principles:[4377]

> (i) In general. A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length. A right or restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business. This determination generally will entail consideration of such factors as the expected term of the agreement, the current fair market value of the

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Under the second requirement, the Restriction cannot be "a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth." § 2703(b)(2). Citing Treasury Regulation § 25.2703–1, the Government contends that this second requirement applies not only to transfers at death but also to inter vivos transfers. See 26 C.F.R. § 25.2703–1(b)(1)(ii) ("The right or restriction is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth."). The Government argues that the term "decedent" in § 2703(b)(2) is ambiguous in light of the statute's place within Subtitle B, Chapter 14 of the Internal Revenue Code, which includes other valuation rules targeting transfer avoidance schemes, and thus the court should defer to the agency's interpretation of the statute.…

Although Chapter 14 is intended to generally address transfer tax avoidance schemes, it is clear from the statute itself that the phrase "members of the decedent's family" unambiguously limits its application to transfers at death. See Black's Law Dictionary (10th ed. 2014) (defining "decedent" as a "dead person, especially one who has died recently"); see also *Smith v. United States*, No. C.A. 02-264 ERIE, 2004 WL 1879212, at *6 (W.D. Pa. June 30, 2004) (noting that "one of Congress's primary concerns [in enacting § 2703(b)(2)] was the free passage of wealth to family members through a device that is testamentary in nature"). Although Congress has attempted to amend § 2703(b)(2) to conform with the agency regulations, no such legislation has been enacted. See *Smith*, 2004 WL 1879212, at *6 n.3 (citing HR Conf. Rep. 1555, 102d Cong., 1st Sess. (1991); The Revenue Bill of 1992, HR Conf. Rep. 11, 102d Cong., 2d Sess. (1992)); see also *Holman*, 601 F.3d at 781 (Bean, J., dissenting) ("I find it telling that members of Congress have failed in their attempts to amend § 2703(b)(2) by substituting the legislative phrase `members of the decedent's family' with the Commissioner's phrase `natural objects of the transferor's bounty.'").

In short, I find that Congress has spoken unambiguously to the precise question at issue: § 2703(b)(2) applies specifically to transfers at death. Because Plaintiffs gifted their shares to their family members as living persons, they are, by definition, not decedents. Therefore, § 2703(b)(2) is satisfied. But even were I to conclude that § 2703(b)(2) does apply to inter vivos transfers, this would not change the result. For as noted above, the family transfer restrictions serve the bona fide purpose of maintaining family ownership and control of the business, and were not intended as a tax avoidance device.

[4376] Reg. § 25.2703-1(b)(3).

[4377] Reg. § 25.2703-1(b)(4).

property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted.

(ii) Evidence of general business practice. Evidence of general business practice is not met by showing isolated comparables. If more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods. It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement. If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.

The Tax Court, convinced that the taxpayer's buy-sell agreement was arrived upon in a manner intended to arrive at fair market value, applied the comparability test in *Estate of Amlie*:[4378]

> For the reasons discussed below, we conclude that the estate has satisfied section 2703(b)(3). By its terms, the statute requires only a showing that the agreement's terms are "comparable" to similar arrangements entered at arm's length. While the regulations caution against using "isolated comparables", we believe that in context the regulations delineate more of a safe harbor than an absolute requirement that multiple comparables be shown.

Even if the above rules are not complied with, obligations do tend to affect a stock's marketability,[4379] in that they cloud the business' future operations.[4380] In reversing the Tax Court,[4381] *Estate of Blount*, 428 F.3d 1338 (11th Cir. 2005) held:

> To establish the fair market value of BCC, the Tax Court blended the analyses of the experts to arrive at a value of $6.75 million. The IRS and the Taxpayer, albeit alternatively, agree that this is the base value for the assets and liabilities of BCC as of the date of Blount's death. We accept the accuracy of this value as not clearly erroneous. The Tax Court then added the insurance proceeds that BCC would receive on Blount's death to the value of the company, concluding that the value of BCC would have been $9.85 million. In doing so, the Tax Court erred.
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> In valuing the corporate stock, "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent that such nonoperating assets have not been taken into account in the determination of net worth." Treas. Reg. § 20.2031-2(f)(2). The limiting phrase, "to the extent that such nonoperating assets have not been taken into account," however, precludes the inclusion of the insurance proceeds in this case. In *Cartwright v. Commissioner*, the Ninth Circuit approved deducting the insurance proceeds from the value of the organization when they were offset by an obligation to pay those proceeds to the estate in a stock buyout. 183 F.3d 1034, 1038] (9th Cir. 1999)[5] ; see also *Huntsman v. Comm'r*, 66 T.C. 861, 875 (1976)[6].
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> [5] The Ninth Circuit observed that the Tax Court "properly determined that [the] insurance policy would not necessarily affect what a willing buyer would pay for the firm's stock because it was

[4378] T.C. Memo. 2006-76.
[4379] Rev. Rul. 77-287 explains valuation adjustments due to stock being restricted from resale pursuant to Federal securities laws.
[4380] *True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004), citing *Estate of Lauder v. Commissioner*, T.C. Memo. 1994-527, for the concept that, even if a provision does not bind the IRS as to estate tax value, it can still affect its value.
[4381] T.C. Memo. 2004-116.

offset dollar-for-dollar by [the] obligation to pay out the entirety of the policy benefit's to [the] estate." *Cartwright*, 183 F.3d at 1038.

[6] The Tax Court focused on the word "consideration" to make its judgment about including life insurance proceeds: "The Commissioner argues that our interpretation of section 20.2031-2(f), Estate Tax Regs., frustrates the clear intent of Congress to include corporate-owned life insurance in the estate of its sole shareholder. See H. Rept. No. 2333, 77th Cong., 1st Sess. (1942), 1942-2 C.B. 372, 491; S. Rept. No. 1631, 77th Cong., 2d Sess. (1942) 1942-2 C.B. 504, 677. However, the statements in the legislative history relied upon by the Commissioner indicate only that Congress believed that a sole shareholder was deemed to have the incidents of ownership possessed by his corporation on insurance policies on his life. The regulations now provide that the incidents of ownership held by a corporation are not to be attributed to its shareholder, and no indication is included in the committee reports that Congress intended property owned by a decedent to be includable in his gross estate at other than its fair market value. Consequently, our interpretation of such section does not frustrate a congressional intent. In accordance with section 20.2031-2(f), Estate Tax Regs., we must determine the fair market value of the decedent's stock in the two corporations by applying the customary principles of valuation and by giving "consideration" to the insurance proceeds." *Huntsman*, 66 T.C. at 875–76.

The rationale in *Cartwright* is persuasive and consistent with common business sense. BCC acquired the insurance policy for the sole purpose of funding its obligation to purchase Blount's shares in accordance with the stock-purchase agreement. Even when a stock-purchase agreement is inoperative for purposes of establishing the value of the company for tax purposes, the agreement remains an enforceable liability against the valued company, if state law fixes such an obligation.[7] Here the law of Georgia required such a purchase.

[7] Other courts have found - when the restrictive agreement is an attempt to effect a testamentary transfer and avoid the estate tax - that honoring a restrictive element in determining fair market value would be improper. See *True v. Comm'r*, 390 F.3d 1210, 1239-41 (10th Cir. 2004) (listing cases that honor restrictive clauses in determining value and cases that do not honor such restrictive clauses). The IRS urges us to adopt the broadest rule that, when an agreement is ignored for valuation purposes, the agreement plays no role in determining the fair market value. We decline to do so because, as proved by this case, such a rule is overinclusive and represents a manifest departure from common business (i.e., market) sense.

Thus, we conclude that the insurance proceeds are not the kind of ordinary nonoperating asset that should be included in the value of BCC under the treasury regulations. To the extent that the $3.1 million insurance proceeds cover only a portion of the Taxpayer's 83% interest in the $6.75 million company, the insurance proceeds are offset dollar-for-dollar by BCC's obligation to satisfy its contract with the decedent's estate. We conclude that such nonoperating "assets" should not be included in the fair market valuation of a company where, as here, there is an enforceable contractual obligation that offsets such assets. To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value.

III. CONCLUSION

The Tax Court properly determined that the 1981 agreement, as amended by the 1996 agreement, had no effect for purposes of determining the value of the BCC shares in Blount's estate and that

> the fair market value of the corporation was the proper basis for tax assessment. The Tax Court erred when it ignored the amended agreement's creation of a contractual liability for BCC, which the insurance proceeds were committed to satisfy. We reject the Tax Court's inclusion of the insurance proceeds paid upon the death of the insured shareholder as properly included in the computation of the company's fair market value. We remand for disposition consistent with this opinion.

Connelly v. U.S., 128 A.F.T.R.2d 2021-5955 (E.D. MO 9/21/2021), agreed with the Tax Court's reasoning and disagreed with the Eleventh Circuit's opinion in *Blount*:

> The Estate urges that the fair market value of Crown C does not include the $3 million in life-insurance proceeds at issue because those proceeds "were off-set dollar for dollar by the obligation to redeem [Michael's] shares" under the Stock Agreement. Doc. 65. According to the Estate, a hypothetical "willing buyer" of Crown C would have to account for substantial liabilities like Crown C's redemption obligation. See, *e.g.*, *Estate of Dunn v. C.I.R.*, 301 F.3d 339, 352 (5th Cir. 2002) (the value of a corporation's assets is discounted by the corporation's capital-gains liability); *Eisenberg v. Comm'r*, 155 F.3d 50, 57 (2d Cir. 1998) (a hypothetical buyer would pay less for shares in a corporation because of the buyer's "inability to eliminate the contingent tax liability"). The Estate emphasizes that a willing buyer would pay less for a company encumbered with a stock-purchase agreement, to account for the company's future decrease in assets when fulfilling the contractual obligation. See *Estate of Blount*, 428 F.3d at 1346.
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> The parties agree that the facts of this case present the same fair-market-value issue as *Estate of Blount*, 2004 WL 1059517, at *26 (T.C. 2004), *aff'd in part*, *rev'd in part*, 428 F.3d 1338 (11th Cir. 2005). Doc. 52 at 12; Doc. 46 at 6–7. In *Estate of Blount*, a closely-held family company entered into a stock purchase agreement with its shareholders, intending that the company would use life-insurance proceeds to redeem a key shareholder's shares upon his death. 428 F.3d at 1340. When one of the shareholders died, his estate argued that the life-insurance proceeds should not be included in the value of the company, for purposes of determining fair market value of the redeemed shares, because of the company's offsetting contractual obligation to redeem those shares from the estate. *Id*. at 1345.
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> The Tax Court in *Estate of Blount* included the life-insurance proceeds in the value of the company and the shareholders' shares, determining that the redemption obligation was not like an ordinary liability because the redemption involved the very same shares being valued. 2004 WL 1059517, at *26. The Eleventh Circuit reversed on this issue, holding that the fair market value of the closely-held corporation did not include life-insurance proceeds used to redeem the shares of the deceased shareholder under a stock purchase agreement. *Estate of Blount*, 428 F.3d at 1346. The Eleventh Circuit reasoned that the stock-purchase agreement created a contractual liability for the company, offsetting the life-insurance proceeds. *Id*. at 1345-46. The Eleventh Circuit concluded that the insurance proceeds were "not the kind of ordinary nonoperating asset that should be included in the value of [the company] under the treasury regulations" because they were "offset dollar-for-dollar by [the company's] obligation to satisfy its contract with the decedent's estate." *Id*. at 1346 (citing 26 C.F.R. § 20.2031-2(f)(2)).
>
> The IRS urges the Court to reject the Eleventh Circuit's holding in *Estate of Blount* and apply the Tax Court's reasoning. Doc. 52 at 12–14. The IRS contends that the Eleventh Circuit's approach violates customary valuation principles, resulting in a below-market valuation for Crown C and a windfall for Thomas at the expense of Michael's estate. *Id*. According to the IRS, a willing buyer and seller would value Crown C at approximately $6.86 million, rather than $3.86 million, because

on the date of Michael's death, Crown C possessed the $3 million in life-insurance proceeds that were later used to redeem Michael's shares. *Id*. at 19. This, in turn, would make Michael's 77.18% interest in Crown C worth about $5.3 million. *Id*. The Estate disagrees, somewhat reflexively arguing that under the Eleventh Circuit's holding in *Estate of Blount*, the Court should not include the $3 million in life-insurance proceeds in the valuation of Crown C because of the redemption obligation in the Stock Agreement. Doc. 46 at p. 6. But other than citing the Eleventh Circuit's holding and its own expert opinions (which essentially say that holding controls), the Estate does not really explain why it believes the Eleventh Circuit's holding is correct. *Id.*

Life-insurance proceeds are nonoperating assets that generally increase the value of a company. 26 C.F.R. § 20.2031-2(f)(2); *Estate of Huntsman*, 66 T.C. at 874. Here, the parties agree that the proceeds are a nonoperating asset that would have increased Crown C's value, but they dispute whether Crown C's redemption obligation was a liability that offset the proceeds for valuation purposes. Doc. 52 at pp. 14-15; Doc. 46 at pp. 5-6. Therefore, to determine the fair market value of Michael's shares as of the date of his death, the Court analyzes whether Crown C's outstanding redemption obligation was a corporate liability that reduced the fair market value of Crown C.

Under the willing-buyer-willing-seller principle, a redemption obligation does not reduce the value of a company as a whole or the value of the shares being redeemed. A redemption obligation requires a company to buy its own shares from a shareholder, and just like any other contractual obligation, a redemption obligation expends company resources. But as the Tax Court observed in *Estate of Blount*, a redemption obligation is not a "value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued." 2004 WL 1059517, at *25.

Consider what a hypothetical "willing buyer" would pay for a company subject to a redemption obligation. See 26 C.F.R. § 20.2031-1(b). The willing buyer would not factor the company's redemption obligation into the value of the company, because with the purchase of the entire company, the buyer would thereby acquire all of the shares that would be redeemed under the redemption obligation; in other words the buyer would pay all of the shareholders the fair market value for all of their shares. The company, under the buyer's new ownership, would then be obligated to redeem shares that the buyer now holds. Since the buyer would receive the payment from the stock redemption, the buyer would not consider the obligation to himself as a liability that lowers the value of the company to him. See *Estate of Blount*, 2004 WL 1059517, at *25 (T.C. 2004) ("To treat the corporation's obligation to redeem the very shares that are being valued as a liability that reduces the value of the corporate entity thus distorts the nature of the ownership interest represented by those shares.").

A willing buyer purchasing Crown C on the date of Michael's death would not demand a reduced purchase price because of the redemption obligation in the Stock Agreement, as Crown C's fair market value would remain the same regardless. The willing buyer would buy all 500 of Crown C's outstanding shares (from Michael's Estate and Thomas) for $6.86 million, acquiring Crown C's $3.86 million in estimated value plus the $3 million in life-insurance proceeds at issue. If Crown C had no redemption obligation, the willing buyer would then own 100% of a company worth $6.86 million.

But even with a redemption obligation, Crown C's fair market value remains the same. Once the buyer owned Crown C outright, the buyer could either: 1) cancel the redemption obligation to himself and own 100% of a company worth $6.86 million, or 2) let Crown C redeem Michael's former shares - the buyer (and not Michael's Estate) would receive roughly $5.3 million in cash and then own 100% of a company worth the remaining value of about $1.56 million, leaving the buyer with a total of $6.86 million in assets. Therefore, with or without the redemption obligation, the fair market value of Crown C on the date of Michael's death was $6.86 million.

The Estate urges the Court to follow the Eleventh Circuit's reasoning in *Estate of Blount*, which declared that "nonoperating assets should not be included in the fair market valuation of a company where, as here, there is an enforceable contractual obligation that offsets such assets." 428 F.3d at 1346 (quotation marks omitted). But as the IRS points out, the Court must determine the fair market value of Crown C on the date of Michael's death, not the value in its post-redemption configuration. See 26 U.S.C. § 2031. Excluding the insurance proceeds from Crown C's value impermissibly treats Michael's shares as both outstanding and redeemed at the same time, reducing Crown C's value by the redemption price of the very shares whose value is at issue. This approach ignores the ownership interest represented by Michael's shares; construing a redemption obligation as a corporate liability only values Crown C post redemption (*i.e.*, excluding Michael's shares), not the value of Crown C on the date of death (i.e. including Michael's shares).

Demonstrating this point, exclusion of the insurance proceeds from the fair market value of Crown C and valuing Michael's shares at $3 million results in drastically different share prices for Michael's shares compared to Thomas's. If on the date of his death, Michael's 77.18% interest was worth only $3 million ($7,774/share), that would make Thomas's 22.82% interest worth $3.86 million ($33,863/share) because Thomas owned all other outstanding shares and the residual value of Crown C was $3.86 million. See Doc. 53-19 at ¶ 61. The residual value of Crown C is the value of the company apart from the $3 million of insurance proceeds at issue. The parties have agreed that this value was $3.8 million. Doc. 48 at ¶¶ 1–3; Doc. 58 at ¶¶ 43, 79–81. Because Thomas was the only other shareholder of Crown C, his ownership interest must therefore equal the residual value of Crown C: $3.8 million. This outcome violates customary valuation principles because Thomas's shares would be worth 336% more than Michael's at the exact same time. See Doc. 53-19 at ¶ 61. A willing seller of Michael's shares would not accept this bargain, as it creates a windfall for the buyer (Crown C of which Thomas would now have 100% control), while undervaluing Michael's shares in comparison.

Only by including the insurance proceeds in the fair market value of Crown C do Michael's and Thomas's shares hold an equal value on the date of Michael's death. Michael's 77.18% interest in a $6.86 million company would be worth $5.3 million ($13,782/share) and Thomas's 22.82% interest would be worth $1.56 million ($13,782/share). This outcome tracks customary valuation principles, because the brothers' shares have the same value-per-share. A willing seller of Michael's shares would only accept this outcome, because it assigns the same value to Michael's shares as to Thomas's and neither party's economic position changes through the transaction.

The Eleventh Circuit declared in *Estate of Blount* that 26 C.F.R. § 20.2031-2(f)(2) precludes the inclusion of insurance proceeds in the corporate value when the proceeds are used for a redemption obligation. 428 F.3d at 1345 ("The limiting phrase, `to the extent that such nonoperating assets have not been taken into account,' however, precludes the inclusion of the insurance proceeds in this case." (citing 26 C.F.R. § 20.2031-2(f)(2))). But, 26 C.F.R. § 20.2031-2(f)(2) begins with a discussion of the factors considered in determining the fair market value of a closely-held corporation, including "the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors." The regulation goes on to state that "[i]n addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth." *Id.*

While in *Estate of Huntsman* the Tax Court ultimately rejected the Commissioner's valuation as not following customary valuation principles, the court found this regulation to mean that the court "must determine the fair market value of the decedent's stock...by applying customary principles of valuation and by giving `consideration' to the [life-]insurance proceeds." 66 T.C. at 875. The Eleventh Circuit's holding in *Estate of Blount* notwithstanding, the text of the regulation does not indicate that the very presence of an offsetting liability means that the life-insurance proceeds have already been "taken into account in the determination of a company's net worth." See 26 C.F.R. § 20.2031-2(f)(2). By its plain terms, the regulation means that the proceeds should be considered in the same manner as any other nonoperating asset in the calculation of the fair market value of a company's stock. See id. And as already discussed, a redemption obligation is not the same as an ordinary corporate liability. See supra at pp. 29–31.

The Eleventh Circuit's opinion in *Estate of Blount* relied heavily on *Estate of Cartwright*, 183 F.3d 1034, 1037 (9th Cir. 1999), which excluded insurance proceeds from the fair market value of a company when the proceeds were offset by an obligation to pay those proceeds to a shareholder's estate. *Estate of Blount*, 428 F.3d at 1345. But *Estate of Cartwright* is distinguishable. As the Tax Court in *Estate of Blount* explained about *Estate of Cartwright*:

> The lion's share of the corporate liabilities in that case which were found to offset the insurance proceeds were *not obligations of the corporation to redeem its own stock*. Rather, we determined that approximately $4 million of the $5 million liability of the corporation was to compensate the decedent shareholder for services; *i.e.*, for his interest in work in progress. Thus, a substantial portion of the liability was no different from any third-party liability of the corporation that would be netted against assets, including insurance proceeds, to ascertain net assets.

2004 WL 1059517, at *27 (emphasis added). Unlike in *Estate of Cartwright*, Crown C's redemption obligation simply bought Michael's shares. See *id*. The redemption did not compensate Michael for his past work, so it was not an ordinary corporate liability. See *Estate of Blount*, 2004 WL 1059517, at *27 (T.C. 2004). While some of the life-insurance proceeds in *Estate of Cartwright* were used for a stock redemption, *Estate of Cartwright* mainly discussed how the insurance proceeds compensated the shareholder for past work, not for his shares in the company. See *Estate of Cartwright* , 1996 WL 337301, at *7-8 (T.C. 1996), *aff'd in part, rev'd in part by*, 183 F.3d 1034, 1037-38 (9th Cir. 1999). And to the extent that *Estate of Cartwright* excluded some of the life-insurance proceeds from the company's fair market value because of an offsetting redemption obligation, the opinion contains the same analytical flaw as *Estate of Blount*, 183 F.3d at 1037, *i.e.* considering a redemption obligation to be a corporate liability that depresses a company's value by ignoring the ownership interest represented by the redeemed shares.

The Court finds the Tax Court's reasoning in *Estate of Blount* persuasive. *Estate of Blount*, 2004 WL 1059517, at *24-27; *see also* Adam S. Chodorow, *Valuing Corporations for Estate Tax Purposes: A Blount Reappraisal*, 3 Hastings Business Law Journal 1, 25 (2006) ("Taking redemption obligations into account leads the court to value the wrong property...redemption obligations are different from other types of corporate obligations in that a redemption obligation both shrinks the corporate assets and changes its ownership structure."). A redemption obligation is not an ordinary corporate liability - a stock redemption involves a change in the ownership structure of the company, where the company buys a shareholder's interest - so a redemption

> obligation does not change the value of the company as a whole before the shares are redeemed. Nor can a redemption obligation diminish the value of the same shares being redeemed; the shareholder is essentially "cashing out" his share of ownership in the company and its assets. Moreover, a stock redemption results in the company (and more specifically its remaining shareholder(s)) getting something of equal value for the cash spent, *i.e.* the decedent's share of ownership in the company; the exchange increases the ownership interest for each of the company's outstanding shares, *i.e.* the surviving shareholders' shares.
>
> For these reasons, the Court respectfully finds that the Eleventh Circuit's opinion in *Estate of Blount* is "demonstrably erroneous" and there are "cogent reasons for rejecting [it]." *Keasler v. United States*, 766 F.2d 1227, 1233 (8th Cir. 1985) ("[T]he tax decisions of other circuits should be followed unless they are demonstrably erroneous or there appear cogent reasons for rejecting them." (internal quotation marks and citation omitted)). Accordingly, the Court holds that the $3 million in life-insurance proceeds used to redeem Michael's shares must be included in the fair market value of Crown C and of Michael's shares.

Connelly hypothesized that a buyer would buy 100% before buying the decedent's interest. Hypothesizing a strategic buyer is reversible error, unless that part of the opinion can be disregarded and the rest of the opinion holds together. Query how the court will value the decedent's stock. If the buy-sell agreement is disregarded, will the resulting liquidity also be disregarded? In that case, the stock needs to be value based on lack of marketability and how much control a hypothetical willing buyer of the company's stock would have over the company.

Keeping a pre-1990 agreement outside of the application of Code § 2703 would avoid the statute's imposition of the comparability test. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in a significant change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification that's would subject it to this test.[4382] If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless updating would not have resulted in a substantial modification.[4383] Adding any family member as a party to a right or restriction is a substantial modification unless either the terms of the right or restriction require the addition or the added family member is assigned to a generation no lower than the lowest generation occupied by individuals already party to the right or restriction.[4384] However, a substantial modification does not include a modification required by the terms of a right or restriction, a discretionary modification of an agreement conferring a right or restriction if the modification does not change the right or restriction, a modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate, or a modification that results in an option price that more closely approximates fair market value.[4385] Amending an agreement to extend the number of years of payment, to clarify that the prime rate is to be established semi-annually, and to update the name of the banking institution from the original bank's name to its successor's name was not a substantial modification.[4386] Issuing nonvoting shares proportionately to the owners of voting stock in an S corporation was not a substantial modification.[4387]

[4382] Reg. § 25.2703-1(c)(1).
[4383] Reg. § 25.2703-1(c)(1).
[4384] Reg. § 25.2703-1(c)(1).
[4385] Reg. § 25.2703-1(c)(2).
[4386] Letter Ruling 201313001.
[4387] Letter Ruling 201536009, reasoning:

Letter Ruling 202014006, approving certain actions and amendments as not ruining grandfathering. Facts included:

> As a result of the transfers of shares of Company stock since the Agreement date, Date 1, Company is now owned by Daughters, C, D, and E, six living grandchildren F, G, H, J, K, and L, as well as six GST Trusts created by C on Date 9.
>
> The Board of Directors of Company proposes to cancel all shares of Company common stock held in treasury and to recapitalize Company so that newly issued voting stock in Company can thereafter be primarily held by shareholders who are active in the management of Company. To accomplish this, Company will amend its Articles to increase the number of common shares and to immediately convert each outstanding common share into one share of Class A voting common stock and x shares of Class B nonvoting common stock. After adoption of the foregoing amended capital structure, the Articles and the Agreement will be amended to reflect the common stock split and the addition of the Class B nonvoting common stock (Plan of Recapitalization).
>
> In addition and as indicated above, after approval of the changes to the corporate structure, C, D and E propose to transfer shares of her Class B nonvoting common stock to the GST Trusts created by her on Date 9 (with respect to C) and Date 10 (with respect to each of D and E).

Letter Ruling 202014006 held:

> **Ruling #1**
>
> The individuals and trusts who were parties to the Agreement as of Date 1 are A, B, C, D, E, the Daughters' Trust, and the six Grandchildren's' Trusts (excluding L's Trust). Under § 2651, A and B, as parents and grandparents of the other parties to the Agreement, are assigned to the eldest generation, which will be referred to as the First Generation. C, D and E, as children of A and B, are assigned to the generation immediately below the First Generation and will be referred to as the Second Generation. The Daughters' Trusts are also assigned to the Second Generation because C, D and E are the only current beneficiaries of the Daughters' Trusts. The six Grandchildren's' Trusts (excluding L's Trust) are assigned to the Third Generation, as each trust benefits only a grandchild of A and B.
>
> There are nine transactions or events after October 8, 1990, in which new parties were treated as having been added to the Agreement. The nine events occurred as follows: (i) on Date 3 with the addition of A's estate upon the death of A; (ii) through (vii) through the addition of F, G, H, J, K, and L, on the date each respective Grandchild's Trust distributed shares of Company stock subject to the Agreement to each such Grandchild, outright and free of trust; (viii) on Date 5 with the addition of B's estate upon the death of B, and (ix) on Date 9 when C transferred shares of her Company stock to the GST Trusts C created, each benefiting a niece or nephew of C.

In this case, the stock split and amendment to the Articles will apply to all of the common shares (whether voting or nonvoting). Because each shareholder will receive c shares for every common share he or she currently holds, the beneficial interests in Company will not be affected by the stock split, amendment, and share dividend.

Likewise, because the number of authorized voting shares will continue to be x, the shareholders' voting rights will remain unchanged.

Consequently, the stock split, amendment to the Articles, and share dividend will not affect the quality, value or timing of any rights under the Articles, and the changes will not be a substantial modification of the Articles for purposes of § 25.2703-1(c). Accordingly, the Articles will remain exempt from the application of chapter 14.

On Date 2, a date after Date 1 but prior to October 8, 1990, A and B created and funded with shares of Company stock a seventh Grandchild's Trust for L (L's Trust), a newly-born descendant. Since L's Trust was not in existence on Date 1, L's Trust was not a party to the Agreement. However, L's Trust was treated as having been added to the Agreement when it received the shares of Company stock from A and B. Pursuant to Paragraph 1 of the Agreement, the gifted shares were subject to the terms of the Agreement and to the obligations of the transferors thereunder and L's Trust was prohibited from transferring such shares except in accordance with the Agreement. Pursuant to Paragraph 8 of the Agreement, the Endorsement appeared on the certificates issued to L's Trust. Accordingly, the addition is mandatory under the terms of the right or restriction within the meaning of § 25.2703-1(c)(1). Further, under § 2651(f)(2), L's Trust is assigned to the same generation as the sole beneficiary, L, a grandchild of A and B. Therefore, L's Trust is assigned to the Third Generation of family members already parties to the Agreement. Accordingly, L's Trust is assigned to a generation no lower than the lowest generation occupied by individuals already party to the right or restriction, within the meaning of § 25.2703-1(c).

On Date 3, A died, survived by his spouse, B, and his Daughters, C, D, and E, and his grandchildren. Pursuant to A's will, B, C, D, and E were the beneficiaries of A's estate. Accordingly, pursuant to § 2651(f)(1) and (2), A 's estate was assigned to the Second Generation of shareholders already parties to the Agreement. Accordingly, the addition of A's estate to the Agreement was the addition of a family member of no lower a generational assignment than the family members already party to the Agreement on Date 1.

On Date 4, and subsequently, the trustee of the Grandchildren's Trusts benefiting F, G, H, J, K, and L distributed shares of Company stock subject to the Agreement to the grandchild for whom a Grandchild's Trust was held, outright and free of trust. The foregoing transfers for J, K and L included shares of Company stock received from Grandchild's Trust for I upon I's death. F , G, H, J, K, and L were treated as having been added to the Agreement when shares of Company stock were distributed to them, outright and free of trust. Pursuant to § 2651(f)(2), each Grandchild's Trust was assigned to the same generational assignment as its sole beneficiary, a grandchild of A and B. Therefore, the addition of the beneficiary of each Grandchild's Trust to the Agreement was the addition of a family member of no lower a generational assignment than the individuals already party to the Agreement as of Date 1.

On Date 5, B died, survived by her Daughters, C, D, and E, and her grandchildren. B's estate is treated as a new party to the Agreement. Pursuant to B's will, C, D , and E were the beneficiaries of B's estate. C, D, and E executed partial disclaimers which resulted in F, G, H, I, J, K , and L acquiring beneficial interests in B's estate. Pursuant to § 2651(f)(1) and (2), B 's estate is treated as being assigned to the Third Generation of shareholders. Therefore, the addition of B's estate to the Agreement was the addition of a family member of no lower than the generational assignment of the individuals already party to the Agreement as of Date 1.

On Date 9, C created and funded six GST Trusts with shares of Company stock for the initial benefit of each of her six living nieces and nephews. A niece or nephew of C, each of whom is also a grandchild of A and B, is the sole beneficiary of each GST Trust for and during the lifetime of each such beneficiary. There are no other permissible distributees from any such GST Trust during such time. Therefore, pursuant to § 2651(f)(1), each GST Trust is treated as being assigned to the Third Generation. Accordingly, a transfer of shares of Company stock subjecting the GST Trust to the Agreement is treated as a transfer to a family member of no lower than the generational assignment of the parties already subject to the Agreement on Date 1. The Agreement was adopted before October 8, 1990 and, consequently is exempt from the application of § 2703, provided the

Agreement is not substantially modified as set forth in § 25.2703-1(c). No family member which is treated as having been added to the Agreement after October 8, 1990 is assigned to a lower generational assignment than the parties already subject to the Agreement on Date 1. Accordingly, based upon the information submitted and representations made, we conclude that none of the transfers of shares of Company stock subject to the Agreement after October 8, 1990, constitute substantial modifications within the meaning of § 25.2703-1(c). Consequently, the Agreement continues to be grandfathered for purposes of chapter 14.

Ruling #2

On Date 7, a date after October 8, 1990, Company amended the Articles to change its name to the current name. On Date 8, Company amended and restated the Articles. Also on Date 8, Company amended and restated the Bylaws that included administrative changes such as name change, indemnification, and number of members constituting the Board of Directors.

Based upon the facts submitted and representations made, we conclude that none of the amendments to the Articles on Date 7, the amendments and restatement of the Articles on Date 8, and the amendment and restatement of the Bylaws on Date 8 constitute substantial modifications of any right or restriction in the Articles, the Bylaws, or the Agreement within the meaning of § 25.2703-1(c). Consequently, we conclude that the Articles, the Bylaws, and the Agreement continue to be grandfathered for purposes of chapter 14.

Ruling #3

The proposed Plan of Recapitalization includes a stock split of one share of Company common stock into one share of Class A voting common stock and x shares of Class B nonvoting common stock. The Articles and Agreement will be amended to reflect the stock split and the addition of Class B nonvoting common stock to the capital structure. The issuance of the Class B nonvoting common stock does not change the terms and conditions to which the shareholders are already subject. In addition, the beneficial interest in the Company will not be affected by the stock split because each shareholder of common stock will receive x shares of Class B nonvoting common stock for every share of common stock held prior to the recapitalization. Accordingly, we conclude that the recapitalization does not affect the quality, value, or timing of any rights of the parties to the Agreement.

Based upon the facts submitted and representations made, we conclude that the proposed Plan of Recapitalization, the proposed amendments to the Articles and Agreement to reflect the stock split and the addition of Class B nonvoting common stock to the capital structure, and the issuance of Class B nonvoting common stock, will not constitute substantial modifications of the Agreement or the Articles within the meaning of § 25.2703-1(c). Further, we conclude that the proposed Plan of Recapitalization and the proposed amendments, described above, will not cause § 2703 to apply to transfers of shares of Company stock subject to the Agreement, as amended.

Ruling #4

C, D and E propose to transfer shares of Class B nonvoting stock in the Company to the GST Trusts created by each. Each GST Trust is assigned to the Third Generation of family members subject to the Agreement. We concluded under Ruling 1 that the prior transfers by C of shares of Company stock to C's GST Trusts do not cause a substantial modification of the Agreement. We likewise conclude that the proposed transfers of shares of Company stock by C to her GST Trusts

> do not cause a substantial modification to the Agreement. Similarly, the proposed transfers by D and E of shares of Company stock to D's and E's GST Trusts, respectively, do not cause a substantial modification of the Agreement.
>
> Accordingly, based upon the facts submitted and representations made, we conclude the proposed transfers of shares of Company stock by C, D and E to the GST Trusts created by each will not constitute substantial modifications of the Agreement within the meaning of § 25.2703-1(c). Further, we conclude that the proposed transfers of shares of Company stock by C, D and E to the GST Trusts created by each will not cause § 2703 to apply to the transfer of shares of Company stock subject to the Agreement, as amended.

Letter Rulings 202014007, 202014008, 202014009, and 202014010 are reported to be companion rulings to Letter Ruling 202014006. Letter Rulings 202015004-202015013 also appear to be companion rulings.

BNA Daily Tax Report (4/24/2020) described ten letter rulings:[4388]

> In 10 similar ruling letters, the IRS concluded that certain events occurring after October 8, 1990 (the date defining whether tax code Section 2703 applies), subject to an agreement that "Company" shareholders (individuals and trusts in a family lineage) entered into before that date, don't constitute substantial modifications of the Agreement or other applicable documents within the meaning of Treasury Regulations Section 25.2703-1(c) such that would cause application of these sections. The events are: (rulings 1,2) transfers of Company shares and additions of new parties to the Agreement - including the estates of first-generation individuals (a husband and wife) upon their deaths, and new generation-skipping transfer (GST) tax-exempt trusts for additional or newly born family members none of whom are assigned to a lower generation than those already subject to the Agreement - as well as amendment and restatement of Company's Articles of Incorporation (including name change); consequently grandfathering continues on all the applicable documents for purposes of Chapter 14 (Special Valuation Rules) of the tax code; (ruling 3) proposed amendments to the Articles and Agreement to reflect Company's plan of recapitalization, including a stock split into voting and nonvoting common shares, deemed as not affecting the quality, value, or timing of any rights of the parties to the Agreement; and (ruling 4) proposed transfers of Company shares by second-generation trust beneficiaries to GST trusts for third-generation beneficiaries.

Finally, many of the buy-sell restrictions in partnership agreements are no more restrictive than would otherwise apply under state law, so the application of Code § 2703 would not have a significant impact on the valuation. Yet the IRS makes a big deal of these issues on audit and acts as if some of the cases cited above give it a major advantage. Consider asking the appraiser to expressly state that (s)he is ignoring any provisions in the agreement that are more restrictive than otherwise applicable state law. That way, when the IRS makes a big deal about Code § 2703, one might respond that one has already assumed that Code § 2703 applied, so that issue is off the table.

[4388] Letter Rulings 202017001, 202017002, 202017003, 202017004, 202017005, 202017006, 202017011, 202017012, 202017013, 202017014.

II.Q.4.i. Life Insurance LLC

Wouldn't it be nice to avoid using a lot of policies, minimize life insurance income tax consequences to owners coming and going,[4389] and keep the life insurance policies in a safer environment? One solution is to place the policies in a limited liability company (LLC) taxed as a partnership. The owners of the business entity also would be the members (owners) of the LLC. A trust company could serve as manager, taking charge of the policies and ensuring that the proceeds are used as intended. Each owner would have an interest in policies insuring the other partners' lives. I obtained Letter Ruling 200747002, which approved such a strategy.

II.Q.4.i.i. The Facts of Letter Ruling 200747002

The flowcharts in the Appendices A and B illustrate the situation. Appendix A illustrates trusts that were set up. Appendix B explains the Insurance LLC's structure. Appendix C illustrates some creative planning described below.

In this case, an S corporation had three shareholders: Child A (Brother), Child B (Sister), and BA. BA was an unrelated shareholder. Although the ruling does not disclose the percentage ownership, in fact BA owned 5% of the stock, and Brother and Sister owned the rest in roughly equal amounts. The buy-sell agreement was funded by term life insurance policies.

The grantor, parent of Brother and Sister, set up an irrevocable trust, Trust 2A, for Brother ("Brother's Irrevocable Trust"). This was a typical flexible generation-skipping trust. Brother was trustee and could make distributions under an ascertainable standard to Brother and Brother's descendants. Brother also had the power to appoint Brother's Irrevocable Trust's assets at Brother's death to anyone except to Brother, Brother's creditors, Brother's estate or the creditors of Brother's estate. The grantor had allocated GST exemption to Brother's Irrevocable Trust, and Brother's Irrevocable Trust was not subject to the rule against perpetuities. Thus, Brother's Irrevocable Trust provides Brother with flexibility to use its assets during life and pass them to practically anyone at death. The grantor also set up Trust 2B for Sister with similar terms ("Sister's Irrevocable Trust").

Under a buy-sell agreement, Brother would buy Sister's and BA's stock at their deaths. Brother owned policies on their lives to fund this purchase. Brother also had the right to assign Brother's purchase rights and obligations to Brother's Irrevocable Trust or other trusts controlled by Brother. Brother would then transfer these policies to the LLC. Brother and Brother's Irrevocable Trust would contribute premiums to the LLC and receive the right to death benefits from Policies on Sister's and BA's lives in proportion to the premiums that Brother and Brother's Irrevocable Trust made these premium contributions. The goal was to maximize Brother's Irrevocable Trust's proportion of contributions, because Brother's Irrevocable Trust and any trusts created under it are excluded from the estate tax system. However, given the uncertainties of cash flow and the impracticality of frequently changing beneficiary designations, being flexible in sharing premiums was important and the LLC's use of partnership accounting seemed to be the best way to accomplish that. Brother and Sister had virtually identical goals regarding the buy-sell arrangement.

The LLC had some other features. The manager was a corporate trustee. Using a corporate trustee as manager provided security to ensure that no party to the buy-sell agreement would use the life insurance

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[4389] See text accompanying fns. 4132-4134 in part II.Q.4.b.i Transfer for Value Rule Generally regarding certain transfers involving partnerships. Distributions from partnerships generally are tax-free, as described in part II.Q.8.b.i Distribution of Property by a Partnership; and, as described in fn 5137, a life insurance contract is not targeted by part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them).

proceeds improperly. The manager was instructed to retain all life insurance proceeds until the parties agreed on their application toward the cross-purchase. Thus, the manager's roles were essentially the equivalent of a combination of trustee of an irrevocable life insurance trust before a shareholder's death and escrow agent for the buy-sell agreement after a shareholder's death.

The LLC's activity required special partnership accounting provisions. Each member had a separate capital account for each policy the member owned on a shareholder. Also, the members needed to contribute cash to pay the LLC's administrative expenses, requiring an additional set of capital accounts.

II.Q.4.i.ii. Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity

Code § 2042(2) provides that an insured's gross estate includes the value of all property "to the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person."[4390]

Code § 2035(a) provides:

> If—
>
> (1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and
>
> (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036 , 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death,
>
> the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

Reg. 20.2042-1(c)(1) begins with:

> Section 2042 requires the inclusion in the gross estate of the proceeds of insurance on the decedent's life not receivable by or for the benefit of the estate if the decedent possessed at the date of his death any of the incidents of ownership in the policy, exercisable either alone or in conjunction with any other person.

[4390] It continues:

> For purposes of the preceding sentence, the term "incident of ownership" includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent. As used in this paragraph, the term "reversionary interest" includes a possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate, or may be subject to a power of disposition by him. The value of a reversionary interest at any time shall be determined (without regard to the fact of the decedent's death) by usual methods of valuation, including the use of tables of mortality and actuarial principles, pursuant to regulations prescribed by the Secretary. In determining the value of a possibility that the policy or proceeds thereof may be subject to a power of disposition by the decedent, such possibility shall be valued as if it were a possibility that such policy or proceeds may return to the decedent or his estate.

Then it continues by pointing out inclusion when incidents of ownership are transferred too soon to death, which is now covered by Code § 2035.

Reg. 20.2042-1(c)(2) provides:

> For purposes of this paragraph, the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. See subparagraph (6) of this paragraph for rules relating to the circumstances under which incidents of ownership held by a corporation are attributable to a decedent through his stock ownership.

Reg. 20.2042-1(c)(3) discusses reversionary interests:

> The term "incidents of ownership" also includes a reversionary interest in the policy or its proceeds, whether arising by the express terms of the policy or other instrument or by operation of law, but only if the value of the reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy. As used in this subparagraph, the term "reversionary interest" includes a possibility that the policy or its proceeds may return to the decedent or his estate and a possibility that the policy or its proceeds may become subject to a power of disposition by him. In order to determine whether or not the value of a reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy, the principles contained in paragraph (c)(3) and (4) of § 20.2037-1, insofar as applicable, shall be followed under this subparagraph. In that connection, there must be specifically taken into consideration any incidents of ownership held by others immediately before the decedent's death which would affect the value of the reversionary interest. For example, the decedent would not be considered to have a reversionary interest in the policy of a value in excess of 5 percent if the power to obtain the cash surrender value existed in some other person immediately before the decedent's death and was exercisable by such other person alone and in all events. The terms "reversionary interest" and "incidents of ownership" do not include the possibility that the decedent might receive a policy or its proceeds by inheritance through the estate of another person, or as a surviving spouse under a statutory right of election or a similar right.

Reg. 20.2042-1(c)(4) is reproduced in part II.Q.4.i.ii.(a) Trust Ownership of Policy.

Reg. 20.2042-1(c)(5) discusses the impact of state law property rights:

> As an additional step in determining whether or not a decedent possessed any incidents of ownership in a policy or any part of a policy, regard must be given to the effect of the State or other applicable law upon the terms of the policy. For example, assume that the decedent purchased a policy of insurance on his life with funds held by him and his surviving wife as community property, designating their son as beneficiary but retaining the right to surrender the policy. Under the local law, the proceeds upon surrender would have inured to the marital community. Assuming that the policy is not surrendered and that the son receives the proceeds on the decedent's death, the wife's transfer of her one-half interest in the policy was not considered absolute before the decedent's death. Upon the wife's prior death, one-half of the value of the policy would have been included in her gross estate. Under these circumstances, the power of surrender possessed by the decedent as agent for his wife with respect to one-half of the policy is not, for purposes of this section, an "incident of ownership", and the decedent is, therefore, deemed to possess an incident of ownership in only one-half of the policy.

Reg. 20.2042-1(c)(6) is reproduced in part II.Q.4.i.ii.(b) Corporate Ownership of Policy.

Simple cross-purchase agreements avoid these issues. Rev. Rul. 56-397 ruled that when each of two business associates owns, is the beneficiary of and pays all premiums for an insurance policy on the other business associate, neither of the business associates possesses incidents of ownership in the policy on his or her respective life.

II.Q.4.i.ii.(a). Trust Ownership of Policy

Reg. § 20.2042-1(c)(4) provides:

> A decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust. Moreover, assuming the decedent created the trust, such a power may result in the inclusion in the decedent's gross estate under section 2036 or 2038 of other property transferred by the decedent to the trust if, for example, the decedent has the power to surrender the insurance policy and if the income otherwise used to pay premiums on the policy would become currently payable to a beneficiary of the trust in the event that the policy were surrendered.

Below are authorities when the insured is a trustee or a beneficiary.

The Official Tax Court Syllabus for *Estate of. Fruehauf v. Commissioner*, 50 T.C. 915 (reviewed 1968), summarized:

> Decedent's wife owned several insurance policies taken out on the life of her husband. She died 14 months before her husband. In the wife's will it was provided that the policies were to go to a trust of which decedent was cotrustee and income beneficiary. The trustees were given broad powers to retain policies as long as they desired, to assign some of the policies to obtain money to pay premiums, to designate themselves as beneficiaries, and to sell or convert policies for cash surrender value. Held, the proceeds of the policies were correctly included in decedent's estate and he held incidents of ownership over the policies within sec. 2042, I.R.C. 1954, and the fact that his powers, affecting the beneficiaries' enjoyment of the proceeds, were held by him in his capacity as trustee, was immaterial.

The majority reasoned and held:

> There is no merit in petitioners' argument. The right of the insured or his estate to the economic benefits of the policy is merely one of the several incidents of ownership. The argument advanced by petitioners was rejected in *United States v. Rhode Island Hospital Trust Co.*, 355 F.2d 7 (C.A. 1, 1966), where the court said:
>
>> Plaintiffs seize on Section 20.2042-1(c)(2) of the Treasury Regulations on Estate Tax, which says "… the term 'incidents of ownership' is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy." Plaintiffs urge that there must be "a real control over the economic benefits". To this there are two answers. First, it is clear that the reference to ownership in the "technical legal sense" is not abandoned and supplanted by reference to "economic benefits". Second, the regulation goes on to list illustrative powers

> > referred to by Congress in its reports. All of these are powers which may or may not enrich decedent's estate, but which can affect the transfer of the policy proceeds…..
>
> In *United States v. Rhode Island Hospital Trust Co.*, *supra*, the court said the relevant question to ask with respect to this statute is: "Did he [decedent] have a capacity to do something to affect the disposition of the policy if he had wanted to?" It cannot be said the capacity to do something to affect the disposition of the policy is lacking merely because it is held in a fiduciary capacity.
>
> It is no answer to say that decedent as trustee owed a duty to the beneficiary to faithfully administer the trust and the beneficiary could have had his actions with respect to the trust corpus reviewed in an action at law or in equity. *Cf. Reinecke v. Smith*, 289 U.S. 172 (1933). As stated in *United States v. Rhode Island Hospital Trust Co.*, *supra*, it is the existence of "powers" that renders the proceeds of the policies taxable as distinguished from the existence of "rights" or duties owed to others.
>
> In the last-cited case, in answer to the same argument with respect to decedent's power over the property being limited because of trustee duties and responsibilities, the court said:
>
> > For decedent had some powers—perhaps not rights, but powers—which could, if exercised alone or in conjunction with another, affect the disposition of some or all of the proceeds of the policy.
>
> There is no doubt at all but that sections 2038 and 2042 are parts of a tax pattern to make includable in the gross estate property over which the decedent held various powers affecting beneficial enjoyment. Since case law makes immaterial for purposes of section 2038 the capacity in which the powers are held, it is not logical to make capacity a significant factor as far as section 2042 is concerned.
>
> In spite of the fact that there is language expressing a contrary view in some of our prior cases, we now hold that the fact the powers over the policies were held by decedent in a fiduciary capacity is no bar to their constituting incidents of ownership under section 2042.

The Sixth Circuit affirmed, 427 F.2d 80 (1970), while disagreeing with the breadth of the Tax Court's reasoning:

> While the opinion of the Tax Court clearly related the holding to the facts of this case, certain language in that opinion is susceptible to interpretation as a broad per se rule that possession by a decedent of powers constituting incidents of ownership in insurance policies on his life, regardless of the capacity in which they are held, always requires inclusion of the proceeds of the policies in the decedent's gross estate. In reasoning to this conclusion the Tax Court placed heavy reliance on a number of cases[2] which arose under § 2038 (and its predecessor sections) of the Code. Section 2038 charges a decedent's gross estate with any property of which he made an inter vivos transfer if, at the date of his death, he possessed the power to "alter, amend, revoke, or terminate" the transfer. The statute also provides that the existence of the power is to be determined "without regard to when or from what source the decedent acquired the power." Thus, the Tax Court reasoned:
>
> > "There is no doubt at all but that sections 2038 and 2042 are parts of a tax pattern to make includable in the gross estate property over which the decedent held various powers affecting beneficial enjoyment. Since case law makes immaterial for purposes of section 2038 the

> capacity in which the powers are held, it is not logical to make capacity a significant factor as far as section 2042 is concerned."

and held that:

> "[T]he fact the powers over the policies were held by decedent in a fiduciary capacity is no bar to their constituting incidents of ownership under section 2042." 50 T.C. at 926.

[2] *E.g.*, *Van Beuren v. McLoughlin*, 262 F.2d 315; (1st Cir. 1958), *cert. denied* (359 U.S. 991 (1959); *Estate of Loughridge v. Commissioner*, 183 F.2d 294 (10th Cir. 1950), *cert. denied*, 340 U.S. 830 (1950); *Union Trust Company of Pittsburgh v. Driscoll*, 138 F.2d 152 (3rd Cir. 1943), *cert. denied*, 321 U.S. 764 (1944); *Welch v. Terhune*, 126 F.2d 695 (1st Cir. 1942).

We must disagree with the Tax Court's broad per se rule. We believe that there is a distinction between the issues arising under § 2038 where the decedent, as transferor of certain property, possesses at his death the power, even though in a fiduciary capacity, to revoke or change the transfer, and the issues in a case arising under § 2042 where the decedent is the transferee, in a fiduciary capacity, of powers constituting incidents of ownership in the insurance policies on his life. Where a decedent holds the requisite powers over policies on his life solely because he is a transferee, in a fiduciary capacity, of those powers, with no beneficial interest therein, such arrangement can hardly be construed as a substitute for testamentary disposition on decedent's part. *Cf. Porter v. Commissioner*, 288 U.S. 436, 444 (1933); *Commissioner v. Chase National Bank*, 82 F.2d 157, 158 (2d Cir. 1936).

Moreover, the Tax Court has previously held that where the decedent himself procured the policies on his life and transferred them to a trust, while retaining certain powers over the policies in a fiduciary capacity, the proceeds of the policies were not includible in the decedent's gross estate. In *Estate of Newcomb Carlton*, 34 T.C. 988 (1960), *rev'd on other grounds*, 298 F.2d 415 (2d Cir. 1962), the decedent originally procured 21 insurance policies on his life. He then transferred them to a trust, together with certain securities, with instructions to use the net income from the securities to pay the premiums on the life insurance policies. The decedent originally retained certain powers over the policies, but by a subsequent instrument he relinquished all rights over the trust except the right to the income from the trust in excess of that necessary to pay the premiums on the life insurance policies, and the right to appoint a co-trustee, including himself, for a co-trustee who had resigned. Decedent never exercised the power to appoint himself as co-trustee, but he retained that power until his death. Had he appointed himself as co-trustee he would have had, in conjunction with the other co-trustees, broad powers to borrow on the insurance policies or surrender them for their cash surrender value, powers which would constitute incidents of ownership in the policies. The Tax Court stated, however:

> "Any control that decedent would have acquired over the insurance policies had he appointed himself co-trustee would have been control over the policies jointly with the corporate trustee as trustee only and such control would be solely for the benefit of the trust. Such control as trustee would not constitute incidents of ownership in the insurance policies in decedent except in his capacity as trustee for the benefit of the trust." 34 T.C. at 996.

In *Estate of Bert L. Fuchs*, 47 T.C. 199 (1966), the decedent was one of three business partners who funded a partnership purchase agreement with insurance policies on the lives of the respective partners. The purchase agreement provided that the beneficiaries would be the owners of the policies, that the beneficiaries would pay the premiums on the policies, and that the insureds would have no right, title or interest in the policies on their respective lives. Through inadvertence on the part of the insurance agent, the policies showed ownership to be in the insured rather than in the beneficiaries, thereby giving the insured the right under the policy to change the beneficiary and to surrender or assign the policies. Nevertheless the Tax Court held that the insured decedent did not possess any incidents of ownership in the policies on his life at the date of his death. While that determination was based on a finding that the insurance policies were subject to the provisions in the partnership purchase agreement, the Tax Court clearly recognized the nature of the fiduciary relationship:

> "Assuming, arguendo, that the insured of each policy herein possessed the naked power to change beneficiaries or make an assignment, we cannot say, in view of the partners' agreement regarding the policies, that the insured herein should be treated in any way differently than a common trustee. Each insured herein was under no less of a legal duty to respect the terms of the partners' agreement than a common trustee legally obligated to respect the terms of a trust indenture. Decedent merely had the same type of power over the ... policies as a trustee's power to affect trust proceeds. We do not believe that this type of naked power alone is sufficient to bring the insurance proceeds within decedent's gross estate." 47 T.C. at 204.

We believe that the Tax Court in this case ignored what it had clearly recognized in these prior cases, *i.e.*, the fundamental nature of the fiduciary relationship. Accordingly, we decline to hold that mere possession by a decedent of any powers in the nature of incidents of ownership in a fiduciary capacity invariably requires inclusion of the proceeds of the policies on the decedent's life in his gross estate.

Our rejection of the per se rule of the Tax Court majority opinion does not dispose of the case, however. In an opinion in which three other judges joined, Judge Simpson of the Tax Court similarly rejected the per se rule of the majority opinion but concurred in the result because of the special facts of this case. Judge Simpson viewed the powers held by decedent in his fiduciary capacity as broad enough to permit their exercise for his individual benefit. Specifically, the concurring opinion concluded that decedent had the power as trustee under paragraph Eighth of his wife's will to surrender the insurance policies for their cash surrender values. The amounts so received could then have been added to the corpus of the trust, thereby increasing the income receivable from the trust by decedent as income beneficiary.

The estate's first response to this analysis of the facts is that decedent did not actually have any powers as trustee or any right to receive any increased income which would result from a surrender of the insurance policies because, at the date of his death, no distribution of assets had been made to the trust, and neither decedent nor any of the other co-trustees had been formally appointed as trustees of the testamentary trust by the state probate court. In support of this argument the estate contends that the normal period for the administration of decedents' estates in Michigan is eighteen months, and since decedent's death here occurred only fourteen months after his wife's death the testamentary trust could not reasonably have been created.

It appears, however, that eighteen months is the maximum period allowable by a Michigan probate court for the administration of an estate before the accrual of interest on pecuniary bequests begins. See *In re Howlett's Estate*, 275 Mich. 596, 602, 267 N.W. 743, 745 (1936). It does not appear that swifter administration of an estate is impossible. Decedent here had the power to become both trustee and life income beneficiary of the testamentary trust through the exercise of his powers as executor of the will. We believe that it is the existence of that power, not its exercise, which is determinative. Merely because decedent had not performed certain acts necessary to enable [pg.

> 70-1627] him to become trustee-beneficiary of the trust does not detract from his power to do so. Moreover, under the terms of paragraph Eighth of his wife's will decedent had the power in his capacity as executor as well as trustee to surrender the policies for their cash value. Accordingly, he could have surrendered the policies for their cash value while he was executor thereby enlarging the income producing ability of the corpus available for distribution in due course to the testamentary trust. We therefore do not consider it significant that decedent had not been formally appointed trustee by the probate court.
>
> The estate's second line of argument is that the fiduciary duty of loyalty imposed upon decedent in his capacity as executor and trustee would have prevented him from exercising any of the powers granted to him in any manner which would benefit himself to the detriment of the remainderman; that any powers granted to decedent which would appear to give him authority to perform acts which would benefit himself to the detriment of the remainderman were void as a matter of law.
>
> It is a well established rule of law that a fiduciary cannot use his position to benefit himself in his individual capacity. See *e.g.*, *Michigan Trust Co. v. Luton*, 267 Mich. 547, 554, 255 N.W. 351, 353-54 (1934); *Chambers v. Chambers*, 207 Mich. 129, 136, 173 N.W. 367, 369-70 (1919); *Sloan v. Silberstein*, 2 Mich. App. 660, 673, 141 N.W.2d 332, 338 (1966); Bogert, *Trusts and Trustees* § 129 (2d ed. 1965); II *Scott on Trusts* § 170.23 (3rd ed. 1967). There is, however, an equally well established countervailing rule of law that a fiduciary may be authorized by the terms of the instrument creating his powers to do that which in the absence of such provision would be a violation of his fiduciary duty of loyalty. II *Scott on Trusts* § 170.9 (3rd ed. 1967). Michigan courts have recognized this rule. See *Waddell v. Waddell*, 335 Mich. 498, 506-7, 56 N.W.2d 257, 260-61 (1953).
>
> Under the provisions of paragraph Eighth of decedent's wife's will, decedent was authorized, both as executor and as trustee, to surrender the policies on his life for their cash value. If this had been done the policies would have been transformed from non-income producing assets designed to benefit primarily the ultimate beneficiary of the trust into income producing assets (since it must be assumed that such proceeds would not remain idle), which would benefit decedent when he assumed his capacity as trustee and income beneficiary of the trust. We must therefore hold that under the facts of this case decedent could exercise powers in the nature of incidents of ownership in the policies to his individual benefit, and that therefore the proceeds of the policies were includible in his gross estate.

Does being the trustee of a trust containing an insurance policy on the trustee's life, with the trustee having no beneficial interest in the trust, result in estate tax inclusion under Code § 2042? *Estate of Skifter v. Commissioner*, 468 F. 2d 699 (2d Cir. 1972) held that the insured as trustee would not have an includable incident of ownership unless the insured had transferred the policy to the trust, implying this requirement into the regulation, which otherwise would not have complied with the statute:

> Although this legislative history is hardly conclusive on the matter, we feel that there is sufficient support to justify our conclusion that Congress intended § 2042 to parallel the statutory scheme governing the interests and powers that will cause other types of property to be included in a decedent's estate. This conclusion is reinforced by the types of interests and powers that Congress indicated were exemplary of what it meant to be included within the scope of "incidents of ownership." The interests there listed are interests that would cause other types of property to be included in a decedent's estate under § 2036 or § 2037; and the powers that Congress discussed are also powers that would result in the property being included in the decedent's estate under

§ 2038 or § 2041.[4391] Therefore, in ruling on the Commissioner's contention that the fiduciary power here involved is an "incident of ownership," a question that has not been considered under § 2042, we feel that we should look to the experience under the statutory scheme governing the application of the estate tax to other types of property. Indeed, the Commissioner, in making his contention before us, relies on numerous analogies to decisions under these other statutory provisions.

The core of the controversy here centers on the decedent's power, as trustee, to prefer the current income beneficiary over the remainderman and all later income beneficiaries through payment of the entire trust corpus. He did not have the power to alter or revoke the trust for his own benefit and he could not name new, additional, or alternative beneficiaries. In this regard, Reg. § 20.2042-1(c)(4) provides:

> A decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

The Commissioner contends that this regulation requires that the proceeds of the policies here be included in decedent's estate.

The Tax Court declined to interpret that regulation so as to make it applicable here, but concluded that, since the power could not be exercised to benefit the decedent or his estate, it would not cause the proceeds to be included in his estate. If the power had been exercisable for the benefit of decedent, or for the benefit of whomever the decedent selected, it would have been necessary to include the proceeds in the estate; for there would be a powerful argument that this was an incident of ownership since he would have had the equivalent of a power of appointment, which under § 2041 would cause other types of property to be included in the estate of the holder of such a power. This distinction causes us to concur in the Tax Court's conclusion that the Commissioner's reliance on our decision in *Commissioner v. Karagheusian's Estate*, 233 F.2d 197 (2d Cir. 1956), is misplaced.

The power that the decedent possessed was over the entire trust corpus, which included property other than the insurance policies. But there is no serious doubt that this power did not result in this other property being in decedent's estate for tax purposes. This type of power would fall under both § 2036 and § 2038. The former provision is clearly not triggered in this case because it only applies to a power retained by the grantor over the income from property when he transferred it to another. Thus, for purposes of § 2036, it would not matter that the decedent effectively had the power to deprive later income beneficiaries of the income from the corpus in favor of an earlier income beneficiary. However, the latter provision, § 2038, would apply because decedent had the power "to alter, amend ..., or terminate" the trust. The Commissioner has pointed to many cases holding that such a power would result in the property interest over which the power could be exercised being included in the estate of the holder of the power. See *e.g. Lober v. United States*, 346 U.S. 335 (1953); *United States v. O'Malley*, 383 U.S. 627 (1966) (decided under § 2036);

[4391] [my footnote:] See parts III.C.1 Whether Code § 2036 Applies, III.D Code § 2038, and II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap, the latter of which covers Code § 2041. Code § 2038 cases often cite *Skifter*.

Commissioner v. Newbold's Estate, 158 F.2d 694 (2d Cir. 1946). Therefore, he argues, this power must be an incident of ownership for § 2042 purposes also.

But the Commissioner's reliance on § 2038 cases exposes the fatal flaw in his position. The cases he cites dealt with powers that were retained by the transferor or settlor of a trust. That is not what we have here; the power the decedent had was given to him long after he had divested himself of all interest in the policies—it was not reserved by him at the time of the transfer. This difference between powers retained by a decedent and powers that devolved upon him at a time subsequent to the assignment is not merely formal, but has considerable substance. A taxpayer planning the disposition of his estate can select the powers that he reserves and those that he transfers in order to implement an overall scheme of testamentary disposition; however, a trustee, unless there is agreement by the settlor and/or beneficiaries, can only act within the powers he is granted. When the decedent is the transferee of such a power and holds it in a fiduciary capacity, with no beneficial interest therein, it is difficult to construe this arrangement as a substitute for a testamentary disposition by the decedent. *Cf. Porter v. Commissioner*, 288 U.S. 436, 444 (1933); *Commissioner v. Chase National Bank*, 82 F.2d 157, 158 (2d Cir. 1936).

Accordingly, we conclude that, although such a power might well constitute an incident of ownership if retained by the assignor of the policies, it is not an incident of ownership within the intended scope of § 2042, when it has been conveyed to the decedent long after he had divested himself of all interest in the policies and when he cannot exercise the power for his own benefit. We justify this interpretation of "incidents of ownership" on the apparent intent of Congress that § 2042 was not to operate in such a manner as to discriminate against life insurance, with regard to estate tax treatment, as compared with other types of property. We also note that our conclusion comports with the views expressed by the Sixth Circuit in *Estate of Fruehauf v. Commissioner*, 427 F.2d 80, 84-85 (6th Cir. 1970). Therefore, we must reject the contention of the Commissioner that the language of § 2042 requires that it be given a broader scope of operation than the statutes covering other types of property.

Until now, the discussion has assumed that § 2038 only applies when the power possessed by the decedent was reserved by him at the time he divested himself of all interest in the property (other than life insurance) subject to the power. This necessitates a brief discussion of the language of § 2038, which provides in pertinent part:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer ..., by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) ... *without regard to when or from what source the decedent acquired such power*), to alter, amend, revoke, or terminate ... (emphasis added).

The emphasized language would appear to indicate that § 2038 would apply even when the power was acquired under circumstances such as are present here. However, there is no indication that the Commissioner has ever made such an argument and we have been able to find no case applying § 2038 in this manner.

The noted language was added to the predecessor of § 2038 in 1936 in response to the decision in *White v. Poor*, 296 U.S. 98 (1935). In that case, the decedent had created an inter vivos trust and conferred on the trustee the power jointly to terminate the trust. Subsequently, the decedent was appointed a successor trustee. Therefore, at death decedent possessed this power to terminate and the Commissioner attempted to apply the predecessor to § 2038; but the Supreme Court held this

> was impermissible because decedent had not retained the power at the time of transfer but had received it later. It was for the purpose of changing this result that Congress added the emphasized language. However, this language appears never to have been applied to a power other than one that the decedent created at the time of transfer in someone else and that later devolved upon him before his death. In essence, the language has been applied strictly to change the result in *White v. Poor*.
>
> We need not here consider the reasons for applying § 2038 to powers such as that involved in *White v. Poor*. Nor need we speculate whether or not such a power would trigger § 2042, for that question is not before us. What is significant for our purposes is that § 2038 has not been applied when the power possessed by decedent was created and conferred on him by someone else long after he had divested himself of all interest in the property subject to the power. Therefore, because of our view that Congress did not intend § 2042 to produce divergent estate tax treatment between life insurance and other types of property, we conclude that the fiduciary power that Skifter possessed at his death did not constitute an "incident of ownership" under § 2042; hence, that provision does not require that the life insurance proceeds at issue be included in Skifter's estate.
>
> The Tax Court was thus correct in holding that Reg. § 20.2042-1(a)(4) must be read to apply to "reservations of powers by the transferor as trustee" and not to powers such as that in issue. Accordingly, the decision of the Tax Court is affirmed.

GCM 39317 followed *Skifter*. However, *Rose v. U.S.*, 511 F.2d 259 (5th Cir. 1975) held that there was no transfer requirement.

Rev. Rul. 84-179 reasoned:

> The legislative history of section 2042 indicates that Congress intended section 2042 to parallel the statutory scheme governing those powers that would cause other types of property to be included in a decedent's gross estate under other Code sections, particularly sections 2036 and 2038. S. Rep. No. 1622, 83rd Cong., 2d Sess. 124 (1954). See *Estate of Skifter v. Commissioner*, 468 F. 2d 699 (2d Cir. 1972).
>
> Sections 2036(a)(2) and 2038(a)(1) concern lifetime transfers made by the decedent. Under these sections, it is the decedent's power to affect the beneficial interests in, or enjoyment of, the transferred property that required inclusion of the property in the gross estate. Section 2036 is directed at those powers retained by the decedent in connection with the transfer. See, for example, *United States v. O'Malley*, 383 U.S. 627 (1966), 1966-2 C.B. 526. Section 2038(a)(1) is directed at situations where the transferor-decedent sets the machinery in motion that purposefully allows fiduciary powers over the property interest to subsequently return to the transferor-decedent, such as by an incomplete transfer. See *Estate of Reed v. United States*, Civil No. 74-543 (M.D. Fla., May 7, 1975); *Estate of Skifter v. Commissioner*, above cited, at 703-05.
>
> In accordance with the legislative history of section 2042(2), a decedent will not be deemed to have incidents of ownership over an insurance policy on decedent's life where decedent's powers are held in a fiduciary capacity, and are not exercisable for decedent's personal benefit, where the decedent did not transfer the policy or any of the consideration for purchasing or maintaining the policy to the trust from personal assets, and the devolution of the powers on decedent was not part of a prearranged plan involving the participation of decedent. This position is consistent with decisions by several courts of appeal. See *Estate of Skifter*; *Estate of Fruehauf v. Commissioner*, 427 F.2d 80 (6th Cir. 1970); *Hunter v. United States*, 624 F.2d 833 (8th Cir. 1980). But see

> *Terriberry v. United States*, 517 F.2d 286 (5th Cir. 1975), *cert. denied*, 424 U.S. 977 (1976); *Rose v. United States*, 511 F.2d 259 (5th Cir. 1975), which are to the contrary. Section 20.2042-1(c)(4) will be read in accordance with the position adopted herein.
>
> The decedent will be deemed to have incidents of ownership over an insurance policy on the decedent's life where decedent's powers are held in a fiduciary capacity and the decedent has transferred the policy or any of the consideration for purchasing and maintaining the policy to the trust. Also, where the decedent's powers could have been exercised for decedent's benefit, they will constitute incidents of ownership in the policy, without regard to how those powers were acquired and without consideration of whether the decedent transferred to property to the trust. *Estate of Fruehauf*; *Estate of Skifter*, above cited at 703. Thus, if the decedent reacquires powers over insurance policies in an individual capacity, the powers will constitute incidents of ownership even though the decedent is a transferee.
>
> In the present situation, D completely relinquished all interest in the insurance policy on D's life. The powers over the policy devolved on D as a fiduciary, through an independent transaction, and were not exercisable for D's own benefit. Also, D did not transfer property to the trust. Thus, D did not possess incidents of ownership over the policy for purposes of section 2042(2) of the Code.

Rev. Rul. 84-179 held:

> An insured decedent who transferred all incidents of ownership in a policy to another person, who in an unrelated transaction transferred powers over the policy in trust to the decedent, will not be considered to possess incidents of ownership in the policy for purposes of section 2042(2) of the Code, provided that the decedent did not furnish consideration for maintaining the policy and could not exercise the powers for personal benefit. The result is the same where the decedent, as trustee, purchased the policy with trust assets, did not contribute assets to the trust or maintain the policy with personal assets, and could not exercise the powers for personal benefit.

Citing Rev. Rul. 84-179 with approval, Letter Ruling 9602010 reasoned and held:

> In the present case, the Indenture of Trust vests the trustees of the separate trusts with all rights, title, and interest in and to the policies and prohibits the trustees from distributing any portion of a life insurance policy or its proceeds to the insured daughter. In addition, neither A nor B can serve as a trustee under the Indenture of Trust. Therefore, we need not address specifically the problems concerning the application of 2042(2) where the insured holds powers over the life insurance policies in a fiduciary capacity. Instead, we must consider A and B's powers over the maintenance and distribution of the assets held in their separate trusts. The ability to control these assets may indirectly give A and B or their estates powers over the economic benefits of the life insurance policies.
>
> Although A and B are the income beneficiaries of their respective separate trusts and each has the right to receive distributions of principal, their rights to distributions of principal are subject to the trustees absolute discretion. Neither A nor B can direct corpus to be distributed to themselves.
>
> Under the Indenture of Trusts, the separate trusts were created by A and B's father. The annual premiums on the life insurance policies will be paid from the principal of the separate trusts. Neither A nor B can transfer assets to their separate trusts. Therefore, neither A nor B can maintain any life insurance policies held by their separate trusts with personal assets.

> Although both A and B have special powers of appointment to cause the trustees of their separate trusts to distribute principal of their separate trusts to such beneficiaries (other than the daughter, her creditors, her estate, or the creditors of her estate) as they designate, these powers of appointment are effective only when there are no life insurance policies on the life of the beneficiary included in trust assets. Generally, an inter vivos exercise of a special power of appointment could reduce the principal of a trust so that there are insufficient funds to pay the premiums on the life insurance policies. In addition, a testamentary exercise of a special power of appointment could result in a reversionary interest in the life insurance policies. In this case, the special powers of appointment are not effective when insurance policies on the life of the beneficiary-daughter are among trust assets. Therefore, A and B cannot exercise their special powers of appointment to gain any economic benefits of the life insurance policies.
>
> Based on the facts and representations made in your request for rulings and your subsequent submissions, we conclude that neither A nor B will possess any incidents of ownership over life insurance policies on their lives held by the trustees of their irrevocable trusts and that the proceeds of the policies will not be includible in their gross estates under section 2042(2).
>
> We express no opinion at this time with respect to the gift tax consequences to A or B where the trustees of their separate trusts invest in a nonincome-producing life insurance policy on their lives.

Letter Ruling 9111028 involved the following facts:

> A is a trustee of the Trust. The Trust, a family trust, was originally part of a revocable trust, which, on B's death, was divided into the Trust and a marital trust. The trustee of the Trust is to pay to or apply for the benefit of A (B's surviving spouse) and B's descendants as much of the net income and principal of the Trust as the trustee deems necessary or advisable for their education, health, maintenance, and support, provided that no distribution to the descendants will operate to discharge or relieve A of any legal support obligation. Any income not distributed is accumulated and added to principal. Distributions of principal from the Trust to A are to be made only after exhaustion of the marital trust principal.
>
> A has a limited power to appoint, at any time, all or any portion of the principal of the Trust, other than any insurance policy on her life, to or for the benefit of B's descendants, in such amounts and proportions, and terms as A may elect. A may remove a trustee without reason by written notice at any time.
>
> The Trust provides that any trustee with an interest in the trust is excluded from decisions to distribute income or principal to such trustee except as limited by an ascertainable standard. In addition, the trustee is excluded from making any decisions with respect to distributions to any person the trustee is legally obligated to support. Any individual trustee whose life is insured by a policy held as trust property is prohibited from exercising any power conferred on the owner of such policy.

Letter Ruling 9111028 reasoned and held:

> In the present case, distributions of income and principal of the Trust can only be made to A or B's descendants when the trustees deem it necessary or advisable for their education, health, maintenance, and support. A, as a trustee whose life is insured by a policy held by the Trust, is specifically prohibited from exercising any power normally conferred on the owner of a policy. In addition, although A has a special power of appointment over the Trust principal, any insurance

> policies on A's life are specifically excluded from the scope of that power. Therefore, A does not possess any incidents of ownership over the policies on A's life held by the Trust that would cause inclusion of the policies in A's gross estate at A's death.

Letter Ruling 9434028 involved the following facts:

> You represent that, in 1975, the taxpayer's father created an irrevocable trust for the benefit of the taxpayer. The taxpayer is the life income beneficiary of the Trust and is currently serving as trustee. As trustee, she may also distribute principal to herself under an ascertainable standard relating to her maintenance. During the taxpayer's lifetime, she has the power to appoint all or any portion of the Trust principal to, or for the benefit of any one or more of her issue. Upon her death, the Trust assets will be distributed to her issue, per stirpes. Under the laws of the state in which the Trust was created, the powers granted to the trustee of the Trust include the power to invest and reinvest, as the fiduciary deems advisable, in insurance contracts on the life of any beneficiary or of any person in whom a beneficiary has an insurable interest, and generally in such property as the fiduciary shall deem advisable, even though such investment shall not be of the character approved by applicable law but for this provision.
>
> The taxpayer proposes to resign as trustee of the Trust. The terms of the Trust provide for a specified successor third-party trustee if the trustee should resign or fail to serve for any reason. If this third-party trustee should fail to serve, a corporate bank is named as trustee. You represent that the successor trustee proposes to purchase a life insurance policy on the life of the taxpayer. It is represented that the annual premium on the policy will be paid from Trust principal. On the taxpayer's death, the insurance proceeds will be paid to the Trust and will be allocated to principal, which will be distributed as set forth in the trust instrument.

Letter Ruling 9434028 reasoned and held:

> In the present case, the taxpayer is currently trustee and income beneficiary of the Trust and has the right to receive discretionary distributions of corpus for her maintenance. The taxpayer proposes to resign as trustee of the Trust. A third-party named in the Trust instrument will become successor trustee. It is represented that the successor trustee, after being named trustee, proposes to purchase a life insurance policy on the life of the taxpayer. The Trust was created and funded by the taxpayer's father during his lifetime and the taxpayer has not transferred any assets to the Trust. The annual premiums on the policy will be paid from the principal of the Trust and the taxpayer will not maintain the policy with personal assets.
>
> We express no opinion at this time with respect to the gift tax consequences to the taxpayer/income beneficiary where the trustee invests in a nonincome-producing life insurance policy on the taxpayer's life.
>
> We conclude that the taxpayer will not possess incidents of ownership over a life insurance policy on her life that is purchased by the successor trustee of an irrevocable trust where the taxpayer is the former trustee. Therefore, the proceeds of the policy will not be includible in the taxpayer's gross estate at her death under section 2042(2), assuming that the taxpayer is not reinstated as trustee and serving in that capacity at the time of her death or, after being reinstated, subsequently resigns as trustee within three years of her death. See *Estate of Fruehauf* and Rev. Rul. 84-179.

Letter Ruling 9602010 involved the following facts:

> The Grantor proposes to execute an Indenture of Trust. Under the Indenture of Trust, the Grantor will establish two separate irrevocable trusts, one for the benefit of each of his two daughters, A and B. Under the terms of the Indenture of Trust, trust assets include the property listed in "Schedule A" of the Indenture of Trust. In addition, the trustees shall accept any other property which may be transferred to them by the Grantor or others by will or other instrument. Neither the Grantor nor his daughters may serve as trustees.
>
> During each daughter's lifetime, the net income of her separate trust is to be distributed to the daughter in convenient periodic installments. The trustees, also, may distribute to each daughter principal of their separate trust. The amount of principal distributable is the amount the trustees, in their absolute discretion, deem advisable and is not limited otherwise.
>
> Generally, during a daughter's lifetime, the trustees must distribute principal of the daughter's separate trust to any beneficiary (other than the daughter, her creditors, her estate, or the creditors of her estate) the daughter designates in writing. This power of appointment, however, is not effective if the daughter's separate trust holds any insurance policies on the life of the daughter.
>
> Upon a daughter's death, the balance of the principal of the daughter's separate trust is distributable to any beneficiary (other than the daughter, her creditors, her estate, or the creditors of her estate) the daughter appoints by will or other written instrument delivered to the trustees during her lifetime. This power of appointment, however, is not effective if, at the time of the daughter's death or immediately prior to her death, the daughter's separate trust holds any insurance policies on the life of the daughter.
>
> To the extent that a daughter fails to exercise her power of appointment or can not exercise her power of appointment prior to or upon her death, the remaining principal of her separate trust will be distributed to her issue then living, per stirpes. If there is no such issue, the trust assets shall be divided among the Grantor's issue then living, per stirpes. Any share attributable to A or B shall be added to such daughter's separate trust established under the Indenture of Trust. In the case of a share attributable to a child of the Grantor born subsequent to the date of the Indenture of Trust, that child's share shall be added to a trust established under another indenture of trust with terms identical to the terms in the Indenture of Trust. Each share attributable to a grandchild of the grantor shall be held in a separate trust for the benefit of such grandchild.
>
> Section VI of the Indenture of Trust gives the trustees of each separate trust the power to purchase life insurance policies on the life of the beneficiary of the separate trust. In addition, section VII indicates that life insurance policies may be among the assets transferred to the separate trusts. Under section VII of the Indenture of Trust, the trustees are vested with all rights, title, and interest in and to the policies. In addition, the trustees of each separate trust may not distribute to the beneficiary all or any portion of a policy of insurance on the life of the beneficiary.
>
> It is represented that the annual premiums on any life insurance policies on the life of the beneficiaries will be paid from principal of the separate trusts. On the death of A or B, the insurance proceeds of the life insurance policies will be paid to their respective separate trust and will be allocated to principal, which will be distributed as set forth in the trust instrument.

Letter Ruling 9602010 reasoned and held:

> Under the facts presented in the ruling, the decedent transferred the policy to the spouse and subsequently, in an unrelated transaction, reacquired incidents of ownership over the policy in a fiduciary capacity. The ruling holds that under these circumstances, the decedent will not be considered to possess incidents of ownership in the policy for purposes of section 2042(2), provided the decedent did not furnish consideration for maintaining the policy and could not exercise the powers for the decedent's personal benefit. The ruling further provides that the result would be the same if the decedent acting as trustee purchased a policy as a trust asset. The ruling states, however, that where the decedent's powers over the policy could have been exercised for the decedent's benefit, they would constitute incidents of ownership in the policy without regard to how those powers were acquired and without consideration of whether or not the decedent was the source of the funds used to pay the premiums. See *Estate of Fruehauf v. Commissioner*, 427 F.2d 80 (6th Cir. 1970).
>
> In the present case, the Indenture of Trust vests the trustees of the separate trusts with all rights, title, and interest in and to the policies and prohibits the trustees from distributing any portion of a life insurance policy or its proceeds to the insured daughter. In addition, neither A nor B can serve as a trustee under the Indenture of Trust. Therefore, we need not address specifically the problems concerning the application of 2042(2) where the insured holds powers over the life insurance policies in a fiduciary capacity. Instead, we must consider A and B's powers over the maintenance and distribution of the assets held in their separate trusts. The ability to control these assets may indirectly give A and B or their estates powers over the economic benefits of the life insurance policies.
>
> Although A and B are the income beneficiaries of their respective separate trusts and each has the right to receive distributions of principal, their rights to distributions of principal are subject to the trustees absolute discretion. Neither A nor B can direct corpus to be distributed to themselves.
>
> Under the Indenture of Trusts, the separate trusts were created by A and B's father. The annual premiums on the life insurance policies will be paid from the principal of the separate trusts. Neither A nor B can transfer assets to their separate trusts. Therefore, neither A nor B can maintain any life insurance policies held by their separate trusts with personal assets.
>
> Although both A and B have special powers of appointment to cause the trustees of their separate trusts to distribute principal of their separate trusts to such beneficiaries (other than the daughter, her creditors, her estate, or the creditors of her estate) as they designate, these powers of appointment are effective only when there are no life insurance policies on the life of the beneficiary included in trust assets. Generally, an inter vivos exercise of a special power of appointment could reduce the principal of a trust so that there are insufficient funds to pay the premiums on the life insurance policies. In addition, a testamentary exercise of a special power of appointment could result in a reversionary interest in the life insurance policies. In this case, the special powers of appointment are not effective when insurance policies on the life of the beneficiary-daughter are among trust assets. Therefore, A and B cannot exercise their special powers of appointment to gain any economic benefits of the life insurance policies.
>
> Based on the facts and representations made in your request for rulings and your subsequent submissions, we conclude that neither A nor B will possess any incidents of ownership over life insurance policies on their lives held by the trustees of their irrevocable trusts and that the proceeds of the policies will not be includible in their gross estates under section 2042(2).

> We express no opinion at this time with respect to the gift tax consequences to A or B where the trustees of their separate trusts invest in a nonincome-producing life insurance policy on their lives.

Letter Ruling 9748020 involved the following facts:

> Decedent's Spouse is the current beneficiary and was one of three co-trustees of Trust B. During her life, the trustees of Trust B are to distribute all of the net income of the trust to Decedent's Spouse. If the income is insufficient to provide for Decedent's Spouse's health, support, and maintenance in accordance with the standard of living she enjoyed at the time of Decedent's death, the trustees are authorized to distribute principal. Decedent's Spouse has no power of appointment over the assets in Trust B. Decedent's children and grandchildren are contingent beneficiaries. Decedent's Spouse resigned as a co-trustee of Trust B on Date 2. The Trust instrument provides that no successor trustee is to be appointed and the remaining trustees will serve as co-trustees.
>
> Trustees of Trust B propose to purchase a policy of insurance on the life of Decedent's Spouse. Trustees request a ruling that Decedent's Spouse will not possess any incidents of ownership over the life insurance policy on her life held by the trustees of Trust B and that the proceeds of the policy will not be includible in her gross estate under sections 2036 and 2042(2).

Letter Ruling 9748020 cited Reg. §§ 20.2042-1(c)(2)[4392] and 20.2042-1(c)(4) and Rev. Rul. 84-179 and reasoned and held:

> In this case, Decedent's Spouse is the current beneficiary of Trust B. During her life, the trustees of Trust B are to distribute all of the net income of the trust to Decedent's Spouse. If the income is insufficient to provide for Decedent's Spouse's health, support, and maintenance in accordance with the standard of living she enjoyed at the time of Decedent's death, the trustees are authorized to distribute principal. Decedent's children and grandchildren are contingent beneficiaries of Trust B.
>
> Because Decedent's Spouse resigned as a trustee of Trust B, Decedent's Spouse will not possess any incidents of ownership over a life insurance policy on her life purchased by the remaining trustees of Trust B and held as an asset of Trust B. Therefore, proceeds of a life insurance policy on her life purchased by the trustees of Trust B and held as an asset of Trust B will not be included in Decedent's Spouse's gross estate provided that (1) she has not transferred any assets to Trust B, (2) the premiums on the policy are paid from the principal of Trust B, (3) she does not maintain the policy with personal assets, and (4) she is not reinstated as a trustee of Trust B.

Letter Ruling 9748029 involved the following facts:

> On May 7, 1990, A, established an irrevocable trust, Trust, for the benefit of his spouse, B, and his children. The Trust was funded with a second to die life insurance policy on the lives of A and B. The trustees of Trust are A's two children. Under the terms of the Trust, any contribution to the Trust may be withdrawn by B, provided the amount of withdrawal can not exceed $5,000 for any calendar year. A's children have the right to withdraw a proportionate amount of any contribution not withdrawn by B, not to exceed $5,000. Each withdrawal right lapses on the earlier of (a) the last of the year in which the contribution was made, or (b) 60 days after the contribution. During A's lifetime, the trustee is authorized to use some or all of the trust income to pay premiums on

[4392] Reg. § 20.2042-1(c)(2) is reproduced in part II.Q.4.i.ii Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity.

policies of life insurance on the lives of A and B. After paying any insurance premium, the trustees may distribute to or for the benefit of B and the children so much of the trust income and principal as the trustees deem appropriate.

After A's death, the trustees are to pay to or for the benefit of B and the children so much of the Trust's income and principal, as the trustees deem appropriate for the comfort and general welfare of those beneficiaries. Upon B's death, the trustees have discretion to pay B's burial expenses, expenses of her last illness, and death and succession taxes. Any remaining corpus is to be divided into separate shares with a separate share to be distributed to each living child and a share to be distributed per stripes to the living descendants of a deceased child.

A transferred property to Trust, and Trust applied for a second to die life insurance policy on the lives of A and B. Trust has owned the policy at all times. The trustees possess all incidents of ownership in the policy. A died on January 26, 1996, survived by B. B has made no transfers to Trust. The trustees have continued to pay the premiums on the insurance policy from trust funds.

Although a bank is named successor trustee, the trustees have the ability to name additional co-trustees. The trust instrument does not prohibit B from being added as an additional co-trustee.

First, the ruling cited a variety of rules, including Reg. § 20.2042-1(b), which provides:

(1) Section 2042 requires the inclusion in the gross estate of the proceeds of insurance on the decedent's life receivable by the executor or administrator, or payable to the decedent's estate. It makes no difference whether or not the estate is specifically named as the beneficiary under the terms of the policy. Thus, if under the terms of an insurance policy the proceeds are receivable by another beneficiary but are subject to an obligation, legally binding upon the other beneficiary, to pay taxes, debts, or other charges enforceable against the estate, then the amount of such proceeds required for the payment in full (to the extent of the beneficiary's obligation) of such taxes, debts, or other charges is includible in the gross estate. Similarly, if the decedent purchased an insurance policy in favor of another person or a corporation as collateral security for a loan or other accommodation, its proceeds are considered to be receivable for the benefit of the estate. The amount of the loan outstanding at the date of the decedent's death, with interest accrued to that date, will be deductible in determining the taxable estate. See § 20.2053-4.

(2) If the proceeds of an insurance policy made payable to the decedent's estate are community assets under the local community property law and, as a result, one-half of the proceeds belongs to the decedent's spouse, then only one-half of the proceeds is considered to be receivable by or for the benefit of the decedent's estate.

Letter Ruling 9748029 reasoned and held:

In the present case, A created and funded the Trust in 1990 and made all transfers to the Trust. B has made no direct contributions nor indirect contributions by reason of the lapse of the $5,000 withdrawal right. See section 2514(e). Under the terms of the Trust, B does not possess any rights within the meaning of sections 2036 or 2038. Assuming B is not named as an additional trustee, B will not have any incidents of ownership in the policy by reason of section 20.2042-1(c)(4). Assuming B does not make any contributions to the Trust (either directly or indirectly) we conclude that the Trust and insurance policy will not be included under sections 2036, 2038, and 2042(2) in B's gross estate upon her death.

> However, we express no opinion regarding the application of section 2042(1) which is dependent on facts presented at the spouse's death; for example, whether the trustee will be legally bound to pay B's burial expenses, expenses of her last illness, and death and succession taxes at that time. See Rev. Rul. 77-157, 1977-1 C.B. 279.[4393]

Note that the surviving spouse in Letter Ruling 9748029 was not a trustee, did not have any power of appointment, and could not receive any distributions until after the insurance premiums were paid. If a policy on only one spouse can use decent mortality charges and the premium savings from a second-to-die policy is mainly due to a longer time to fund the death benefit, consider whether that timing of premium payments is really worth sacrificing giving the surviving spouse the control that a surviving spouse often has over a spousal limited access trust.

Letter Ruling 200314009 found no incidents of ownership where a grantor had the power to name as a successor trustee anyone except himself or any party related or subordinate to the grantor when the two designated trustees are unavailable to act as trustee or are removed; however, the grounds for removal were not spelled out. The IRS pointed out that Reg. § 20.2042-1(c)(4) provides that:

> A decedent is considered to have an incident of ownership in an insurance policy on his life held in trust if, under the terms of the policy, the decedent, (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

The IRS looked to Rev. Rul. 77-182 (no Code § 2036 inclusion where decedent could appoint a successor corporate trustee if the original trustee resigned or was removed by judicial process) and Rev. Rul. 95-58 (no Code § 2036 inclusion where decedent could remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent).[4394]

In Letter Rulings 201919002-201919003, the settlor established an irrevocable trust for the benefit of Child 1 and Child 1's descendants, with the trustee being Child 1. When the trustee planned to buy life insurance, the trustee petitioned to have the trust modified so that Child 2 (presumably Child 1/s sibling) would serve as special trustee over insurance, holding all incidents of ownership, and Child 1 would have no power of appointment over the life insurance policy. However, Child 1 had the power to change trustees, so long Child 1 did not appoint a person related to or subordinate to Child 1, within the meaning of Code § 672(c), as successor insurance trustee. Citing Rev. Rul. 84-179 but not Rev. Rul. 95-58, the ruling held:

> In this case, Child 1's powers, in the capacity as Trustee and beneficiary were eliminated prior to the acquisition of the life insurance policy on Child 1's life. Trust is the owner and beneficiary of the policy. Accordingly, when the Insurance Trustee purchased a life insurance policy on Child 1's life, Child 1 did not possess and did not have the power to exercise, any incidents of ownership in the policy acquired by Trust. Child 1 will not relinquish or transfer any incidents of ownership in the policy as a result of the modification prior to the acquisition of the policy.
>
> Accordingly, based on the facts submitted and the representations made, we conclude that Child 1 does not and will not possess any incidents of ownership over any life insurance policy on Child 1's life acquired by Trust, as amended, and that the proceeds of any policy on Child 1's life will not be includible in Child 1's gross estate under § 2042(2). The above conclusions assume that Child 1 is not serving as Insurance Trustee at the time of Child 1's death, or Trust is modified such that Child 1 regains fiduciary powers over life insurance on Child 1's life.

[4393] Rev. Rul. 77-157 ruled as to Code § 2039(c), which has since been repealed; therefore, Rev. Rul. 88-85 obsoleted Rev. Rul. 77-157.

[4394] "Related or subordinate" looked to Code § 672(c) – see fn. 2458 in part II.J.3.h Drafting for Flexibility in Trust Income Taxation.

A decedent's right to veto a change in the transfer of a policy, where the decedent could gain no economic benefits from the veto power, did not constitute incidents of ownership.[4395]

Letter Ruling 200404013 involved the following facts:

> On Date 1, A created and funded an irrevocable trust, Trust. Under the terms of Trust, the co-trustees (B, A's spouse, and Corporate Trustee) have absolute discretion to distribute income and corpus to A's children and their descendants for such person's care, health, education, maintenance, support, purchase or improvement of home, to establish a professional practice, or acquire an interest in a business. Upon the death of A, or earlier if the Trust fails to qualify as a grantor trust for federal income tax purposes, the trustees are to segregate any shares of stock of a corporation which is an S corporation for federal income tax purposes. The segregated stock is to be held in separate trusts (hereinafter referred to as separate trusts), one trust for each child or deceased child of A. The remainder of any Trust assets are to be held in trusts (hereinafter referred to as remainder trusts), one trust for each child or deceased child of A.
>
> Under the terms of the separate trusts, the net income is to be paid quarterly to the designated child (or in the case of a trust created for a deceased child, the child's descendants). The trustees also have absolute discretion to distribute corpus to such child (or child's descendants as the case may be) for care, health, education, maintenance, support, purchase or improvement of home, to establish a professional practice, or acquire an interest in a business. Upon the death of a child, any remaining corpus that has not been appointed pursuant to a testamentary special power of appointment, is to be held in further trust, under terms and conditions described above, for the child's descendants.
>
> Under the terms of the remainder trusts, the trustees have absolute discretion to distribute income and corpus to A's child and that child's descendants for such person's care, health, education, maintenance, support, purchase or improvement of home, to establish a professional practice, or acquire an interest in a business. Upon the death of a child, any remaining corpus that has not been appointed pursuant to a testamentary special power of appointment, is to be held in further trust, under terms and conditions described above, for the child's descendants.
>
> In the case of the Trust, separate trusts, and remainder trusts, no income or principal may be distributed for support or maintenance of a beneficiary if A or B is legally obligated to support such beneficiary.
>
> Under the terms of Trust, the Corporate Trustee may be replaced by the vote of three designated advisors. Under Article XVII, a trustee, by written instrument, may renounce in whole or in part any one or more powers, authorities or discretion given by Trust or by law to that trustee. Under Article XXIV, A may not be appointed trustee, nor may A remove a trustee or appoint a successor trustee.
>
> Trust purchased a joint and survivor life insurance policy on the lives of A and B. It is represented that Trust will make ten annual premium payments and that the Trust should have adequate income each year to fully pay the annual premium. B, as trustee, also executed a written instrument renouncing her right as trustee to: (1) change the beneficiary of the policy; (2) revoke any change of beneficiary; (3) assign the policy; (4) revoke any assignment of the policy; In addition, B has renounced any right to make contributions to Trust and to appoint a successor advisor.
>
> It is represented that A funded Trust, but that B has consented to treat the gift as made one-half by A and one-half by B under § 2513. Further, it is represented that sufficient GST exemption under § 2631 was allocated to Trust, such that Trust has a zero inclusion ratio for GST tax purposes.

[4395] *Estate of Rockwell v. Commissioner*, 779 F.2d 931 (3rd Cir. 1985).

Letter Ruling 200404013 reasoned and held:

> In the present case, neither A or B have any beneficial interest in Trust. Trust has purchased the life insurance policy using funds held in trust. Further, it is represented that neither A nor B will make any additional transfers to Trust for the purpose of paying premiums on the policy. Under these circumstances, we conclude that the purchase by Trust of the life policy with Trust assets will not be a treated as a gift by A or B.
>
> In the present case, Trust purchased and owns the life insurance policy. Trust is also the designated beneficiary of the policy proceeds and Trust will also make all future premium payments from Trust assets. Accordingly, we conclude that A will not possess any incidents of ownership, under § 2042(2) and § 20.2042-1(c)(2), in the policies owned by Trust. Further, we conclude that the proceeds of the policies payable to the trustee of Trust will not be includible, under § 2042(2) in the gross estate of A. Further, in the present case, it is represented that B has not transferred any property to Trust, nor will B make any transfers to Trust in the future to maintain the policy. Accordingly, notwithstanding that B is a trustee of Trust, we conclude that B will not possess any incidents of ownership, under § 2042(2) and § 20.2042-1(c)(2), in the policies owned by Trust and the proceeds of the policies payable to the trustee of Trust will not be includible, under § 2042(2) in the gross estate of B. Rev. Rul. 84-179.
>
> In the present case, A and B have treated A's transfer to Trust, as made one-half by each under § 2513. Under § 2652(a)(2), if the requirements for signifying consent under § 2513(b) were satisfied, A and B are each deemed the transferor for Federal GST tax purposes of one-half of A's gift to Trust. It is represented that A and B have each allocated sufficient GST exemption to the Trust such that Trust will have an inclusion ratio of zero for GST tax purposes. As noted above, it is represented that the insurance policy was purchased with current trust assets and all future premium payments will be paid from Trust assets. Accordingly we conclude that the purchase of the insurance policy by Trust, will not effect the identity of the transferors of Trust for GST tax purposes, nor will the purchase effect the inclusion ratio with respect to Trust.

Letter Ruling 200518005 involved the following facts:

> Trust A and Trust B were not established by Taxpayer. Pursuant to the terms of each trust, Taxpayer is to receive the net income of each trust for her life. Upon her death, the principal of each trust is to be divided into equal shares for the benefit of Taxpayer's children. Taxpayer was a co-trustee of Trust A and Trust B, but on Date 1, she renounced all of her rights as co-trustee of Trust A and Trust B in connection with life insurance policies on her life. Life insurance policies on Taxpayer's life were purchased by Trusts A and B using trust corpus subsequent to Taxpayer's renunciation. Taxpayer resigned as co-trustee of Trust A and Trust B on Date 2 and Date 3, respectively. Trustee A and Trustee B are the current co-trustees of both trusts.

Letter Ruling 200518005 reasoned and held:

> In the present case, Taxpayer is the current income beneficiary of Trust A and Trust B. During her life, the trustees of Trust A and Trust B are to distribute all of the net income of each trust to Taxpayer. Upon Taxpayer's death, the trust is to be divided into equal shares for Taxpayer's issue. It has been represented that Taxpayer will not contribute assets to Trust A or Trust B, or maintain the life insurance policies held as assets of Trust A and Trust B with Taxpayer's personal assets.
>
> Based on the foregoing, Taxpayer will not possess any incidents of ownership over the life insurance policies held as assets of Trust A and Trust B because Taxpayer renounced her rights as co-trustee of Trust A and Trust B in connection with the life insurance policies and ultimately resigned as co-trustee of the trusts. Therefore, we conclude that the proceeds of the life insurance policies held as assets of Trust A and Trust B will not be included in Taxpayer's gross estate under § 2042(2) or 2035, provided the premiums for the policies are not paid from the income of Trust A or Trust B.

Letter Ruling 200617008 involved the following facts:

The Trustees are to pay Wife the entire net income and so much of the principal of Trust A as the trustees in their absolute discretion determine. Trust A is to terminate upon the death of Wife, and the balance of the Trust A corpus is to be paid to Husband's then living issue, per stirpes. The balance of the Trust corpus (after providing for the funding of Trust A) is to be paid to husband's then living issue, per stirpes, provided that any property payable to a child of Husband who had not attained the age of 29 is to be held in further trust for the benefit of the child.

Article Fifth (I) of the Trust Agreement provides that if any person currently eligible to receive any principal or income from any trust created under the terms of Trust is acting as a trustee, then such trustee shall have no power whatsoever to make or participate in making decisions affecting in any way the disposition of the income or principal of such trust to himself or herself, including determining how much income or principal should be distributed and whether the trust should be terminated.

… Wife and Father are currently serving as co-trustees of Trust A.

Wife proposes to resign as co-trustee of Trust A. Subsequent to Wife's resignation, Father, as trustee of Trust A, will apply for and purchase a policy of insurance on Wife's life. Trust A will be the owner and beneficiary of the policy. It is represented that the principal of Trust A will be used to pay the premiums on the policy and that the annual premiums will be less than Q% of the principal of Trust A. Wife will not pay any premiums with respect to the policy or otherwise contribute towards the maintenance of the policy. All the income of Trust A will continue to be paid to Wife.

Letter Ruling 200617008 reasoned and held:

In the present case, Wife will resign as co-trustee of Trust A prior to the acquisition by Trust A of the life insurance policy on Wife's life. Trust A will be the owner and beneficiary of the policy. Accordingly, because Wife is resigning as co-trustee prior to the acquisition of the policy, Wife will never possess, or have the power to exercise, any incidents of ownership in the policy to be acquired by Trust A, nor will she relinquish or transfer any incidents of ownership in the policy by resigning as co-trustee prior to the acquisition of the policy. Further, it is represented that only trust principal will be used to pay the premiums on the policy and the annual premiums will be less than Q% of the Trust A principal. All the income of Trust A will continue to be paid to Wife. In addition, Wife has not transferred, nor will she transfer any assets to Trust A, and she will not pay any premiums with respect to the policy to be held as an asset of Trust A.

Based on the foregoing, we conclude that the proceeds of the life insurance policy to be acquired by Trust A, as described above, will not be includible in Wife's gross estate under section 2042(2). Further, the policy proceeds will not be includible under section 2035(a), if Wife dies within three years of resigning as co-trustee of Trust A. The above conclusions assume that Wife is not reinstated as co-trustee and is not serving as co-trustee at the time of her death, or after being reinstated, subsequently resigns within three years of death. See Rev. Rul. 84-179.

Letter Ruling 201327010 involved the following facts:

Over a period of years, Taxpayer s spouse, Decedent, purchased several life insurance policies naming Taxpayer as the insured and Decedent s estate as the beneficiary. It is represented that Taxpayer paid none of the premiums on the policies and, as well, that Taxpayer anticipates that no further premiums will be due on the policies.

Decedent died on Date 1. Under Decedent s will ownership of the policies passed to Family Trust. Under the terms of Family Trust, income and principal is distributable to Taxpayer and Decedent s descendants in the discretion of the trustee. The remainder is payable to such persons, other than Taxpayer, Taxpayer s estate, Taxpayer s creditors, or the creditors of Taxpayer s estate, as Taxpayer shall appoint by will, and in default of appointment, to certain takers in default. Taxpayer is named the trustee of Family Trust, as well as the protector of Family Trust, with the power to remove and replace trustees. As trustee, Taxpayer possessed the incidents of ownership in the policies.

On Date 2, pursuant to its terms, Family Trust was divided into two trusts, Family Trust 1 and Family Trust 2. Family Trust 1 was funded with the insurance policies, while Family Trust 2 was funded with the remaining assets. Concurrent with the division of Family Trust, Taxpayer relinquished his roles as trustee and protector of Family Trust 1, his ability to be reappointed as trustee of Family Trust 1, and his power of appointment over the assets of Family Trust 1. Taxpayer retained his beneficial interest in Family Trust 1 as a permissible distributee of trust income and principal.

Letter Ruling 201327010 reasoned and held:

Here, prior to the Date 2 transaction, Family Trust held policies of insurance on Taxpayer's life. Under the terms of Decedent s will, Taxpayer possessed trustee powers over the Family Trust assets, a beneficial interest in Family Trust, and a testamentary power of appointment over the Family Trust assets. Taxpayer could exercise in a fiduciary capacity the trustee powers over the incidents of ownership in the policies of insurance on Taxpayer's life for Taxpayer's own benefit, and could exercise in his individual capacity the power of appointment over the proceeds of the policies. On these facts, both the fiduciary powers and individually held powers constitute incidents of ownership in the policies, without regard to how those powers were acquired and without consideration of whether Taxpayer transferred property to Family Trust. Section 20.2042-1(c)(4). After the Date 2 transactions, however, with regard to Family Trust 1, Taxpayer held only a beneficial interest as a permissible distributee of income and corpus, but no powers over the policies or their proceeds, and thus, no incidents of ownership for purposes of § 2042(2). Assuming that Taxpayer survives the three-year period of § 2035, the proceeds of the policies will not be includible in Taxpayer s gross estate. Section 20.2042-1(c)(1).

The mere right to the dividends, by itself, is not an incident of ownership that would cause the value of the insurance proceeds to be included in Decedent's gross estate under Code § 2042(2).[4396] This conclusion was based on the view that dividends represent a return of premiums[4397] and did not address whether dividends in excess of premiums would be treated differently.

Letter Ruling 201919002 involved the following facts:

On Date 1, Settlor established an irrevocable trust, Trust, for the benefit of Child 1 and Child 1's descendants. The Trustee of Trust is Child 1. Settlor predeceased Child 1. It is represented that Child 1 has not made any contributions to Trust and does not intend to make any contributions to Trust.

Section 2.1 of Trust provides that the Trustee is expressly granted the power to own and acquire life insurance and to pay the premiums on existing life insurance on the life of any person in which the trust or its beneficiaries may have an insurable interest. The ownership of any and all policies of insurance applied for and purchased by the Trustee or transferred and assigned to the Trustee is irrevocably vested in the Trustee.

Under Section 2.4, the Trustee is vested with all rights, powers, options, elections, privileges and incidents of ownership in all insurance policies owned by Trust.

[4396] CCA 201328030.

[4397] CCA 201328030 cited *Estate of Bowers v. Commissioner*, 23 T.C. 911, 917 (1955) (the right to dividends, which may be applied against a current premium, is nothing more than a reduction in the amount of premiums paid rather than a right to the income of the policy) and *Estate of Jordahl v. Commissioner*, 65 T.C. 92, 99 (1975) (since dividends are merely a reduction in the amount of premiums paid, the right to dividends is not an incident of ownership).

Section 2.5 provides that the Trustee shall have the power to use all or any part of the net income or corpus of Trust to pay all or any part of any premiums or other charges due on any insurance policies held in trust. Provided, however, notwithstanding any contrary provision in this paragraph, in the event the Trust owns any life insurance on the life of Settlor, premium payments shall only be made out of corpus, and not out of income (as determined for federal income tax purposes under Subpart E of Part I, Subchapter J, Chapter 1, Subtitle A of the Internal Revenue Code (Code)).

Under Article III, during Child 1's lifetime, the Trustee shall have the power to distribute net income and corpus of Trust as Trustee may determine to be appropriate to provide for the health, support, maintenance and education of Child 1 and Child 1's descendants. Any undistributed net income shall be accumulated and added to the corpus of Trust.

Section 6.1 provides that upon the death of Child 1, Child 1 shall have a testamentary special power of appointment over the remaining assets of Trust limited to the class consisting of Child 1's descendants. To the extent Child 1 does not exercise or ineffectively exercises Child 1's testamentary special power of appointment, then the Trustee shall apportion the property of Trust into separate equal trusts, one for the benefit of each of Child 1's then living children (Child's Trust) and one trust for the benefit of the descendants (Descendant's Trust), taken collectively, of each child of Child 1 who is then deceased leaving descendants then surviving. Moreover, Sections 6.2 and 6.3 grant a testamentary special power of appointment to the primary beneficiary of a Child's Trust or a Descendant's Trust.

Under Section 7.2, Child 1 shall have the power to appoint one or more persons, individual or corporate, to serve as Co-Trustee or sole Trustee of Trust or the separate trusts created hereunder and shall have the power to remove or replace any Co-Trustee or sole Trustee whether named in Trust or appointed pursuant to Article VII. If Child 1 should die, resign or be unable or unwilling to serve as Trustee for any reason, or fail to appoint a successor, then Settlor appoints Child 1's spouse, Spouse, as Trustee. If Spouse is unable to serve for any reason, then Settlor appoints Child 2. Upon the death of Child 1, if Child 1 has not appointed a trustee to succeed upon Child 1's death, Settlor appoints each child of Child 1 as sole Trustee of any separate trust created for his or her benefit.

Section 7.12 provides that Settlor does not intend that the Trustee have any power over trust property that, if held by the Trustee in a fiduciary capacity, would result in inclusion of trust assets in the estate of the Trustee for federal estate tax purposes. To this end, the Settlor appoints the Co-Trustee or, if none, the next Successor Trustee named or appointed under Article VII who is qualified to serve as Trustee and who does not suffer the same disability, as Special Co-Trustee during any period in which a trust governed by this agreement provides for current distribution to beneficiaries to whom the primary Trustee owes a legal obligation of support or contains property over which the primary Trustee's powers would result in such inclusion.

Section 7.12(a) provides that a Special Co-Trustee shall be appointed if a trust governed under this agreement owns or otherwise possesses any incidents of ownership over any life insurance policies on the life of the primary Trustee within the meaning of § 2042.

Section 7.12(c) provides that a Special Co-Trustee shall be appointed if a trust governed under this agreement provides for current distributions to beneficiaries to whom the primary Trustee has a legal obligation of support. The Special Co-Trustee shall have the sole power to determine the amount and timing of any discretionary distribution to a beneficiary to whom the primary Trustee has a legal obligation of support. The primary Trustee's powers at such times shall be limited to management of trust assets and distributions to beneficiaries to whom the primary Trustee owes no legal support obligation.

In Year 1, Trustee proposed to purchase a life insurance policy on the joint lives of Child 1 and Spouse. However, Section 6.1 of Trust provides Child 1 with a testamentary special power of appointment over all assets contained in Trust. As a result, if Trust owned a life insurance policy on the life of Child 1, there is a risk that the life insurance death benefit proceeds will be included in Child 1's gross estate for federal estate tax purposes upon Child 1's death.

Accordingly, Child 1, in the capacity of Trustee of Trust, petitioned Court to modify the terms of Trust to remove Child 1's testamentary special power of appointment over any life insurance policy on Child 1's life or the proceeds of such policy; to add an Insurance Trustee, who will have sole authority over any insurance policies on the life of Child 1 purchased by Trust; and to modify Trust to require that premium payments on life insurance policies on Child 1 must be paid out of Trust corpus. On Date 2, in Year 1, a Final Judgment of Modification was issued by Court approving the modification of Trust.

Pursuant to the Final Judgment of Modification, Trust is modified as follows: Section 2.5, as modified, provides that if Trust owns any life insurance on the life of Settlor, a beneficiary, or a trustee, premium payments shall only be made out of corpus, and not out of income (as determined for federal income tax purposes under Subpart E of Part I, Subchapter J, Chapter 1, Subtitle A of the Internal Revenue Code (Code)).

Sections 6.1, 6.2 and 6.3, as modified, provide that a holder of a testamentary special power of appointment under the terms of Trust, Child's Trust or Descendant's Trust is excluded from exercising the power over any life insurance policy on such beneficiary's life or proceeds of such policy on such beneficiary's life.

Section 7.12(a) of Trust, as modified, is deleted and replaced with the following:

> Notwithstanding the foregoing procedure, [Child 2] is appointed as Insurance Trustee (hereinafter referred to as “Insurance Trustee”) if a trust governed by this Agreement intends to purchase, purchases, owns or otherwise possesses any incidents of ownership over any life insurance policies on the life of the primary Trustee within the meaning of § 2042 of the Internal Revenue Code. [Child 1] shall have the power to: (i) change the Insurance Trustee succession herein, (ii) appoint one or more persons, individual or corporate, excluding [Child 1], to serve as Insurance Trustee or Co-Trustees of this trust or any trust created hereunder, and (iii) remove such persons appointed, whether now serving or appointed to serve in the future. Provided, however, [Child 1] shall not have the power to appoint a person related to or subordinate to [Child 1], within the meaning of § 672(c) of the Internal Revenue Code, as successor Insurance Trustee. The Insurance Trustee shall have the power to maintain the policies in which the applicable trust has an ownership interest and pay the trust's proportionate share of the premiums thereon. If for any reason there are not sufficient funds to pay the premiums and maintain the policies in force, the Insurance Trustee shall have authority to accept paid-up insurance for the policies. Additionally, if necessary for the health, support or maintenance of the beneficiary of that trust, the Insurance Trustee shall have complete authority to surrender the said policies, or borrow on them, and to utilize the proceeds for the benefit of that trust beneficiary. The Insurance Trustee shall not be liable to any beneficiary by virtue of its decision in exercising its discretion and in carrying out these instructions. If [Child 2] should die, resign or be unable or unwilling to exercise the power described in this subparagraph, unless [Child 1] has otherwise named a successor Insurance Trustee, then a majority of the beneficiaries then entitled or permitted to receive income from each separate trust hereunder, per stirpes and not per capita, who are at least twenty-one (21) years of age, shall have the authority to appoint a successor Insurance Trustee, other than Settlor.

Statute provides, in pertinent part, that on the petition of a trustee or a beneficiary, a court may order that the terms of the trust be modified if because of circumstances not known to or anticipated by the settlor, the order will further the purposes of the trust; modification of administrative, non-dispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust's administration; the order is necessary or appropriate to achieve the settlor's tax objectives and is not contrary to the settlor's intentions; or the order is not inconsistent with the material purpose of the trust and all beneficiaries of the trust have consented or are deemed to have consented to the order.

In Year 2, subsequent to the Court's Final Judgment, Child 2, in the capacity of Insurance Trustee, purchased a second-to-die policy on the lives of Child 1 and Spouse.

Letter Ruling 201919002 reasoned and held:

In the present case, prior to the modifications of Trust, Section 2.1 of Trust expressly granted the Trustee the power to own and acquire life insurance and to pay the premiums on existing life insurance on the life of any person in which the trust or its beneficiaries may have an insurable interest. The ownership of any and all policies of insurance applied for and purchased by the Trustee or transferred and assigned to the Trustee is irrevocably vested in the Trustee. Under Section 2.4, Child 1, as the Trustee, is vested with all rights, powers, options, elections, privileges and incidents of ownership in all insurance policies owned by Trust. Accordingly, prior to the modifications, Child 1 possessed all incidents of ownership in any life insurance policy on Child 1's life that the Trust may acquire.

The modifications to Trust relinquished Trustee's powers with respect to any life insurance policy on Child 1's life acquired by Trust and granted such powers to an Insurance Trustee. Under Section 7.12(a), as modified, Child 2 is appointed as Insurance Trustee with power to maintain and pay premiums on a life insurance policy on the life of Child 1. Child 2 shall have complete authority to surrender policies, borrow on them, or utilize the proceeds for the benefit of the beneficiary if necessary for the health, support or maintenance of the beneficiary. Accordingly, Trustee is precluded from exercising any power normally conferred on the owner of a policy.

Child 1 retains a beneficial interest in income and principal of Trust, subject to an ascertainable standard. However, under Section 2.5, as modified, premium payments will only be made out of corpus and not income. In addition, Child 1 has not made any contributions to Trust and further represents that Child 1 will not make any contributions to Trust.

Further, prior to the modifications of Trust, Child 1 possessed a testamentary special power of appointment over the Trust principal, which would include any proceeds from life insurance on the life of Child 1 that Trust may hold. This power gave Child 1 the power to change the beneficial ownership of the proceeds. However, the modifications to Trust restrict Child 1's testamentary special power of appointment. Under Section 6.1, as modified, Child 1 may not exercise Child 1's testamentary special power of appointment over any life insurance policies on the life of Child 1. Accordingly, Child 1 may not exercise Child 1's testamentary special power of appointment to change the beneficial interests in the proceeds of the life insurance policy on Child 1's life.

In this case, Child 1's powers, in the capacity as Trustee and beneficiary were eliminated prior to the acquisition of the life insurance policy on Child 1's life. Trust is the owner and beneficiary of the policy. Accordingly, when the Insurance Trustee purchased a life insurance policy on Child 1's life, Child 1 did not possess and did not have the power to exercise, any incidents of ownership in the policy acquired by Trust. Child 1 will not relinquish or transfer any incidents of ownership in the policy as a result of the modification prior to the acquisition of the policy.

Accordingly, based on the facts submitted and the representations made, we conclude that Child 1 does not and will not possess any incidents of ownership over any life insurance policy on Child 1's life acquired by Trust, as amended, and that the proceeds of any policy on Child 1's life will not be includible in Child 1's gross estate under § 2042(2). The above conclusions assume that Child 1 is not serving as Insurance Trustee at the time of Child 1's death, or Trust is modified such that Child 1 regains fiduciary powers over life insurance on Child 1's life.

We neither express nor imply any opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

Reviewing various authorities cited above, Mezzullo, T.M. 826-3rd, *Life Insurance*, Detailed Analysis Part I.D., "Special Issues in Trust-Owned Insurance: Application of Incidents of Ownership Test," subpart 1, "What Are Consequences of Decedent Serving as Trustee of Trust Holding Insurance Policy on Decedent's Life?" point e, "Practical Application of Rules," suggests:

- The most cautious approach is for the insured not to serve as a trustee of a trust that holds insurance policies on his or her life, whether or not he or she is the transferor.

- If the insured is to serve as a trustee in a *Estate of Skifter v. Commissioner*[94] situation (that is, where the trust is created by someone other than the insured), certain precautions should be taken. First, the insured should not have a beneficial interest in the trust. If the insured's spouse or children are trust beneficiaries, language should be used precluding trust distributions that may satisfy the insured's obligation of support to the spouse and children. Second, there should be a source for premium payments other than the insured because, under Rev. Rul. 84-179, the insured's powers as trustee may result in the inclusion of the insurance policies in his or her gross estate, if the insured furnished "consideration for maintaining the policies." Thus, it will probably be necessary for the trust holding the insurance policies to hold other assets that can be used to pay premiums.

- If there is a plan for a trust to acquire a policy of insurance on the life of a trustee who is a beneficiary of the trust, the trustee should, before the policy is acquired, either renounce all powers that may affect the policy or resign as trustee.

- Notwithstanding the result in *Estate of Bloch v. Commissioner*,[95] the insured/trustee should not use the trust property for his own benefit in contravention of the terms of the trust. At some point, a court may conclude that the transaction is a sham. Moreover, the planning objective is to avoid, rather than encourage, litigation with the IRS.

- Where a question of inclusion in the decedent's gross estate of the proceeds of an insurance policy on the decedent's life is raised not in a planning context, but as a fait accompli, it should not be assumed that inclusion is inevitable, even if the decedent is transferor, trustee, and beneficiary. As in *Estate of Jordahl v. Commissioner*,[96] the powers of the decedent (under the terms of the relevant document and based on the actual facts) should be analyzed closely in determining whether, in fact, the decedent possessed any incidents of ownership.

- [94] 468 F.2d 699 (2d Cir. 1972).

- [95] 78 T.C. 850 (1982).

- [96] 65 T.C. 92 (1975), *acq.*, 1977-1 C.B. 1.

Reviewing various authorities cited above, Mezzullo, T.M. 826-3rd, *Life Insurance*, Detailed Analysis Part I.D., "Special Issues in Trust-Owned Insurance: Application of Incidents of Ownership Test," subpart 2, "What Are Consequences if Decedent Is Beneficiary of Trust Holding Insurance Policy on Decedent's Life?" point g, "Guidelines," suggests:

> There are no definitive answers, but the following thoughts are offered as possible guidelines in the insured/beneficiary arena:

- In a number of rulings, the IRS has ruled favorably where the insured/beneficiary was entitled to the income. However, if the insured has the right, as income beneficiary, to demand that the policy be converted to income-producing assets, there is a significant risk that (1) this could create a § 2042 problem under the reasoning of *Estate of Fruehauf v. Commissioner*[99] and/or (2) the failure to exercise the right could have adverse gift and estate tax consequences.

[99] 427 F.2d 80 (6th Cir. 1970).

- If the insured is entitled to income, the trust should provide that all premium payments will be made from principal, although this will have the effect of reducing the income in the future.

- If distributions to the beneficiary/insured are permitted with no reference to a standard, the insured has no right to the economic benefit of the policy and § 2042 should not apply.

- If distributions can be made to the insured only in accordance with a standard and the standard is not satisfied, § 2042 should not apply because no distribution could be made to the beneficiary.

- If distributions are required to be made to the insured only in accordance with a standard and the standard is satisfied, § 2042 should not apply. Even though the beneficiary has a right to distributions (which right, if not enforced, may create estate and gift tax issues in and of itself), the beneficiary should have no § 2042 economic benefit in the policy if he or she has no right to demand distribution of the policy itself.

- If distributions are permitted (but not required) to be made to the insured only in accordance with a standard and the standard is satisfied, possible § 2042 includibility is even more remote than in the bullet point immediately above.

- All of the above assumes that the insured has not made contributions to the trust. While it may well be that contributions by the insured should have no relevance in the § 2042 context (or at least in this aspect of § 2042), the fact that the favorable result in Rev. Rul. 84-179 (and in each of the private rulings discussed above) is contingent on the no-contribution condition raises a significant concern.

- All of the above assumes that the insured is not a trustee of the trust (or at least has no distribution powers as trustee). While PLR 9111028 shows that it may be possible for the insured/beneficiary to serve as trustee, *Fruehauf* points out the potential danger. A fair inference from the private letter rulings discussed above is that the renunciations and resignations were a prerequisite to the favorable rulings.

- The beneficiary/insured should not hold any power of appointment (inter vivos or testamentary) over the insurance policy.

- *Bottom* Line: The taxpayer may want to consider requesting a private letter ruling. While there are certainly trusts with other terms that should be outside the scope of § 2042, a conservative approach is to draft a trust in which (1) the only permissible distributions to the insured are in the discretion of the trustee (without a standard), (2) distribution to the insured of any insurance policy on his or her life is prohibited, and (3) the insured has no power of appointment over any such policies.

To me, the focus seems to be whether the beneficiary might have been able to make a claim on the money used to pay premiums because the trustee diverted to the policy money that should have been distributed to the beneficiary. I think that this emphasis is misplaced, in that the beneficiary cannot control the trustee's actions and should not be imputed incidents of ownership unless the beneficiary actually obtains authority to exercise incidents of ownership; however, the IRS' and courts' opinion is much more important than my view. To avoid these concerns, the trustee might consider forming a partnership to hold the policy.[4398]

II.Q.4.i.ii.(b). Corporate Ownership of Policy

However, redemptions require further analysis, as do arrangements for cross-purchase agreements when all of the parties hold policies on each other through an entity. If a decedent is the sole or controlling shareholder of a corporation that owns an insurance policy on the decedent's life, then the decedent will

[4398] See text accompanying fns 2927-2928 in part II.J.19.b Comparing Annuity to Life Insurance.

not be deemed to possess incidents of ownership as a result of the decedent's stock ownership so long as the proceeds of the policy are payable to the corporation.

Reg. 20.2042-1(c)(6) provides:

> In the case of economic benefits of a life insurance policy on the decedent's life that are reserved to a corporation of which the decedent is the sole or controlling stockholder, the corporation's incidents of ownership will not be attributed to the decedent through his stock ownership to the extent the proceeds of the policy are payable to the corporation. Any proceeds payable to a third party for a valid business purpose, such as in satisfaction of a business debt of the corporation, so that the net worth of the corporation is increased by the amount of such proceeds, shall be deemed to be payable to the corporation for purposes of the preceding sentence. See § 20.2031-2(f) for a rule providing that the proceeds of certain life insurance policies shall be considered in determining the value of the decedent's stock. Except as hereinafter provided with respect to a group-term life insurance policy, if any part of the proceeds of the policy are not payable to or for the benefit of the corporation, and thus are not taken into account in valuing the decedent's stock holdings in the corporation for purposes of section 2031, any incidents of ownership held by the corporation as to that part of the proceeds will be attributed to the decedent through his stock ownership where the decedent is the sole or controlling stockholder. Thus, for example, if the decedent is the controlling stockholder in a corporation, and the corporation owns a life insurance policy on his life, the proceeds of which are payable to the decedent's spouse, the incidents of ownership held by the corporation will be attributed to the decedent through his stock ownership and the proceeds will be included in his gross estate under section 2042. If in this example the policy proceeds had been payable 40 percent to decedent's spouse and 60 percent to the corporation, only 40 percent of the proceeds would be included in decedent's gross estate under section 2042. For purposes of this subparagraph, the decedent will not be deemed to be the controlling stockholder of a corporation unless, at the time of his death, he owned stock possessing more than 50 percent of the total combined voting power of the corporation. Solely for purposes of the preceding sentence, a decedent shall be considered to be the owner of only the stock with respect to which legal title was held, at the time of his death, by (i) the decedent (or his agent or nominee); (ii) the decedent and another person jointly (but only the proportionate number of shares which corresponds to the portion of the total consideration which is considered to be furnished by the decedent for purposes of section 2040 and the regulations thereunder); and (iii) by a trustee of a voting trust (to the extent of the decedent's beneficial interest therein) or any other trust with respect to which the decedent was treated as an owner under subpart E, part I, subchapter J, chapter 1 of the Code immediately prior to his death. In the case of group-term life insurance, as defined in the regulations under section 79, the power to surrender or cancel a policy held by a corporation shall not be attributed to any decedent through his stock ownership.

II.Q.4.i.ii.(c). Partnership Ownership of Policy

Neither Code § 2042 nor its Regulations specifically address the issues raised by insurance owned by a partnership in which the insured is a partner. However, case law and IRS rulings have analyzed these issues. The Tax Court has held that a general partner does not possess incidents of ownership in a policy that names a general partnership as the owner and beneficiary if the policy was purchased in the partnership's ordinary course of business and the insured partner owned less than a 50% interest in the general partnership.[4399] Rev. Rul. 83-147 held that a partner does possess incidents of ownership if the policy on the partner's life is owned by the partnership, designates a member of the partner's family as the beneficiary, and premiums were paid by the partnership in partial satisfaction of the partner's share of partnership income. The ruling stated that the result was different than the Tax Court case because the beneficiary was not the partnership.

[4399] *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), *acq*. in result, 1959-1 C.B. 4, *aff'd* on another issue 244 F.2d 436 (4th Cir.), *cert. denied*, 355 U.S. 827 (1957).

In a number of Letter Rulings, the IRS has addressed Code § 2042 with respect to a partnership that owns and is designated as the beneficiary of an insurance policy on the life of one of its partners.

Letter Ruling 9623024 held that the insured general partner does not possess incidents of ownership in the policy if the partnership agreement states that the proceeds, once received by the partnership, can be distributed to the remaining partners in proportion to their interests to the extent that the proceeds from the policy were not needed to pay the partnership's obligations. The IRS reasoned that the value of the deceased partner's interest would include his pro rata portion of the proceeds and therefore inclusion under Code § 2042 would amount to unwarranted double counting of the proceeds.

Letter Rulings 9625022 and 9625023 ruled that life insurance proceeds would not be included in the estate of a member in a limited liability company (that was taxed as a partnership) who could not participate in decisions regarding a policy insuring the member's life held. Letter Rulings 9625013-9625019 had the same result and also involved using the proceeds to fund the purchase of a deceased owner's share of a related corporation and also of the limited liability company, which held real estate that it rented to the corporation.

Letter Rulings 9843024 and 200111038 held that the insured limited partner does not possess incidents of ownership in the policy if the partnership agreement precludes the limited partners from exercising any control over the partnership's management and investment activities.

Letter Ruling 200017051 ruled that the insured general partner does not possess incidents of ownership in the policy if the partnership agreement expressly states that an insured partner "had no right or power to exercise or to otherwise participate in the exercise of any of the incidents of ownership with respect to such policy or policies."[4400]

In Letter Ruling 200214028, the IRS ruled that the insured general partner did not possess incidents of ownership because the proceeds were payable to or for the benefit of the partnership. In that case, the partnership agreement required that the proceeds be used to redeem the insured partner's interest in the partnership.

TAM 200432015 dealt with Code section 2042 and the transfer of insurance policies to a limited liability company. The TAM deals with Code §§ 2035 and 2042 and involves an insured who transferred an insurance policy on his own life to a limited liability company. If none of the insureds own policies on their own lives that they transfer to a limited liability company, the TAM would not apply.

II.Q.4.i.iii. IRS' Response to Request that Resulted in Letter Ruling 200747002

In response to my ruling request, Letter Ruling 200747002 held that none of the insureds possessed incidents of ownership on the policies that the others contributed to the LLC.

However, the IRS requested some modifications to the LLC's operating agreement. The IRS limited the members' ability to make decisions regarding the LLC's holding of policies. Not mentioned in the ruling is that the operating agreement originally allowed the members voting rights customarily given in a manager-managed LLC, limiting them only to the extent that no member could vote regarding insurance on that member's life. The IRS was concerned that the members could collude in a manner akin to the reciprocal trust doctrine, so it required that the operating agreement preclude members from voting on anything relating to any life insurance policy. Similarly, the IRS required that the operating agreement not

[4400] It did not think to cite cases involving trust-owned insurance on a beneficiary's life, where no incidents of ownership were attributed to the beneficiary. Letter Rulings 9602010 and 9748020. Rev. Rul. 84-179 might also be helpful.

expressly authorize amendments by the members, preferring that applicable state law defaults control the situation.

The ruling did not address the effect of the members' assigning their interests in the LLC to others. Although the IRS was not troubled by the prospect of that occurring, it did not wish to consider situations that might arise by reason of such an assignment.

An issue with respect to with a ruling was not sought is the transfer-for-value rules, which make death benefits taxable if policies are transferred in various taxable transactions.[4401] Formation of the LLC should not implicate these rules, because formation is a nontaxable transfer.[4402] Similarly, a Member receiving an increased ownership percentage of a policy due to an increased contribution is also a nontaxable transfer.[4403] In our case, the Members also participated in other LLCs that held rental real estate; because they were partners for income tax purposes, the transfer-for-value rules do not apply to transfers of policies between them.[4404]

II.Q.4.i.iv. Significance of Letter Ruling 200747002

The ruling has other implications. Using a corporate trustee to hold the policies as manager of the LLC provides security that the proceeds will be used as intended. As mentioned, one of the disadvantages of a cross-purchase is that a shareholder's creditors might be able to prevent application of the proceeds. Depending on applicable state law, the insurance being in an LLC might make a charging order the exclusive remedy. A charging order allows creditors to receive any distributions that belong to the debtor but does not allow the creditor to force the LLC to make distributions. The manager's duty to the other members would prevent the proceeds from being distributed without the consent of the deceased shareholder's beneficiaries.

The operating agreement's original restrictions on members' voting rights generally should be sufficient to avoid estate inclusion. The additional restrictions should be placed in the operating agreement only if seeking a Letter Ruling or advising a client who is willing to sacrifice flexibility to be as close as possible to the letter ruling's facts.

Letter Ruling 200747002 is not geared towards a policy with cash values. However, through a split-dollar arrangement, one might carve out the term portion for the LLC and make other arrangements with the cash value.[4405] Although the term portion eventually becomes uneconomic, one could use a variety of estate-planning techniques with the cash value portion before that happens so that, ultimately, the insurance arrangement becomes sustainable.

The ruling also held that Brother's Irrevocable Trust was a grantor trust, in which Brother was treated as owning Brother's Irrevocable Trust's assets for income tax purposes under Code § 678; Sister was similarly treated as the owner of Sister's Irrevocable Trust. This was critically important to allow Brother's Irrevocable Trust and Sister's Irrevocable Trust to own stock in the S corporation. Brother initially had a withdrawal right in Brother's Irrevocable Trust that had since lapsed; the same tool was used for Sister and Sister's Irrevocable Trust. Although such withdrawal rights are usually used to obtain the gift tax

[4401] Code § 101(a)(2).
[4402] Code §§ 101(a)(2)(A), 721(a).
[4403] Code § 721(a).
[4404] Code § 101(a)(2)(B).
[4405] See footnote 4097 for a summary of how split-dollar arrangements work.

annual exclusion, in this case a significant purpose of granting withdrawal rights was to obtain grantor trust status treating the beneficiary as the owner.

The above issues are as far as was the ruling was sought to cover. However, this structure has uses far beyond the issues discussed in the ruling.

First, Trusts 2A and 2B were originally funded with modest gifts that they invested in LLCs that used bank financing to buy real estate. These LLCs leased the real estate to the S corporation. The net cash flow from the rental operations would be used to pay the life insurance premiums through the insurance LLC. Thus, the income tax goal of holding real estate in partnerships was married with leveraging gifts to generation-skipping trusts.

Second, Trusts 2A and 2B were ideal for the tactic of selling stock to an irrevocable grantor trust.[4406] For example, Brother could sell S stock to Brother's Irrevocable Trust in exchange for a promissory note. No income tax would result during Brother's life, because Brother is treated for income tax purposes as owning Brother's Irrevocable Trust. If the IRS determined that the stock's value was too high and that therefore Brother made a gift, Brother would pay no gift tax because the gift is an incomplete gift due to Brother's power to appoint the trust's assets at death. If Brother's Irrevocable Trust were thinly funded, Brother and other trusts created by Grantor for Brother could guarantee the promissory note to provide additional economic reality to the sale.

If Brother dies during the term of the note, Sister and BA would use the insurance to buy Brother's Irrevocable Trust's stock, thus providing cash to retire the note to Brother.

If the sale of S stock to Brother's Irrevocable Trust generates cash flow in excess of the note payments, the excess cash could be used to pay premiums through the insurance LLC, allowing Brother's Irrevocable Trust to participate more in the buy-sell than it would have been able to do with just the net rental proceeds.

Note that Brother has access to the excess funds for Brother's support. The excess funds could also be used to help Brother's children when they are no longer legally dependents, without being limited by the annual gift tax exclusion or using Child 2A's applicable exclusion amount.

What if the parties had used a cash value policy subject to a split-dollar arrangement instead of term policies? After Brother's Irrevocable Trust fully repays the note on the sale of stock, it should have plenty of cash flow to repay the split-dollar obligations.

Sister would use the same strategy.

II.Q.4.i.v. Practical Logistics for Life Insurance LLC

First, keep in mind that any person who is at least a 5% owner of the LLC would be considered an employee whose notice and consent are required, as described in part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance. Whether the parties transfer the life insurance to the LLC or the LLC buys original issue insurance, the parties will probably use a notice and consent along the lines of part II.Q.4.g.iii Consent for Owner Who Is Not an Employee. However, the operating agreement might also include notice and consent as a safety valve.[4407]

[4406] See part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.
[4407] See fn. fn. 4356, which is found in part II.Q.4.g.i Analysis of Code § 101(j); for an example, see part II.Q.4.g.ii Consent Integrated into Operating Agreement.

Often, the operating business will pay the premiums on behalf of the owners – just to make sure it gets done so that the business' succession plan is funded as expected.

If the operating business is a C corporation, it would account for the premium payments as compensation (as an officer or director), because dividends are nondeductible to the company and taxable to the shareholders.

If the operating business is an S corporation, it would account for the premium payments as compensation or as a distribution. Compensation tends to be the more popular choice, in that it can be non-pro rata, but the parties' economic deal might make distributions more attractive, and any temporary timing differences of distributions should not cause problems with the S corporation single class of stock rules.[4408]

When the operating company is taxed as a partnership, it might consider setting up a separate distribution account for premiums paid on behalf of each owner. That way, the distributions can be reconciled more easily against what the life insurance LLC is doing.

When the operating company pays a term premium, the life insurance LLC would credit the relevant owner's capital account with a contribution and debit premium expense, with the premium expense separately allocated to the relevant owner.

II.Q.4.i.vi. Letter Ruling 200947006

The IRS has also ruled that an insured who was a partner in a partnership had no incidents of ownership. In Letter Ruling 200947006, the insured had direct and indirect ownership of a partnership that held a policy on his life.[4409] That partnership and other partnerships (in which the insured had direct or indirect ownership) were beneficiaries. The arrangement was restructured so that the insured had no right to make decisions on behalf of a trust that owned the partnership, and the insured's other direct or indirect interest in the partnership was terminated. The IRS ruled that the insured not only had no incidents of ownership after the transaction but also (to avoid Code § 2035) had no incidents of ownership before the transaction.

II.Q.4.i.vii. Conclusion

The Insurance LLC provides security for the owners, facilitates flexibility in making premium payments, and demonstrates a model for reducing the number of policies that must be used in a cross-purchase. Convincing the business owners' parents to set up generation-skipping perpetual trusts to buy real estate used in the business can help the business owners continue to enjoy the business' financial success while moving the business outside of the estate tax system.

For income tax issues generally, see parts II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies. If a life insurance policy owned on a surviving owner receives a new basis when the beneficial owner predeceases the surviving owner,[4410] consider whether this new basis increases the "investment in the contract" and, if not, whether additional steps should be taken to effectuate that increase.[4411]

[4408] See part II.A.2.i.ii Temporary Timing Differences.

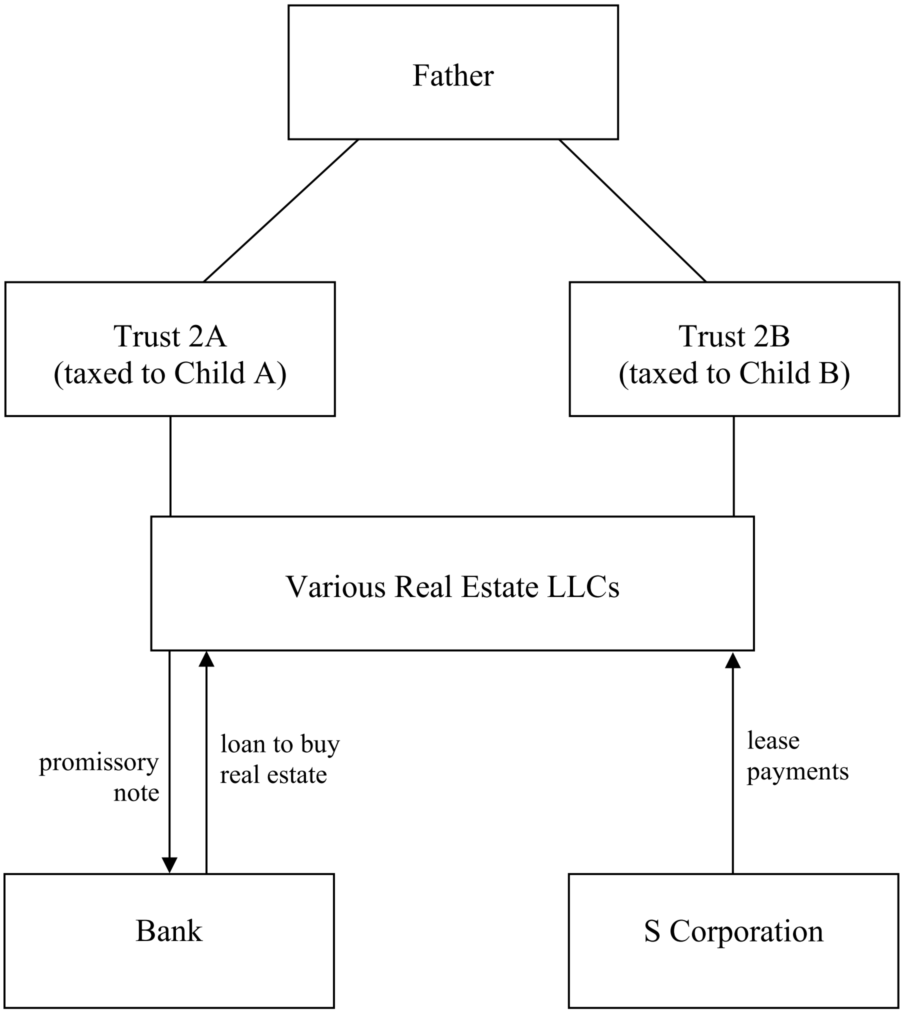
[4409] See also Letter Rulings 200948001 and 200949004, which appear to be companion rulings.

[4410] For basis changes when a partner dies, see part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations. For basis changes on the death of an owner other than the insured, see part II.Q.4.e.i Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured.

[4411] See part II.Q.4.e.ii Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured.

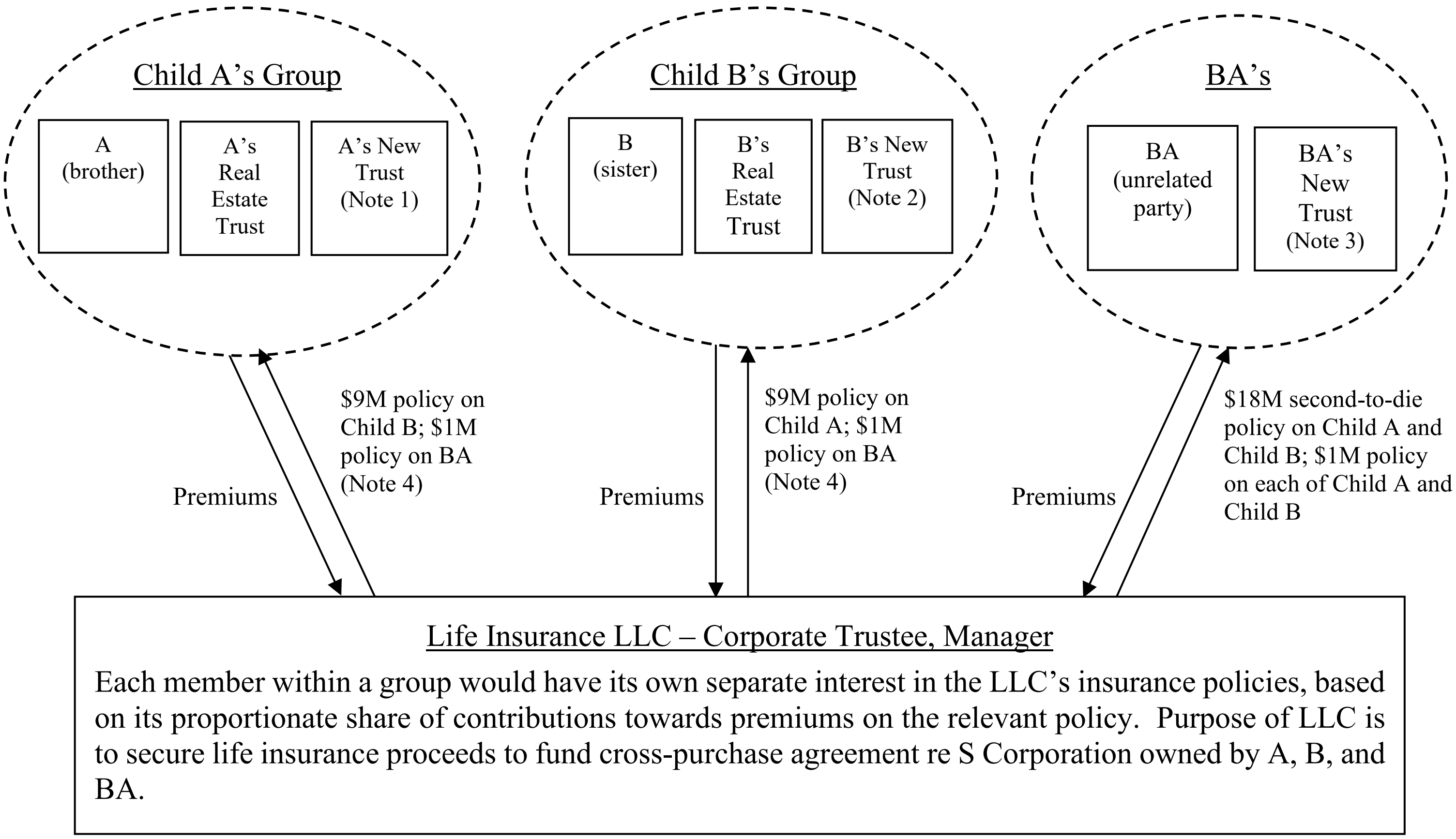
Appendix A

Prior Formation of Trusts



Appendix B

Insurance LLC Structure



Note 1: Child A would be the grantor and trustee of this irrevocable trust for his spouse's and their descendants' support, with appropriate prohibitions against discharging any support obligations.

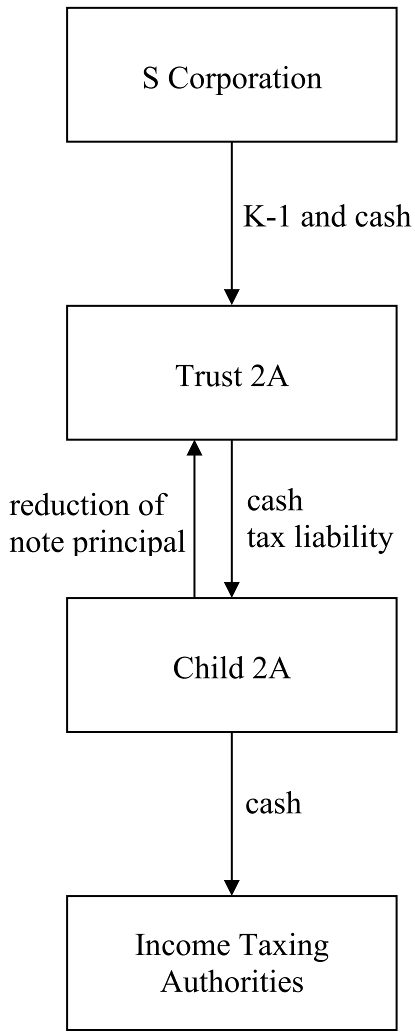
Note 2: Child B would be the grantor and trustee of this irrevocable trust for her descendants' support. (Her children are adults.) Her grandchild would be cut out, but her son could include him.

Note 3: BA would be the grantor and trustee of this irrevocable trust for his wife's and their descendants' support, with appropriate prohibitions against discharging any support obligations.

Note 4: If Child A dies first, Child B's group would become the premium payer with respect to Child A's group's policy on BA's life. If Child B dies first, Child A's group would become the premium payer with respect to Child B's group's policy on BA's life.

Appendix C

Later Sale of S corporation Stock to Irrevocable Grantor Trust



II.Q.7.a.vi. Redemptions and Accumulated Earnings Tax

Generally, a C corporation that accumulates funds could also be subject to the 20% accumulated earnings tax.[4612] The tax applies to every corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed,"[4613] except:[4614]

(1) a personal holding company (as defined in section 542),

(2) a corporation exempt from tax under subchapter F (section 501 and following), or

(3) a passive foreign investment company (as defined in section 1297).

Thus, it complements the personal holding company tax, which is also designed to force C corporations to declare dividends. See part II.A.1.e Personal Holding Company Tax.

The tax is on "accumulated taxable income."[4615] "Accumulated taxable income" means the adjusted taxable income,[4616] minus the sum of the dividends paid deduction[4617] and the accumulated earnings credit.[4618]

The accumulated earnings credit works as follows:

- "If the corporation is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which $250,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year."[4619]

- Otherwise, the accumulated earnings credit is equal to such part of the earnings and profits for the taxable year as are retained for the business' reasonable needs, minus a certain deduction relating to U.S.-source capital gains.[4620] The dividends paid deduction[4621] reduces retained earnings and profits.[4622] The accumulated earnings credit for such a corporation is no less than the amount by which $250,000 exceeds the corporation's accumulated earnings and profits at the close of the preceding taxable year.[4623] The $250,000 amount is reduced to $150,000 for a corporation the principal function of which is the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.[4624]

Let's examine how the $250,000 credit would work for a mere holding or investment company. Suppose the accumulated earnings and profits at the close of the preceding taxable year were $250,000 or more.

[4612] Code § 531.
[4613] Code § § 532(a).
[4614] Code § § 532(b).
[4615] Code § 531.
[4616] Code § 535(b) adjusts taxable income, including to deduct federal income and certain other taxes, deduct charitable contributions with modifications, disallow the dividends-received deductions, allow capital losses subject to modifications, and deduct U.S.-source capital gains.
[4617] Code § 561.
[4618] Code § 535(b).
[4619] Code § 535(c)(3).
[4620] Code § 535(c)(1).
[4621] Code § 561.
[4622] Code § 535(c)(1).
[4623] Code § 535(c)(2)(A).
[4624] Code § 535(c)(2)(B).

The credit would be zero, because $250,000 did not exceed the accumulated earnings and profits at the close of the preceding taxable year. Suppose the accumulated earnings and profits at the close of the preceding taxable year were $200,000. The credit would be $50,000, leaving $200,000 subject to the tax. the sweet spot would seem to be $125,000 accumulated earnings and profits at the close of the preceding taxable year, where a credit of $125,000 ($250,000 minus $125,000) would offset the $125,000 accumulated earnings and profits at the close of the preceding taxable year. Of course, that assumes that the corporation is not a personal holding company, which is exempt from the accumulated earnings tax.[4625]

Earnings and profits of a corporation accumulating beyond the business' reasonable needs is determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence proves otherwise.[4626] A corporation being a mere holding or investment company is prima facie evidence of the purpose to avoid income tax with respect to shareholders.[4627] If the corporation does not the liquidity to pay a cash distribution, it should consider declaring a Code § 565 consent dividend,[4628] being extra careful about the consent dividend if a trust that makes charitable contributions is a shareholder.[4629]

However, reasonable business needs include the business' reasonably anticipated needs, funding a redemption to pay estate tax or expenses of estate administration, or is being used to fund certain redemptions of charitable shareholders.[4630] Consider documenting the business purposes for accumulating earnings in annual meeting minutes. If the earnings get too high and cannot be reduced through high but reasonable compensation (especially qualified retirement plans) or rent, consider making an S election.[4631]

II.Q.7.b.iii. S Corporation Receipt of Life Insurance Proceeds

In Letter Ruling 200409010, upon the death of the key person, the S corporation (presumably using the accrual method of accounting) would immediately redeem the stock held by the key person at the time of death by issuing a promissory note to the key person's estate. After the redemption, the remaining shareholders would elect to cut off the taxable year.[4673] By terminating the taxable year after the redemption but before submitting a claim on the life insurance policy, the remaining shareholders sought to have all of the insurance proceeds allocated to their stock for purposes of increasing their tax basis. The IRS ruled that the life insurance death benefit will be required to be recognized as of the date of death. Notwithstanding needing to go through the claims submission and evaluation process, death would establish the corporation's rights to the proceeds as a beneficiary of the insurance policy.

Thus, the basis increase due to the receipt of the life insurance death benefit would not be allocated solely to the surviving shareholders. By using a redemption, they would have received a smaller basis increase than if they had received the life insurance proceeds directly and bought the decedent's stock. In fact, if and to the extent that an accounting cut-off can<u>not</u> be made, a portion of the basis increase would be allocated to the decedent's stock and perhaps subsumed (and, as a practical matter, lost) in the basis step-

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[4625] See fn 4614 and part II.A.1.e Personal Holding Company Tax.
[4626] Code § 533(a).
[4627] Code § 533(a).
[4628] CCA 201653017 asserted accumulated earnings tax on a holding company and would not accept lack of liquidity as an excuse, pointing to the consent dividend procedure and relying on the discussion of that procedure's purpose in TAM 9124001.
[4629] See part II.Q.7.c.i.(b) Business Income Limiting Trust Income Tax Deduction, including the paragraph accompanying fn. 4692.
[4630] Code § 537(a)(1), (2).
[4631] Although S corporations cannot have excessive income from investments, that prohibition is easy to avoid using a modest amount of oil and gas investments. See part II.P.3.b.iii Excess Passive Investment Income, especially fn. 3833.
[4673] Code § 1377(a)(2); for more details, see part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest.

up of that stock upon death. If the accounting cut-off places date of death events into the decedent's hands, then perhaps the decedent's portion of basis from nontaxable income would be allocated to the decedent's stock and subsumed (and, as a practical matter, lost) in the basis step-up of that stock upon death.

Although cash basis taxpayers should be able to avoid these issues, be careful to see how the accounting cut-off would apply, because it can be quite tricky.

Of course, a C corporation's remaining shareholders receive no basis step-up as a result of a redemption (whether or not funded by life insurance).

To avoid these issues, I tend to prefer the planning in part II.Q.4.i Life Insurance LLC.

II.Q.7.b.iv. S Corporation Distributions of, or Redemptions Using, Life Insurance Proceeds

II.Q.7.b.iv.(a). S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations

Below is a variation of the theme of part II.P.3.b.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

In Rev. Rul. 2008-42,[4674] an S corporation purchased an employer-owned life insurance contract on the life of one of its employees in order to cover expenses the company would incur as a result of the death of the employee (also known as a key-man policy). The employee was a highly compensated employee of the corporation. The corporation paid all of the premiums for the policy and was the beneficiary of the policy. At the end of the taxable year, the corporation had earnings and profits ("E&P"). The IRS reminded us that Code 101(j) imposes notice and reporting requirements regarding employer-owned life insurance to preserve the Code § 101 exclusion of life insurance proceeds from income taxation.[4675]

The IRS ruled that premiums paid did not reduce the S corporation's AAA. It also ruled that the death benefit received does not increase the S corporation's AAA. What the IRS does not point out is the general ordering rules of Code § 1368, which are that distributions from an S corporation are treated as the following:[4676]

1. A tax-free distribution to the extent of the lesser of stock basis or AAA, then
2. A taxable dividend to the extent of E&P, then
3. Return of principal to the extent of remaining basis, and finally
4. Capital gain.

Suppose, for example, that the shareholders contributed $10,000 to the corporation at its inception, and no stock has been transferred since inception. It operated as a C corporation and earned $1,000,000 of E&P. Then it elects S status and has $250,000 of AAA. A key employee dies, and the corporation receives $1,500,000 of life insurance proceeds from a term policy and then distributes $700,000 to the shareholders. The consequences are:

[4674] See New Ruling Provides Guidance on AAA of S corporations, *Business Entities* (WG&L) (Jan./Feb. 2009).
[4675] See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.
[4676] See part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally.

- Immediately before the employee died, the shareholders had tax basis in their stock of $260,000, which is the sum of the initial $10,000 contribution and the $250,000 of AAA. Immediately after the death, this tax basis is increased to $1,760,000 due to the receipt of death benefits.

- Of the $700,000 the shareholders receive, $250,000 is a tax-free return of AAA that they could have pulled out tax-free before the employee died; their stocks' tax basis is reduced to $1,510,000 by reason of the $250,000 tax-free distribution. The remaining $450,000 is a taxable dividend out of the $1,000,000 E&P, even though it can be traced to the tax-free life insurance proceeds and even though the shareholders have ample basis to receive distributions if the corporation had never been a C corporation. E&P is reduced to $550,000, since $450,000 out of the $1,000,000 E&P has been distributed.

Turning tax-free life insurance proceeds into taxable dividends – not a good deal!

Suppose instead that the shareholders had owned the policy, had been the beneficiaries, and had received distributions from the corporation to pay premiums:

- Each year, AAA would have been reduced to the extent of the distributions that were used to pay premiums.

- The shareholders receive the life insurance proceeds tax-free, assuming they complied with Code § 101(j) as in the Revenue Ruling.

- When the shareholders invest into the company the $800,000 that, under the above example was retained in the corporation, their stock basis increases by that $800,000 to $1,060,000 from the pre-death $260,000 used in the example.

- Thus, the shareholders have lower basis than in the first example, which is the price they pay for not having dividend income.

- If future distributions exceed AAA, they could have dividend income up to the full $1,000,000 of E&P.

Thus, this alternative defers dividend taxation but does not avoid it if future distributions significantly exceed AAA. However, if future distributions in excess of AAA are in the form of redemptions that are taxed as such, then this alternative might very well avoid dividend taxation.

A more tax-efficient way to structure this alternative would be for the shareholders to contribute their $800,000 investment of the life insurance proceeds to a new limited liability company taxed as a partnership. Then either:

- The new LLC loans the proceeds to the S corporation as needed, documenting the loan with interest at the applicable federal rate, or

- The S corporation then contributes all of its business assets to the LLC. Later, when the LLC does not need part or all of the $800,000 anymore, it can distribute that excess money to the shareholders as a tax-free return of their capital contribution. This might or might not be a practical alternative, depending on the non-tax issues caused by transferring the S corporation's assets, as well as the annual expense of filing two business income tax returns instead of one. This is more cumbersome than the loan alternative, but it might have the positive effect of shifting a significant portion of the business operations to a partnership income tax model, which is more tax-efficient when changing the composition of the business' equity ownership, as discussed at the beginning of part II.M Buying into a Business, as well at part II.M.4 Providing Equity to Key Employees and an Introduction to Code § 409A Nonqualified Deferred Compensation Rules, of these materials.

Finally, to protect the life insurance from various business exigencies inherent in the shareholders owning life insurance under the alternative, the shareholders should consider forming a limited liability company to hold the life insurance.

These issues could be avoided if the corporation had an S election in place from inception or to the extent it had distributed all of its E&P in the past. Owners of S corporations with E&P might consider cleansing the corporation's E&P while dividend rates are low. Code § 1368(e)(3) allows taxpayers to elect to reverse the normal distribution rules and have distributions come first from E&P and then from AAA to implement this strategy.[4677]

Finally, owners of limited liability companies or other entities taxed as partnerships would not need to even consider this issue.

II.Q.7.b.iv.(b). S Corporation Redemptions Using Life Insurance Proceeds

When an S corporation redeems stock under Code § 302(a) or 303(a):

- AAA is reduced by an amount equal to the AAA multiplied by the number of shares redeemed and divided by the number of shares of stock in the corporation immediately before the redemption.[4678]
- E&P is reduced by a ratable share of post-2/28/1913 E&P.[4679]
- These reductions in AAA and E&P are independent of each other.[4680]

If an S corporation is a former C corporation with significant E&P, then a disadvantage of a redemption relative to a cross-purchase is that AAA is reduced in a redemption, whereas in a cross-purchase AAA is not affected. (It could be an advantage if the goal is to cleanse the corporation of E&P to avoid worrying about the passive investment income rules, but those rules are easy to work around by investing in oil and gas partnerships; see part II.P.3.b.iii Excess Passive Investment Income.)

[4677] See part II.P.3.b, for issues relating to S corporations that have E&P.
[4678] Code § 1368(e)(1)(B); Reg. § 1.1368-2(d)(1)(i).
[4679] Code § 312(n)(7), superseding the limitations of Reg. § 1.312-5. Rev. Rul. 79-376, which had governed, was obsoleted by Rev. Rul. 95-71, presumably in response to this change; see T.M. 767 Redemptions IV.A.2.c. The Senate Report to P.L. 98-369 that enacted the current statutory language provides:

> In the case of a distribution by a corporation in redemption of its own stock, earnings and profits are to be reduced in proportion to the amount of the corporation's outstanding stock that is redeemed. However, the Senate does not intend that earnings and profits be reduced by more than the amount of the redemption.

[4680] Reg. § 1.1368-2(d)(1)(iii).

II.Q.7.k. Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation

Code § 1202 excludes part or all of the gain[4934] on the sale of stock in a qualified small business corporation originally issued to the seller (with some exceptions)[4935] and held for at least five years;[4936] be sure also to check for state income tax recognition of the exclusion.[4937] Many types of businesses are ineligible.[4938] Also, the corporation needs to have no more than $50 million at all times before and immediately after stock issuance[4939] and needs to have conducted sufficient business activities at all times.[4940] These business activities need to be either directly or through C corporation subsidiaries and require at least 80% of the assets being used for those activities (with additional restrictions on real estate ownership); they do not appear to be able to be done be through partnership subsidiaries.[4941] The corporation must have been a C corporation during substantially all of the taxpayer's holding period for such stock.[4942] Thus, stock in a former S corporation would not qualify, but an S corporation may form a C corporation subsidiary that would qualify;[4943] but beware of the mechanics.[4944]

The exclusion for most taxpayers is the greater of $10 million or 10 times the qualified small business stock's adjusted basis of the issued by the corporation and disposed of by the taxpayer during the taxable year.[4945] Adjusted basis used in the 10-times calculation includes the fair market value of property contributed to the corporation, but any built-in gain in contributed assets is not eligible for the exclusion, so running a business as a partnership and then converting to a C corporation has advantages and disadvantages for Code § 1202 purposes,[4946] as well as other tax considerations (beware of contributing too much debt; also consider forming a separate corporation for each business).[4947]

In contrast to the Code § 1202 exclusion, which requires a five-year holding period, under Code § 1045 a taxpayer may roll over the gain on the sale of qualified small business stock (QSBS) held for only six

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[4934] See text accompanying fns 4957-4962 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation. CCA 200609024 took the position that, in determining whether the statute of limitations was extended by omitting more than 25% of gross income, any capital gain excluded by Code § 1202 is not included in the gross income calculation.

[4935] See text accompanying fns 4977-5001 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[4936] See text accompanying fn 4965 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[4937] See Exhibit 3 of Jenson & Kohn, "Maximize Qualified Small Business Stock Exclusion," *Estate Planning Journal* (WG&L), October 2018.

[4938] See text accompanying fns 5012-5017 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[4939] See text accompanying fns 5007-5011 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[4940] See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.

[4941] See fns 5024-5027 and 5037-5039 in part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.

[4942] See fn 5002 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[4943] See text accompanying fns 4981-4987 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[4944] See text accompanying fns 5004-5006 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[4945] See text accompanying fns 4957-4962 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[4946] See text accompanying fns 5081-5082 in part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership?

[4947] See text accompanying fns 5082-5083 in part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership?

months by investing in other QSBS. See part II.Q.7.k.iv Code § 1045 Rollover of Gain from Qualified Small Business Stock (QSBS) to Another QSBS.

Note, however, that purchasers of businesses want to get a new basis in the business' assets rather than just buying stock. If they buy stock instead of assets, they tend to require the sellers to make a special election to treat the stock sale as an asset sale followed by a liquidation; for example, see part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold in part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations. Furthermore, a seller-financed sale of a partnership may be able to avoid capital gain tax on the sale of goodwill, making it more tax-efficient than a tax-free sale of stock. For how the Code § 1202 exclusion compares to other sales of business, see part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis. You will notice that a redemption (purchase by the C corporation) is less taxing than a cross-purchase (purchase by other shareholders). In a cross-purchase, the purchased stock will not be eligible for the Code § 1202 exclusion when the buyer later sells it, because it was not originally issued to the buyer.[4948] Similarly, if stock is issued too close to a redemption (within two years), the transactions may be stepped together and the new stock treated as if it had been sold to the buyer instead of issued to the buyer.[4949]

Here is an example, taken from an ABA Section of Taxation meeting:[4950]

- Tom Investor and Tammy Techy organize We Are Tech, LLC on 1/1/2016.
- Each provides capital contributions of $2 million in exchange for 50% interest in the LLC, which is taxed as a partnership.
- During 2016, the LLC purchases a building for $2 million cash and no debt, creates IP assets worth $2 million, and sustains a $1 million loss.
- Thus, each member's capital account and outside basis is $1.5 million at the end of 2016.
- On January 1, 2017, the LLC incorporates as We Are Tech, Inc., a C corporation that would qualify as a qualified small business stock, in an assets-over transaction:
    - The LLC contributes all assets to the C corporation in exchange for stock, then distributes stock to each member in liquidation.
    - The transaction qualifies under Code § 351.[4951] See also Rev. Rul. 84-111.[4952]

[4948] See text accompanying fns 4977-4980 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[4949] See text accompanying fns 4989-5001 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[4950] May 2018 meeting of the Sales, Exchanges and Basis Committee II.Q.7.k.ie of the American Bar Association's Section of Taxation, program name "The Tax Exemption for Small Business Stock is Big Business," slides named "Section 1202 Qualified Small Business Stock," presented by Kohn, Friedman, Rappaport, and Kristall (the latter probably did not author, because the IRS does not author presentation materials at such meetings).
[4951] See part II.M.2 Buying into or Forming a Corporation.
[4952] See fn 3876 in part II.P.3.c.ii Transfer of Partnership Assets and Liabilities to a Newly Formed Corporation in Exchange for All of its Stock.

- The fair market value of the LLC's assets was $5 million at the time of transaction.

- Each shareholder receives a $1.5 million carry-over basis for general tax purposes[4953] and a $2.5 million basis (50% of fair market value) in applying Code § 1202.[4954]

- On January 1, 2018, Tom sells his stock in We Are Tech, Inc. for $10 million. Tom has realized an $8.5 million long-term capital gain ($10 million proceeds minus $1.5 million adjusted basis).

- Within 60 days, Tom reinvests in Tech Savvy, Inc., a qualified small business, for $8 million and elects rollover treatment under Code § 1045.[4955] Consequences:

  - Total recognition of $3 million long-term capital gain (LTCG), consisting of:

    - Immediate recognition of $1 million LTCG, which is the built-in gain deferred upon incorporation.[4956]

    - Immediate recognition of $2 million LTCG, which under Code § 1045(a) is the $10 million gross sales price minus the $8 million gross purchase price of replacement qualified small business stock

  - Adjusted basis under Code § 1045(b)(3) is $2.5 million.

- On January 2, 2021, Tom sells all of his stock in Tech Savvy, Inc. for $25 million without rolling over to another qualified small business:

  - Tom has realized an $22.5 million long-term capital gain ($25 million proceeds minus $2.5 million adjusted basis).

  - The Code § 1202 exclusion limit is $25 million, which is ten times the $2.5 million basis under Code § 1202.

  - The $22.5 million long-term capital gain is less than the Code § 1202 exclusion limit of $25 million, so all of the gain is excluded.

- Contrast with Tom selling all We Are Tech, Inc. stock to purchase Tech Savvy, Inc. in a non-Code § 1045 rollover:

  - $1 million total long-term capital gain recognition.

  - No need to recognize the other $2 million under Code § 1045(a).

  - However, Tom would need to wait until January 2, 2023 to sell in order to meet his holding period requirement.

[4953] Code § 358(a).

[4954] See fns 4960-4967 (overall limitation on amount of gain excluded and determination of gain subject to exclusion) of part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[4955] See part II.Q.7.k.iv Code § 1045 Rollover of Gain from Qualified Small Business Stock (QSBS) to Another QSBS.

[4956] See fns 4960-4967 (overall limitation on amount of gain excluded and determination of gain subject to exclusion) of part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

Other ideas when selling C corporation stock are covered in parts:

- II.G.7 Deferral or Partial Exclusion of Capital Gains (Even from Investment Assets) Invested in Opportunity Zones
- II.G.8 Code § 165(a) Loss for Worthlessness; Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy
- II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244
- II.Q.7.m Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company.

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

This part II.Q.7.k applies to stock issued on or after August 11, 1993. The amount of gain that is subject to partial or complete exclusion from income cannot exceed the greater of:[4957]

(A) $10 million ($5 million for married filing separately)[4958] reduced by the aggregate amount of eligible gain taken into account under this rule for prior taxable years and attributable to dispositions of stock issued by such corporation, or

(B) 10 times the aggregate adjusted bases[4959] of qualified small business stock issued by the corporation and disposed of by the taxpayer during the taxable year. The greater of basis or the fair market value of property contributed for Code § 1202 stock counts towards this basis limitation.[4960] The adjusted basis of any stock is determined without regard to any addition to basis after the date on which such stock was originally issued;[4961] therefore, to maximize the benefit of capital contributions, they should be made only in exchange for new stock when the company has assets with a basis (subject to unusual rules defining basis) of no more than $50 million.[4962]

The taxpayer must not be a corporation.[4963] However, an S corporation that holds qualified small business stock may be looked through to its owners who are taxed on the gain.[4964]

[4957] Code § 1202(b)(1).
[4958] Code § 1202(b)(3).
[4959] Only the basis on the date of issuance counts for purposes of this test. See the flush language at the end of Code § 1202(b)(1).
[4960] Code § 1202(i)(1) provides that, for purposes of Code § 1202:

> *Stock exchanged for property*. In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation -
> (A) such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and
> (B) the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.

The legislative history quoted in the text accompanying fn 4966 makes me wonder whether this increase in the overall amount excluded was intended, but the statute's literal language appears to provide this result.
[4961] Code § 1202(b)(1) (flush language).
[4962] See fns 5007-5011.
[4963] Code § 1202(a)(1).
[4964] Code § 1202(g), discussed in the text accompanying fns 4981-4987 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

Gain is eligible only if from the sale or exchange of qualified small business stock held for more than 5 years.[4965] Also:[4966]

> If property (other than money or stock) is transferred to a corporation in exchange for its stock, the basis of the stock received is treated as not less than the fair market value of the property exchanged. Thus, only gains that accrue after the transfer are eligible for the exclusion.

Thus, contributing appreciated property in exchange for stock is a double-edged sword. On one hand, it provides an even greater amount of future gain that can be excluded. On the other hand, the built-in gain at the time of contribution is not eligible for the exclusion, whereas it would have been eligible if the property had been contributed earlier so that the appreciation occurred after contribution. Thus, if a partnership is considering converting to a C corporation, its owners should consider how long before they intend to sell (so that the 5-year holding period is satisfied) and whether appreciation while a partnership is good (to increase the 10-times-basis exclusion) or bad (pre-conversion appreciation ineligible for the exclusion).[4967]

A taxpayer who wishes to try to exceed these limitations might transfer stock to family members or others by gift before the stock appreciates, and presumably each donee would separately apply the limitation.[4968] If the taxpayer has insufficient lifetime gift tax exemption, consider transferring part of the stock to one or more incomplete gift nongrantor (ING) trusts;[4969] however, beware part II.J.9.c Multiple Trusts Created for Tax Avoidance. Another way to get more than $10 million limitation would be to have a separate C corporation for each qualified business.

For "qualified small business stock" issued after September 27, 2010 and held for more than five years, Code § 1202 excludes from income all of the gain from its sale or exchange, within the limits set forth above.[4970]

For "qualified small business stock" issued before September 28, 2010 and held for more than five years, Code § 1202 excludes from income a portion of the gain from its sale or exchange (within the limits set forth above)[4971]:

[4965] Code § 1202(b)(2).

[4966] H. Rept. No. 103-111 (P.L. 103-66), p. 603. Code § 1202(i) provides that, for purposes of Code § 1202:

(1) *Stock exchanged for property*. In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation-
   - (A) such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and
   - (B) the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.

(2) *Treatment of contributions to capital.* If the adjusted basis of any qualified small business stock is adjusted by reason of any contribution to capital after the date on which such stock was originally issued, in determining the amount of the adjustment by reason of such contribution, the basis of the contributed property shall in no event be treated as less than its fair market value on the date of the contribution.

[4967] See fn 5082 in part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership?

[4968] See Code § 1202(h), discussed at fns. 5043-5044.

[4969] See text accompanying fns 2436-2438 in part II.J.3.e.i Strategic State & Local Tax Issues re: Residence, briefly mentioning the idea of an incomplete gift nongrantor (ING) trust.

[4970] See text accompanying fn 4957.

[4971] See text accompanying fn 4957.

- If the above and other requirements are satisfied, then the portion excluded from income is 50% for stock (60% for gain attributable to an empowerment zone business) acquired before February 18, 2009 and 75% for stock acquired on or before September 27, 2010.[4972]

- Any gain that is not excluded is subject to 28% tax instead of the usual, lower capital gain rates.[4973]

- Note also that taxable gain from the sale of C corporation stock is subject to the 3.8% tax on net investment income,[4974] whereas gain on the sale of a partnership or S corporation stock engaged in a trade or business is largely excluded from that tax.[4975]

For stock acquired after September 27, 2010, alternative minimum taxable income no longer applies to the amount excluded from regular taxable income.[4976]

An example combining Code §§ 1202 and 1045 is in the text following fn 4950 in part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation.

"Qualified small business stock" means any stock in a C corporation which the taxpayer acquires on original issue by a qualified small business either in exchange for money or other property (not including stock)[4977] or as compensation for services provided to such corporation (other than services performed as an underwriter of such stock).[4978] An option to acquire stock does not count as stock until the stock is actually issued to the taxpayer.[4979] The House Report for the 1993 Revenue Reconciliation Act, P.L. 103-66, included:

[4972] Code § 1202(a).
[4973] Compare Code § 1(h)(4) (tax on Code § 1202 gain) to Code § 1(h)(1) (tax on capital gains generally).
[4974] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[4975] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[4976] Code § 1202(a)(4)(C), eliminating the application of Code § 57(a)(7).
[4977] But, if a corporate reorganization is involved, see fn 5047 of part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.
[4978] Code § 1202(c)(1).
[4979] *Natkunanathan v. Commissioner*, T.C. Memo. 2010-15, *aff'd* 479 Fed. Appx. 775 (9th Cir. 2012), held that, where the taxpayer had been issued options to buy stock in his employer and did not exercise those options, except to acquire shares in a corporation (Intel) that acquired his employer, the taxpayer could not apply Code § 1202:

> Section 1202 itself does not define the term "stock" or otherwise specify what securities constitute stock for purposes of the qualified small business stock exclusion. By comparison, some provisions of the Code explicitly specify that the term "stock" includes options to acquire stock. See, *e.g.*, sec. 305(d)(1) ("For purposes of this section, the term `stock' includes rights to acquire such stock."); sec. 1091(a) (same). We are unaware of any authority that has interpreted the term "stock" for purposes of section 1202. However, we have previously declined to extend the term "stock" beyond its plain meaning in a statutory provision and construe it expansively to include options to acquire stock. See *Gantner v. Commissioner*, 91 T.C. 713 (1988) (options to purchase stock are not "shares" of "stock or securities" under the plain language of section 1091, which was subsequently amended to explicitly provide otherwise), *affd*. 905 F.2d 241 (8th Cir. 1990). Moreover, the legislative history of section 1202 suggests that Congress did not intend section 1202 to cover options to acquire stock.
>
> Section 1202 was added to the Code by the Omnibus Budget Reconciliation Act of 1993, Pub.L. 103-66, sec. 13113(a), 107 Stat. 422. The accompanying conference report included the following statement: "Stock acquired by the taxpayer through the exercise of options * * * is treated as acquired at original issue. The determination whether the gross assets test is met is made *at the time of exercise* * * * and the holding period of such stock is treated as beginning at that time." H. Conf. Rept. 103-213, at 526 (1993), 1993-3 C.B. 393, 404 (emphasis added). The second sentence of the excerpt from the conference report quoted above, in the absence of any countervailing argument by petitioner, suggests to us that the original issuance contemplated by section 1202 in petitioner's case would be the issuance of Intel stock to petitioner upon exercise of his options. This conclusion seems appropriate since both the application of the gross assets test and the commencement of the holding period would occur at the time of such exercise.

Options, nonvested stock, and convertible instruments.

Stock acquired by the taxpayer through the exercise of options or warrants, or through the conversion of convertible debt, is treated as acquired at original issue. The determination whether the gross assets test is met is made at the time of exercise or conversion, and the holding period of such stock is treated as beginning at that time.

In the case of convertible preferred stock, the gross assets determination is made at the time the convertible stock is issued, and the holding period of the convertible stock is added to that of the common stock acquired upon conversion.

Stock received in connection with the performance of services is treated as issued by the corporation and acquired by the taxpayer when included in the taxpayer's gross income in accordance with the rules of section 83.

Offsetting short positions.

A taxpayer cannot exclude gain from the sale of qualified small business stock if the taxpayer (or a related person) held an offsetting short position with respect to that stock anytime before the 5-year holding period is satisfied. If the taxpayer (or a related person) acquires an offsetting short position with respect to qualified small business stock after the 5-year holding period is satisfied, the taxpayer must elect to treat the acquisition of the offsetting short position as a sale of the qualified small business stock in order to exclude any gain from that stock.

An offsetting short position is defined to be (1) a short sale of property substantially identical to the qualified small business stock (including writing a call option that the holder is more likely than not to exercise or selling the stock for future delivery) or (2) an option to sell substantially identical property at a fixed price.

If any stock in a corporation is acquired solely through the conversion of other stock in such corporation which is qualified small business stock in the hands of the taxpayer, the stock so acquired is treated as qualified small business stock in the hands of the taxpayer and is treated as having been held during the period during which the converted stock was held.[4980]

Special rules apply to C corporation stock owned by certain pass-through entities.[4981] A pass-through entity is any partnership, any S corporation,[4982] any regulated investment company (RIC),[4983] or any

Reading the term "stock" as used in section 1202 to exclude petitioner's options to acquire stock, we hold that petitioner could not possibly have satisfied the 5-year holding period requirement of section 1202(a)(1). Petitioner concedes that he sold the Intel stock received upon exercise of his options on the same day that he had exercised the options. Therefore, the period during which petitioner could have held qualified small business stock would, at most, have lasted 1 day. Moreover, for the stock underlying petitioner's options to constitute qualified small business stock under section 1202(d)(1), the aggregate gross assets of Intel on the date of exercise would have to have been less than or equal to $50 million. Petitioner makes no such claims with respect to Intel's aggregate gross assets.

[4980] Code § 1202(f).

[4981] Code § 1202(g).

[4982] Code § 1202(g)(4)(B).

[4983] Code § 1202(g)(4)(C). Notice 97-64, § 8, contemplates that temporary regulations will provide guidance on how RICs may designate dividends as "section 1202 gain distributions," which guidance is:

> expected to provide that: (1) section 1202 gain distributions will be designated separately for different issuers of qualified small business stock; (2) the exclusion from income permitted by section 1202 will be determined at the shareholder level not the RIC level; and (3) the maximum distributable section 1202 gain for each issuer will be

common trust fund.[4984] If any amount included in gross income by reason of holding an interest in a pass-through entity meets the requirements of the following sentence, the amount shall be treated as Code § 1202(a) gain and, for purposes of applying Code § 1202(b), that amount is treated as gain from a disposition of stock in the corporation issuing the stock disposed of by the pass-through entity and the taxpayer's proportionate share of the adjusted basis of the pass-through entity in such stock is taken into account.[4985] The amount must be attributable to gain on the sale or exchange by the pass-through entity of stock which is qualified small business stock in the hands of such entity (determined by treating such entity as an individual) and which was held by such entity for more than 5 years, and such amount must be includible in the gross income of the taxpayer by reason of the holding of an interest in such entity which was held by the taxpayer on the date on which such pass-through entity acquired such stock and at all times thereafter before the disposition of such stock by such pass-through entity.[4986] This gain exclusion does not apply to any amount to the extent such amount exceeds the amount to this rule would have applied if the amount were determined by reference to the interest the taxpayer held in the pass-through entity on the date the qualified small business stock was acquired.[4987]

The original issuance requirement means that stock bought from another shareholder would not qualify. May one avoid this prohibition by redeeming the seller and issuing stock to the buyer? Code § 1202(c)(3) imposes a waiting period related to redemption activity (including certain cross-purchases between related persons).[4988] Stock is disqualified if, at any time within 2 years before or after the issuance of such stock, the corporation issuing such stock purchased (directly or indirectly) any of its stock from the taxpayer or from a person related[4989] to the taxpayer.[4990] In applying the preceding sentence, one can ignore stock acquired from the taxpayer or a related person if the aggregate amount paid for the stock does not exceed $10,000 and no more than 2% of the stock held by the taxpayer and related persons is acquired.[4991] Also, stock is disqualified if, within the year before or after the issuance of such stock, the corporation

calculated separately from limitations on all other classes of capital gain dividends but in the aggregate will not exceed the RIC's net capital gain.

Notice 2015-41, § 5, provides that Notice 97-64, § 8, continues to apply. Notice 2015-41, § 3, requires that RICs must account for "section 1202 gain" in distributions. Code § 1202(g) applies to such distributions.

[4984] Code § 1202(g)(4).

[4985] Code § 1202(g)(1).

[4986] Code § 1202(g)(2).

[4987] Code § 1202(g)(3).

[4988] Code § 1202(c)(3)(C) refers to Code § 304(a), "Acquisition by related corporation (other than subsidiary)," which provides:

For purposes of sections 302 and 303, if -

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,

then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. To the extent that such distribution is treated as a distribution to which section 301applies, the transferor and the acquiring corporation shall be treated in the same manner as if the transferor had transferred the stock so acquired to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in such transaction.

[4989] Within the meaning of Code § 267(b) or 707(b). For a description of Code § 267(b), see part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses. For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

[4990] Code § 1202(c)(3)(A).

[4991] Reg. § 1.1202-2(a)(2), which further provides:

The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

made one or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5% of the aggregate value of all of its stock as of the beginning of that 2-year period.[4992] The preceding sentence has a similar de minimis rule.[4993] These rules are strict and do not exclude redemptions that are not tied to issuances. For example, two founders don't get along, and the departing founder could sell his stock to either the corporation or to the remaining founder. If the departing founder were the buyer, the corporation may need to issue a dividend to that buyer, causing the buyer to pay a dividend tax.[4994] If the corporation were the buyer, this dividend tax could be avoided,[4995] but under the above anti-abuse rule the redemption may taint any issuance to a related party, whether the continuing founder or a new investor.

Although generally a shareholder who transfers stock to an employee or independent contractor (or to a beneficiary of an employee or independent contractor) is treated has transferring the stock to the corporation and the corporation then transferring the stock to the employee or independent contractor,[4996] any such deemed transfer to the corporation is not treated as such for purposes of the anti-redemption rules.[4997] The anti-redemption rules also are not triggered by any of the following:

- The stock was acquired by the seller in connection with the performance of services as an employee or director and the stock is purchased from the seller incident to the seller's retirement or other bona fide termination of such services.[4998]

- Before a decedent's death, the stock (or an option to acquire the stock) was held by the decedent or the decedent's spouse (or by both), by the decedent and joint tenant, or by a trust revocable by the decedent or the decedent's spouse (or by both), and the stock is purchased from the decedent's estate, beneficiary (whether by bequest or lifetime gift), heir, surviving joint tenant, or surviving spouse, or from a trust established by the decedent or decedent's spouse; and the stock is purchased within 3 years and 9 months from the date of the decedent's death.[4999]

- The stock is purchased incident to the disability or mental incompetency of the selling shareholder.[5000]

- The stock is purchased incident to the divorce (within the meaning of Code § 1041(c)) of the selling shareholder.[5001]

During substantially all of the taxpayer's holding period for such stock, the corporation must be a C corporation and use at least 80% (by value) of its assets in the active conduct of one or more qualified

[4992] Code § 1202(c)(3)(B).
[4993] Reg. § 1.1202-2(b)(2) provides that, for purposes of this exception:

> … stock exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of all outstanding stock is purchased. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

[4994] See part II.Q.1.a.i.(c) C Corporation Double Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation, which is a variation of part II.Q.1.a.i.(a) C Corporation Triple Taxation.
[4995] Contrast part II.Q.1.a.i.(b) C Corporation Redemption with part II.Q.1.a.i.(a) C Corporation Triple Taxation.
[4996] Reg. § 1.83-6(d)(1).
[4997] Reg § 1.1202-2(c).
[4998] Reg. § 1.1202-2(d)(1)(i).
[4999] Reg. § 1.1202-2(d)(2).
[5000] Reg. § 1.1202-2(d)(3).
[5001] Reg. § 1.1202-2(d)(4).

trades or businesses.[5002] See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold. Therefore, the C corporation cannot have been an S corporation. However, an S corporation can contribute its assets to a C corporation, and the C corporation could then qualify for the exclusion.[5003] To simplify this process, the owners of the S corporation form a parent S corporation, which new parent assumes all of the original S corporation's tax attributes;[5004] this makes the original corporation a disregarded entity;[5005] then the original corporation elects C corporation treatment. Although technically this reorganization works, it appears that the subsidiary would have the same tax ID as the parent S corporation,[5006] making the C corporation appear on the IRS' records as a former S corporation, even though technically it is considered a new C corporation.

The corporation's aggregate gross assets cannot have a basis exceeding $50 million:[5007]

(A) the aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993, and before the issuance did not exceed $50,000,000,

(B) the aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) does not exceed $50,000,000, and

(C) such corporation agrees to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section.[5008]

Although regulations have not been issued regarding reporting requirements, taxpayers will lose the deduction if they do not have records to substantiate that the stock met this requirement.[5009]

[5002] Code § 1202(c)(2)(A), (e). The taxpayer must affirmatively prove what the business assets are and that they met this 80% test. *Holmes v. Commissioner*, T.C. Memo. 2012-251, held:

> The record is again devoid of documentary evidence showing the amount of corporate assets owned during the years in which he held the stock and the amount of those assets used in its business of providing on demand physician practice management software. In fact, the only evidence in the record concerning LeonardoMD's business is a stipulated paragraph describing its business as providing on demand physician practice management software delivered over the Web, and petitioner's above-cited testimony. We cannot, on the basis of uncorroborated testimony and a stipulation that does not rule out inactive business assets and income, reasonably conclude that petitioner met his burden of proving that, during substantially all of his holding period for LeonardoMD stock, the corporation used at least 80% of its assets in the active conduct of one or more qualified trades or businesses.

[5003] See fn 4982.

[5004] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization, especially fn 3955.

[5005] See part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

[5006] See Reg. § 301.6109-1(i)(3) in the text accompanying fn 193 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

[5007] Code § 1202(d). This applies to gross assets at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993 and before the issuance, as well as immediately after the issuance (determined by taking into account amounts received in the issuance).

[5008] [Footnote is mine and not in the statute:] Federal Tax Coordinator Analysis (RIA) ¶ S-4455 Reports With Respect to Exclusion of Gain From Qualified Small Business Stock (QSBS) reports:

> IRS has yet to issue either any reporting requirements described in Code Sec. 1202(d)(1)(C) … or any guidance as to the manner in which, as mandated by Code Sec. 1202(d)(1)(C), a corporation is to agree to meet these requirements. RIA understands that, until IRS provides guidance as to the manner in which a corporation is to agree, a corporation can issue QSBS without the necessity for the corporation to file any sort of agreement that it will comply with any reporting requirements, if and when issued. Presumably, if IRS ever does require reporting, it will prescribe procedures at that time for making the agreement called for in the Code.

[5009] *Natkunanathan v. Commissioner*, T.C. Memo. 2010-15, *aff'd* 479 Fed. Appx. 775 (9th Cir. 2012), held:

As used above, "aggregate gross assets" means the amount of cash and the aggregate adjusted bases of other property held by the corporation.[5010] As used in (A) above:[5011]

> The adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution.

The following businesses are not eligible for this treatment:[5012]

> There are no balance sheets or other financial statements of Cognet in the record that establish the amounts of total assets, total liabilities, or owner's equity of Cognet at any time, and petitioner made no attempt to introduce any such evidence at trial.[5] In the absence of any such evidence, we cannot determine the value of Cognet's gross assets at the time that it issued options to petitioner and, therefore, cannot conclude that Cognet constituted a qualified small business within the meaning of section 1202(d)(1) at that time.
>
> [5] After the trial petitioner attached to his reply brief a document purporting to be a statement by the chief executive officer of Cognet at the time of its acquisition by and merger with Intel declaring that "*To the best of my recollection*, the company's assets, including physical assets and total value of outstanding shares did not exceed $50,000,000 before the acquisition." [Emphasis added.] Subsequently, after the record had closed upon the filing of reply briefs, petitioner filed a motion for leave to reopen the record in order to introduce a notarized version of this and other documents. A notarized written statement from Cognet's chief executive officer, even if it were introduced at trial, could have been subject to a hearsay objection and, absent concessions or stipulation by respondent, would probably not have been admitted into evidence. But here, where the purported statement constitutes an affidavit attached to a brief, Rule 143(b) explicitly bars us from considering it as evidence. We have previously issued an order denying petitioner's motion to reopen the record as inappropriate because petitioner has not shown good cause for his failure to introduce such evidence at trial.

Issuing stock options does not necessarily qualify as issuing stock; however, the taxpayer did not hold actual stock for the five-year holding period, so that's why the court looked at when the stock options were issued. See fn 4979 for more about these issues.

[5010] Code § 1202(d)(2)(A).

[5011] Code § 1202(d)(2)(B).

[5012] Code § 1202(e)(3). Code § 1202(e)(3)(A) is discussed in part II.E.1.c.iv Specified Service Trade or Business (SSTB) If Taxable Income Exceeds Certain Thresholds. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202.

- any trade or business involving the performance of services in the fields of health,[5013] law, engineering, architecture, accounting, actuarial science, performing arts,[5014] consulting,[5015] athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees,[5016]

[5013] Letter Ruling 201436001 held that the health service and related exclusion did not apply to the taxpayer:

> Section 1202(e)(3) excludes various service industries and specified non-service industries from the term qualified trade or business. Thus, a qualified trade or business cannot be primarily within service industries, such as restaurants or hotels or the providing of legal or medical services. In addition, § 1202(e)(3) excludes businesses where the principal asset of the business is the reputation or skill of one or more of its employees. This works to exclude, for example, consulting firms, law firms, and financial asset management firms. Thus, the thrust of § 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services, whether those services are the providing of hotel rooms, for example, or in the form of individual expertise (law firm partners).
>
> Company is not in the business of offering service in the form of individual expertise. Instead, Company's activities involve the deployment of specific manufacturing assets and intellectual property assets to create value for customers. Essentially, Company is a pharmaceutical industry analogue of a parts manufacturer in the automobile industry. Thus, although Company works primarily in the pharmaceutical industry, which is certainly a component of the health industry, Company does not perform services in the health industry within the meaning of § 1202(e)(3). Neither are Company's business activities within any of the prohibited categories set forth in § 1202(e)(3).

Letter Ruling 201717010 held that the health service and related exclusion did not apply to a lab:

> Company provides laboratory reports to health care professionals. However, Company's laboratory reports do not discuss diagnosis or treatment. Company neither discusses with, nor is informed by, healthcare providers about the diagnosis or treatment of a healthcare provider's patients. Company's sole function is to provide healthcare providers with a copy of its laboratory report.
>
> Company neither takes orders from nor explains laboratory tests to patients. Company's direct contact with patients is billing patients whose insurer does not pay all of the costs of a laboratory test.
>
> In addition, you represent that the skills employees bring to Company are not useful in performing X tests and that skills they develop at Company are not useful to other employers.
>
> Further, none of Company's revenue is earned in connection with patients' medical care. Other than the laboratory director [who federal law required to have certain qualifications], Company's laboratory technicians are not subject to state licensing requirements or classified as healthcare professionals by any applicable state or federal law or regulatory authority.
>
> Although Company's laboratory reports provide valuable information to healthcare providers, Company does not provide health care professionals with diagnosis or treatment recommendations for treating a healthcare professional's patients nor is Company aware of the health care provider's diagnosis or treatment of the healthcare provider's patients. In addition, the skills that Company's employees have are unique to the work they perform for Company and are not useful to other employers.
>
> Thus, based on the facts and representations submitted, we conclude that for purposes of § 1202(e)(3), Company is not in a trade or business (i) involving the performance of services in the field of health or (ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees.

For additional context, when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See part II.E.1.c.iv.(b) Health. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202.

[5014] For additional context regarding performing arts, when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See part II.E.1.c.iv.(f) Performing Arts. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202.

[5015] For additional context regarding consulting, when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See part II.E.1.c.iv.(g) Consulting. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202.

[5016] However, a commission sales business might not be disqualified under this provision. In *Owen v. Commissioner*, T.C. Memo. 2012-21, a company that sold prepaid legal service policies, including estate planning services, which were like insurance in that purchasers would get a reduced fee in legal cost by joining this prepaid legal membership, was a qualified small business. The court seemed to accept the taxpayer's testimony that, in the industry, independent contractors generally sold the products and services offered by the company. The taxpayer performed services as an executive and as a sales representative and his compensation was reported on Form W-2 (as an executive) and Form 1099-MISC (as an independent

- any banking, insurance, financing, leasing, investing, or similar business,
- any farming business (including the business of raising or harvesting trees),
- any business involving the production or extraction of products, such as oil, gas and mines, eligible for certain depletion deductions, or
- any business of operating a hotel, motel, restaurant, or similar business.

However, engaging in the above activities is not fatal, if it comprises a sufficiently small part of the business.[5017]

The corporation must be a domestic corporation other than a DISC or former DISC, corporation with respect to which an election under Code § 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect, regulated investment company, real estate investment trust, REMIC, or cooperative.[5018]

II.Q.7.k.ii. Limitation on Assets a Qualified Small Business May Hold

During substantially all of the taxpayer's holding period for the qualified small business stock,[5019] the corporation must use at least 80% (by value) of its assets in the active conduct of one or more qualified trades or businesses and be an eligible corporation.[5020] Assets used for certain start-up or research activities count as qualified.[5021] A specialized small business investment company automatically meets

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consultant who furnished services through his personal corporation that received commissions and in turn paid him using Form 1099-MISC. The court held:

> Although respondent argues that FFAEP is not qualified because one of the principal assets is the skill of Mr. Owen, the Court disagrees. While we have no doubt that the success of the Family First Companies is properly attributable to Mr. Owen and Mr. Michaels, the principal asset of the companies was the training and organizational structure; after all, it was the independent contractors, including Mr. Owen and Mr. Michaels in their commission sales hats, who sold the policies that earned the premiums, not Mr. Owen in his personal capacity.

However, ultimately this holding was moot (which did not stop the court from opining on it), because the taxpayer was trying to do a Code § 1045 rollover of gain on sale from one company to another. Although the new company qualified as described above, the company being sold did not (fn. 5030), resulting in the taxpayer losing the case. So, keep in mind the IRS' lack of incentive to appeal this holding when viewing it as instructive.

[5017] See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold, especially fns 5020-5022.

[5018] Code § 1202(e)(4).

[5019] Code § 1202(c)(2).

[5020] Code § 1202(e)(1).

[5021] Code § 1202(e)(2), "Special rule for certain activities," provides:

> For purposes of paragraph (1), if, in connection with any future qualified trade or business, a corporation is engaged in—
>
> (A) start-up activities described in section 195(c)(1)(A),
>
> (B) activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under section 174, or
>
> (C) activities with respect to in-house research expenses described in section 41(b)(4),
>
> assets used in such activities shall be treated as used in the active conduct of a qualified trade or business. Any determination under this paragraph shall be made without regard to whether a corporation has any gross income from such activities at the time of the determination.

the active business requirement.[5022] Query whether the active business requirement of Code § 355[5023] may inform this discussion, even though it does not literally apply to Code § 1202.

In applying the requirement that the corporation hold active business assets, stock and debt in any subsidiary corporation are disregarded and the parent corporation is deemed to own its ratable share of the subsidiary's assets and to conduct its ratable share of the subsidiary's activities;[5024] no special rule applies to a subsidiary partnership.[5025] The parent owns more than 50% of the combined voting power of all classes of stock entitled to vote, or more than 50% in value of all outstanding stock, of a corporation for the parent to be able to treat the corporation as a subsidiary.[5026] If the holding falls below this threshold, then watch out – the parent fails the active business asset test for any period during which more than 10% of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations which are not subsidiaries of such corporation (other than assets described under the "working capital" exception).[5027]

Under the "working capital" exception, active business assets include assets held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or held for investment and are reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business.[5028] However, for periods after the corporation has been in existence for at least two years, no more than 50% of the assets of the corporation may qualify as used in the active conduct of a qualified trade or business by reason of this rule.[5029] Be careful not to start the C corporation just accumulating cash for possible business operations, which will disqualify the corporation.[5030] To avoid this issue and

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[5022] Code § 1202(c)(2)(B), referring to an eligible corporation licensed to operate under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993). As to "specialized small business investment company," see part II.Q.7.m Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company.

[5023] See part II.Q.7.f.iii Active Business Requirement for Code § 355.

[5024] Code § 1202(e)(5)(A). Code § 1202(d)(3)(A) provides that all corporations which are members of the same parent-subsidiary controlled group shall be treated as one corporation for purposes of the assets test. In determining what is a "parent-subsidiary controlled group," Code § 1202(d)(3)(B) refers to Code § 1563(a)(1), except that:

(i) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a)(1), and
(ii) section 1563(a)(4) shall not apply.

[5025] See fns 5037-5039 in part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.

[5026] Code § 1202(e)(5)(C).

[5027] Code § 1202(e)(5)(B).

[5028] Code § 1202(e)(6).

[5029] Code § 1202(e)(6).

[5030] *Owen v. Commissioner*, T.C. Memo. 2012-21. The court addressed the qualifications of two companies, one of which did not qualify (this footnote) and one of which did qualify (fn. 5016). In discussing why the company was not a qualified small business under Code § 1202 and therefore not eligible for a capital gain deferral under Code § 1045 (which rollover is not necessary for newer companies), the court imposed a 20% accuracy-related penalty:

> We also find that the Owens did not act with good faith with respect to the section 1045 transaction. Mr. Owen explained that it was his vision to build up J&L Gems as he had the Family First Companies; yet even as late as 2 years after the money had been deposited in the company, J&L Gems had only 16 pieces of jewelry. Mr. Owen should not in good faith have believed that deferring income tax under section 1045, by operating a business, merely involved depositing a large amount of cash in an account. Nor could he reasonably believe that using less than 8 percent of that cash to purchase inventory and selling only a part of what little inventory he did buy to his friends and coworkers was sufficient to defer the tax. Even under Mr. Owen's understanding of section 1045, that he had to operate the business in good faith and reasonably, he failed to meet that requirement.

for other reasons as well, consider instead starting as an LLC taxable as a partnership then later converting to a corporation.[5031]

A corporation also fails the active business assets test for any period during which more than 10% of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business.[5032] In applying the preceding sentence, the ownership of, dealing in, or renting of real property is not treated as the active conduct of a qualified trade or business;[5033] renting the property to the business may be better anyway.[5034]

In applying the active business asset test, rights to computer software which produces active business computer software royalties[5035] are treated as an asset used in the active conduct of a trade or business.[5036]

Although Code § 1202 authorizes qualified small business stock to be held by a partnership[5037] and corporate subsidiaries,[5038] it does not discuss the corporation conducting its business through one or more partnerships. Accordingly, from a planning perspective, I would not recommend having a corporation seeking qualified small business status invest its assets in a partnership. However, if one is asked to advice an owner of a corporation that is already invested in a partnership, I would look to the active business rules for corporate split-ups, which describe when an interest in a partnership constitutes an active business asset.[5039]

In discussing Letter Ruling 202016013, which was a Code § 721(b) ruling, Banoff and Cohen comment:[5040]

> We observe that Section 1202 has (at least at first glance) a similar disconnect between subsidiary corporations and subsidiary partnerships. See Shop Talk, "Is LLC Business Attributed to Corporate Member for Section 1045 Purposes?," 93 *JTAX* 254 (October 2000). In that article, we hypothesized a taxpayer looking to roll over her sales proceeds from the sale of qualified small business stock (QSBS) within the meaning of Section 1045. (Coincidentally, Section 1045 (like the amendment to Section 351(e)) was enacted by The Taxpayer Relief Act of 1997.) Generally, under Section 1045(a), a noncorporate taxpayer may defer the recognition of otherwise taxable gain from the sale of QSBS that was held more than six months prior to the date of sale of the QSBS. In our 2000 Shop Talk article, we asked whether our hypothetical taxpayer could successfully invest those proceeds in a corporation that itself does not conduct a qualified small business but has an interest in a partnership or an LLC that engages in a business that otherwise would satisfy Section 1045 if the business were conducted by the corporation.

5031 See part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? (especially the text accompanying fns. 5077-5085).
5032 Code § 1202(e)(7).
5033 Code § 1202(e)(7).
5034 See parts II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation; Possible Way to Attain Basis Step-Up (which is even more of a concern for C corporations) and II.Q.1.b Leasing.
5035 Within the meaning of Code § 543(d)(1).
5036 Code § 1202(e)(7).
5037 See part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation, especially fns. 4981-4987.
5038 See fns. 5024-5027 in part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.
5039 See part II.Q.7.f.iii Active Business Requirement for Code § 355.
5040 Shop Talk column, "Section 721(b)-A Partnership Issue, a Corporate Issue, or Just a Jumble?" *Journal of Taxation* (7/2020). For a reproduction of most of Letter Ruling 202016013 and their detailed discussion of it, see text preceding and accompanying fns 3463-3464 in part II.M.3.b Exception: Diversification of Investment Risk.

Section 1045 defines QSBS by incorporating the definition of QSBS contained in Section 1202. Stock will be treated as QSBS under Section 1202 if, among other things, during substantially all of the period during which the taxpayer holds the stock, the issuing corporation must be engaged in an active trade or business.

In order to satisfy the active business requirement, at least 80% of the issuer's assets (as measured by their FMV) must be used in the active conduct of one or more qualified businesses. A special look-through rule applies when a parent corporation owns stock in a subsidiary corporation that is engaged in a qualified business. Specifically, the parent corporation will be deemed to own a ratable share of the subsidiary's assets and to conduct its ratable share of the subsidiary's activities. Section 1202(e)(5)(A). To get this look-through treatment, the parent corporation must own more than 50% of the combined voting power of all classes of stock or more than 50% of the value of all the outstanding stock of the subsidiary corporation. Section 1202(e)(5)(C).

Can the look-through rule that applies to parent and subsidiary corporations as described in Section 1202(e)(5) be extended to a corporation that owns an interest in a partnership or LLC, for purposes of Section 1202? Todd D. Golub, a Chicago CPA and attorney and author of a then-contemporaneous article on Section 1045 rollovers, provided Shop Talk in our 2000 article with these observations:

> If the corporation is not the sole member and the LLC is taxable as a partnership, the look-through rule applicable to parent-subsidiary corporations on its face does not apply. Further, Section 1045 provides special rules for persons who invest in a flow-through entity that invests in QSBS to obtain the benefits of Section 1045. See also Rev. Proc. 98-48, 1998-2 CB 367, providing further guidance for persons who invest in flow-through entities to get the benefits of Section 1045. Thus, both Congress and the IRS considered the application of the aggregate theory of partnerships when enacting Section 1045 but did not extend that theory to the determination of whether the qualified business requirement is met if a corporation invests in an LLC that engages in a qualified business. Thus, this omission may indicate that the look-through rule does not extend to a subsidiary LLC for purposes of Section 1045.
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> The 1997 Blue Book states at page 58 that Congress enacted Section 1045 with the hope that the deferral benefit would encourage investors to reinvest funds in qualified small businesses, making more capital available to new, small businesses that are important to the long-term growth of the economy. There is no indication of why Congress limited the deferral benefit to investors that provide funds to small businesses that operate only in corporate form. So long as Congress intended to provide such a benefit, there is no apparent reason why it should not be extended to flow-through entities. In fact, by limiting this benefit to parent-subsidiary corporate relationships, Congress actually may have limited the funding that otherwise might be available to businesses that choose not to incorporate.
>
> Accordingly, it would seem that [for purposes of Sections 1045 and 1202] a look-through rule should apply to corporations that have an interest in LLCs or other entities taxed as partnerships that are engaged in a qualified business....
>
> Congress, however, did not go so far as to specifically provide for a look-through rule when a corporation invests directly in an LLC or partnership. So, if one looks solely to the statute [Section 1202], the business of the LLC arguably may not be attributable to the corporate member.

> Golub's conclusion in our 2000 Shop Talk article is eerily and equally applicable to the corporate-partnership conundrum discussed in this article with respect to Section 721(b): "One can only hope that future guidance will clarify that the deferral benefit of Section 1045 should apply to the shareholders of corporations that invest directly in qualified businesses regardless of the form of entity that engages in the qualified business."
>
> Golub's plea for guidance under Section 1045 (via Section 1202) published in Shop Talk 20 years ago apparently has gone unheard; there seems to have been no further guidance issued with respect to the attribution of a partnership's or an LLC's trade or business to a corporate member for purposes of Section 1045, notwithstanding strong policy reasons to support that result (just as there are under Sections 721(b) and 351(e)). Moreover, we are unaware of any letter rulings that provide relief to subsidiary partnerships and their corporate partners for purposes of Section 1045. On the other hand, Ltr. Rul. 202016013 (and the two predecessor letter rulings described above) have created a niche where certain qualifying (majority interest) contributors to partnerships would apparently be able to apply a corporate look-through rule to subsidiary partnerships. And these Section 721(b) rulings by analogy may give some (albeit indirect) comfort to taxpayers and practitioners for purposes of Section 1045 that the Service would similarly apply a corporate look-through/attribution rule to subsidiary partnerships for purposes of attributing their trades or businesses to corporate partners holding majority interests in their partnerships.

Special rules apply to certain tax-free transfers.[5041] If a transfer is by gift,[5042] at death, or from a partnership,[5043] the transferee is treated as having acquired such stock in the same manner as the transferor and having held such stock during any continuous period immediately preceding the transfer during which it was held (or treated as held under these rules) by the transferor:[5044]

- Presumably a taxpayer whose stock's value exceeds the cap of the exclusion of gain[5045] by giving the stock to family members, each of whom could sell the stock separately.

- If the transfer is from a partnership, it must be to a partner of stock with respect to which requirements similar to the pass-through rules described above are met at the time of the transfer (without regard to the 5-year holding period requirement).[5046]

In a Code § 351 formation of a corporation or a Code § 368 reorganization, if qualified small business stock is exchanged for other stock which would not qualify as qualified small business stock but for this rule, that other stock shall be treated as qualified small business stock acquired on the date on which the exchanged stock was acquired.[5047] Unless the stock treated as qualified small business stock by reason of

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[5041] Code § 1202(h).
[5042] See text accompanying fn 4969 regarding gifts to trusts.
[5043] Code § 1202(h)(2).
[5044] Code § 1202(h)(1).
[5045] See fn. 4957.
[5046] Code § 1202(h)(2)(C).
[5047] Code § 1202(h)(4)(A). Letter Ruling 9810010 applied Code § 1202(h)(4) to a corporate split-up that was partly tax-free under Code §§ 355(a)(1) and 368(a)(1)(D). Letter Ruling 9810010 said that Code § 1202(h)(4)(A) necessarily means:

> Thus, stock received in a section 368 reorganization may be treated as QSBS despite the prohibition in section 1202(c)(1)(B)(i) against stock received in exchange for other stock.

Letter Ruling 9810010 continued:

> In the instant case, the taxpayers have represented that the portion of the Distributing stock given up by A through N in exchange for Controlled stock was qualified small business stock (QSBS) and that Controlled was a qualified small business at the time of the reorganization. As part of the section 368 reorganization, A through N received Controlled

the preceding sentence is issued by a corporation that (as of the time of that transfer) is a qualified small business, Code § 1202 applies to gain from the sale or exchange of stock treated as qualified small business stock by reason of the preceding sentence only to the extent of the gain which would have been recognized at the time of the transfer described in the preceding sentence if Code § 351 or 368 had not applied at that time.[5048]

To the extent provided in regulations, stock in a corporation, the basis of which (in the hands of a taxpayer) is determined in whole or in part by reference to the basis in his hands of stock in such corporation which meets certain requirements or which is received in a reorganization that is a mere change in form in exchange for stock which meets such requirements (and interests in an LLC that elected C corporation taxation qualify as stock),[5049] is treated as meeting such requirements.[5050] For more discussion, see "Section 351 Transactions and Section 368 Reorganizations" in RIA Checkpoint *Catalyst* ¶ 511:114 Original Issuance Requirement within ¶ 511:110 Qualified Small Business Stock: Definition.

If the taxpayer has an offsetting short position with respect to any qualified small business stock, Code § 1202(a) shall not apply to any gain from the sale or exchange of such stock unless the stock was held by the taxpayer for more than 5 years as of the first day on which there was such a short position, and

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> stock in exchange for a portion of their Distributing stock and thereafter sold their remaining Distributing stock to FX. Unless the specific shares of Distributing stock exchanged for Controlled stock can be adequately identified by each of the exchanging shareholders, it is assumed pursuant to section 1.1012-1(c)(1) that the Distributing stock exchanged will be charged against the earliest of such lots acquired in order to determine cost or other basis and holding period. This rule also applies in determining whether the Distributing QSBS held by each of the exchanging shareholders at the time of the exchange was among the Distributing stock exchanged for Controlled stock.
>
> Based on the assumption that the portion of the Distributing stock given up by A through N was QSBS in the hands of such shareholders as determined by applying the rules of section 1.1012-1, a portion of the Controlled stock received by such shareholders in exchange therefor will be treated as QSBS acquired on the date the exchanged Distributing QSBS was acquired (section 1202(h)(4)(A)). If the stock exchanged by a Distributing shareholder consists of both QSBS and non-QSBS, then only a proportionate amount of the Controlled stock received in exchange will be treated as QSBS.

Ruling 12 of Letter Ruling 9810010 held:

> Based solely on the taxpayer's representations that a portion of the Distributing stock owned by A through N was classified as qualified small business stock under section 1202 (Distributing QSBS), a proportionate amount of Controlled stock received by each of A through N in exchange for such individual's Distributing QSBS will be treated as qualified small business stock (section 1202(h)(4)(A)). The holding period for the Controlled stock treated as qualified small business stock under section 1202(h)(4)(A) includes the holding period for which each of A through N held the Distributing QSBS. Further, based on the representation that Controlled was a qualified small business at the time of the reorganization, the limitation in section 1202(h)(4)(B) will not apply.
>
> Ruling (12) only applies to the Controlled stock that was received in exchange for Distributing stock that was QSBS in the hands of the individual shareholders at the time of the exchange. We have not been asked, and we do not address, whether any stock issued by Distributing was qualified small business stock at any time or whether Controlled is a qualified small business within the meaning of section 1202(d).

[5048] Code § 1202(h)(4)(B). Letter Ruling 9810010 noted:

> Section 1202(h)(4)(B) limits the amount of gain that can be excluded under section 1202(a) if the stock constitutes qualified small business stock by virtue of section 1202(h)(4)(A). However, the limitation does not apply if the stock is issued by a corporation that is itself a qualified small business as of the time of the reorganization.

Code § 1202(h)(4)(C) provides:

> *Successive application*. For purposes of this paragraph, stock treated as qualified small business stock under subparagraph (A) shall be so treated for subsequent transactions or reorganizations, except that the limitation of subparagraph (B) shall be applied as of the time of the first transfer to which such limitation applied (determined after the application of the second sentence of subparagraph (B)).

[5049] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. Converting a corporation into an LLC taxed as a corporation was such a change. Letter Rulings 201603010-201603014.

[5050] Code § 1202(h)(3), incorporating by reference Code § 1244(d)(2).

the taxpayer elects to recognize gain as if such stock were sold on such first day for its fair market value.[5051] For purposes of the preceding sentence, the taxpayer shall be treated as having an offsetting short position with respect to any qualified small business stock if the taxpayer has made a short sale of substantially identical property, the taxpayer has acquired an option to sell substantially identical property at a fixed price, or to the extent provided in regulations, the taxpayer has entered into any other transaction which substantially reduces the risk of loss from holding such qualified small business stock; in applying this rule, any reference to the taxpayer is treated as including a reference to any person who is related (within the meaning of Code § 267(b)[5052] or 707(b)[5053]) to the taxpayer.[5054]

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

Does the exclusion for the sale of certain stock make being a C corporation more attractive than an S corporation or a partnership? First, we will explore when the sale of such stock has advantages, when the sale does not have advantages, and operational income tax issues.

If and to the extent that the gain on the sale of a business relates to the sale of self-created goodwill, the basis of the ownership interest does not reflect that basis, no matter what kind of entity owns the business. To that extent, the sale of such stock is more favorable than the sale of stock in an S corporation[5055] and the sale for cash of a partnership interest.[5056] However, the seller-financed sale of a partnership interest still produces better results than the sale of such stock.[5057]

In some situations, the exclusion for the sale of certain C corporation stock does not provide any particular advantage, if and to the extent that the owner of a pass-through interest would not have gain on sale. If and to the extent that the sale of the business interest arises from reinvested earnings, the basis of a partnership interest[5058] or stock in an S corporation is increased.[5059] Furthermore, if a pass-through entity redeems only part of one's ownership, the reinvested earnings might offset part or all of the gain on the sale – perhaps even that attributable to self-created goodwill.[5060]

[5051] Code § 1202(j)(1).
[5052] Code § 267(b) is reproduced in part II.G.4.l.iii Code § 267 Disallowance of Related-Party Deductions or Losses.
[5053] For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.
[5054] Code § 1202(j)(2).
[5055] Compare part II.Q.1.a.i.(c) with part II.Q.1.a.i.(d) (moderate tax states) and part II.Q.1.a.ii.(c) with part II.Q.1.a.ii.(d) (California).
[5056] The sale of a partnership interest for cash generally would have similar dynamics regarding goodwill as the sale of S corporation stock. The sale of a partnership interest would have a slight advantage, in that the goodwill could obtain a basis step-up (part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations and fn. 5435, unless the anti-churning rules apply per part II.Q.1.c.iv Goodwill (and other intangible) Anti-Churning Rules, especially fn. 4051), but amortization would be over a 15-year period under Code § 197 (fn. 5320). Also, amortizing goodwill turns it into a hot asset, reducing opportunities for deferral on its sale; for more information on the sale of goodwill, including disadvantages of goodwill being amortized, see part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.
[5057] See parts II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill and II.Q.1.a.ii.(g) Partnership Use of Same Earnings as C Corporation – Redemption (California).
[5058] Code § 705. However, as described in part II.Q.8.e.ii.(a) Unitary Basis, a partner does not have the flexibility of a shareholder to pick and choose which shares to sell.
[5059] Code § 1367.
[5060] For S corporations, see part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally, especially fns. 4649-4651. Of course, the basis resulting reduction basis reduces the ability to take distributions and increases future gains

Furthermore, the exclusion is available only for qualified stock that is issued, gifted, or bequeathed to the taxpayer,[5061] making it unavailable to subsequent purchasers of the stock. Some states, such as California,[5062] do not recognize the exclusion. Also, during substantially all of the taxpayer's holding period for the qualified small business stock, the corporation must use at least 80% (by value) of its assets in the active conduct of one or more qualified trades or businesses and be an eligible corporation.[5063] No rules explain how often one must evaluate the company's assets to see whether they satisfy that test; presumably testing whenever the qualified small business stock is issued[5064] and annually[5065] would suffice, to inject some reasonableness into the statute, but I am unaware of any authority addressing how frequently the corporation must evaluate its assets and their use to help its shareholders prove this element.

A stock sale tends to have a lower sale price than an asset sale, due to buyer's concerns about assuming undisclosed or unseen liabilities and perhaps not receiving a basis step-up in the corporation's assets. Because buyers want to depreciate or amortize business assets or may later sell them, buyers like to obtain a new basis in the entity's assets when they buy an interest in an entity. See Part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations. This is especially important when an entity sells only a business line,[5066] rather than the entire business. Therefore, many business sales are actual or deemed asset sales; for the latter, see part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold. When the entity sells all of its assets, it might as well liquidate to take full advantage of the exclusion on the gain on sale of the stock and let the shareholders move the sale proceeds outside of a potentially risky business environment.[5067]

Until the 21% federal corporate income tax rate increases, a C corporation selling business assets tends to use a lower rate than does a pass-through entity. The latter generates income taxed at higher rates:

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on the sale of the stock, the latter which might not be of concern if and to the extent the stock receives a new basis on the shareholder's death. See part II.H.9 Basis Step-Up In S Corporations That Had Been C Corporations.
For partnerships, see part II.Q.8.b Partnership Redemption or Other Distribution.

[5061] See various requirements described in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[5062] Cal. Rev. & Tax. Cd. § 18152.5(n).

[5063] See text accompanying fns 5019-5020 in part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.

[5064] An example of what purported evidence does not work is described in fn 5009 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[5065] A taxpayer who did not even come close to hitting the target of investing cash quickly enough is in fn 5030 in part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.

[5066] One cannot easily divide a business tax-free, sell a business line, and liquidate the corporation owning just that business lines. See part II.Q.7.f.ii Code § 355 Requirements.

[5067] See part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale. Levun's article, cited at fn. 5088, comments:

> Note that the receipt of liquidation proceeds after a corporate asset sale also qualifies for the QSBC exclusion. However, because of the corporate-level tax exacerbated by the lack of a corporate capital gains rate, the scales would still tip in favor of flow-through taxation, notwithstanding no tax due on liquidation. In other words, assume all an entity owns is zero-basis self-created goodwill having a value of $1 million. In the case of an asset sale as an LLC, there would be federal tax due of $200,000 (assuming a 20-percent maximum capital gains rate). In the case of the same asset sale by a QSBC, while there would be no shareholder tax on the liquidation of the corporation, the corporate entity-level federal tax burden would be $340,000 (or tax at a 35-percent rate, to the extent the corporation has taxable income in excess of $10 million).

The reference to a 35% tax rate was before 2017 tax reform lowered the corporate tax rate.

- Any equipment, amortizable (purchased) Code § 197 intangibles (including goodwill),[5068] certain intellectual property,[5069] and various other property[5070] is subject to taxation at high ordinary income tax rates. See part II.G.6.b Code § 1245 Property. Although ordinary income from the sale of business assets may be qualified business income eligible for the 20% deduction under Code § 199A, [5071] not all businesses qualify,[5072] and even those that do often won't be able to take advantage of large income from such sales because the deduction is limited to a formula based on wages paid, with possible adjustments for depreciable property held at the end of the year.[5073]

- Depreciable real estate may also trigger capital gain tax on depreciation recapture at higher rates.[5074] Also, if and to the extent that selling business assets generated a prior Code § 1231 ordinary loss, later gain from selling business assets is taxed as ordinary income instead of capital gain.[5075]

I am a big fan of partnerships, as described in part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and diagrammed in part II.E.6 Recommended Partnership Structure – Flowchart, after starting more simply as an LLC as described in part II.E.3 Recommended Structure for Start-Ups. Partnerships that are not capital-intensive are great candidates for avoiding any tax on the seller-financed sale of a partnership interest;[5076] that tool tends to apply to a sale to management or other owners, who care more about paying over time, in a manner than devotes less earnings to the buy-out, than they care about inside basis step-up. Furthermore, the death of a partner or sale or other qualified transfer of a partnership interest generates a new basis in the partnership's assets attributable to the relevant partnership interest; see part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

Furthermore, if one decides that a C corporation structure is ultimately desirable, one might consider instead starting as an LLC taxable as a partnership or sole proprietorship, which enables start-up losses to be deducted more easily anyway;[5077] then, if one determines that a C corporation is the ideal structure,

[5068] Goodwill and other intangibles are not amortized and therefore not subject to this rule when they are self-created. When a business buys such assets, then they are amortizable. For how these rules work, see part II.G.19.d Amortization of Code § 197 Intangibles.
[5069] See parts II.G.19.b Sale or Exchange of Intellectual Property - Capital Gain vs. Ordinary Income and II.G.19.c Patents (the latter being subject to the former).
[5070] Various assets that are not capital assets, such as inventory (see Code § 1221(a), reproduced in fn 6710 in part III.B.2.j.iii.(e) Allocation of Specific Items), and assets triggering the assignment of income, such as cash basis accounts receivable, are among them. For certain assets held by a partnership, see part II.Q.8.b.i.(f) Code § 751 – Hot Assets.
[5071] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.
[5072] See part II.E.1.c.iv Specified Service Trade or Business (SSTB) If Taxable Income Exceeds Certain Thresholds.
[5073] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[5074] See fn 1452 in part II.G.6.a Code § 1231 Property. If and to the extent accelerated depreciation applied, beware of ordinary income treatment under part II.G.6.b Code § 1245 Property.
[5075] See text accompanying fn 1454 in part II.G.6.a Code § 1231 Property.
[5076] See parts II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill and II.Q.1.a.ii.(g) Partnership Use of Same Earnings as C Corporation – Redemption (California).
[5077] See part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner, especially part II.G.4.f Comparing C Corporation Loss Limitations to Those for Partnership and S Corporation Losses.

convert[5078] to a qualified small business corporation[5079] the earlier of five years before a sale is anticipated or shortly before the $50 million gross asset limitation is exceeded.[5080] Factors when considering this strategy include:

- The delay in forming the corporation can help avoid being disqualified for not deploying start-up capital quickly enough.[5081]

- During this initial operating period, the owners could build value in the business, and the greater of value or basis of the partnership's assets when it converts to a C corporation is used in computing the exclusion of ten times the investment.[5082] This is a double-edged sword in that any value in excess of basis (in other words, built-in gain) at the time of the conversion is not eligible for the exclusion.[5083]

- The ability to deduct start-up losses may be good or bad, depending on whether the owner is in a high or low tax bracket. See part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. If the taxpayer is in a high tax bracket, then consider taking bonus depreciation[5084] and generating a high-tax-rate deduction now, then paying tax at a lower rate when the assets are sold after conversion to C corporation taxation.

- If the entity accumulates debt in excess of basis, forming the corporation might be a taxable event.[5085]

- Before converting to ***a*** qualified small business corporation, consider whether the LLC might divide into separate entities, each of which conducts a separate business,[5086] and then each separate business would become its own qualified small business corporation with a separate limitation on the amount of gain that is excluded. That may also help stay under the $50 million gross asset limitation for each corporation.

For a case study on converting a partnership to a C corporation to accommodate a venture capital firm's desire for this exclusion, whether converting to a C corporation is a good idea, the Code § 1045 rollover,

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[5078] See part II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations. One might simply file Form 8832 to elect corporate taxation, assign the LLC to a corporation, or convert or merge the LLC into a corporation. As to the former, Letter Ruling 201636003 held:

> While ownership of a corporation is normally tied to stock ownership, and under state law LLC owners hold a member interest and not formal stock, the term "stock" for federal tax purposes is not restricted to cases where formal stock certificates have been issued. Rather, it has been consistent Service position that for federal tax purposes stock ownership is a matter of economic substance, *i.e.*, the right to which the owner has in management, profits, and ultimate assets of a corporation. The presence or absence of pieces of paper called "stock" representing that ownership is immaterial. See Rev. Rul. 69-591, 1969-2 C.B. 172.
>
> Therefore, based on the facts and representations submitted, we rule that the Corporation stock meets the definition of qualified small business stock under §§§ 1202(c), 1202(f) and 1202(h).

[5079] See part II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations.

[5080] See fn. 5007.

[5081] See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold, especially the text accompanying fns. 5028-5030.

[5082] See part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation, especially fns. 4959-4967.

[5083] See paragraph of text accompanying fn. 4967 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[5084] See part II.G.5 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation, especially part II.G.5.b Bonus Depreciation.

[5085] See parts II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities and II.M.2.c Contribution of Partnership Interest to Corporation.

[5086] See part II.Q.8.d Partnership Division.

and issues facing recipients of profits interests on conversion,[5087] see Levun, "Using Partnerships to Leverage "Zero-Tax" Code Sec. 1202 Stock."[5088]

II.Q.7.k.iv. Code § 1045 Rollover of Gain from Qualified Small Business Stock (QSBS) to Another QSBS

Code § 1045 allows a taxpayer to roll over the gain into new qualified small business stock.[5089]

In the case of any sale of qualified small business stock held for more than 6 months[5090] by a taxpayer other than a corporation and with respect to which the taxpayer elects to apply Code § 1045, gain from the sale is recognized only to the extent that the amount realized on such sale exceeds the cost of any qualified small business stock (QSBS) purchased by the taxpayer during the 60-day period beginning on the date of such sale, reduced by any portion of that cost previously taken into account under Code § 1045.[5091]

Code § 1045 does not apply to any gain which the Code treats as ordinary income.[5092]

QSBS has the meaning given such term by Code § 1202(c). See various explanations under other subparts of this part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation. However, only the first 6 months of the taxpayer's holding period for the stock referred to in Code § 1045(a)(1) are taken into account for purposes of applying Code § 1202(c)(2).[5093]

[5087] See part II.M.4.f Issuing a Profits Interest to a Service Provider. Levun, fn. 5088, points out:

> As a final observation, and somewhat of a frolic and detour, let's assume that the LLC being discussed in this column had a service provider that had been previously admitted as a partner (either by reason of (1) having received a fully vested LLC interest, (2) having received a profits interest subject to a substantial risk of forfeiture but for which the requirements of Rev. Proc. 2001-43, 2001-2 CB 191, had been satisfied or (3) having received a capital interest subject to a substantial risk of forfeiture for which a timely Code Sec. 83(b) election had been made. Also assume that, as part of the incorporation transaction contemplated above (to obtain QSBC stock), the service provider was required to agree to a substantial risk of forfeiture with respect to the C corporation stock he was now obtaining in the LLC to C corporation conversion transaction. Rev. Rul. 2007-49, 2007-2 CB 237, would require that a Code Sec. 83(b) election be made in order for the service partner to be treated as a shareholder in the corporation. This revenue ruling provides that the transfer of vested stock in exchange for nonvested stock in a tax-free corporate reorganization requires a Code Sec. 83(b) election in order for the service provider to be considered the tax owner of the shares received in the reorganization. While the revenue ruling addresses a tax-free reorganization under Code Sec. 368(a), there is no reason to believe that the result would be any different in a Code Sec. 351 transaction. Note that making a Code Sec. 83(b) election does not result in any tax to the service provider, as under the principles contained in Rev. Rul. 2007-49, the service provider would be considered to have paid an amount for the QSBC stock equal to its fair market value.

[5088] *Partnership Tax Watch Newsletter* (Current), No. 349, PARTNERSHIP TAX PLANNING and PRACTICE 11/22/2016, saved as Thompson Coburn LLP document no. 6486765.

[5089] Rev. Proc. 98-48 explains how to elect Code § 1045 deferral, the deadline for which may be extended using Reg. § 301.9100-3 relief (*see*, *e.g.*, Letter Ruling 201650010). Reg. § 1.1045-1 provides rules for partnerships and supersedes Rev. Proc. 98-48 to that extent (see T.D. 9353 8/14/2007).

[5090] Code § 1045(b)(4)(A) provides, "the taxpayer's holding period for such stock and the stock referred to in subsection (a)(1) shall be determined without regard to section 1223."

[5091] Code § 1045(a).

[5092] Code § 1045(a).

[5093] Code § 1045(b)(4)(B). Code § 1202(c)(2), "Active business requirement; etc.," provides:

> (A) *In general*. Stock in a corporation shall not be treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for such stock, such corporation meets the active business requirements of subsection (e) and such corporation is a C corporation.
>
> (B) *Special rule for certain small business investment companies*.

A taxpayer is treated as having purchased any property if, but for Code § 1045(b)(3), the unadjusted basis of such property in the hands of the taxpayer would be its cost (within the meaning of Code § 1012).[5094] Code § 1045(b)(3) uses the deferred gain to reduce the basis of any QSBS the taxpayer buys during the 60-day rollover period.

II.Q.7.l. Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244

An individual[5095] may deduct the first $50,000 of loss[5096] on the sale of "section 1244 stock" as an ordinary loss, rather than a capital loss.[5097]

"Section 1244 stock" is stock of a domestic corporation if:[5098]

- at the time such stock is issued, such corporation was a small business corporation,
- such stock was issued by such corporation for money or other property (other than stock and securities), and
- such corporation, during the period of its five most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50% of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.

The corporation cannot be capitalized with more than $1 million adjusted basis of assets.[5099]

Although it applies to the sale of stock in an S corporation, it might not provide much of a benefit, as often such a loss arises from loss due to operations and therefore was already deducted as a loss on the K-1 issued to the shareholder each year. Similarly, this provision might not provide much of a benefit when choosing whether to be taxed as a corporation instead of a partnership, as often such a loss arises from loss due to operations and therefore was already deducted as a loss on the K-1 issued to the partners each year. Furthermore, S corporation shareholders and partners in a partnership would likely obtain a current deduction for such losses, rather than having to wait until their ownership is disposed of, and they would not be required to jump through any statutory hoops similar to Code § 1244 to obtain the ordinary loss deduction. For more information on the concepts described in this paragraph, see part II.G.4 Limitations on Losses.

(i) *Waiver of active business requirement*. Notwithstanding any provision of subsection (e), a corporation shall be treated as meeting the active business requirements of such subsection for any period during which such corporation qualifies as a specialized small business investment company.

(ii) *Specialized small business investment company*. For purposes of clause (i), the term "specialized small business investment company" means any eligible corporation (as defined in subsection (e)(4)) which is licensed to operate under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993).

As to "specialized small business investment company," see part II.Q.7.m Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company.

[5094] Code § 1045(b)(2).

[5095] Trust, estates, and corporations are not eligible for this treatment. Code § 1244(d)(4); see Part II.J.11.b Code § 1244 Treatment Not Available for Trusts. Individuals may deduct losses flowing through partnerships if the partnerships were the original owners, and corporations may not claim this benefit. Reg. § 1.1244(a)-1(b)(2).

[5096] $100,000 if married filing jointly. Code § 1244(b).

[5097] Code § 1244(a).

[5098] Code § 1244(c).

[5099] Code § 1244(c)(3).

II.Q.8.b.ii. Partnership Redemption – Complete Withdrawal Using Code § 736

II.Q.8.b.ii.(a). Introduction to Code § 736

When a partnership redeems[5251] a partner's interest in full,[5252] Code § 736(a) provides that payments may be deductible to the partnership and ordinary income to the selling partner;[5253] if and to the extent that these payments are based on partnership income rather than being fixed, they constitute a shifting of a distributive share of partnership income to the retiring partner, rather than a deduction to the partnership and income to the retiring partner.[5254] Or, one may choose to apply Code § 736(b) so that they are nondeductible to the partnership (although possibly depreciated or amortized) and gain to the partner.[5255]

In analyzing the discussion below, note that one must be careful in relying on the regulations, which were last amended before P.L. 103-66 was enacted in 1993. The legislative history to 1993 changes to Code § 736 provides:

> *In general.*
>
> The bill generally repeals the special treatment of liquidation payments made for goodwill and unrealized receivables. Thus, such payments would be treated as made in exchange for the

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5251 Code § 736 applies only to payments made by the partnership and not to transactions between partners. Reg. § 1.736-1(a)(1)(i). If the responsibility for making payments in a transaction between partners is assigned to the partnership, the assignment does not transform the sale into a Code § 736 redemption. *Coven v. Commissioner*, 66 T.C. 295 (1976), *acq.* 1976-2 C.B. 1, reasoning:

> We therefore conclude that petitioner sold his partnership interest to Suttenberg individually. The resulting tax consequences accordingly cannot be determined by section 736, since that section applies "only to payments made by the partnership and not to transactions between the partners." Sec. 1.736-1(a)(1)(i), Income Tax Regs. See also *Karan v. Commissioner*, 319 F.2d 303, 307 (7th Cir. 1963), *affg.* a Memorandum Opinion of this Court; *Smith v. Commissioner*, 313 F.2d 16, 19 (10th Cir. 1962), *affg.* 37 T.C. 1033 (1962); *Charles F. Phillips*, 40 T.C. 157, 161 (1963); 1 Willis, Partnership Taxation, sec. 46.01, p. 606 (2d ed. 1976).[10]
>
> 10 Although the agreement made a specific allocation for goodwill, capital gains treatment under sec. 736(b)(2)(B) would still not be possible, even if that agreement were not later superseded, because sec. 736 is inapplicable to this sale between partners. Furthermore, even if sec. 736 were applicable, the Consultant Contract, which was adopted, does not make any reference to goodwill, and the partnership did not operate under a written agreement: no operative written partnership agreement specifying payments for goodwill thus existed. Sec. 736(b)(2)(B) would therefore still be inapplicable. See *V. Zay Smith*, 37 T.C. 1033, 1037 (1962), *affd.* 313 F.2d 16 (10th Cir. 1962).

5252 Code § 736 applies only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. Code § 736 does not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Reg. § 1.736-1(a)(1)(i). A partner retires when that person ceases to be a partner under local law. However, for partnership income tax purposes, a retired partner or a deceased partner's successor will be treated as a partner until such partner's interest in the partnership has been completely liquidated. Reg. § 1.736-1(a)(1)(ii). Thus, if one of the members of a two-person partnership retires or dies and the retiring member or deceased member's estate is to receive Code § 736 payments, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's or deceased member's estate's entire interest is liquidated, since the retiring partner or deceased member's estate continues to hold a partnership interest in the partnership until that time. Reg. § 1.736-1(a)(6).

5253 For whether such payments are subject to self-employment tax, see part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.

5254 Reg. § 1.736-1(a)(4). The retiring partner might like (if credits are passed through) or dislike (if nondeductible expenses increase taxable income) this result.

5255 Except to the extent Code § 751(b) applies (see part II.Q.8.b.i.(f) Code § 751 – Hot Assets), the amount of any gain or loss with respect to such payments is determined under Code § 731. Reg. § 1.736-1(b)(6). However, where the total of such payments is a fixed sum, the seller may elect (in the seller's tax return for the first taxable year for which the seller receives such payments), to report and to measure the amount of any gain or loss by the difference between the amount treated as a distribution under Code § 736(b) in that year, and the portion of the partner's adjusted basis that bears the same proportion to the partner's total adjusted basis for the partner's partnership interest as the amount distributed under Code § 736(b) in that year bears to the total amount to be distributed under Code § 736(b). *Id*.

partner's interest in partnership property, and not as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent. The bill does not change present law with respect to payments made to a general partner in a partnership in which capital is not a material income-producing factor. The determination of whether capital is a material income-producing factor would be made under principles of present and prior law [e.g., sections 401(c)(2) and 911(d) of the Code and old section 1348(b)(1)(A) of the Code]. For purposes of this provision, capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual. The practice of his or her profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts his or her practice so long as such capital investment is merely incidental to such professional practice. In addition, the bill does not affect the deductibility of compensation paid to a retiring partner for past services.

> *Unrealized receivables.*
>
> The bill also repeals the special treatment of payments made for unrealized receivables (other than unbilled amounts and accounts receivable) for all partners. Such amounts would be treated as made in exchange for the partner's interest in partnership property. Thus, for example, a payment for depreciation recapture would be treated as made in exchange for an interest in partnership property, and not as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent.

Regarding payments for past services, see part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner, regarding when such payments are not subject to self-employment tax.

Code § 736 prevails over the rules of Code § 1001 that normally govern sales.[5256] For further discussion, see part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.

We will see below that generally a Code § 736(b) payment is taxed under Code § 731(a), so one might wonder how important it might be to be within the scope of Code § 736. Part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale, especially the text accompanying fns. 5284-5287, explains why Code § 736 treatment can be extremely important.

Further below, a brief discussion illustrates why a partner whose interest is being redeemed would generally prefer Code § 736(a) treatment, even though at first glance it would seem that the retiring partner would prefer Code § 736(b) treatment, since capital gains rates are lower than ordinary income rates.

II.Q.8.b.ii.(b). Flexibility in Choosing between Code § 736(a) and (b) Payments

Before explaining this counter-intuitive rule, let's discuss the flexibility allowed. Within certain limits, the redemption agreement can provide that as much or as little of the redemption payments receive

[5256] The first sentence of Reg. § 1.1001-1(a) says, "**Except as otherwise provided in subtitle A of the Code**, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained." (emphasis added) treatment under Code § 736(a) or (b).[5257] However, Code § 736(b) payments cannot exceed the fair market value of the withdrawing partner's share of the partnership property;[5258] therefore, Code § 736(a) must apply to such excess.

Except as discussed below, Code § 736(b) payments cannot be for (and therefore Code § 736(a) must apply to) the partnership's:

- Unrealized receivables;[5259]

- Goodwill, except to the extent that the partnership agreement provides for a payment with respect to goodwill.

The above limitation on what constitutes Code § 736(b) payments means that such payments must be classified as Code § 736(a) payments. It does not mean that such payments are the only types of payments that can be classified as Code § 736(a) payments instead of Code § 736(b) payments.[5260]

However, starting in 1993, payments for unrealized receivables and goodwill are eligible for Code § 736(a) treatment only if capital is not a material income-producing factor for the partnership and the retiring or deceased partner was a general partner in the partnership.[5261] The regulations have not been updated to take into account this rule. In applying this rule, capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other

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[5257] Reg. § 1.736-1(b)(5)(iii). For what constitutes an agreement designating payments, see *Commissioner v. Jackson Investment Company*, 346 F.2d 187 (9th Cir. 1965), *rev'g* 41 T.C. 675 (reviewed decision 1964 holding that a withdrawal agreement was not given effect under Code § 736 as it did not constitute a partnership agreement); the Tax Court seems to have abandoned its decision in *Jackson Investment Company* in other Circuits as well – see *Spector v. Commissioner*, T.C. Memo. 1982-433, characterizing *Jackson Investment Company* as involving an ambiguous provision. If an agreement between all the remaining partners and the withdrawing partner or his successor in interest does not designate payments, then, subject to the limits described further below, Reg. § 1.736-1(b)(5)(i), (ii) provide the following:

> If a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number of years, the portion of each payment to be treated as a distribution under section 736(b) for the taxable year shall bear the same ratio to the total fixed agreed payments for such year (as distinguished from the amount actually received) as the total fixed agreed payments under section 736(b) bear to the total fixed agreed payments under section 736(a) and (b). The balance, if any, of such amount received in the same taxable year shall be treated as a distributive share or a guaranteed payment under section 736(a)(1) or (2). However, if the total amount received in any one year is less than the amount considered as a distribution under section 736(b) for that year, then any unapplied portion shall be added to the portion of the payments for the following year or years which are to be treated as a distribution under section 736(b). For example, retiring partner W who is entitled to an annual payment of $6,000 for 10 years for his interest in partnership property, receives only $3,500 in 1955. In 1956, he receives $10,000. Of this amount $8,500 ($6,000 plus $2,500 from 1955) is treated as a distribution under section 736(b) for 1956; $1,500, as a payment under section 736(a).
>
> If the retiring partner or deceased partner's successor in interest receives payments which are not fixed in amount, such payments shall first be treated as payments in exchange for his interest in partnership property under section 736(b) to the extent of the value of that interest and, thereafter, as payments under section 736(a).

Whether a Code § 754 election is in effect or is deemed to be in effect might affect whether undesignated payments are 736(a) or 736(b) payments. McBride, Alice's Estate in the Wonderland of Subchapter K, *Tax Notes* 2/23/2009, pages 971-980.

[5258] Reg. § 1.736-1(b)(5)(iii).

[5259] Code § 736(b)(2)(A). Unrealized receivables include the right to payments for (1) goods delivered, or to be delivered, to the extent the proceeds would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered. Code § 751(c), which is further described in part II.Q.8.b.i.(f) Code § 751 – Hot Assets. However, for purposes of Code § 736, they do not include other items that Code § 751 would normally treat as unrealized receivables. See text accompanying fns. 5226-5237.

[5260] Reg. § 1.736-1(b)(3) provides a ceiling on payments for goodwill, not a floor under which they may not be lowered. *Tolmach v. Commissioner*, T.C. Memo. 1991-538.

[5261] Code § 736(b)(3).

compensation for personal services performed by an individual.[5262] The professional practice of a doctor, dentist, lawyer, architect, or accountant is not treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts that practice if the capital investment is merely incidental to such professional practice.[5263]

Code § 736(a) payments are available for payments in the form of mutual insurance not determined by reference to any partnership asset,[5264] payments of compensation to a retired partner for past services,[5265] and perhaps a portion[5266] of payments where capital is a material income-producing factor.[5267]

If and to the extent that goodwill would not be eligible for Code § 736(a) treatment, consider how one would measure goodwill. For example, if the retiring partner was undercompensated for prior services before the company reached its full potential or for any other reason, payments could be allocated to past services.

If none of the above works around the inability to apply Code § 736(a) to goodwill, consider doing a partial redemption instead of a complete termination. Code § 736 applies only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership.[5268] Instead, provide a preferred interest in the partnership's profits up to a certain limit. Generally, reallocating profits between partners is not a taxable event.[5269]

II.Q.8.b.ii.(c). Comparing Code § 736(a) with (b) Strategically

See the example in part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis. The "Capital Gains to Seller" scenario corresponds to part II.Q.1.a.i.(d) S Corporation Double Taxation, which corresponds to Code § 736(b) payments, and the "Ordinary Income to Seller" scenario corresponds to part II.Q.1.a.i.(e) Partnership Single Taxation of Goodwill, which corresponds to Code § 736(a) payments. The contrast between these scenarios is illustrated in part II.Q.1.a.i.(f) Partnership Use of Same Earnings as S Corporation in Sale of Goodwill.

Main Points

1. Using a capital gain Code § 736(b) scenario, taxes consume much more to the parties as a whole than would the ordinary income Code § 736(a) scenario in meeting the targeted payments of "principal." Thus, the ordinary income scenario provides more money available to buy out the seller and ease the stress of the buy-out.

2. To compensate the seller for a higher ordinary income tax rate, the seller must receive more to generate the same after-tax flow. Thus, the stated sales price would appear to be higher and more burdensome, although really the buyer is better off because deducting the payments saves more than the additional purchase price cost.

[5262] See part II.Q.8.b.ii.(a) Introduction to Code § 736.
[5263] See part II.Q.8.b.ii.(a) Introduction to Code § 736.
[5264] Reg. § 1.736-1(a)(2).
[5265] See part II.Q.8.b.ii.(a) Introduction to Code § 736.
[5266] If the partners have agreed that the value of the Code § 736(b) payments is not to exceed a certain amount that is below fair market value, the remainder would be Code § 736(a) payments.
[5267] Banoff, More on Section 736(a) Payments After RRA '93 Changes, 83 *Journal of Taxation* 191 (Sept. 1995).
[5268] See fn. 5252.
[5269] See part II.C.6 Shifting Rights to Future Profits.

3. In the § 736(a) scenario, increases in ordinary income tax rates harm the seller disproportionately, although it might be possible for the buyer to agree to pay seller more because the buyer saves more tax by making those additional payments. On the other hand, in a capital gain scenario, an increase in capital gain rates without a corresponding increase in ordinary income rates would not help the buyer save as much tax by paying the seller more.

4. Code § 736(a) requires a complete liquidation in the redeemed partner's interest.[5270] However, the complete redemption may be made over time, and Code § 736 does not terminate the partnership, even if only one owner is left (but Code § 736 does not prevent termination if the partnership ceases activity).[5271] If the partnership assumes the partner's share of liabilities, it cannot deduct the payment of those liabilities under Code § 736 later than the year in which the partner's relationship with the partnership terminated;[5272] the liabilities are treated as relieved (and therefore cash is deemed paid) when the withdrawing partner is no longer a partner (ignoring the Code § 736 deemed continuation).[5273]

5. The above treatment does not apply to the extent that the LLC is repaying the seller's capital account, to the extent that the seller's capital account would be the LLC's earnings that are allocated to the

[5270] Reg. § 1.736-1(a)(1)(i).

[5271] Rev. Rul. 75-154 involved the following facts:

> ABC partnership was formed in 1968 to conduct a management consulting business. Under the terms of the partnership agreement, upon retirement, the retiring partner was entitled to receive, in addition to amounts paid for his interest in partnership property, a specified amount payable in monthly installments over a three-year period following his retirement. There was no provision in the partnership agreement with respect to the payment to a retiring partner for goodwill. Partner C retired on January 2, 1972, and received 12 monthly payments from the partnership during 1972. On January 2, 1973, all of the business and financial activities of the partnership ended and A and B withdrew from the business. The former partners, A and B, assumed their share of the remaining liability to C and made the required payments for the years 1973 and 1974.

The ruling analyzed and held:

> Section 1.736-1(a)(6) of the Income Tax Regulations provides, in part, that a retiring partner or a deceased partner's successor in interest receiving payments under section 736 of the Code is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated. Therefore, if one of the members of a 2-man partnership retires under a plan whereby he is to receive payments under section 736, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's entire interest is liquidated, since the retiring partner continues to hold a partnership interest in the partnership until that time.
>
> Section 1.736-1(a)(6) of the regulations prevents the termination of a partnership under section 708 of the Code, only in those situations in which the partnership would otherwise be terminated because of the withdrawal of a retiring or a deceased partner who is entitled to receive payments under section 736(a)(2). However, in the instant case, section 1.736-1(a)(6) of the regulations does not prevent the termination of the partnership under section 708, even though C was receiving liquidating payments under section 736(a)(2). It was the withdrawal of A and B that caused the partnership to terminate, not C's prior retirement.
>
> Accordingly, the partnership did not continue to exist under section 736 of the Code, but terminated under section 708 when partners A and B discontinued the financial operation of the partnership and withdrew from the business.
>
> It has been previously held that payments that would have been deductible by a partnership had it continued in existence were deductible by the former partners after termination of the partnership. See *Flood v. United States*, 133 F.2d 173 (1st Cir. 1943).
>
> Thus, in the instant case, after the partnership terminated, payments made by former partners A and B, in satisfaction of the liability to retired partner C, are deductible by them as trade or business expenses under section 162(a) of the Code in the year paid, since the payments would have been deductible by the partnership if it had not terminated. Furthermore, the payments to C are includible in C's gross income under section 61(a) in the year received.

[5272] *Whitman & Ransom v. Commissioner*, T.C. Memo. 2005-172.

[5273] See Reg. § 1.736-1(b)(7), Example (1), implementing Reg. § 1.736-1(a)(2) (treating assumption of liabilities treated as a distribution of money under Code § 752 in applying Code § 736).

seller but not distributed. The seller would not be taxed on such distributions, because they were taxed when originally earned.

6. Combined with a Code § 754 election, a Code § 736(b) payment would generate a separate basis for each asset whose basis is adjusted, and each year a new set of assets would be created.[5274] Rather than try to recover that tax benefit, a Code § 736(a) is an easier way for the remaining partners to avoid tax on earnings used to buy the redeemed partner.

7. A partnership might be structured with profits interests that shift over time, which might achieve results similar to that of Code § 736 without the partner completely retiring. For example, suppose an older partner brought in a lot of business, but the agreement would be that the younger partners would take over the business after a number of years. The partnership might be structured to give the older partner a larger profits interest in early years and a smaller profits interest in later years. Generally, merely shifting interests in future profits is not a taxable event.[5275] The objective would be to structure it not as a sale, but rather as an allocation of profits related to the business each partner generates and the services each partner performs.

8. A technique similar to Code § 736 ordinary income payments used to be available to corporations in some situations. If the corporation could make a case that the departing shareholder was under-compensated for prior services, the corporation would pay compensation to him or her, with economic results similar to that of Code § 736 ordinary income payments. Code § 409A has made that strategy more difficult to use, imposing a 20% penalty on deferred compensation to the extent substantially vesting occurs after December 31, 2004, unless the statute's strict requirements are satisfied. To use deferred compensation payments based on prior services, the parties would need to prove that it is fair to compensate the selling owner-employee for prior services even though the employer was previously not legally obligated to do so. The sooner one plans for this future compensation, the easier it will be to prove reasonableness, since the owner-employee will be earning the compensation over time in a manner that is specifically referred to as an incentive for continued efforts. A challenge is that an appropriate level of compensation may be difficult to determine many years in advance of a sale.

<u>Additional Code § 736 Issues</u>

As discussed above, to the extent permitted by law, generally:

- Returns of basis should be structured as Code § 736(b) payments, because the seller is not taxed on them, and

- Profit on the sale of a partnership should be structured as Code § 736(a) payments, and the sale price should be increased at least enough to compensate the seller for paying taxes at ordinary income and self-employment and similar tax rates instead of any applicable capital gain rates.

II.Q.8.b.ii.(d). Comparing Code § 736(b) to an Installment Sale

Suppose one partner is exiting and being bought out over time, and one or more remaining partners will have higher interests in profits and losses. Should it be structured as a sale from one partner to another, or should the partnership redeem the exiting partner? If the latter, should the partnership issue a note to the partner?

[5274] See the paragraph of text accompanying fn. 5305 in part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.
[5275] See part II.C.6 Shifting Rights to Future Profits.

In many cases, the partnership should redeem the exiting partner, documented by the partnership agreement without a separate promissory note. Code § 736 redemptions of a retiring partner are often better than an installment sale; and issuing a note might move the transaction into an unclear tax posture, whereas relying solely on the partnership agreement avoids certain questions. Merely shifting the right to future profits would not generate an income tax consequence;[5276] however, shifting a partner's capital account and any gain or loss inherent in that partner's share of the partnership's existing value would have income tax consequences. We have already seen how Code § 736(a) payments tend to work better for the partnership's value relating to goodwill;[5277] the rest of this part II.Q.8.b.ii.(d) discusses all components of value in a general sense.

Code § 736 taxes the retired partner on Code § 736 payments as if the retired partner were still a partner;[5278] complete liquidation of a partner's interest does not occur until no more payments may be made to the withdrawn partner.[5279] Code § 736(a) payments are taxed in the year for which they are made, rather than in the year of receipt.[5280] Furthermore, except to the extent Code § 751(b) applies, the amount of any gain or loss with respect to payments under Code § 736(b) for a retiring or deceased partner's interest in property for each year of payment is determined under Code § 731.[5281]

Code § 736 redemptions do not appear to contemplate the installment sale rules applying. If Code § 736 applies instead of the installment sale rules applying, then, rather than pro rating basis among the scheduled installment payments the way an installment sale would work, basis is applied fully to the earliest payments until it is used up. Thus, Code § 736 payments defer recognition of gain on sale relative to installment sales, a benefit that is not present in the sale of stock in a C or an S corporation; it also allows distributions to be applied to the partner's entire basis in the partnership,[5282] whereas distributions to shareholders are applied pro rata to their shares and are taxed according to the basis in each block of shares,[5283] perhaps heightening the impact of deferred basis recovery for those sales that are redemptions recharacterized as distributions.

The installment sale of a partnership interest can be particularly disastrous if the partnership has significant "hot assets," which can include not only inventory and accounts receivable but also depreciable property,[5284] because income from those items is taxable immediately – even if it exceeds the amount that the seller received up front.[5285] However, depreciable property and certain other property[5286] are not "hot assets" when applying Code § 736.[5287] Also, when a partnership redeems a partnership interest and the redeemed partner is allocated ordinary income from

[5276] See part II.C.6 Shifting Rights to Future Profits.

[5277] See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis, especially parts II.Q.1.a.i.(f) Partnership Use of Same Earnings as S Corporation in Sale of Goodwill and II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill.

[5278] Reg. § 1.736-1(a)(6). Although a partner retires when he ceases to be a partner under local law, a retired partner or a deceased partner's successor will be treated as a partner for partnership income tax purposes (subchapter K, chapter 1 of the Code) until the partner's interest in the partnership has been completely liquidated. Reg. § 1.736-1(a)(1)(ii). Does this continuation of treatment as a partner apply for purposes of the income in respect of a decedent rules of Code § 1014(c), which is found in subchapter O of chapter 1 of the Code? See part II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411.

[5279] *Brennan v. Commissioner*, T.C. Memo, 2012-209 (citing Reg. § 1.761-1(d) and imposing a negligence penalty for failure to report the partner's distributive share of income earned before the partner received the final payment) , *aff'd* 116 A.F.T.R.2d 2015-6569 (9th Cir. 2015).

[5280] Reg. § 1.736-1(a)(5).

[5281] Reg. § 1.736-1(b)(6).

[5282] See part II.Q.8.e.ii.(a) Unitary Basis.

[5283] See part II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property, especially fn. 4867.

[5284] See part II.Q.8.b.i.(f) Code § 751 – Hot Assets.

[5285] See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests, especially fn. 5415.

[5286] See part II.Q.8.b.i.(f) Code § 751 – Hot Assets, especially fns. 5228-5235.

[5287] See part II.Q.8.b.i.(f) Code § 751 – Hot Assets, especially fn. 5226.

hot assets, the remaining partners receive basis in those hot assets.[5288] This contrasts with S corporations, where the remaining shareholders report ordinary income on corresponding items.[5289]

Not all redemptions qualify for Code § 736 treatment – they need to be "in liquidation of the interest of a retiring partner or a deceased partner."[5290] If a Code § 736 payment obligation is evidenced as a promissory note rather than contract right, do the installment sale provisions apply when the partner receives the note?[5291] The amounts paid for his interest in assets are treated in the same manner as a distribution in complete liquidation under Code §§ 731, 732, and, where applicable, 751.[5292]

Neither Code § 731 nor Code § 732 nor the regulations under either statute address the effect of distributing a note in which the partnership is the maker. For purposes of maintaining capital accounts, generally distributions of notes do not count as distributions except to the extent that the partner disposes of or the partnership repays the note, but a distribution of a note will count as a distribution if the note is readily tradable on an established securities

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[5288] Reg. § 1.751-1(g), Example (2), paragraph (e)(1).

[5289] See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[5290] Code § 736(a), (b)(1). Reg. § 1.736-1(a)(1)(i) elaborates:

> Section 736 and this section apply only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. See section 761(d). Section 736 and this section do not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Section 736 and this section apply only to payments made by the partnership and not to transactions between the partners. Thus, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of section 736.

[5291] See Kim and Saunders, Redeeming a Partner with The Partnership's Note, *TM Memorandum* (BNA) (3/21/2016) (saved as Thompson Coburn doc. 6817740).

[5292] Reg. § 1.736-1(a)(2), which also refers to Reg. § 1.751-1(b)(4)(ii). Reg. § 1.751-1(b)(4)(ii) provides:

> Section 751(b) does not apply to payments made to a retiring partner or to a deceased partner's successor in interest to the extent that, under section 736(a), such payments constitute a distributive share of partnership income or guaranteed payments. Payments to a retiring partner or to a deceased partner's successor in interest for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, constitute payments under section 736(a) and, therefore, are not subject to section 751(b). However, payments under section 736(b) which are considered as made in exchange for an interest in partnership property are subject to section 751(b) to the extent that they involve an exchange of substantially appreciated inventory items for other property. Thus, payments to a retiring partner or to a deceased partner's successor in interest under section 736 must first be divided between payments under section 736(a) and section 736(b). The section 736(b) payments must then be divided, if there is an exchange of substantially appreciated inventory items for other property, between the payments treated as a sale or exchange under section 751(b) and payments treated as a distribution under sections 731 through 736. See subparagraph (1)(iii) of this paragraph, and section 736 and § 1.736-1.

However, the scope of unrealized receivables is narrower under Code § 736 than on other transactions involving hot assets; see part II.Q.8.b.i.(f) Code § 751 – Hot Assets, especially the text accompanying fn. 5226.

market,[5293] is negotiable,[5294] or perhaps if it is payable upon demand.[5295] However, a leading treatise strongly opposes counting a note in which the partnership is the maker, whether or not negotiable, as a distribution;[5296] the treatise does, suggest, however, reducing the basis available to allocate to other distributed assets by the amount of

[5293] In addition to Reg. § 1.704-1(b)(2)(iv)(e)(2) that is reproduced in fn. 5294, consider that Code §§ 731(c)(2)(B)(ii) (any financial instrument which, pursuant to its terms or any other arrangement, is readily … exchangeable for, money or marketable securities) and 731(c)(2)(C) (The term 'financial instrument' includes … evidences of indebtedness ….) treat a distribution of publicly traded debt as a cash distribution.

[5294] Reg. § 1.704-1(b)(2)(iv)(e)(2) provides:

> *Distribution of promissory notes*. Notwithstanding the general rule of paragraph (b)(2)(iv)(b)(5), except as provided in this paragraph (b)(2)(iv)(e)(2), if a promissory note is distributed to a partner by a partnership that is the maker of such note, such partner's capital account will be decreased with respect to such note only when there is a taxable disposition of such note by the partner or when the partnership makes principal payments on the note. The previous sentence shall not apply if a note distributed to a partner by a partnership who is the maker of such note is readily tradable on an established securities market. Furthermore, the capital account of a partner whose interest in a partnership is liquidated will be reduced to the extent of (i) the fair market value, at the time of distribution, of any negotiable promissory note (of which such partnership is the maker) that such partnership distributes to the partner on or after the date such partner's interest is liquidated and within the time specified in paragraph (b)(2)(ii)(b)(2) of this section, and (ii) the fair market value, at the time of liquidation, of the unsatisfied portion of any negotiable promissory note (of which such partnership is the maker) that such partnership previously distributed to the partner. For purposes of the preceding sentence, the fair market value of a note will be no less than the outstanding principal balance of such note, provided that such note bears interest at a rate no less than the applicable federal rate at time of valuation.

[5295] Consider that Code §§ 731(c)(2)(B)(ii) (any financial instrument which, pursuant to its terms … is readily convertible into, or exchangeable for, money) and 731(c)(2)(C) (The term 'financial instrument' includes … evidences of indebtedness ….) treat a distribution of a demand note as a cash distribution.

[5296] McKee, Nelson & Whitmire, ¶19.05. Distributions in Complete Liquidation of a Partnership Interest, *Federal Taxation of Partnerships & Partners* (WG&L), reasons (footnotes omitted):

> Treating even a secured negotiable promissory note of the partnership as cash or a cash equivalent, the distribution of which triggers gain under § 731(a), would be inconsistent with the statutory scheme of Subchapter K because a § 754 election by the partnership would permit the partnership to increase the basis of its assets as the result of the distribution of zero-basis property. Similarly, treating a partnership's promissory note as property for purposes of applying §§ 731 and 732 also would produce results totally inconsistent with the Subchapter K scheme. Property characterization in connection with a current distribution would give the note a zero basis in the distributee-partner's hands under § 732(a)(1) because it would have a zero basis in the partnership's hands immediately prior to the distribution. Subsequent payments on the note would have to be treated as payments rather than distributions; the expenditure of partnership assets with no corresponding overall impact on the bases of the partners' interests would destroy the symmetry between the partnership's basis in its assets and the partners' bases in their interests, which Subchapter K strives to preserve. Similarly, if a partnership note were treated as property distributed as the sole consideration for the liquidation of a partner's entire interest in the partnership, it would take on a basis equal to the distributee-partner's basis in his interest. If a § 754 election were in effect, the partnership would be required to reduce the basis of its retained assets under § 734(b)(2)(B) by the amount of the distributee-partner's post-distribution basis in the note. By contrast, a cash distribution in the amount of the note would produce an increase in the basis of partnership assets if the cash distributed exceeded the distributee-partner's predistribution basis in his interest. A partnership note should thus not be treated as property under §§ 731 and 732, either. Payments on the note should be treated as distributions of cash, subject to all the rules applicable to such distributions.

payments expected to be made.[5297] Issuing a formal note creates much complexity and uncertainty,[5298] so one might consider keeping the payment right a contract right not reduced to a note. On the other hand, using a note and installment sale treatment would enable a cleaner break between the redeemed partner and the partnership and simplify inside basis step up issues (fn. 5305). The clean break from the partnership allows the retiring partner not to be treated as a partner any more for income tax purposes[5299] but also locks in the installment sale gain as income in respect of a decedent, the latter making the installment obligation ineligible for a basis step-up at death, whereas mere Code § 736(b) installments appear eligible for a basis step-up at death.[5300]

One might also be cautious when admitting a partner and redeeming a partner close in time to each, lest the IRS argue a disguised sale between the retiring partner and the new partner.[5301]

[5297] McKee, Nelson & Whitmire, ¶19.05. Distributions in Complete Liquidation of a Partnership Interest, *Federal Taxation of Partnerships & Partners* (WG&L), reasons in a footnote:

> See Reg. § 1.732-1(b) (Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of his interest in the partnership reduced by the amount of any money distributed to him *in the same transaction*. (emphasis added)). The reference to the same transaction should be interpreted to refer to the entire series of liquidating distributions in order to be consistent with the Regulations § 1.761-1(d) definition of liquidation. Further, any other interpretation of Regulations § 1.732-1(b) would make the timing of liquidating distributions a key ingredient in determining the basis of distributed property, and would allow taxpayers to artificially inflate the basis of property distributed in liquidation by agreeing to defer cash distributions. For example, assume a partner, whose basis of his interest is $10,000, is to receive $4,000 cash and a capital asset in liquidation of his interest. Under the interpretation suggested in the text, the distributed capital asset will have a basis of $6,000 to the partner regardless of the order in which the distributions are made. If subsequent cash distributions are not taken into account in computing the basis of the distributed capital asset, the capital asset will take a basis of $10,000 if it is distributed first and the $4,000 cash distribution will be taxable when received, a combination that would allow the distributee to accelerate losses (by selling the distributed capital asset) in exchange for a deferred gain on the eventual receipt of the cash.

[5298] See Cuff, Distributions of Promissory Notes In Liquidation of a Partner's Interest, *Journal of Real Estate Taxation* (now simply *Real Estate Taxation*) (WG&L), (1st Qtr. 2006) (capital accounting for promissory note distributions to a partner, allocations with respect to contributed property, allocations after a book-up of partnership assets, the minimum gain chargeback, the qualified income offset, unrecaptured Code § 1250 gain, allocation of partnership liabilities, and collapsible partnerships); Cuff, Promissory Notes In Liquidation of a Partner's Interest Still Hold Questions, *Journal of Real Estate Taxation* (now simply *Real Estate Taxation*) (WG&L), (2nd Qtr. 2006) (considering the interplay of the rules described in the 1st Qtr. Article, and the rules on disguised sales and collapsible partnerships).

[5299] See fns. 5278-5279.

[5300] See fns. 5303 and 5304 and part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[5301] See Kim and Saunders, Redeeming a Partner with The Partnership's Note, *TM Memorandum* (BNA) (3/21/2016) (saved as Thompson Coburn doc. 6817740). Announcement 2009-4 stated:

> Until new guidance is issued, any determination of whether transfers between a partner or partners and a partnership is a transfer of a partnership interest will be based on the statutory language, guidance provided in legislative history, and case law.

Announcement 2009-4 looks askance at a couple of cases in this area, which cases are discussed in the Kim and Saunders article but which might control, notwithstanding the IRS' view. Announcement 2009-4 stated:

> Section 707(a)(2)(B) provides that, under regulations prescribed by the Secretary, if transfers of property between a partner or partners and a partnership, when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated as either transactions between the partnership and one who is not a partner or between two or more partners acting other than in their capacity as partners. The legislative history of section 707(a)(2)(B) indicates the provision was adopted as a result of Congressional concern that taxpayers were deferring or avoiding tax on sales of partnership property, including sales of partnership interests, by characterizing sales as contributions of property, including money, followed or preceded by related partnership distributions. See H.R. Rep. No. 861, 98th Cong. 2nd Sess. 861 (1984), 1984-3 (Vol. 2) CB 115. Specifically, Congress was concerned about court decisions that allowed tax-free treatment in cases that were economically indistinguishable from sales of property to a partnership or another partner, and believed that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance. See H.R. Rep. No. 432, 98th Cong. 2nd Sess. 1218 (1984) (H.R. Rep.), and S. Prt. No. 169 (Vol. I), 98th Cong. 2nd Sess. 225 (1984) (S. Prt.) (discussing *Communications Satellite Corp. v. United States*, 625 F.2d 997 (Ct. Cl. 1980), and *Jupiter Corp. v. United States*, 2 Cl. Ct. 58 (1983), both of which involved disguised sales of a partnership interest).

Letter Ruling 8304059 assumed that using a promissory note to redeem a partner does not necessarily take the transaction out of Code § 736 and ruled that any interest paid constitutes a Code § 707(c) guaranteed payment and that Reg. §§ 1.267(b)-1(b) and 1.707-1(c) prevent Code § 267 from limiting the timing of the interest deduction. Although a Code § 736 payment may bear interest, it need not.[5302] For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

It appears that a basis adjustment would apply at the retiring partner's death, which might eliminate a considerable part of the gain to be recognized on future installments (to the extent that gain is not attributable to the deceased partner's share of items constituting income in respect of a decedent)[5303] and might also lead to depreciation and goodwill amortization deductions.[5304] Thus, installment sales lock in gain as income in respect of a decedent, whereas Code § 736 payments appear eligible for a basis step-up. A partnership agreement might even convert Code § 736(a) payments to Code § 736(b) payments upon death, perhaps reducing the installments to take into account the smaller tax burden imposed on the seller.

Suppose that the partnership agreement provided for a Code § 736(b) payment with respect to goodwill. Each Code § 736(b) installment would give rise to a new goodwill asset that could be amortized over 180 months.[5305] Thus, the parties could get some tax arbitrage by the buyer getting ordinary deductions

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[5302] Garlock, ¶1308 Debt Contributed To And Distributed From Partnerships, *Federal Income Taxation of Debt Instruments* (CCH), asserts in ¶1308.02 Distributions of Debt Instruments from Partnerships, [B] Debt of the Partnership:

> …The real issue, then, is whether interest will be imputed on partnership notes to partners that do not bear adequate stated interest. As noted above, the better view is that interest should not be imputed.
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> If a partnership's note distributed to a partner is respected for all tax purposes, and if the partner's interest in the partnership is not reduced as a result of the distribution (as would be the case in a situation involving a pro rata distribution of notes to all partners), the determination of its issue price is unclear. The note is not issued for cash or property because the partner is not giving anything to the partnership in exchange for the note. There is no partnership analogue to section 1275(a)(4), which deems a corporation's note distributed to a shareholder as being issued in exchange for property. Hence, section 1273(b) does not provide any rule for determining the note's issue price.[258] Reg. § 1.1273-2(d)(1), which is broader than the corresponding statutory rule, effectively treats any debt instrument not issued for money or publicly traded property or subject to section 1274 as having an issue price equal to its stated redemption price.
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> If the debt distributed provides for qualified stated interest (QSI), then its stated redemption price at maturity equals its stated principal amount and little is at stake here. The stated interest is respected as interest, and the stated principal amount is respected as principal. Even if the interest is at a rate below the AFR (or is zero), no interest is imputed under section 1274 because the debt was not issued in exchange for property and no interest is imputed under section 7872 because a loan from a partnership to a partner is not one of the categories of loans subject to that section, absent regulations treating the loan as a significant tax effect loan.[259] The only real problem arises if the debt provides for stated interest that is not QSI. Because all payments other than QSI are included in a debt's stated redemption price at maturity,[260] the effect of treating the debt's issue price as being equal to its stated redemption price at maturity would be to recharacterize all stated interest on the debt as principal. It is doubtful that this result was intended. The more sensible rule is to treat the debt instrument as issued for its stated principal amount in this situation.
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> [258] See ¶ 203. Section 1273(b)(1) and (2) apply to debt instruments not issued for property, but the rules in those paragraphs depend on the price at which the instruments were offered for sale or actually sold, and this does not apply in the present case. Section 1273(b)(4) is generally the rule that applies if no other rule applies (and it deems the issue price to be equal to the stated redemption price at maturity), but it only applies to debt issued for property.
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> [259] See ¶ 402.02.
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> [260] See ¶ 202.01.

[5303] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 5440.

[5304] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, especially fn. 5442.

[5305] Reg. § 1.734-1(e)(1), referred to by McKee, Nelson & Whitmire, ¶25.02. Allocations of Section 734(b) Adjustments to Partnership Assets: Section 755, *Federal Taxation of Partnerships & Partners* (WG&L), interpreting the consequence of Rev. Rul. 93-13, which provides:

over 15 years when the seller gets capital gain, but query what the time value of money would be like in a business deal, which generally requires a faster payback. If assets have a faster depreciation period but the number of assets to track is high, consider abandoning the use of Code § 736(b) payments and simply using Code § 736(a); see part II.Q.8.b.ii.(c) Comparing Code § 736(a) with (b) Strategically.

Presumably, this lack of installment sale treatment would allow partnership redemptions to avoid the interest on deferred tax liabilities that Code § 453A imposes on installment sales. A prominent treatise states:[5306]

> A selling partner who receives deferred payments and reports gain under § 453 may be subject to acceleration of deferred gain under the pledge rule in § 453A(d) and may be required to pay interest on his deferred tax liability under § 453A(c). There are no analogous provisions applicable to deferred distributions to partners whose partnership interests are liquidated under § 736.

The treatise later states:[5307]

> In general, amounts that are computed like interest and paid to a partner for the use of partnership capital constitute guaranteed payments under § 707(c). Because a retired partner who receives post-retirement liquidation distributions is treated as a continuing partner (and not as a partnership creditor) for Subchapter K purposes until his interest is completely liquidated, it seems that any "interest" paid with respect to deferred § 736(b) distributions should be treated as guaranteed payments to the retired partner for the use of his unreturned capital. This notion is buttressed by the fact that § 736(a)(2) treats all payments "made in liquidation of the interest of a retiring partner" as § 707 guaranteed payments if they are determined without regard to partnership income and are not paid for the retiring partner's interest in partnership property under § 736(b).
>
> If deferred liquidation payments cannot bear tax-recognized interest, it follows that the imputed interest rules of §§ 483, 1272, and 7872 do not apply to deferred liquidation distributions under § 736. [In other words, deferred payments under Code § 736 should not be recharacterized as part principal and part interest.] From a policy perspective, inapplicability of these rules may not be as offensive as might first appear, since the timing of any tax benefits and burdens of deferred liquidation payments under § 736 are matched. Thus, because deferred liquidation payments are not treated as liabilities, the continuing partners cannot increase the bases of their partnership interests by the amount of deferred payments under § 752(a). In addition, the partnership is entitled to adjust the basis of its assets under § 734(b) only when the deferred payments are actually made and the retired partner actually recognizes gain or loss. Finally, if amounts payable to a retired partner include interest-like payments, such payments constitute § 736(a)(2) payments that will be included in the income of the retired partner at the same time that they are deducted by the partnership under the matched timing rules of § 707(c).

I am not aware of any primary authority addressing the above issue.

> If a partnership that has in effect an election to adjust basis under section 754 of the Internal Revenue Code completely liquidates the interest of a partner by agreeing to make a series of cash payments that are treated as distributions under section 736(b)(1), the section 734(b) basis adjustments to partnership property respond in timing and amount with the recognition of gain or loss by the retiring partner with respect to those payments.

If the Code § 736(b) payments were contingent, perhaps Reg. § 1.197-2(f)(2) would apply to amortize the new payments over the remaining months of the 180-month period.

[5306] McKee, Nelson & Whitmire, ¶16.02. Transfers of Partnership Interests by Sale or Exchange: Tax Consequences of Liquidations Compared, *Federal Taxation of Partnerships & Partners*.

[5307] McKee, Nelson & Whitmire, ¶22.02[4][c] Interest on Deferred Section 736(b) Payments, *Federal Taxation of Partnerships & Partners*. For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

II.Q.8.b.ii.(e). Effect of Code § 736 Payments, Installment Sale Payments, or Deferred Compensation on Balance Sheet

Generally, Code § 736(a)(1) payments that are structured as preferred distributions of profits are considered equity and do not affect the entity's net worth.

On the other hand, Code § 736(a)(2) guaranteed payments and Code § 736(b) installment sale payments would be liabilities on the entity's balance sheet. Similarly, in a cross-purchase, the buyers would have liability on their balance sheets (which can also impede the use of guaranties). Finally, deferred compensation agreements, which are the corporate attempt to replicate Code § 736(a)(2) guaranteed payments, would also constitute a liability on the entity's balance sheets.

Liabilities on balance sheets can impede access to credit before and during the buy-out period. That a business is transitioning from the successful founder to new management doesn't help that situation.

Thus, Code § 736(a)(1) payments that are structured as preferred distributions of profits might very help the business' operations relative to the other ways of structuring buyouts.

II.Q.8.b.ii.(f). Planning for the 3.8% Tax on Net Investment Income and Passive Loss Rules When Using Code § 736 Payments

For purposes of the 3.8% tax on net investment income,[5308] see part II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411.

See also part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736.

II.Q.8.b.ii.(g). Code § 736 Payments as Retirement Income – Possible FICA and State Income Tax Benefits

Compensatory payments to be made for the rest of a partner's life, which generally would be Code § 736(a) payments, might be excluded from FICA but would be subject to Code § 409A. See part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.

No state may impose income tax on any retirement income of an individual who is not a resident or domiciliary of that state (as determined under that state's laws).[5309] "Retirement income" includes income from a written plan, program, or arrangement that is in effect immediately before retirement begins and provides retirement payments in recognition of prior service to be made to a retired partner,[5310] if the income is from an excess benefit plan[5311] or

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[5308] See part II.I 3.8% Tax on Excess Net Investment Income.

[5309] 4 U.S.C. § 114(a). Missouri Private Letter Ruling No. LR 3570 (1/2/2007) held that this statute protected the following payments from state income tax:

> Applicant is a participant of a Retirement Plan (RP) and is also a participant of an Insurance Plan (collectively, the Plans). The purpose of the Plans is to supplement retirement benefits from the Pension Plan (Pension Plan) and the Retirement Plan for eligible corporate officers in recognition of service to their employer. The administrator of the RP is the Corporation and the administrator of the insurance plan is a committee within the Pension Plan.
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> ….
>
> In this case the Plans are plans or arrangements as described in IRC section 3121(v)(2)(C) and the monthly payments meet the requirements of section 114(b)(1)(I)(i) of Title 4 of the United States Code. Therefore, for purposes of state income tax, the monthly payments from the Plans received by Applicant will be treated as retirement income as defined in section 114(b) of Title 4 of the United States Code.

[5310] 4 U.S.C. § 114(b)(4) provides:

> For purposes of this section, the term retired partner is an individual who is described as a partner in section 7701(a)(2) of the Internal Revenue Code of 1986 and who is retired under such individual's partnership agreement.

[5311] 4 U.S.C. § 114(b)(1)(I)(ii) refers to:

if the income is part of a series of substantially equal periodic payments payable at least annually for either the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and a designated beneficiary of the recipient) or a period of not less than 10 years.[5312]

II.Q.8.b.ii.(h). Interaction of Death with Code § 736 Payments

Generally, the retiring partner's payments would consist of:

- Code § 736(a) payments (taxable as ordinary income), grossed up for income taxes as illustrated in the different purchase prices used in parts II.Q.1.a.i.(f) Partnership Use of Same Earnings as S Corporation in Sale of Goodwill and II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill, would be paid during the retiring partner's life, and

- Code § 736(b) payments, not grossed up but generally tax-free because the deceased partner's successor in interest has received a basis step-up, would be made after the retiring partner's death.[5313]

Perhaps the partnership has life insurance to pay a retired partner. The life insurance is received tax-free (so long as the partnership complies with the rules on employer-owned life insurance, which apply to any 5% partner, whether or not the partner actually works in the business).[5314] Thus, the partnership does not need to deduct payments it makes to the retired partner's beneficiaries. Furthermore, the basis step-up mentioned above, if my assumption is correct, means that there is no capital gain tax for the retired partner's beneficiaries to avoid. Code § 753 denies a basis step-up to Code § 736(a) payments but does not address Code § 736(b) payments, which implies that Code § 736(b) payments receive a basis step-up. Therefore, consider converting Code § 736(a) payments to Code § 736(b) payments when a partner dies, perhaps reducing the payments to take into account that the seller does not need to be grossed up to pay the seller's taxes on the distribution.

III.A.3.e. QSSTs and ESBTs

III.A.3.e.i. QSSTs

After reviewing a variety of QSST issues that apply during the beneficiary's life, see part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, for a discussion of various issues one should consider when a beneficiary makes a QSST election.

> a payment received after termination of employment and under a plan, program, or arrangement (to which such employment relates) maintained solely for the purpose of providing retirement benefits for employees in excess of the limitations imposed by 1 or more of sections 401(a)(17), 401(k) , 401(m) , 402(g), 403(b), 408(k), or 415 of such Code or any other limitation on contributions or benefits in such Code on plans to which any of such sections apply.

I have assumed, without verification, that withdrawal from a partnership counts as termination of employment, consistent with the treatment of partners as employees eligible to participate in a qualified retirement plan. Please let me know what you discover when you research this issue.

[5312] 4 U.S.C. § 114(b)(1)(I)(i).

[5313] For the basis step-up, see fns. 5303 and 5304 in part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.

[5314] See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

III.A.3.e.i.(a). QSSTs Generally

After determining a trust's eligibility for its beneficiary to make a "qualified subchapter S trust" (QSST) election, see part III.A.3.c.iii Deadlines for QSST and ESBT Elections. A beneficiary may make a protective QSST election.[5784]

A QSST may have only one beneficiary[5785] (who also must be a U.S. citizen or resident) who may receive income or corpus during the beneficiary's lifetime, and all of its income[5786] must be distributed currently

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[5784] See Reg. § 1.1361-1(k)(1), Example (2), part (iii), reproduced in the text accompanying fn 5726 in part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.

[5785] Code § 1361(d)(3)(A) and Reg. § 1.1361-1(j)(1)(ii), (iii). A trust cannot qualify as a QSST if it provides that, if the trust does not hold shares of an S corporation, the trust may terminate during the life of the current income beneficiary and distribute its corpus to persons other than the current income beneficiary. Rev. Rul. 89-55. Consistent with this limitation, Reg. § 1.1361-1(j)(2)(iii) restricts powers of appointment:

> If, under the terms of the trust, a person (including the income beneficiary) has a special power to appoint, during the life of the income beneficiary, trust income or corpus to any person other than the current income beneficiary, the trust will not qualify as a QSST. However, if the power of appointment results in the grantor being treated as the owner of the entire trust under the rules of subpart E, the trust may be a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section.

Note, however, that failure to make a trust a spendthrift trust (and therefore allowing the beneficiary's interest to be assignable) will not disqualify the trust as a QSST unless it gets assigned (and then it might or might not disqualify the trust). Reg. § 1.1361-1(j)(2)(iv). On the other hand, Letter Ruling 9437021 viewed the possibility of distribution from the QSST to another trust for that same beneficiary as an error, but ruled that it was harmless error in that case because the recipient trust never existed and therefore could never receive a distribution (see also fn. 5787 regarding the distribution of income other than directly to the beneficiary); however, one might not want to assume that the IRS' national office will repeat this kind and gentle approach. Thus, one may need to avoid authorizing the merger or decanting of any trust that has a QSST election in place. For decanting, see fn. 2554, found in part II.J.4.i Modifying Trust to Make More Income Tax Efficient. However, the Uniform Trust Decanting Act allows decanting to be done by trust amendment rather than actual transfer of assets, in which case a QSST need not prevent decanting; for details on decanting by mere amendment, see fn. 2861, found in part II.J.18 Trust Divisions, Mergers, and Commutations; Decanting.

Also, the grantor trust treating a person other than the current income beneficiary as the owner of a part or all of that portion of a trust which does not consist of the S corporation stock does not disqualify the trust from making a QSST election. Reg. § 1.1361-1(j)(2)(vi). Does that, by negative implication, suggest that the settlor (who is not the beneficiary) being treated as deemed owner of the portion of a trust that includes the S corporation stock precludes a QSST election? Reg. § 1.1361-1(j)(4) suggests that prohibition exists; Reg. § 1.1361-1(k)(1), Example (10), paragraph (iii) (reproduced in fn. 5792) confirms that result.

[5786] All of the trust's income, not just the income from the S stock, must be distributed or distributable currently. Letter Ruling 9603007. This refers to trust accounting income, not taxable income. Reg. § 1.1361-1(j)(1)(i). Letter Ruling 200446007 held that the amount of a deemed dividend under Code § 1361(d)(3)(B) was not required to be distributed. Also, consistent with ideas discussed in part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally (with fn 4653 referring the reader here), Letter Ruling 200451021 clarifies that, when Code § 302(d) taxes a partial liquidation as a distribution rather than as a redemption, the trust itself is not taxed on any income on the distribution if the trust has sufficient AAA to absorb the basis reduction (Ruling Request 1) and the proceeds from the sale of stock in partial liquidation are principal that the QSST does not need to distribute (Ruling Request 2). Similarly, in Letter Ruling 9349009:

> Company wishes to make a substantial distribution to its shareholders, but for estate planning purposes, its shareholders prefer that the distribution be treated as principal of the Trusts rather than income distributable to the Beneficiaries. Company proposes making a cash distribution to its shareholders ("Distribution") in a stock redemption under section 302(d) of the Code.

Letter Ruling 9349009 held:

> As indicated above, each of the Trusts gives the trustee broad discretionary power to allocate trust receipts between income and principal. Moreover, it is represented that under State law the Distribution should be allocated to principal. Accordingly, the Distribution proceeds received by the Trusts will not constitute fiduciary accounting "income" within the meaning of section 643(b) of the Code.

to that beneficiary[5787] while the trust[5788] holds S stock.[5789] The income distribution rule is that all income either actually is distributed each year or is required to be distributed each year;[5790] inadvertent termination

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> Assuming the Distribution will qualify as a redemption under section 302(d) of the Code, we conclude that the provisions of sections 1368(b) and 1368(c) will apply for purposes of determining whether the Distribution to Company's shareholders will be includable in their gross income. In addition, the treatment of the proposed Distribution by the Trusts as principal rather than income will not cause the Trusts to fail to satisfy the current distribution requirement of section 1361(d)(3). Therefore, assuming the Trusts otherwise qualify as qualified subchapter S trusts, the Distribution will not adversely affect Company's election to be an S corporation.

If the income may be used to discharge the beneficiary's parent's support obligation, actual (not mere potential) use for that purpose may ruin the trust's qualification. Reg. 1.1361-1(j)(2)(ii)(B), "Legal obligation to support," provides:

> If under local law a distribution to the income beneficiary is in satisfaction of the grantor's legal obligation of support to that income beneficiary, the trust will not qualify as a QSST as of the date of distribution because, under section 677(b), if income is distributed, the grantor will be treated as the owner of the ordinary income portion of the trust or, if trust corpus is distributed, the grantor will be treated as a beneficiary under section 662. See § 1.677(b)-1 for rules on the treatment of trusts for support and § 1.662(a)-4 for rules concerning amounts used in discharge of a legal obligation.

Reg. § 1.1361-1(j)(2)(ii)(C) provides an example illustrating Reg. 1.1361-1(j)(2)(ii)(B):

> *Example*. F creates a trust for the benefit of F's minor child, G. Under the terms of the trust, all income is payable to G until the trust terminates on the earlier of G's attaining age 35 or G's death. Upon the termination of the trust, all corpus must be distributed to G or G's estate. The trust includes all of the provisions prescribed by section 1361(d)(3)(A) and paragraph (j)(1)(ii) of this section, but does not preclude the trustee from making income distributions to G that will be in satisfaction of F's legal obligation to support G. Under the applicable local law, distributions of trust income to G will satisfy F's legal obligation to support G. If the trustee distributes income to G in satisfaction of F's legal obligation to support G, the trust will not qualify as a QSST because F will be treated as the owner of the ordinary income portion of the trust. Further, the trust will not be a qualified subpart E trust because the trust will be subject to tax on the income allocable to corpus.

However, if the distribution is caught within the first 2½ months of the year, consider converting the trust to an ESBT. See parts III.A.3.c.iii Deadlines for QSST and ESBT Elections and III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

[5787] Code § 1361(d)(3). Letter Ruling 9014008 ruled that a distribution to a grantor trust created by the beneficiary would not qualify, but Letter Rulings 9442036, 9444022, 9444024, and 9444059 permitted distributions to a disability trust because the beneficiary did not have legal capacity, and Letter Rulings 8831020, 9001010, and 9140055 approved distributions to custodial accounts under the Uniform Transfers to Minors Act (the latter also approved distributions to "a court-appointed guardian or conservator of the beneficiary"). This requirement does not preclude secured sales in which all income is used to buy the stock (part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls)), nor does it prevent the trust from agreeing to make payments to a third party if stock the trust bought is resold within a certain number of years after the trust's purchase (Letter Ruling 200140040).

[5788] In Letter Ruling 200404037, the IRS accepted the representation that applicable state law deemed a life estate, with the power to sell, to be a trust relationship between the life tenant and the remaindermen and that the deemed trust satisfies the requirements for treatment as a QSST. Letter Ruling 200247030 elaborated on the basis for this deemed trust treatment:

> It is represented that under State law, a life tenant, with the power to sell or dispose of property devised to him or her for life with remainder to designated persons, is a trustee or quasi trustee and occupies a fiduciary relationship to the remaindermen. In the exercise of that power, the life tenant owes to the remaindermen the highest duty to act honorably and in good faith. A life tenant is a trustee in the sense that he cannot injure or dispose of property to the injury of the rights of the remaindermen, but differs from a pure trustee in that he may use property for his exclusive benefit and take all income and profits.

[5789] Rev. Rul. 92-20 held that a provision in a trust agreement authorizing the trustee to accumulate trust income if the trust does not hold any shares of an S corporation does not, by itself, preclude the trust's qualification as a QSST.

[5790] Code § 1361(d)(3)(B); Reg. § 1.1361-1(j)(1)(i), the latter which expressly recognizes that income distributed in the first 65 days of the year may be treated under Code § 663(b) as being distributed in the immediately preceding year. Letter Rulings 8508048, 8836057, and 199927011 approved trusts in which the income must be distributed currently, but the beneficiary may elect in any year to have the trustee retain all or any portion of the income of the trust (it is not clear whether the trusts expressly permitted their beneficiaries to elect that retention or whether that was simply a practice that was contemplated); for related issues not discussed in the rulings, see part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts, especially part III.B.2.i.ix Creditor and Gift/Estate Tax Issues Regarding Withdrawal Rights, Whether Currently Exercisable or Lapsed.

relief may be available if the income is not distributed and catch-up distributions are made.[5791] Special rules apply to an inter vivos QTIP or another trust for a spouse.[5792] If a QSST ceases to meet any of the requirements of Reg. § 1.1361-1(j)(1)(ii), the QSST rules will cease to apply as of the first day on which that requirement ceases to be met.[5793] If such a trust ceases to meet the income distribution requirement of Reg. § 1.1361-1(j)(1)(i), but continues to meet all of the requirements Reg. § 1.1361-1(j)(1)(ii), the QSST rules will cease to apply as of the first day of the first taxable year beginning after the first taxable year for which the trust ceased to meet that income distribution requirement. See parts III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation[5794] and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.

[5791] Letter Ruling 201710001.

[5792] Reg. § 1.1361-1(j)(4) approves testamentary QTIP trusts but, for inter vivos ones, prohibits a QSST election during marriage and requires one to ensure that the grantor is treated as wholly owning the trust:

> However, if property is transferred to a QTIP trust under section 2523(f), the income beneficiary may not make a QSST election even if the trust meets the requirements set forth in paragraph (j)(1)(ii) of this section because the grantor would be treated as the owner of the income portion of the trust under section 677. In addition, if property is transferred to a QTIP trust under section 2523(f), the trust does not qualify as a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section (a qualified subpart E trust), unless under the terms of the QTIP trust, the grantor is treated as the owner of the entire trust under sections 671 to 677.

Reg. § 1.1361-1(k)(1), Example (10), provides:

> (i) *Transfers to QTIP trust*. On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A's spouse B, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, B is the sole income beneficiary for life. In addition, corpus may be distributed to B, at the trustee's discretion, during B's lifetime. However, under section 677(a), A is treated as the owner of the trust. Accordingly, the trust is a permitted shareholder of the S corporation under section 1361(c)(2)(A)(i), and A is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.
>
> (ii) *Transfers to QTIP trust where husband and wife divorce*. Assume the same facts as in paragraph (i) of this Example 10, except that A and B divorce on May 2, 1997. Under section 682, A ceases to be treated as the owner of the trust under section 677(a) because A and B are no longer husband and wife. Under section 682, after the divorce, B is the income beneficiary of the trust and corpus of the trust may only be distributed to B. Accordingly, assuming the trust otherwise meets the requirements of section 1361(d)(3), B must make the QSST election within 2 months and 15 days after the date of the divorce.
>
> (iii) *Transfers to QTIP trust where no corpus distribution is permitted*. Assume the same facts as in paragraph (i) of this Example 10, except that the terms of the trust do not permit corpus to be distributed to B and require its retention by the trust for distribution to A and B's surviving children after the death of B. Under section 677, A is treated as the owner of the ordinary income portion of the trust, but the trust will be subject to tax on gross income allocable to corpus. Accordingly, the trust does not qualify as an eligible shareholder of the S corporation because it is neither a qualified subpart E trust nor a QSST.

Paragraph (iii) illustrates two points. First, to qualify as a wholly owned grantor trust (see part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust), the trust must have not only its income but also its principal deemed owned wholly by the same individual (see part III.A.3.a.ii How a Trust Can Fall Short of Being Wholly Owned by One Person, especially fn. 5696); therefore, when drafting a trust for a spouse that holds stock in an S corporation for which an ESBT election is not in effect, one should consider including a grantor trust power beyond merely Code § 677, to make sure that the entire trust is taxed to the grantor (see part III.B.2.h How to Make a Trust a Grantor Trust). Second, no part of a QSST may be deemed owned by a person other than the beneficiary; see fn. 5785.

Paragraph (ii) offers insight into the application of Code § 677(a) after divorce. See part III.B.2.h.ix Code § 682 Limitations on Grantor Trust Treatment, the result of which is that, if distributions are made after separation, the trust no longer qualifies as a wholly owned grantor trust and a QSST election is unavailable; therefore, an ESBT election must be made (but note that Code § 682 is being repealed by 2017 tax reform). For the interaction of divorce with Chapter 14, see parts III.B.7.b.iv Divorce Planning to Avoid Code § 2701 and III.B.7.d Code § 2702 Overview, especially the text accompanying fns. 7160-7165.

[5793] Reg. § 1.1361-1(j)(5).

[5794] Especially fn 6649 in part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest.

Reg. § 1.1361-1(k)(1), Example (4) illustrates the income distribution rule (before the number of shareholder limitation was increased from 75 to 100):

(i) *QSST when terms do not require current distribution of income*. Corporation Q, a calendar year corporation, makes an election to be an S corporation effective for calendar year 1996. On July 1, 1996, G, a shareholder of Corporation Q, transfers G's shares of Corporation Q stock to a trust with H as its current income beneficiary. The terms of the trust otherwise satisfy the QSST requirements, but authorize the trustee in its discretion to accumulate or distribute the trust income. However, the trust, which uses the calendar year as its taxable year, initially satisfies the income distribution requirement because the trustee is currently distributing all of the income. On August 1, 1996, H makes a QSST election with respect to Corporation Q that is effective as of July 1, 1996. Accordingly, as of July 1, 1996, the trust is a QSST and H is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *QSST when trust income is not distributed currently*. Assume the same facts as in paragraph (i) of this Example 4, except that, for the taxable year ending on December 31, 1997, the trustee accumulates some trust income. The trust ceases to be a QSST on January 1, 1998, because the trust failed to distribute all of its income for the taxable year ending December 31, 1997. Thus, Corporation Q ceases to be an S corporation as of January 1, 1998, because the trust is not a permitted shareholder.

(iii) *QSST when a person other than the current income beneficiary may receive trust corpus*. Assume the same facts as in paragraph (i) of this Example 4, except that the events occur in 2003 and H dies on November 1, 2003, and the trust does not qualify as an ESBT. Under the terms of the trust, after H's death, L is the income beneficiary of the trust and the trustee is authorized to distribute trust corpus to L as well as to J. The trust ceases to be a QSST as of November 1, 2003, because corpus distributions may be made to someone other than L, the current (successive) income beneficiary. Under section 1361(c)(2)(B)(ii), H's estate (and not the trust) is considered to be the shareholder for purposes of section 1361(b)(1) for the 2-year period beginning on November 1, 2003. However, because the trust continues in existence after H's death and will receive any distributions from the corporation, the trust (and not H's estate) is treated as the shareholder for purposes of sections 1366, 1367, and 1368, during that 2-year period. After the 2-year period, the S election terminates and the trust continues as a shareholder of a C corporation. If the termination is inadvertent, Corporation Q may request relief under section 1362(f). However, the S election would not terminate if the trustee distributed all Corporation Q shares to L, J, or both on or before October 31, 2005, (the last day of the 2-year period) assuming that neither L nor J becomes the 76th shareholder of Corporation Q as a result of the distribution.

Suppose a QSST owns the S corporation stock through a single-member LLC that is disregarded for income tax purposes. Only distributions from the LLC to the trust – rather than distributions from the S corporation – must be distributed to satisfy the QSST rules. I would tend to stay away from the idea of reducing what must be distributed to the beneficiary:

- I am concerned about gift tax issues for failure to require the trustee to pull out the LLC's assets.[5795] Is the trustee making sure the statute of limitations runs annually so that the income beneficiary's

[5795] See discussion of Rev. Rul. 84-105 in part III.B.1.b Transfers for Insufficient Consideration, Including Restructuring Businesses or Trusts.

claim at death is not huge,[5796] and is the annually retained income less than 5% of the distributions?[5797] Does the lapse generate Code § 678 issues regarding the LLC's non-S corporation income[5798] or Code § 2036 issues regarding the excess lapse?[5799]

- I am also concerned about – upon termination - the trustee distributing the LLC to more than one beneficiary without getting income tax advice from someone who knows what they are doing.[5800]

Reg. § 1.1361-1(k)(1), Example (7) illustrates the effect of a remote possibility[5801] that principal may be distributed to someone other than the current income beneficiary and curing that defect:

> QSST when settlor of trust retains a reversion in the trust. On January 10, 1996, M transfers to a trust shares of stock in corporation X, an S corporation. D, who is 13 years old and not a lineal descendant of M, is the sole income beneficiary of the trust. On termination of the trust, the principal (including the X shares) is to revert to M. The trust instrument provides that the trust will terminate upon the earlier of D's death or D's 21st birthday. The terms of the trust satisfy all of the requirements to be a QSST except those of section 1361(d)(3)(A)(ii) (that corpus may be distributed during the current income beneficiary's life only to that beneficiary) and (iv) (that, upon termination of the trust during the life of the current income beneficiary, the corpus, must be distributed to that beneficiary). On February 10, 1996, M makes a gift of M's reversionary interest to D. Until M assigns M's reversion in the trust to D, M is deemed to own the entire trust under section 673(a) and the trust is a qualified subpart E trust. For purposes of section 1361(b)(1), 1366, 1367, and 1368, M is the shareholder of X. The trust ceases to be a qualified subpart E trust on February 10, 1996. Assuming that, by virtue of the assignment to D of M's reversionary interest, D (upon his 21st birthday) or D's estate (in the case of D's death before reaching age 21) is entitled under local law to receive the trust principal, the trust will be deemed as of February 10, 1996, to have satisfied the conditions of section 1361(d)(3)(A)(ii) and (iv) even though the terms of the trust do not explicitly so provide. D must make a QSST election by no later than April 25, 1996 (the end of the 16-day-and-2-month period that begins on February 10, 1996, the date on which the X stock is deemed transferred to the trust by M). See example (5) of § 1.1001-2(c) of the regulations.

Some annual expenses are ordinarily allocated one-half to income and one-half to principal. Generally, these include (1) the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee, and (2) expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests.[5802] If S corporation distributions are the trust's only source of cash, this rule is impractical, because the trust would be unable to pay the portion of the expense

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[5796] See part II.J.4.j.i Need to Provide Notices.
[5797] See text following fn 2532 in part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary, discussing Rev. Rul. 66-87 and *Fish v. U.S.*
[5798] See part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.
[5799] Part III.C Code § 2036.
[5800] See text accompanying fns 151-162 in part II.A.2.f Shareholders Eligible to Hold S Corporation Stock.
[5801] Using the latest mortality tables that had issued, on July 5, 2019 a 13-year-old had a 99.5% chance of reaching age 21. I don't know why Code § 673(a) was chosen, because the facts below do not appear to satisfy Code § 673(a), which provides that, subject to subsection (b) when the beneficiary is a minor descendant, "The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion."
See fn 5806, which reproduces the holding of Rev. Rul. 93-31 regarding a remote possibility that the corpus of the trust will be distributed during the lifetime of the current income beneficiary to someone other than that beneficiary
[5802] Section 501 of the Uniform Principal and Income Act, which can be found at http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008).

allocated to principal. Accordingly, I often suggest that the trustee make an adjustment, allocating the entire expense to income, which might be authorized under either state law[5803] or the governing instrument.[5804] If the business or the stock is sold later, the proceeds are taxable to the trust, rather than the beneficiary; at that time, some of the proceeds might be allocated to income to make up for these prior allocations of administrative expenses, which would help move taxable items from the trust's high rates to the beneficiary's potentially lower rates.[5805]

A trust that has substantially separate and independent shares, each of which is for the sole benefit of one beneficiary, may qualify as a QSST with respect to each separate share.[5806] For example, a grantor sets up an irrevocable trust for the benefit of his four children, who are the only children he will ever have. Each child receives one-fourth of the income and corpus distributions. Each child would be considered the owner of one-fourth of the stock owned by the trust.[5807] This could also work well for a vested trust for a grandchild, which qualifies for the GST annual exclusion;[5808] see part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust for an example of a vested trust.

To avoid the requirement that all of the trust income – not just its S corporation income – be distributed to the beneficiary, it is not uncommon for a trust agreement to divide the trust so that the QSST is a separate trust. For inter vivos QSSTs, this approach might have additional state income tax benefits; see part II.J.15.b QSSTs and State Income Tax Issues. On a separate but related note, suppose a QSST holds investments (such as partnerships) that generate taxable income without necessarily generating trust accounting income. Can the nongrantor trust portion of the QSST take an income distribution deduction

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[5803] See part II.J.8.c.i.(a) Power to Adjust.

[5804] See parts II.J.8.c.i.(d) Exceptions in the Governing Instrument and II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law, especially fns. 2670-2675 (language that might be included in one's forms authorizing such an adjustment, as well as the consequences of using such language).

[5805] See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets. See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the . For form language that might facilitate this allocation, see fn. 2670, found in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

[5806] Code § 1361(d)(3); see Letter Ruling 201119005, discussed in fn 5820 in part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies. Although the statute cites to the separate share rules under Code § 663(c) (see part II.J.9.a.ii Separate Share Rule), the test is more stringent than that. Code § 663(c) provides for that distributions to other beneficiaries be ignored in determining separate share treatment if the possibility of distribution is remote. Rev. Rul. 93-31 holds:

> A substantially separate and independent share of a trust, within the meaning of section 663(c) of the Code, is not a QSST if there is a remote possibility that the corpus of the trust will be distributed during the lifetime of the current income beneficiary to someone other than that beneficiary.

For example, if an inter vivos QSST includes a clause requiring the payment of estate tax if the grantor dies during the beneficiary's life, and that payment clause might benefit the grantor's estate beyond whatever applicable law would provide but for that clause, the IRS' view is that mere possibility of such a diversion might disqualify the QSST from inception. Letter Ruling 201451001 (which I obtained to obtain inadvertent termination relief at the insistence of the CPAs for the company that was acquiring my client). However, paying transfer tax on the beneficiary's death should not cause any QSST problem. Letter Ruling 9014008 (GST tax).

See the text accompanying fn 5801 for an example in the regulations about what happens when the remote possibility is cured.

[5807] However, it would not work if trust provided that the birth of another child after the trust is created would cause the trust to be divided five ways, essentially diverting one-fourth of each existing trust. Rev. Rul. 89-45.

[5808] Code § 2642(c)(2) provides that the GST annual exclusion applies to a trust that uses *Crummey* withdrawal rights only if the grandchild (or other skip person) is the sole beneficiary of the trust, and the trust's assets must be includible in the beneficiary's gross estate upon her death. Code § 2654(b) provides that substantially separate and independent shares of different beneficiaries shall be treated as separate trusts under the GST rules. Suppose a grantor sets up an irrevocable trust for the benefit of his four grandchildren. Each grandchild receives one-fourth of the income and corpus distributions; the trust distributes all of its income each year; and each of the four living grandchild would be considered the owner of one-fourth of the stock owned by the trust. If a grandchild who dies before or after trust termination holds a general power of appointment over one-fourth of the trust's assets, the trust will qualify for the GST annual exclusion and as a QSST.

with respect to the distributions to the beneficiary of trust accounting income derived from S corporation? The QSST regulations[5809] do not address it, but the grantor trust regulations provide some support for my preliminary view that the nongrantor trust portion cannot get credit for those distributions.[5810]

The beneficiary of a QSST is taxed on all of the QSST's K-1 income and losses from the S corporation[5811] (although the trust still needs to get its own tax ID and use a grantor information statement to report K-1 items to the beneficiary).[5812] However, when the QSST sells the stock, the trust itself is taxable on any gain on the sale,[5813] including any gain the corporation incurs after adopting a plan of complete liquidation[5814] or from the deemed asset sale resulting from a Code § 338(h)(10) election.[5815] If the corporation actually sells its assets without adopting a plan of liquidation, I am unsure of the result. For additional planning issues, see parts II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI), and II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). From the above, one can glean that depreciation recapture on the actual or deemed sale of personal property is ordinary income that is principal but might be best taxed to the beneficiary, who might either be in a lower tax bracket or might have losses from operations during the year of sale passing through the grantor trust portion to offset; thus, consider including in one's trust the flexibility to distribute principal or to reallocate principal to income.[5816]

The beneficiary must make a separate QSST election with respect to each corporation whose stock the trust holds.[5817]

[5809] Reg. § 1.1361-1(j).

[5810] Reg. § 1.671-3(a)(2) provides:

> If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code.

"Items" refers to "items of income, deduction, and credit against tax attributable to or included in that portion," so I can't say with absolute certainty what the answer is. However, I think that the "better" answer is that distributions from the trust of S corporation trust accounting income would be attributable to the grantor trust portion. This is consistent with the IRS' general approach in CCA 201327009, discussed in the text accompanying fns 5937-5939 in part III.A.3.e.vi.(a) Grantor Trust Issues Involved in a Sale of S Stock to a QSST.

[5811] Code § 1361(d)(1)(B). Reg. § 1.1361-1(j)(7)(i) provides:

> The income beneficiary who makes the QSST election and is treated (for purposes of section 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

Reg. § 1.1361-1(j)(8) further provides:

> If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made.

[5812] Reg. § 1.671-4(b)(6)(iii).

[5813] Reg. § 1.1361-1(j)(8). However, for purposes of recognizing any losses suspended due to the at-risk rules of Code § 465 or the passive activity rules of Code § 469, the regulation treats the beneficiary as having sold the stock so that the suspended losses can be triggered. For more details on such sales, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

[5814] Letter Rulings 9721020 and 199905011. This includes gain from the actual sale of assets as well as gain on the Code § 336 deemed sale of assets distributed to shareholders. Of course, Code § 331 gain on the deemed sale of stock on dissolution is also taxed to the trust.

[5815] Letter Rulings 9828006, 199920007, and 201232003.

[5816] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, which includes parts discussing allocating to income what otherwise would be principal receipts.

[5817] Reg. § 1.1361-1(j)(6)(i). Inadvertent termination relief is available when the trust acquires stock in another S corporation if a timely QSST election is not made with respect to that other S corporation. Letter Ruling 201618003.

See part II.A.2.d Estate Planning Strategies Available Only for S Corporation Shareholders for a brief introduction to a QSST's unique benefits. To explore a QSST's unique attributes as a grantor trust deemed owned by its beneficiary, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

Also note that a QSST election might enhance (or perhaps reduce) the trust's ability to deduct charitable contributions made by the S corporation.[5818]

III.A.3.e.i.(b). QSST Issues When Beneficiary Dies

QSSTs have excellent post-mortem planning flexibility:

- A QSST may hold stock for two years after the beneficiary's death without making any election at all.[5819]

- If a QSST continues as separate QSST-eligible shares for each beneficiary after termination but before the new QSST trusts are actually funded, no new election is required until actual funding of the new trusts; in other words, the QSST election stays in effect, with the individual remaindermen taxed as the QSST beneficiaries until actual post-mortem trust funding occurs.[5820]

The latter is a very important tool. Consider what happens after the beneficiary dies and before the stock is retitled in the remaindermen's names. If the S corporation does not distribute all of its taxable income, the trust might not be able to obtain an income distribution deduction to carry out all of the income to the remaindermen, thereby trapping the income[5821] at the trust's presumably higher income tax rates.[5822] Keeping the QSST election intact post-mortem before stock retitling to make sure that individual beneficiaries are taxed directly on the S corporation's K-1 income might save income tax during that period.

However, challenges arise when the remaindermen are not the residual beneficiaries of the beneficiary's estate plan. The S corporation might make distributions to pay the shareholders' income taxes after the beneficiary dies, and then how will the beneficiary's estate pay tax on the beneficiary's allocable share[5823]

[5818] See part II.Q.7.c S Corporation Owned by a Trust Benefitting Charity, especially the text accompanying fn. 4716.

[5819] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, especially part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.

[5820] See Reg. § 1.1361-1(j)(9)(ii), contrasting Example (1) with Example (2). Code § 1361(d)(2)(B)(ii) provides:

> Elections with respect to successive income beneficiaries. If there is an election under this paragraph with respect to any beneficiary, an election under this paragraph shall be treated as made by each successive beneficiary unless such beneficiary affirmatively refuses to consent to such election.

Letter Ruling 201119005 held that, when the QSST beneficiary died, separate shares were created that qualified as QSSTs, without any QSST election needing to be affirmatively made with respect to the remaindermen, in the following scenario:

> Upon B's death, Trust's assets were divided into two shares. The income from one share is required to be paid to C and the income from the other share is required to be paid to D. During the life of each of C and D (the income beneficiaries), the income and principal from one beneficiary's share can only be paid to that income beneficiary. Neither income beneficiary has a claim against the income and principal of the other beneficiary's share. Since Date 4, the income from each share of Trust has been distributed to the income beneficiary of that share. Neither beneficiary has affirmatively refused to consent to the QSST election made for Trust on Date 3.

For separate share treatment for QSSTs, see fn 5806 in part III.A.3.e.i.(a) QSSTs Generally.

[5821] See parts III.A.4 Trust Accounting Income Regarding Business Interests and III.F.2 Trust Accounting and Taxation.

[5822] Note, however, that trapping income inside trusts might be beneficial. See parts II.J.3 Strategic Fiduciary Income Tax Planning and III.A.3.e.ii.(c) When ESBT Income Taxation Might Help, the latter not directly on point but having some helpful ideas.

[5823] See part III.B.2.j Tax Allocations upon Change of Interest, especially part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

of the S corporation's income? What happens when a QSST's beneficiary dies, the beneficiary's estate is taxed on pre-mortem income, and the remaindermen are different than the beneficiaries of the beneficiary's estate? This might occur, for example, in a second marriage situation. Although the Uniform Principal and Income Act discusses issues along these lines to a certain extent,[5824] drafting to address this issue would be advisable:

- If the beneficiary does not control disposition of the trust's assets, the beneficiary might consider negotiating income tax reimbursement provisions with the trustee as a condition of making the QSST election.

- If the beneficiary does control disposition, the beneficiary might consider exerting that control to require that the remaindermen reimburse the beneficiary's estate for income tax on the pre-mortem income. On the other hand, if the QSST's remaindermen are the same as under the beneficiary's estate plan generally, the opportunity to create a debt (taxes on the earned but undistributed income) on the beneficiary's estate tax return might prove beneficial. In the latter case, the beneficiary might exercise any power of appointment he or she might have to provide for the QSST election to remain in place after the beneficiary's death during trust administration before the trust is divided.

One might consider a provision along the following lines:

(1) If the individuals to whom the S corporation stock is allocated do not share in the residue of the deceased beneficiary's estate (in this Agreement, Article 5 determines the sharing of the residue of my estate, because my will bequeaths my estate to the Revocable Trust and Article 5 bequeaths the residuary trust assets), then any distributions the S corporation makes to pay its shareholders' taxes with respect to their distributive shares of taxable income before the date of death shall be treated as income earned before the beneficiary's death and paid to the beneficiary's estate.

(2) If and to the extent that paragraph (1) does not apply, during trust administration, after the beneficiary's death and before separate trusts can be funded, the trust will not terminate but rather will continue as a single trust with separate shares pursuant to U.S. Treas. Reg. section 1.1361-1(j)(9)(ii), Example (1), and the trusts for the beneficiaries will be amended under [the QSST provisions].

Such a provision would not cause any marital deduction problems for the trust that is terminating.[5825] However, if the trust is included in the beneficiary's estate and the beneficiary is bequeathing the stock to a QTIP trust and income otherwise payable to the QTIP trust is diverted, query whether that violates the requirement that QTIP exclusively benefit the surviving spouse.

[5824] Section 201 of the Uniform Principal and Income Act (last amended or revised in 2008; see http://www.uniformlaws.org/shared/docs/principal%20and%20income/upia_final_08_clean.pdf) addresses actions when a trust terminates.

[5825] Rev. Rul. 92-64 generally allows income earned during the surviving spouse's life but paid after the surviving spouse's death to be paid to either the surviving spouse's estate (if allowed under state law) or the successor beneficiary. State corporate law often limits the gap between record date (the date on the shareholder actually owned the stock) and payment date; generally, an LLC taxed as an S corporation would not face this problem. Of course, in a trust situation, with either type of entity the trust would receive the distribution and then direct it according to the beneficiaries' respective interests, if the ownership interest was not transferred between death and date of the distribution from the corporation.

A successive income beneficiary may disaffirm this QSST continuation, retroactively by as much as 2 months and 15 days (but may not disaffirm after that period).[5826]

The amount of income allocated before and after death is also potentially subject to considerable uncertainty, unless an election to close the corporation's books is made, as described in part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation, especially part III.B.2.j.ii.(d) Death of a Shareholder.

If the stock is bequeathed to a person other than the persons receiving the trust's residue, consider the issues in part III.A.3.d Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests, which addresses timing issues relating to distributions to pay taxes on the trust's distributive share of the entity's income.

Letter Ruling 201420005 addressed the following facts:

> The information submitted states that X was incorporated under the laws of State on Date 1, and elected to be an S corporation effective Date 2. Trust 1, Trust 2 and Trust 3, each of which was a qualified subchapter S trust (QSST) under § 1361(d)(1) for which A was the sole income beneficiary, were shareholders of X.
>
> On Date 3, A died. Trust 1, Trust 2 and Trust 3 each continued to qualify as a permissible S corporation shareholder under § 1.1361-1(j)(7)(ii) of the Income Tax Regulations for the 2-year period beginning on the day of the deemed owner's death and ending on Date 4.
>
> On Date 4, Trust 1, Trust 2 and Trust 3 each became an ineligible shareholder of X and X's election to be an S corporation terminated. On Date 5, the trustees of each of Trust 1, Trust 2 and Trust 3 distributed each Trust's stock in X to Trust 4, which X represents is a QSST. X represents that the circumstances resulting in the termination of X's S corporation election were inadvertent and were not motivated by tax avoidance or retroactive tax planning.

Without mentioning any of the rules stated above, Letter Ruling 201420005 concluded:

> Based solely on the information submitted and the representations made, we conclude that X's S corporation election terminated on Date 4, when Trust 1, Trust 2 and Trust 3 became ineligible shareholders. We further conclude that the termination of X's S corporation election was an inadvertent termination within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as an S corporation from Date 4 and thereafter, provided that X's S corporation election was otherwise valid and has not otherwise terminated under § 1362(d).

[5826] Reg. § 1.1361-1(j)(10), "Affirmative refusal to consent," provides:

(i) *Required statement*. A successive income beneficiary of a QSST must make an affirmative refusal to consent by signing and filing with the service center where the corporation files its income tax return a statement that -
  - (A) Contains the name, address, and taxpayer identification number of the successive income beneficiary, the trust, and the corporation for which the election was made;
  - (B) Identifies the refusal as an affirmative refusal to consent under section 1361(d)(2); and
  - (C) Sets forth the date on which the successive income beneficiary became the income beneficiary.

(ii) *Filing date and effectiveness*. The affirmative refusal to consent must be filed within 15 days and 2 months after the date on which the successive income beneficiary becomes the income beneficiary. The affirmative refusal to consent will be effective as of the date on which the successive income beneficiary becomes the current income beneficiary.

The ruling did not address how Trust 1, Trust 2 and Trust 3 were administered after A's death. Did they accumulate income, as trusts do between date of termination and date of funding the downstream trusts? Or, did they distribute all of the income to the sole beneficiary of Trust 4, who presumably under state law should have received any fiduciary accounting income not necessary to wind up Trust 1, Trust 2 or Trust 3? These questions make me want to be very specific in referring to Reg. § 1.1361-1(j)(9)(ii), Example (1), as does the sample clause listed above. If one does not have similar language, consider documenting in writing that this continuation is in fact occurring between date of termination and date of funding the downstream trusts if for some reason it is impractical to fund the downstream trusts before the two-year post-mortem grace period expires. That documentation might also save income taxes; see fns 5821-5822 and the accompanying text.

III.A.3.e.ii. Electing Small Business Trusts (ESBTs)

III.A.3.e.ii.(a). Qualification as an ESBT

After determining eligibility to make an electing small business trust (ESBT) election, see part III.A.3.c.iii Deadlines for QSST and ESBT Elections. Make sure the election correctly refers to the date shares were transferred to the trust that is selected as the effective date.[5827]

To qualify to make an ESBT election,[5828] the trust cannot have as a beneficiary any person other than an individual, an estate, a charity within certain definitions;[5829] if a potential current beneficiary of an ESBT is not an eligible shareholder of an S corporation, the S election terminates.[5830] "Beneficiary" includes a person who has a present, remainder, or reversionary interest in the trust.[5831] A distributee trust is the beneficiary of the ESBT only if the distributee trust is a Code § 170(c)(2) or (3) organization.[5832] In all other situations, any person who has a beneficial interest in a "distributee trust" is a beneficiary of the ESBT, rather than the trust itself being considered to be a beneficiary.[5833] A "distributee trust" is a trust

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[5827] Letter Ruling 201941006 granted inadvertent termination relief as of Date 3 in the following situation:

> On Date 2, Trust 1 acquired shares in A. Trust 1 qualified under § 1362(c)(2)(A)(v) as an eligible S corporation shareholder and timely filed an ESBT election effective Date 2. A represents that on Date 3, under the laws of State Trust 1 merged with and into Trust 2, with Trust 2 surviving. As a result of the merger, the shares of A owned by Trust 1 were transferred to Trust 2 as of Date 3.
>
> On Date 4, the trustee of Trust 2 filed an election under § 1362(c)(2)(A)(v) to be treated as an ESBT effective Date 5. The ESBT election incorrectly stated that the shares of A owned by Trust 1 prior to the merger were transferred to Trust 2 on Date 5, when the shares were actually transferred on Date 3. A represents that Trust 2 intended the ESBT election to be effective as of Date 3. As a result, A's S corporation election terminated on Date 3 because Trust 2 was an ineligible shareholder.

See parts II.J.18.b Trust Mergers and II.J.18.c Decanting, the latter being relevant because a decanting may be a trust merger treated as a mere continuation of the original trust.

[5828] Code § 1361(e)(1)(A)(iii) authorizes the election.

[5829] Code § 1361(e)(1)(A)(i). Permitted charities include an organization described in Code § 170(c)(2), (3), (4), or (5) or, if it has a contingent interest in the trust and is not a potential current beneficiary, a Code § 170(c)(1) organization. As described in part II.A.2.f Shareholders Eligible to Hold S Corporation Stock, 2017 tax reform allowed a nonresident alien (NRA) to be a beneficiary. In exchange, any part of the trust that the NRA is deemed to own is taxed as a nongrantor S portion; see fns 147-148.

[5830] Reg. § 1.1361-1(m)(5)(iii), which provides further:

> For example, the S corporation election will terminate if a charitable remainder trust becomes a potential current beneficiary of an ESBT. Such a potential current beneficiary is treated as an ineligible shareholder beginning on the day such person becomes a potential current beneficiary, and the S corporation election terminates on that date. However, see the special rule of paragraph (m)(4)(iii) of this section. If the S corporation election terminates, relief may be available under section 1362(f).

[5831] Reg. § 1.1361-1(m)(1)(ii)(A).

[5832] Reg. § 1.1361-1(m)(1)(ii)(B).

[5833] Reg. § 1.1361-1(m)(1)(ii)(B).

that receives or may receive a distribution from the ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.[5834]

If an impermissible shareholder might become a potential current beneficiary, one might consider taking steps to exclude that person from being a potential current beneficiary ("PCB") of the ESBT portion.[5835] Generally, a PCB is any person who at any time during the taxable year is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust;[5836] the deemed owner of a grantor trust is also a PCB.[5837] A potential trap applies when an ESBT terminates in favor of trusts (the "downstream trusts"). After the event terminating the ESBT (such as the primary beneficiary's death) and before the trust distributes its assets to the downstream trusts, the downstream trusts might become PCBs, applying the following rules:

(1) Generally, a trust that exists is a distributee trust if it becomes entitled to, or at the discretion of any person, may receive a distribution from principal or income of an ESBT.[5838] A trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit.[5839] A trust that is not yet funded not currently a distributee trust.[5840]

(2) If the distributee trust qualifies a trust described in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, then the persons who would be its PCBs if the

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[5834] Reg. § 1.1361-1(m)(1)(ii)(B).

[5835] Letter Ruling 200913002 held that such a modification did not affect GST grandfathering.

[5836] Code § 1361(e)(2). Reg. § 1.1361-1(m)(4)(i) provides:

> *Generally*. For purposes of determining whether a corporation is a small business corporation within the meaning of section 1361(b)(1), each potential current beneficiary of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of this paragraph (m)(4), a potential current beneficiary generally is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust. A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust. No person is treated as a potential current beneficiary solely because that person holds any future interest in the trust. An NRA potential current beneficiary of an ESBT is treated as a shareholder for purposes of the 100-shareholder limit under section 1361(b)(1)(A). However, an NRA potential current beneficiary of an ESBT is not treated as a shareholder in determining whether a corporation is a small business corporation for purposes of the NRA-shareholder prohibition under section 1361(b)(1)(C).

Reg. § 1.1361-1(m)(4)(iii) further provides:

> *Special rule for dispositions of stock*. Notwithstanding the provisions of paragraph (m)(4)(i) of this section, if a trust disposes of all of the stock which it holds in an S corporation, then, with respect to that corporation, any person who first met the definition of a potential current beneficiary during the 1-year period ending on the date of such disposition is not a potential current beneficiary and thus is not a shareholder of that corporation.

Reg. § 1.1361-1(m)(4)(v) also provides:

> *Contingent distributions*. A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a potential current beneficiary until such time or the occurrence of such event.

For the effect of a power of appointment, see fn 5851.

[5837] Reg. § 1.1361-1(m)(4)(ii) provides:

> *Grantor trusts*. If all or a portion of an ESBT is treated as owned by a person under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code, such owner is a potential current beneficiary in addition to persons described in paragraph (m)(4)(i) of this section.

[5838] Reg. § 1.1361-1(m)(4)(iv)(A).

[5839] Reg. § 1.1361-1(m)(4)(iv)(A).

[5840] Reg. § 1.1361-1(m)(4)(iv)(A). Letter Rulings 200816012 and 200913002 approved as an ESBT a trust prohibiting distributions to a nonresident alien for so long as (1) the trust has an ESBT election in effect, and (2) a non-resident alien is not permitted to be a PCB of an ESBT under the Code and Regs. (I do not know why the rulings cited Reg. § 1.1361-1(m)(4)(iv) instead of Reg. § 1.1361-1(m)(4)(v). I wonder whether that is a typo.) However, starting in 2018, a nonresident alien may be a beneficiary of an ESBT. See part II.A.2.f Shareholders Eligible to Hold S Corporation Stock, especially fns 145-136.

distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT.[5841] However, if the distributee trust is a former grantor trust[5842] or is a testamentary trust,[5843] in either case during the special initial 2-year period, then the relevant estate is treated as the ESBT's PCB during that period.[5844]

(3) If the distributee trust is not a trust described in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates.[5845] However, if the distributee trust would be a valid QSST or ESBT if the relevant election were made and the election is not made because the trust does not hold S stock, then the distributee trust does not count as a PCB,[5846] and the distributee trust's PCBs would count as PCBs of the trust that does hold the

[5841] Reg. § 1.1361-1(m)(4)(iv)(C).
[5842] See part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.
[5843] See part III.A.3.b.iii A Trust with Respect to Stock Transferred to It Pursuant to The Terms of a Will (or a Qualified Revocable Trust When a Code § 645 Election Terminates), But Only for the 2-Year Period Beginning on The Day on Which Such Stock Is Transferred to It.
[5844] Reg. § 1.1361-1(m)(4)(iv)(C).
[5845] Reg. § 1.1361-1(m)(4)(iv)(B).
[5846] Reg. § 1.1361-1(m)(4)(iv)(D) provides:

> For the purposes of paragraph (m)(4)(iv)(C) of this section, a trust will be deemed to be described in section 1361(c)(2)(A) if such trust would qualify for a QSST election under section 1361(d) or an ESBT election under section 1361(e) if it owned S corporation stock.

Letter Ruling 200912005 approved a distributee trust that would have been eligible to make an ESBT election even though its sole remainderman was a charity (it did not, as drafted, qualify as a charitable remainder trust).

Reg. § 1.1361-1(m)(8)(vi), Example 6, provides:

> (A) *Distributee trust that would itself qualify as an ESBT*. Trust-1 holds stock in X, an S corporation, and has a valid ESBT election in effect. Under the terms of Trust-1, the trustee has discretion to make distributions to A, B, and Trust-2, a trust for the benefit of C, D, and E. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. Under paragraph (m)(4)(iv) of this section, Trust-2's potential current beneficiaries are treated as the potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Thus, A, B, C, D, and E are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Trust-2 itself will not be counted as a shareholder of Trust-1 for purposes of section 1361(b)(1).
>
> (B) *Distributee trust that would not qualify as an ESBT or a QSST*. Assume the same facts as Example 6 in paragraph (m)(8)(vi)(A) of this section except that D is a charitable remainder trust. Trust-2 would not be eligible to make an ESBT or QSST election if it owned S corporation stock and therefore Trust-2 is a potential current beneficiary of Trust-1. Since Trust-2 is not an eligible shareholder, X's S corporation election terminates.
>
> (C) *Distributee trust that is a section 1361(c)(2)(A)(ii) trust*. Assume the same facts as in Example 6 in paragraph (m)(8)(vi)(A) of this section except that Trust-2 is a trust treated as owned by A under section 676 because A has the power to revoke Trust-2 at any time prior to A's death. On January 1, 2003, A dies. Because Trust-2 is a trust described in section 1361(c)(2)(A)(ii) during the 2-year period beginning on the day of A's death, under paragraph (m)(4)(iv)(C) of this section, Trust-2's only potential current beneficiary is the person listed in section 1361(c)(2)(B)(ii), A's estate. Thus, B and A's estate are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1).

S stock.[5847] Another option is for the main trust to partially fund the distributee trust and have the distributee trust then qualify as a shareholder.[5848]

Each potential current beneficiary is treated as a shareholder for the purposes of the 100-shareholder limitation.[5849]

Regulations had provided that an open-ended inter vivos power of appointment violates the 100-shareholder limitation; however, Congress modified that provision for years beginning after December 31, 2004 to provide that powers of appointment are considered during a period only to the extent exercised during that period,[5850] and the regulations now reflect this change.[5851] If a distribution can be made to an existing trust, that trust must be qualify under the general rules for trusts as S corporation

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[5847] Reg. § 1.1361-1(m)(4)(iv)(B) provides:

> If the distributee trust is a trust described in section 1361(c)(2)(A), the persons who would be its potential current beneficiaries (as defined in paragraphs (m)(4)(i) and (ii) of this section) if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT. Notwithstanding the preceding sentence, however, if the distributee trust is a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate described in section 1361(c)(2)(B)(ii) or (iii) is treated as the potential current beneficiary of the ESBT for the 2-year period during which such trust would be permitted as a shareholder.

See Reg. § 1.1361-1(m)(8)(vi), Example 6, reproduced in fn. 5846.

[5848] Reg. § 1.1361-1(m)(8)(v), Example 5, provides:

> *Potential current beneficiaries and distributee trust holding S corporation stock*. Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to make distributions to A directly or to any trust created for the benefit of A. On January 1, 2003, M creates Trust-2 for the benefit of A. Also on January 1, 2003, the trustee of Trust-1 distributes some S corporation stock to Trust-2. A, as the current income beneficiary of Trust-2, makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1. Trust-2 itself will not be counted toward the shareholder limit of section 1361(b)(1)(A). Additionally, because A is already counted as an S corporation shareholder because of A's status as a potential current income beneficiary of Trust-1, A is not counted again by reason of A's status as the deemed owner of Trust-2.

[5849] Code § 1361(c)(2)(B)(v).

[5850] Code § 1361(e)(2).

[5851] Reg. § 1.1361-1(m)(4)(vi)(A) provides:

> (A) *Powers of appointment*. A person to whom a distribution may be made during any period pursuant to a power of appointment (as described for transfer tax purposes in section 2041 and § 20.2041-1(b) of this chapter and section 2514 and § 25.2514-1(b) of this chapter) is not a potential current beneficiary unless the power is exercised in favor of that person during the period. It is immaterial for purposes of this paragraph (m)(4)(vi)(A) whether such power of appointment is a ``general power of appointment'' for transfer tax purposes as described in §§ 20.2041-1(c) and 25.2514-1(c) of this chapter. The mere existence of one or more powers of appointment during the lifetime of a power holder that would permit current distributions from the trust to be made to more than the number of persons described in section 1361(b)(1)(A) or to a person described in section 1361(b)(1)(B) or (C) will not cause the S corporation election to terminate unless one or more of such powers are exercised, collectively, in favor of an excessive number of persons or in favor of a person who is ineligible to be an S corporation shareholder. For purposes of this paragraph (m)(4)(vi)(A), a ``power of appointment'' includes a power, regardless of by whom held, to add a beneficiary or class of beneficiaries to the class of potential current beneficiaries, but generally does not include a power held by a fiduciary who is not also a beneficiary of the trust to spray or sprinkle trust distributions among beneficiaries. Nothing in this paragraph (m)(4)(vi)(A) alters the definition of "power of appointment" for purposes of any provision of the Internal Revenue Code or the regulations.
>
> (B) *Powers to distribute to certain organizations not pursuant to powers of appointment*. If a trustee or other fiduciary has a power (that does not constitute a power of appointment for transfer tax purposes as described in §§ 20.2041-1(b) and 25.2514-1(b) of this chapter) to make distributions from the trust to one or more members of a class of organizations described in section 1361(c)(6), such organizations will be counted collectively as only one potential current beneficiary for purposes of this paragraph (m), except that each organization receiving a distribution also will be counted as a potential current beneficiary. This paragraph (m)(4)(vi)(B) shall not apply to a power to currently distribute to one or more particular charitable organizations described in section 1361(c)(6). Each of such organizations is a potential current beneficiary of the trust.

shareholders;[5852] similar to the power of appointment rule, that rule does not apply until the distributee trust has been created.[5853]

An ESBT cannot have a beneficiary whose interest was acquired by purchase.[5854] This prohibition does not have anything to do with whether the trust has purchased or might later purchase S stock.[5855]

5852 Reg. § 1.1361-1(m)(4)(iv)(B).

5853 Reg. § 1.1361-1(m)(4)(iv)(A), which further provides:

> For this purpose, a trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit. Thus, if a trust instrument provides for a trust to be funded at some future time, the future trust is not currently a distributee trust.

5854 Code § 1361(e)(1)(A)(ii). For whether a change in a beneficiary's interest in a trust might cause an interest in the trust to be obtained by purchase in violation of this rule, see Potter, Trust Decanting of S corporation Shareholders: Avoiding Inadvertent Termination of the Company's S Election, *TM Memorandum* (BNA) (12/29/2014) or *TM Estates, Gifts and Trusts Journal* (BNA) (3/12/2015).

Letter Ruling 201834007 ruled:

> A is causing A's grantor trust to transfer the shares of X stock to the Trust pursuant to the divorce Decree, and the amount of the liabilities assumed plus the liabilities that the property transferred is subject to does not exceed the adjusted basis of the property transferred.
>
> Accordingly, based on the facts submitted and representations made, provided that the transfer of the shares of X stock to the Trust occurs within six years of the entry of final judgment and the terms of the Trust as executed by A and B remain materially identical to those submitted, we conclude that § 1041(a) applies and A and B will not recognize any gain or loss on the transfer of the shares of X stock from A's grantor trust to the Trust.
>
> Further, § 1041(b) applies such that the transfer is treated as a gift under § 1041(b). As such, B's acquisition of B's lifetime distribution rights in the Trust for consideration is not a purchase within § 1361(e) because the sale is not governed by § 1012(a). Accordingly, B's acquisition of B's distribution rights will not disqualify Trust from being an ESBT.

Letter Rulings 201436006 and 201436007 ruled that the following transactions did not constitute a prohibited purchase of an interest in a trust:

> X created Trust 1 on D1. Trust 1 is a grantor trust wholly owned by X. X proposes to create Trust 2 which will be a grantor trust wholly owned by X. X proposes to contribute S corporation stock to Trust 2 and sell the Trust 2 remainder interest to Trust 1. Trust 2 will elect to be an electing small business trust (ESBT) under 1361(e) upon creation.
>
> ….
>
> [W]e conclude that the sale of the Trust 2 remainder interest to Trust 1 will not disqualify Trust 2 from being an ESBT under § 1361(e) during the period when Trust 1 is a grantor trust as to X because the sale of the remainder interest is not a purchase within the meaning of § 1361(e). The sale of the remainder interest is not a purchase within the meaning of 1361(e) because the sale is not governed by § 1012(a). However, to the extent that the sale is treated as a gift, the sale will be covered by § 1015(a). In addition, we conclude that Trust 2 will not cease to be or fail to qualify as an ESBT after the termination of Trust 1's grantor trust status because Trust 1's acquisition of the remainder is not a purchase within the meaning of § 1361(e).

5855 Reg. § 1.1361-1(m)(1)(iii) provides:

> *Interests acquired by purchase*. A trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. Generally, if a person acquires an interest in the trust and thereby becomes a beneficiary of the trust as defined in paragraph (m)(1)(ii)(A), and any portion of the basis in the acquired interest in the trust is determined under section 1012, such interest has been acquired by purchase. This includes a net gift of a beneficial interest in the trust, in which the person acquiring the beneficial interest pays the gift tax. The trust itself may acquire S corporation stock or other property by purchase or in a part-gift, part-sale transaction.

T.D. 8994 (5/13/2002) stated:

> Two commentators requested clarification on whether a trust is eligible to be an ESBT if it acquires property in a part-gift, part-sale transaction, such as a gift of encumbered property or a net gift, in which the donor transfers property to a trust provided the trust pays the resulting gift tax. Section 1361(e)(1)(A)(ii) provides that a trust is eligible to be an ESBT only if "no interest in the trust was acquired by purchase." Section 1361(e)(1)(C) defines purchase as "any acquisition if the basis of the property acquired is determined under section 1012." The proposed regulations provide that if any portion of a beneficiary's basis in the beneficiary's interest is determined under section 1012, the beneficiary's interest was acquired by purchase. The final regulations clarify that the prohibition on purchases applies

If an ESBT transfers stock to a qualified voting trust,[5856] the ESBT continues to be treated as the owner for purposes of reporting income and the current beneficiaries of the ESBT continue to be treated as the shareholders for purposes of determining whether the corporation remains eligible to be taxed as an S corporation.[5857]

If an ESBT is decanted, be sure to file a new ESBT election.[5858]

A trust ceases to be an ESBT on the first day the trust fails to meet the definition of an ESBT, and the last day the trust is treated as an ESBT is the day before the date on which the trust fails to meet the definition of an ESBT.[5859] A trust ceases to be an ESBT on the first day following the day the trust disposes of all S corporation stock; but, if the trust is using the installment method to report income from the sale or disposition of its stock in an S corporation, the trust ceases to be an ESBT on the day following the earlier of the day the last installment payment is received by the trust or the day the trust disposes of the installment obligation.[5860]

III.A.3.e.ii.(b). ESBT Income Taxation - Overview

ESBT income taxation is complicated. An ESBT is treated as two separate trusts for purposes of chapter 1 of subtitle A of the Code.[5861] The portion that consists of stock in one or more S corporations is treated as one trust, and the portion that consists of all the other assets in the trust is treated as a separate trust.[5862] The grantor trust rules trump this treatment;[5863] but, to the extent a nonresident alien is a deemed owner, that portion is reallocated to the nongrantor S portion.[5864] However, the ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return.[5865]

The income from the Schedule K-1 that the S corporation files for the trust is separately taxed to the trust at the highest individual income tax rate for that type of income.[5866] Very few deductions are allowed against this income, and the income distribution deduction is not available;[5867] the IRS has taken the

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> to purchases of a beneficiary's interest in the trust, not to purchases of property by the trust. A net gift of a beneficial interest in a trust, where the donee pays the gift tax, would be treated as a purchase of a beneficial interest under these rules, while a net gift to the trust itself, where the trustee of the trust pays the gift tax, would not.

The Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96), December 18, 1996 (Blue Book), stated:

> No interest in the trust may be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis (determined under sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc. The trust itself may acquire property (including stock of an S corporation) by purchase.

[5856] See part III.A.3.b.iv A Trust Created Primarily to Exercise the Voting Power of Stock Transferred to It.
[5857] Letter Ruling 201837012.
[5858] Letter Ruling 201442047, essential parts of which are reproduced in the text accompanying fn 2868 in part II.J.18.c.ii Tax Consequences of Decanting, viewed decanting as requiring a new ESNT election. The ruling seems to indicate that beneficial interests did not change in the trust merger and that the decanting was solely to change trustee provisions.
[5859] Reg. § 1.1361-1(m)(5)(i).
[5860] Reg. § 1.1361-1(m)(5)(ii).
[5861] Code § 641(c); Reg. § 1.641(c)-1(a).
[5862] Reg. § 1.641(c)-1(a).
[5863] Reg. § 1.641(c)-1(a).
[5864] See fns 147-148 in part II.A.2.f Shareholders Eligible to Hold S Corporation Stock.
[5865] Reg. § 1.641(c)-1(a).
[5866] Code § 641(c)(1); Reg. § 1.641(c)-1(e).
[5867] Code § 641(c)(2).

position that net operating losses (NOLs) are not allowable deductions,[5868] but capital loss carryforwards appear to be allowable.[5869]

State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion are taken into account by the S portion.[5870] These items may be allocated in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the trustee's practice with respect to the trust if it is reasonable and consistent.[5871] Note that the $10,000 limit on state income tax deductions[5872] would apply separately to the S portion and the non-S portion,[5873] allowing the trust to deduct up to $20,000 in state income tax.

Complications arise if the ESBT is a grantor trust in whole or in part or if the trust is a charitable lead trust or other trust eligible for a charitable income tax deduction. The charitable deduction applies only the charitable contributions passing through a K-1 from the S corporation to the trust and not to contributions made by the trust.[5874] Effective for tax years beginning after December 31, 2017, an ESBT's contribution deduction does not apply Code § 642(c) but rather uses the Code § 170 limits based on the rules that apply to individuals,[5875] which means that the charitable deduction generally is based on the fair market of

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[5868] The IRS has taken the position that a net operating loss (NOL) carryover arising from pre-ESBT activity is not deductible because an NOL carryover is not one of the specifically enumerated expenses. CCA 200734019 (consider whether the logic in that CCA might also be applied to NOLs generated from post-ESBT activity).

Making a Code § 645 election for a revocable trust to be taxed as an estate avoids this issue for short-term post-mortem planning, since estates can hold S stock during a reasonable administration period, whereas revocable trusts are limited to two years under Code § 1361(c)(2)(A)(ii). Trusts created under a revocable trust are considered trusts created under wills pursuant to Reg. § 1.1361-1(k)(1), Example 3, paragraph (ii) if a Code § 645 election is in place and therefore can hold S stock for up to two years after funding before making an ESBT or QSST election, flexibility that is not present absent a Code § 645 election. See also the text accompanying fn. 5878 for how to avoid the ESBT generating an NOL when it has significant losses from its S corporation stock; this generally requires advance planning.

[5869] Reg. § 1.641(c)-1(d)(3)(i) disallows deductions for losses capital losses that exceed gains by more than $3,000 under Code § 1211(b) but does not refer to capital loss carryforwards under Code § 1212. Nothing directly addresses whether capital losses incurred before making an ESBT election but relating to S corporation items can be deducted against capital gain incurred while an ESBT.

[5870] Reg. § 1.641(c)-1(d)(4)(i), which is specifically authorized by Code § 641(c)(2)(C)(iii).

[5871] Reg. § 1.641(c)-1(h). For an example, see Reg. § 1.641(c)-1(*l*)(1)(iv).

[5872] For the $10,000 limit, see the text accompanying fn 2431 in part II.J.3.d Who Benefits Most from Deductions. Because Reg. § 1.641(c)-1(d)(4)(i).says that these taxes are "taken into account," rather than "deducted," the regulation does not appear to provide an independent basis for a deduction.

[5873] See fns 5861-5862 in this part III.A.3.e.ii.(b).

[5874] The charitable deduction is not allowed against ESBT income if made directly by the trust. See Code § 641(c)(2)(C) and Reg. § 1.641(c)-1(d)(1), disallowing all deductions except those expressly listed (but the deduction should be allowed against the non-S portion of the trust). However, Reg. § 1.641(c)-1(d)(2)(ii) describes charitable deductions passing through a K-1 the ESBT receives from an S corporation:

> *Special rule for charitable contributions*. If a deduction described in paragraph (d)(2)(i) of this section [referring to K-1 items] is attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1) [the unlimited charitable deduction for trusts]. The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion.

Code § 512(e)(1)(B)(i) provides all S corporation K-1 income is per se unrelated business income, so Code § 681 and Reg. § 1.681(a)-2(a) would apply the individual contribution limits, rather than the unlimited Code § 642(c), to such deductions. For more information about Code § 681, mentioned in the last sentence of this regulation, see part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.

[5875] Code § 641(c)(2)(E) provides:

(i) Section 642(c) shall not apply.

property donated, in contrast to the Code § 642(c) deduction being limited to the property's adjusted basis;[5876] furthermore, Code § 170 but not Code § 642(c) deductions may be passed through to beneficiaries as excess deductions on termination.[5877] For other differences between Code §§ 170 and 642(c), see part II.J.4.c Charitable Distributions.

For application of the passive loss rules to ESBTs, see part II.K.2.b.v Electing Small Business Trusts (ESBTs) and the Passive Loss Rules. In light of the IRS' position on NOLs for ESBTs,[5878] consider whether the trustee should be passive, as discussed in part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good (and note that an ESBT avoiding NOLs might be at the cost of incurring the 3.8% tax on net investment income).[5879]

Regarding the Code § 199A deduction, which generally is 20% of qualified business income, see part II.E.1.f Trusts/Estates and the Code § 199A Deduction, especially part II.E.1.f.ii Electing Small Business Trusts (ESBTs).

If the nongrantor trust portion of an ESBT is included in a person's estate, the ESBT election might prevent a basis step-up of depreciable property.[5880]

For a corporate split-up involving ESBTs, see Letter Ruling 202033005, when a family business divided when a trust holding it terminated. It is reproduced in part II.Q.7.f.ii.(f) Continuity of Interest.[5881]

III.A.3.e.ii.(c). When ESBT Income Taxation Might Help

ESBT income taxation can be favorable in the right circumstances. For example:

- The trust's income might be taxed at lower state income rates (or not at all) inside the trust than in the beneficiary's hands, or

- The beneficiary might be in the top income tax bracket, and reporting additional income would cause the beneficiary to lose some itemized deductions, AMT exemption, or personal exemptions.

In either case, the ESBT can make distributions to the beneficiary without passing S corporation income to the beneficiary. To maximize this flexibility, the trustee might consider dividing the ESBT into two

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(ii) For purposes of section 170(b)(1)(G), adjusted gross income shall be computed in the same manner as in the case of an individual, except that the deductions for costs which are paid or incurred in connection with the administration of the trust and which would not have been incurred if the property were not held in such trust shall be treated as allowable in arriving at adjusted gross income.

The Senate report adopting this rule said:

> The Senate amendment provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

[5876] See fn 4700 in part II.Q.7.c.i.(a) Contribution Must Be Made from Gross Income.

[5877] See text accompanying fn 2478 in part II.J.3.i Planning for Excess Losses.

[5878] See fn. 5868.

[5879] See part II.I 3.8% Tax on Excess Net Investment Income (NII), especially parts II.I.8 Application of 3.8% Tax to Business Income and II.J.14 Application of 3.8% NII Tax to ESBTs.

[5880] See part II.J.11.a.ii.(c) Trust vs. Separately Recognized Business Entity Holding Depreciable Property, particularly fns. 2799-2800.

[5881] Beginning with the text accompanying fn 4803.

separate trusts – one that holds S stock and one that holds any distributions that the trustee intends to reinvest, based on the following analysis:

1. Distributions from a trust that generates investment income (other than S corporation K-1 income) will carry out income to the beneficiary.

2. If the investments are held in a separate trust, that trust can accumulate income and trap the investment income.

3. Therefore, when the trustee of the trust that holds S stock receives a distribution, the trustee would retain enough to pay income tax and administrative expenses, distribute to the beneficiary as appropriate, and then transfer the balance of the cash to the trust that generates investment income.

This three-part analysis applies when the S corporation distributes all of its income. It would not apply if the corporation distributes only enough for its shareholders to pay tax and uses the rest to grow the business (or its marketable securities portfolio). For trusts that are somewhere in between, it might or might not be helpful.

III.A.3.e.iii. Comparing QSSTs to ESBTs

A QSST tends to be used when:

- The trust is a marital trust or other trust whose income is required to be distributed currently to one beneficiary with no other current beneficiary. Under the marital trust rules,[5882] all income must be distributed annually, which means that, under normal trust rules, the income that the spouse is required to receive is taxable to her, just like any other mandatory income beneficiary.[5883]

- The beneficiary's income tax rate is lower than the trust's income tax rate. Because trust income above a modest threshold is taxed at the highest possible rates that apply to individuals,[5884] a beneficiary in a lower bracket should save taxes.

A QSST is not the best for trusts intended to accumulate their income, including trusts with multiple current beneficiaries. In most such cases, such trusts should be ESBTs.

ESBTs might avoid the 3.8% NII tax[5885] by appointing a trustee who is active in the business if the beneficiary is not active in the business.[5886] A QSST's income is not subject to the 3.8% NII tax if the beneficiary is active in the business[5887] or has income below the threshold;[5888] however, because the trustee's participation is what counts when the QSST sells the stock, consider making the trustee active well in advance of a potential sale.[5889] Also note that, if the trust directly or indirectly owns real estate that is rented to the S corporation, a QSST election might complicate a trust's qualification for the self-

[5882] Code §§ 2056(b)(1) and 2523(b).
[5883] Code § 651.
[5884] Code § 1(e)(2).
[5885] For the 3.8% tax on net investment income (NII), see II.I 3.8% Tax on Excess Net Investment Income. For calculating the tax on an ESBT, see fn 2816 (which also refers to an example in the proposed regulations) and the accompanying text.
[5886] See parts II.K.2.b.i Participation by a Nongrantor Trust: Authority and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[5887] A QSST is a grantor trust deemed owned by the beneficiary. The 3.8% tax looks to the character of the income in the hands of the deemed owner; see fn. 2241.
[5888] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[5889] See part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

rental exception, which exception would enable the taxable rental income avoid the 3.8% NII tax, so the trustee might consider retaining some stock in an ESBT, rather than moving all of the stock into a QSST.[5890] See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good.

See part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, for a discussion of various issues one should consider when a beneficiary makes a QSST election.

Other than possible complexity regarding taxes on the earned but undistributed income, a QSST generally has more flexibility than an ESBT. A QSST offers options for deferring S corporation trust tax elections.[5891] If the trustee of an irrevocable grantor trust makes an ESBT election as a protective measure,[5892] the trust's ESBT taxation continues after death,[5893] in effect springing into place without any of the savings that other former irrevocable grantor trusts (including QSSTs) have.[5894]

On the other hand, ESBTs might provide more flexibility that QSSTs in avoiding adverse taxation of certain related party sales of depreciable or amortizable property or in replicating an inside basis step-up if the stock receives a basis step-up. For related party sales, see part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).[5895] For inside basis step-up opportunities,[5896] see part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation, explaining how to replicate an inside basis step-up for property to the extent that Code § 1239 is not triggered, as well as state income tax issues that can complicate matters when the taxpayer is not a resident of the state in which the property is located.[5897]

A QSST complicates purchases made out of earnings, as described in part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST. In ESBTs, interest on the promissory note is deductible only for tax years beginning after December 31, 2006.[5898] A better solution is a trust taxable to its beneficiary under

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5890 See part II.I.8.g Structuring Businesses in Response to 3.8% Tax, particularly the text accompanying fns. 2384-2385.

5891 See text accompanying fns. 5819-5820.

5892 A trustee cannot make a conditional ESBT election. Reg. § 1.1361-1(m)(2)(v). If the trustee of a grantor trust makes an unconditional current ESBT election, the election is in effect but does not control the trust's taxation to the extent trumped by the grantor trust rules. Reg. § 1.641(c)-1(c). T.D. 8994 (5/13/2002) includes the government's response to the idea that a protective ESBT election should be available:

> One commentator suggested that grantor trusts should be permitted to make protective ESBT elections in light of the uncertain status of some trusts that may be grantor trusts under section 674. The IRS and the Treasury Department continue to believe that a conditional ESBT election that only becomes effective in the event the trust is not a wholly-owned grantor trust should not be available. A conditional ESBT election should not be allowed because the ESBT election must have a fixed effective date. If, in the absence of a conditional ESBT election, the trust is an ineligible shareholder, relief under section 1362(f) may be available for an S corporation. In addition, a trust that qualifies as an ESBT may make an ESBT election notwithstanding that the trust is a wholly-owned grantor trust.

5893 Reg. § 1.1361-1(m)(8)(iv), Example 4.

5894 part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, especially part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death regarding a grantor trust's continuing eligibility to hold S stock for two years after the deemed owner's death. Normal trust income tax rules, which generally are more favorable than ESBT income tax rules, apply during that time. See text accompanying fns. 5866-5869 for ESBT taxation.

5895 For a comparison of ESBTs and QSSTs, see text accompanying fn. 4842.

5896 Part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations explains such issues.

5897 See part II.H.8.a.ii State Income Tax Disconnect.

5898 Reg. § 1.641(c)-1(d)(4)(ii) provides, (ii) *Special rule for certain interest*. Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion. This was repealed for tax years beginning after December 31, 2006 by Code § 641(c)(2)(C)(iv).

Code § 678.[5899] Also, it might be possible for the income beneficiary to sell S corporation stock to the QSST and not recognize gain or loss on the sale.[5900]

III.A.3.e.iv. Flexible Trust Design When Holding S Corporation Stock

Consider a GST-exempt trust with only one beneficiary, with discretionary distributions of income and principal under an ascertainable standard. An independent person is authorized to direct that, for a period of no less than 36 months, all of the income is required to be distributed, based on the following:

- The minimum period of time between ESBT and QSST conversions is 36 months. This minimum period applies between conversions but does not apply to the first conversion. In other words, once the first ESBT or QSST election is made, a conversion to the alternate form (QSST or ESBT) can be made at any time. However, once one converted from a QSST to an ESBT or vice versa, the 36-month period applies in reversing the conversion.[5901] But for this process, Reg. § 1.1361-1(m)(6) provides:

  > An ESBT election may be revoked only with the consent of the Commissioner. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request under the appropriate revenue procedure.

- Mandatory distributions ensure no missteps in distributing income to maintain QSST status, because mandatory income trusts are not required to prove actual distributions of all of the income. However, a trust that actually distributes all of its income qualifies even without a mandatory distribution clause.[5902]

- Before converting, split the trust if it has assets other than S corporation stock, so that the other assets are not subjected to the QSST distribution scheme.

- The independent person would also be authorized to turn off the mandatory income direction for any trust taxable year that begins after the date the mandatory income direction is turned off. (Otherwise, the IRS might argue that the mandatory income provision is illusory because it could get turned off at any time during the year.)

This would open up the opportunity to toggle between QSST and ESBT taxation, while allowing any ESBT income to accumulate inside an environment protected from estate taxes and creditors. After a trust has been an ESBT for 36 months, it may be divided into a separate trust for each beneficiary, and each new trust can separately either continue as an ESBT or become subject to a QSST election.[5903] Thus, every three years the trustee can consider how much of the trust should be a QSST and how much an ESBT and then ask the independent person to adjust the mandatory income direction as appropriate. This toggling decision would take into account the expected annual S corporation income, the beneficiary's adjusted gross income, and the beneficiary's participation in the business (see below).

In making these elections, consider part III.A.3.c.iii Deadlines for QSST and ESBT Elections.

[5899] See fn 5681.
[5900] See part III.B.2.i.xiv QSST as an Alternative Form of Beneficiary Deemed-Owned trust.
[5901] Reg. §§ 1.1361-1(j)(12)(iii), 1.1361-1(m)(7)(iii).
[5902] See fn. 5790.
[5903] Letter Ruling 201122003.

Note that toggling only affects whether income distributions to that beneficiary may or must be mandatory or discretionary; the beneficiary must remain the trust's sole beneficiary of income[5904] and principal[5905] during the beneficiary's life.[5906] Thus, if the beneficiary has an inter vivos limited power of appointment, the beneficiary can hold the power of appointment during an initial ESBT period,[5907] but once the trust converts to a QSST the beneficiary must permanently renounce the power of appointment.[5908]

S corporation business income is free from the 3.8% tax on net investment income (NII) if the recipient significantly participates in the S corporation's business activity.[5909] For a QSST, one would look to the beneficiary's participation, whereas for an ESBT the IRS would look to the participation of a trustee;[5910] however, for a QSST, the IRS would look to trustee participation when the trust sells S corporation stock or the S corporation sells substantially all of its business assets.[5911] If the beneficiary materially participates in the business, then either QSST or ESBT taxation could avoid the tax, the latter if the beneficiary is appointed as a trustee for purposes of holding the S corporation stock and satisfies the rules for trustee participation.[5912] If the beneficiary does not materially participate in the business, the S corporation income would constitute NII; however, the beneficiary might be in a sufficiently low tax bracket that the 3.8% tax on NII might not apply to the beneficiary at all.

Additionally, if the beneficiary already owns stock in the S corporation, the trust might buy the stock from the beneficiary, perhaps without any capital gain tax on the sale.[5913]

Finally, QSSTs provide more post-mortem tax options than ESBTs, so pre-mortem toggling to QSST status can provide this enhanced flexibility.[5914]

III.A.3.e.v. Converting a Multiple Beneficiary ESBT into One or More QSSTs

III.A.3.e.v.(a). Strategic Issues

Every dollar of ESBT income is taxed at 37% federal income tax and 3.8% tax on net investment income ("NII").[5915] The beneficiaries' federal income tax brackets might be significantly lower,[5916] and the NII tax would not apply except to the extent that their modified adjusted gross income exceeds $200,000 for a single individual or $250,000 for a married person filing jointly.

5904 Code § 1361(d)(3)(A)(i).
5905 Code § 1361(d)(3)(A)(ii).
5906 Rev. Rul. 93-31 provides that even a remote possibility of these conditions not being met would disqualify the trust from being a QSST. See fn 5806 in part III.A.3.e.i.(a) QSSTs Generally.
5907 See text accompanying fns. 5850-5851.
5908 See fm. 5785.
5909 See part II.I.8 Application of 3.8% Tax to Business Income (application of the 3.8% tax on net investment income), especially part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
5910 See parts II.J Fiduciary Income Taxation (application of the 3.8% tax on net investment income) (particularly fn. 2241 and later sections of part II.J dealing with the sale of QSST or ESBT stock) and II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business (determining when a trust materially participates).
5911 See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).
5912 See parts II.K.2.b.i Participation by a Nongrantor Trust: Authority and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
5913 See part III.B.2.i.xiv QSST as an Alternative Form of Beneficiary Deemed-Owned trust.
5914 See text accompanying fn. 5891.
5915 See part II.I 3.8% Tax on Excess Net Investment Income. It's possible that some ESBT income might be below the adjusted gross income threshold. See part II.J.14 Application of 3.8% NII Tax to ESBTs.
5916 Consider the effect of phase-outs based on adjusted gross when evaluating the beneficiaries' income tax rates.

However, any trustee and tax preparation fees might be deductible by the beneficiaries as miscellaneous itemized deductions (and disallowed for AMT purposes) rather than being deducted directly against the S corporation income.[5917]

This might increase the state income tax on the business income. As an ESBT, only the trust's state income tax posture is considered. Depending on the ESBT's state of residence, the ESBT might not be responsible for tax on the trust's income (particularly investment income) that is not sourced to a particular state. If the trust is converted to QSSTs, each beneficiary would need to file an income tax return for each state in which the S corporation does business, reporting his or her share of each state's income, thereby complicating each beneficiary's income tax return preparation. Additionally, each beneficiary who lives in a state with income tax would need to pay state income tax on his or her share of income, ameliorated in whole or in part by a credit for income taxes paid to other states.

The ESBT might have been accumulating income or perhaps distributing income to separate GST-exempt trusts for beneficiaries, the latter so that each beneficiary decides on a case-by-case basis whether to accumulate income in a protected trust. This accumulation might be important for estate tax reasons, as well as perhaps for nontax reasons. Now, however:

- With the $5+ million estate tax exemption, this accumulation strategy has less estate tax benefit, if the beneficiaries do not have estates near the exemption.

- Trusts that accumulate income face the same increase in federal income tax and NII tax as described above if they are ESBTs or have more than $12,000[5918] in taxable income, so the accumulation strategy would have additional income tax costs.

III.A.3.e.v.(b). Implementation

The trustee might consider the following:

- Evaluate the trustee's authority to divide trusts and to convert separate trusts into QSSTs. If the trust has beneficiaries of more than one generation (*e.g.*, children and grandchildren), the trustee needs to consider any fiduciary duties to the lower generations (*e.g.*, grandchildren) in dividing the trust into separate trusts for the upper generation (*e.g.*, children). The trustee might obtain ratification from all adult beneficiaries to protect the trustee. The parent (who is not a beneficiary) of any minor or unborn descendant would sign on behalf of that descendant; this can be problematic if the child who is a beneficiary is divorced or otherwise having marital troubles. A consent by a beneficiary might raise Code § 2702 issues; this is less of a concern if the beneficiary had not been receiving distributions and never expected to receive distributions before that beneficiary's parent's death.

- If centralized management is a concern:

    - Determine whether the trustee is authorized to commingle the QSSTs, treating them as separate shares.[5919] The trustee might maintain a single new bank account for new deposits, which would then either distribute anything it receives or reimburse the existing

[5917] Reg. § 1.67-2T(b)(1).
[5918] $12,750 in 2019 per Rev. Proc. 2018-57, § 3.01, Table 5; presumably higher in future years.
[5919] This is permitted under the last sentence of Code § 1361(d)(3) and Reg. § 1.1361-1(j)(3).

account for administrative expenses the trust incurs. The division of shares would be done simply by recording the shares on a spreadsheet.

    - o See whether the beneficiaries have the right to change the trustees of their separate trusts, which rights they might not have had in the main trust.

- Determine whether paying 100% of annual trustee fees and administrative expenses regarding the QSST portion out of income reasonably and fairly balances the interests of the income and remainder beneficiaries, as the trust might not have another source to pay those fees; the trustee would want to reserve the right to allocate them to principal in the year of sale.[5920] Normally such fees and expenses are allocated one-half to income and one-half to one-half to principal.[5921] Perhaps the corporation would pay the fees, but note that the payment might need to be a separately stated K-1 item, if the character of the fees would change on a beneficiary's income tax return.[5922]

III.A.3.e.v.(c). Timing Tax Deductions in Year of Conversion

Consider which expenses would be better deductions against ESBT or QSST income and pay them in the appropriate time period.

K-1 items need to be pro-rated.[5923]

Presumably, administrative expenses relating to S corporation income would be allocated to the time before and after the conversion and any expenses allocable to the QSST portion would be deductible by the beneficiary.

III.A.3.e.vi. QSST as a Grantor Trust; Sales to QSSTs

Because the beneficiary pays tax on not only the S corporation's distributed income but also its undistributed income, a QSST can be a way to:

- Avoid high trust income tax rates and take advantage of a full run through the beneficiary's graduated tax rates.

- Allow the beneficiary to deduct a loss before the trust's termination, if the stock has sufficient basis.

- Have the beneficiary pay tax on any reinvested earnings used to grow the S corporation, increasing the trust's value and reducing the beneficiary's gross estate.

[5920] Gain on sale of stock, including any gain reported on a K-1 form the S corporation issues reporting gain by reason of a Code § 338(h)(10) election to treat a stock sale as an asset sale, is taxable to the trust, rather than the being taxable as the grantor trust portion. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and III.A.3.e.i QSSTs, particularly the text accompanying fns. 5813-5815, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale. For additional planning issues, see parts II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI). Of course, the trust might obtain a distribution deduction by distributing the sale proceeds; see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI), especially part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus.
[5921] Section 501 of the Uniform Principal & Income Act.
[5922] See text accompanying fn. 5917 and Code § 1366(a)(1)(A).
[5923] See part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

- Prevent the grantor of a trust for a spouse from being taxed on any reinvested taxable income after divorce.[5924] If the beneficiary/former spouse may also receive principal distributions, the beneficiary may elect to treat the trust as a QSST, thereby ensuring that the taxable items of the trust's assets inside an S corporation owned by the trust are taxable to the beneficiary, whether or not actually distributed to the beneficiary.[5925]

- Allow the beneficiary to sell S corporation stock (and, indirectly, other assets) to the trust on what appears to be a tax-free basis.[5926] A sale to an irrevocable grantor trust is a powerful estate planning technique.[5927] Clients sometimes balk at selling assets to a trust where they are not beneficiaries, because they might need the assets for their living expenses. For a client who refuses to part with all of the enjoyment of sufficient assets, consider suggesting that he or she sell assets to a trust in which he or she is a beneficiary and is the deemed owner - a beneficiary deemed-owned trust.[5928]

The grantor trust aspects can be powerful planning techniques but are also subject to some significant disadvantages.[5929]

Beneficiary deemed-owned trusts involve complex tax issues, including the risk that the Internal Revenue Service, which generally has stopped issuing private letter rulings regarding such trusts,[5930] might at some point take a position inconsistent with its many past favorable private letter rulings. The complexity involved often includes a sale being highly leveraged (sometimes using a trust funded with no more than $5,000), which might invite IRS scrutiny.

QSSTs do not face the funding issues that apply to many other beneficiary deemed-owned trusts. They can be funded very substantially and still be entitled to grantor trust treatment.

III.A.3.e.vi.(a). Grantor Trust Issues Involved in a Sale of S Stock to a QSST

If a QSST buys the beneficiary's stock from the beneficiary after making a QSST election for its then-existing S stock (issued by the same corporation), that would be a disregarded transaction for income tax purposes, following the general principle under Rev. Rul. 85-13 that a transaction between a trust and its deemed owner (for income tax purposes) is disregarded (for income tax purposes).[5931]

[5924] Code § 677 treats the grantor as owners of any items that can be distributed to or held for eventual distribution to the grantor or the grantor's spouse. Code § 672(e)(1)(A) treats as the spouse any individual who was the spouse of the grantor at the time of the creation of such power or interest. Thus, divorce does not terminate grantor trust treatment. However, Reg. § 1.682(a)-1(a)(1) provides that the grantor is not taxed as the owner to the extent that income is paid, credited, or required to be distributed and therefore taxed to the former spouse.

[5925] See fn. 5792, noting the contrast between paragraphs (ii) and (iii) within Example (10).

[5926] See part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls).

[5927] See part III.B.2 Irrevocable Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

[5928] See part III.B.2.i Code § 678 Beneficiary Deemed-Owned Trusts.

[5929] See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts.

[5930] Rev. Proc. 2015-3, Section 4.01(39), provides that ordinarily the IRS will not rule on:

> Whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under § 671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of § 2041, if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.

[5931] Code § 1361(d)(1)(B) provides, for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the [QSST] election … is made.

The regulation that treats the beneficiary as the Code § 678(a) provides that the trust's selling or distributing the stock is attributable to the trust, not the beneficiary,[5932] but does not discuss the consequences of the trust buying S corporation stock. This regulation overrode Rev. Rul. 92-84, which applied grantor trust treatment to a QSST's sale of S corporation stock; however, the logic of Rev. Rul. 92-84 might continue to apply (as a matter of good analysis, not as a matter of precedent) to the extent that the regulation is silent. The preamble to the regulation[5933] overrode Rev. Rul. 92-84 for practical reasons: if the trust no longer holds S stock during the deferred consummation of an installment sale, how could QSST treatment apply? That should not be a concern when the trust is buying stock. Although the IRS might have concerns about the asymmetry involved (the trust buying stock from the beneficiary having a different result than the trust selling stock to the beneficiary), those concerns would not appear to be supported by the IRS' official pronouncements.[5934]

If an income beneficiary who sells S corporation stock to an existing QSST that already owns stock in the same S corporation, the above analysis might be more comfortable. Three companion private letter rulings, in approving the merger of one QSST into another, used analysis that supports this concept:[5935]

> Under 1.1361-1(j)(7), the X shares which make up the corpus of Exempt QSST A and Exempt QSST B are treated as directly owned by Y. Any transfer of the X shares, pursuant to a merger under Article 5.6, would effectively be a transfer of the shares from Y to Y.

What is the tax treatment of interest payments on a promissory note a QSST uses to buy stock in an S corporation?[5936] The IRS has taken the position that, when the QSST buys stock from a third party

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[5932] For gain on sale of stock or assets and for related planning opportunities, see text accompanying fns. 5813-5815.

[5933] T.D. 8600.

[5934] This asymmetry already exists under Rev. Rul. 85-13. In that ruling, initially the trust was not a grantor trust. The grantor bought stock from the trust in exchange for an unsecured promissory note. The note's existence is what made the trust a grantor trust deemed owned by its grantor and caused the transaction to be disregarded. On the other hand, if the trust had bought stock from its grantor, its grantor would have recognized gain on the sale, because a promissory note owed by the trust to the grantor would not have triggered grantor trust status. This asymmetry did not prevent that ruling from becoming the IRS' formal position.

Notice 97-24 points out that Rev. Rul. 85-13 avoids assets receiving a basis step-up. In the case of a beneficiary selling to a QSST, if the beneficiary did not pay capital gain tax on the sale to the trust, then the stock the trust acquires, which will be outside of the estate tax system, will not receive a new basis and therefore will be taxed more highly to the trust if sold after beneficiary's death (or after any other event terminating grantor trust status).

Based on a long line of law, Rev. Rul. 85-13 held that the deemed owner was the deemed owner of the trust's property. See fn. 6335.

The bottom line is that the beneficiary would be deemed to own the stock that the beneficiary sells to the trust both before and after the proposed transaction. One cannot have a recognition event when one sells closely-held business stock, which Rev. Rul. 90-7 expressly held is deemed owned by a trust's deemed owner, to oneself. Rev. Rul. 85-13 recognized this longstanding principle when it reasoned:

> A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. See *Dobson v. Commissioner*, 1 B.T.A. 1082 (1925).

The *Dobson* case itself involved closely-held business stock. Rev. Rul. 2007-13, reproduced in fn 4130 in part II.Q.4.b.i Transfer for Value Rule Generally, reaffirmed this concept, and it should be applied to the sale to a QSST as well.

[5935] Letter Rulings 200441013, 200441014, and 200441015.

[5936] In all fairness, the beneficiary should get the deduction, especially in light of the separate share rules under Code § 663. However, an argument can be made that only S corporation K-1 items are treated as part of the Code § 678 share allocated to the beneficiary. Code § 1361(d)(1)(B) provides, "for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made...." On the other hand, Code §§ 1361(d)(1)(B) and 641(c)(1)(A) use very similar language. Therefore, when an issue is not expressly addressed by authority, the ESBT and QSST rules should be read consistently. The principle behind the ESBT regulation quoted in fn 5898 tends to support the beneficiary's deduction of interest under using a promissory note, the note is part of the S corporation portion that is deemed owned by the QSST's beneficiary and therefore is deductible by the beneficiary.[5937] Informal conversations indicated that this position was the result of discussions at the highest levels of IRS policy-makers. Interest expense is deductible on Schedule E, Part II of the beneficiary's individual income tax return.[5938]

This position - that the promissory note is part of the S corporation portion that the beneficiary is deemed to own - gives me confidence that a beneficiary's sale to a QSST would be disregarded under Rev. Rul. 85-13 because the beneficiary would be considered to be selling to himself or herself.[5939]

III.A.3.e.vi.(b). Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts (Whether or Not a Sale Is Made)

Using QSSTs involves challenges that do not apply to other Code § 678 trusts. Consider the disadvantages of an S corporation as an investment vehicle that is shared among family members:

Code § 1361(d)(1)(B) (or a disregard of the interest income and deduction under Code § 678 if the seller is the beneficiary), because the Regulation's allocation of the interest to the S portion remains intact.

Furthermore, often a trust that holds stock in an S corporation is split off as a separate QSST, which never accumulates any income, because all of the income is distributed to the beneficiary. Allocating income to a nonexistent non-S portion would not make sense in those situations. That contrasts with ESBTs, where generally there is no reason for the S stock to be held in a separate trust.

Allocating the interest deduction to the non-S corporation portion of the trust would result in a mismatch, in that the interest the trust pays is allocated to income that the beneficiary, not the trust, is treated as owning for income tax purposes. It would appear to run counter to the spirit of the debt-tracing rules of Reg. § 1.163-8T, which would characterize the interest as related to the S corporation. If the interest is allocated to the non-S corporation portion of the trust, its deductibility should relate to the nature of the income passing through on the K-1 the trust receives from the company. To the extent the K-1 income is income from a trade or business, presumably the interest would be expense from trade or business that would generate a net operating loss carryover if the trust did not have sufficient other income. Reg. § 1.163-8T(a)(4)(i). Notice 89-35 supports this approach:

> In the case of debt proceeds allocated under section 1.163-8T to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and the associated interest expense shall be allocated among all the assets of the entity using any reasonable method. Reasonable methods of allocating debt among the assets of a passthrough entity ordinarily include a pro-rata allocation based on the fair market value, book value, or adjusted basis of the assets, reduced by any debt of the passthrough entity or the owner allocated to such assets.

If the trust generates a net operating loss (NOL) carryforward due to the interest expense, be sure not to make an ESBT election, as Chief Counsel Advice 200734019 takes the position that the NOL carryforward is not deductible against ESBT income.

[5937] CCA 201327009 allows the beneficiary to deduct the interest when the QSST buys from a third party using a promissory note. The IRS declined to rule on the loan's effect under the at-risk rules out of concern that taxpayers would set up a Code § 465(c)(4) device to limit liability. Because the trust had no other assets, debt tracing was not a concern, and all of the interest was allocated to the S corporation activity. The IRS also declined to address the passive loss rules.

[5938] The 2013 instructions to Form 1040, Schedule E, Part II say:

> Interest expense relating to the acquisition of shares in an S corporation may be fully deductible on Schedule E. For details, see Pub. 535.

Publication 535, for use in preparing 2013 returns, says to report interest expenses from S corporation business borrowing on Schedule E (Form 1040), line 28, entering interest expense and the name of the S corporation in column (a) and the amount in column (h). Presumably this would also apply to loans to a QSST to acquire stock in an S corporation.

[5939] This background on CCA 201327009 results from informal discussions with an attorney, who has since left the IRS, when I asked whether the IRS would consider approving a sale to a QSST. The IRS informally indicated that it would decline to issue such a ruling if I sought it, because it was not totally certain of the result and does not wish to encourage sales to Code § 678 trusts. It was suggested that the IRS never would have approved a sale to an irrevocable grantor trust if it had realized that the technique would become so popular.

- Inability to Divide S corporation. An S corporation that does not engage in a trade or business would not be able to be divided income-tax free under Code § 355.[5940] This would trap all family members in a single investment entity, unable to manage investments suitable for each person's goals.

- Tax Cost of Distributing Investments. A distribution of investments would be taxed as a sale.[5941] Thus, distributing marketable securities to family members so that they go their separate ways would subject them to capital gain tax on the deemed sale of the investments. Distributing depreciable property might subject them to tax on ordinary income.[5942]

  However, pre-mortem planning might help. Suppose the trust is a credit shelter trust or a GST-exempt trust and the beneficiary's estate is subject to estate tax. If the QSST sells its investments that have unrealized gain, the income (capital gain) tax liability will be a debt deductible on the beneficiary's estate tax return. Harvesting gain would prevent the distribution of securities from being a taxable event at the shareholder level. However, the distribution of securities in a corporation would generate income tax to the extent that the fair market value of the distribution exceeds the basis (and might generate dividend income if and to the extent the corporation had been a C corporation and the distribution constituted a distribution of earnings and profits); on the other hand, the recognition of gain on the sale of securities would increase the stock's basis.[5943] Just be sure that the pre-mortem gain harvesting is not pursuant to a plan of liquidation[5944] or a sale of stock combined with a Code § 338(h)(10) election;[5945] either event would subject to sale of assets to stock at the trust's level, rather than the beneficiary's level.[5946]

- Inability to Swap. Although a beneficiary does not recognize gain or loss when selling S corporation stock to a QSST, the trust would recognize income on selling S corporation stock back to the beneficiary.[5947]

- All Income Must Be Distributed. A QSST must distribute to its beneficiary all of its trust accounting income. This can be controlled by the S corporation not making distributions to the trust. The IRS might argue that the beneficiary's failure to compel the trustee to compel a distribution from the S corporation constitutes a gift. Note, however, that the IRS considers 3%-5% to be a reasonable range for income distributions, so the IRS should view any distributions within than range as sufficient.[5948] If distributions were below this range, the IRS would argue that the lapsing withdrawal right 5-and-5 safe harbor of Code § 2514(e) that appears to protect such a small lapse is calculated in a way that does not provide much protection.[5949]

- Personal Use Assets. Placing personal use assets inside an S corporation would require the charging of rent. The S corporation would recognize rental income, and those paying rent would not be able to

[5940] See part II.Q.7.f Corporate Division, including part II.Q.7.f.iii Active Business Requirement for Code § 355.
[5941] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.
[5942] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property.
[5943] See part II.Q.7.b Redemptions or Distributions Involving S Corporations.
[5944] See fn. 5814, found within part III.A.3.e.i.(a) QSSTs Generally. This is important because an S corporation that used be a C corporation can avoid dividend taxation by engaging in a liquidation; see fn. 4636, found within part II.Q.7.a.vii Corporate Liquidation.
[5945] See fn. 5815, found within part III.A.3.e.i.(a) QSSTs Generally.
[5946] In addition to the citations within fns. 5944 and 5945, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).
[5947] Reg. § 1.1361-1(j)(8); see fns. 5813-5815.
[5948] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text accompanying fn. 2669.
[5949] See part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.

deduct that rent. If the beneficiary uses a trust asset for personal purposes, he does not need to pay rent, since the point of the trust is to benefit him.

These limitations are not imposed on Code § 678(a)(2) trusts. When their assets are divided among family members, the division is done on a tax-free basis and they can each go their separate ways quite easily.

Consider who pays income tax for the year in which the beneficiary dies.[5950] These considerations also apply when the beneficiary of a Code § 678(a)(2) trust dies, although the beneficiary of the latter has a broader power of appointment than the former.

Income tax difficulties in splitting an S corporation after the beneficiary's death might be addressed as follows:

- Form a Partnership. By forming an entity taxed as a partnership with the beneficiary, other family members, or other trusts, a QSST might be able to access investment opportunities not otherwise available to it or might be able to facilitate their access to investment opportunities not available to them. Although such a partnership could preserve the expected annual cash flow, the commitment to retaining funds in the partnership would reduce the fair market value of the S corporation's partnership interest. This value reduction would also reduce the tax if the corporation distributes some or all of assets when the QSST divides upon the beneficiary's death. Such a partnership should be formed well in advance of the beneficiary's death.[5951] When the beneficiary dies, perhaps the S corporation would distribute some of its partnership interests right away so that the trust could immediately fund part of the bequests; then, later, after the trustee is satisfied that all tax and other fiduciary liabilities have been resolved, the S corporation could distribute the remaining partnership interests.[5952] Furthermore, the partnership could later divide in a variety of ways on a tax-free basis,[5953] so that each family member can implement his or her own investment strategy over time; however, if the family members do not have strategies that either are consistent with each other's or complement each other's, pursuing different investment strategies would rend to require asset sales that might generate capital gain tax.[5954]

- Create Separate Corporations. Suppose a trustee decides to contribute its assets to an S corporation with the expectation that the beneficiary will make a QSST election. Instead, consider forming a separate S corporation for the future benefit of each of the beneficiary's children. When the beneficiary dies, each of the beneficiary's children will be allocated a separate S corporation, thereby eliminating the need to divide the corporation or distribute its assets. This solution merely postpones the issue, because these issues would need to be addressed when a child of the beneficiary dies (or if a child predeceases the beneficiary, but that postponement might be sufficiently beneficial to address concerns for a while).

See also parts II.A.2.d.ii Estate Planning and Income Tax Disadvantages of S Corporations, II.A.2.d.iii Which Type of Entity for Which Situation? and III.A.3.d Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

[5950] See part III.A.3.d Special Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.
[5951] See part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially fn 4875.
[5952] Distributing in stages would tend to alleviate the concerns described in fn 4875.
[5953] See part II.Q.8 Exiting From or Dividing a Partnership.
[5954] If the strategies are consistent with each other's, then the partnership could simply divide pro rata. If the strategies complement each other's, then each person could take the assets that interest him or her. Anything else would require post-division adjustments, most likely accomplished through sales.

III.A.3.e.vi.(c). Required Structure for a Sale to a QSST (Including Possible Pitfalls)

In QSSTs, all income must be distributed to the beneficiary.[5955] Therefore, at first glance, it would appear impossible for a QSST to use its S corporation distributions to buy stock.

However, if a QSST buys stock in a secured sale in which it pledges all of its S corporation distributions, the trust never receives the distributions, so the trust has no income receipts to pay to the beneficiary.[5956] Private letter rulings have readily accepted this theory for mandatory income trusts;[5957] this theory should apply to a discretionary income trust.[5958]

A significant disadvantage is that this method might take twice as long as a normal sale to a grantor trust. In most states, the trustee must transfer from principal to income an amount equal to the income paid to reduce the principal balance of the note (as used in this part III.A.3.e.vi.(c), the "adjustment amount").[5959] Thus, although note payments complete the sale (the obligation to the beneficiary in the beneficiary's capacity as a creditor), they create an obligation that the trust owes to the beneficiary as a beneficiary:

- <u>Worst Case Scenario – Simplistic view</u>. In other words, first the trust repays the note, then the trust repays the beneficiary the income that was diverted from the beneficiary (as a beneficiary) to pay the note. Thus, the original note principal is not removed from the estate tax system until both the note and the adjustment amount to the beneficiary are fully paid. However, if the adjustment amount is not expected to paid made for a while, consider that the possible inclusion of the adjustment amount in

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[5955] Reg. § 1.1361-1(j)(1)(i) provides

> All of the income (within the meaning of § 1.643(b)-1) of the trust is distributed (or is required to be distributed) currently to one individual who is a citizen or resident of the United States. For purposes of the preceding sentence, unless otherwise provided under local law (including pertinent provisions of the governing instrument that are effective under local law), income of the trust includes distributions to the trust from the S corporation for the taxable year in question, but does not include the trust's pro rata share of the S corporation's items of income, loss, deduction, or credit determined under section 1366….

[5956] The trust would need to pay any future cash receipts of principal to the beneficiary to make up for this diversion of amounts that would otherwise constitute trust accounting income. Adopting Section 502(b) of the Uniform Principal and Income Act (last amended or revised in 2008; see http://www.uniformlawcommission.com/Act.aspx?title=Principal and Income Amendments (2008)), RSMo section 469.453.2 provides:

> If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee shall transfer from principal to income an amount equal to the income paid to the creditor in reduction of the principal balance of the obligation.

[5957] This accounting treatment is consistent with Letter Rulings 200140040 (which not only diverted dividends to repay the seller but also required that the trust pay additional purchase price if it resold the stock within a certain period of time after buying the stock), 200140043, and 200140046 (trust's purchases from another shareholder), as well as 9140055 (distributions used to pay bank loan used to buy stock), which rulings essentially treated the repayment of principal on the notes as income disbursements rather than principal disbursements. See also Letter Ruling 9639013, permitting the use of income to repay notes on a seller-financed sale to QSSTs. CCA 201327009 did not expressly consider this issue; however, based on the facts and conclusion, it implicitly assumed that the use of S corporation distributions to repay the note was permitted.

Other rulings dealing with principal and income issues include Letter Rulings 9140055 (beneficiary repayment of trust distribution to pay interest QSST owed bank), 200446007 (deemed dividend is not fiduciary accounting income and therefore not required to be distributed), and 200451021 (redemption treated as distribution for income tax purposes, but proceeds were principal not required to be distributed).

[5958] What if the trust would be relying on the payment of actual income to satisfy Code § 1361(d)(3)(B) and Reg. § 1.1361-1(j)(1)(i)? One might be concerned that the trust would be receiving no income and therefore would be making no distributions of income. On the other hand, all of the company's distributions that are payable to the trust would in fact wind up in the hands of the trust's sole beneficiary; it will simply get there as a note repayment, rather than as a distribution. Thus, relying on the payment of actual income would not appear to violate the spirit of Code § 1361(d)(3)(B) and Reg. § 1.1361-1(j)(1)(i).

[5959] See fn. 5956.

the beneficiary's estate might very well be the present value of that principal distribution, which might be significantly less than the amount of the principal that is owed.

- Actual Law – Not So Bad? The trust's obligation is to transfer to income principal equal to the adjustment amount. This means that, when the trust receives cash generally classified as principal, it must reclassify that cash as income, to the extent of the adjustment amount. That principal receipt might never happen during the beneficiary's life, and the trust might never be required to pay the beneficiary.

Consider the following ways to repay this additional obligation, if it exists:

1. Suppose the trust is a discretionary income trust. Perhaps an independent trustee would be able to toggle on and off the mandatory income feature (which, of course, is not possible in a one-lung QTIP plan[5960] but might be possible using a *Clayton*-QTIP plan).[5961] After the note is repaid, the independent trustee might turn off the mandatory income obligation. If the beneficiary never needs the income under the standards provided by the trust, the trust might accumulate funds thereafter and never pay cash equal to the full adjustment amount. However, the IRS might argue that such a modification undermines the point of recharacterizing the principal as income,[5962] so consider a compromise: Instead of the trustee accumulating income under the discretionary standards and perhaps never paying the adjustment amount, the trustee and beneficiary come to the following agreement: The trustee agrees to pay future income to the beneficiary to the extent of the adjustment amount, notwithstanding the fact that the trustee has determined that the beneficiary would not receive income under the trust's new distribution standards. That income is payable until the earlier of the beneficiary's death or amounts equal to the adjustment amount have been paid. The trustee might sign a revocable letter directing the company to pay the beneficiary directly any distributions of income (up to the adjustment amount) that normally would have gone to the trust.

2. If the trust is a mandatory income trust, see whether the corporation will make a distribution to all shareholders in partial liquidation of the entity or merely redeem the trust's stock, depending whether it is important to keep proportionate stock ownership. Such a distribution or redemption might very well constitute a nontaxable return of AAA (reinvested S corporation taxable income).[5963] For example, a partial liquidation would be a principal distribution for trust accounting purposes (even if it is a distribution of AAA for income tax purposes) that could then be used to repay the principal obligation.

3. If the trust has other assets, then gain from the sale of other assets would be used to repay this principal obligation. Being transferred to income[5964] or being used to determine a distribution[5965] should cause the capital gain to be taxed to the beneficiary.

[5960] For an explanation of a one-lung plan, including some of its advantages and disadvantages, see part II.H.2.a Free Basis Step-Up When First Spouse Dies.
[5961] For a description of a *Clayton*-QTIP plan, see the paragraph accompanying fn. 5977.
[5962] Reg. § 1.643(b)-1 provides, "Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized." See part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law, especially the text accompanying fn. 2668.
[5963] See part II.Q.7.b Redemptions or Distributions Involving S Corporations.
[5964] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law.
[5965] See part II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.

When drafting a trust that might engage in such a transaction, keep in mind the above issue. Perhaps the trustee might have some flexibility in allocating receipts and disbursements between principal and income?[5966] Perhaps the trust might have a provision requiring the trustee to give the beneficiary notice of a right to principal and provide that the right to that principal adjustment lapses as provided in Code § 2514(e)?

Consider whether the IRS might attack the sale as follows:

- The IRS might argue that stock's value exceeded the sale price; therefore, the IRS might argue, the seller made a gift to a trust that benefits the seller, triggering Code § 2036 inclusion.

- One might consider using a defined value clause,[5967] instructing the trustee to distribute any excess value to a separate share of the trust, of which 10% would be structured as a completed gift (no power of appointment over the remainder) and 90% would be structured as an incomplete gift (power of appointment over the remainder - perhaps even a presently exercisable withdrawal right) or a sale. With adequate disclosure, the gift tax statute of limitations would run regarding how much comprises the completed gift and incomplete gift portions.[5968]

- The separate share of the trust would be treated as a separate trust for QSST purposes; however, the separate share's treatment as a grantor trust as to the seller[5969] would make a QSST election unnecessary during the seller's life.

- Might the fact that the separate share is created only in the event of an audit cause that share to be disrespected? It did for a charitable gift (see part III.B.3.g *Moore*), but charitable gifts have stricter standards than noncharitable gifts.

Such a possible Code § 2036 attack may deter using this technique. If one is trying to move miscellaneous assets by contributing them to an S corporation and selling the S corporation stock to a trust, consider instead using a preferred partnership.[5970] However, if one has an operating business in an S corporation, a preferred partnership is not available[5971] unless the transferor is the sole owner or all of the owners have the same estate planning goal.[5972]

III.A.3.e.vi.(d). Using a QSST to Buy Stock When Using a "One-Lung" Marital Deduction Plan

One of my favorite estate planning tools for married couples is to bequeath the entire residue into a trust that can qualify to the QTIP marital deduction. The executor may elect a marital deduction with respect to none, part, or all of the trust. For an explanation of some of the advantages and disadvantages of such a plan, see part II.H.2.a Free Basis Step-Up When First Spouse Dies.

[5966] For flexibility in allocating between income and principal, see part II.J.8.c.i Capital Gain Allocated to Income Under State Law, which includes a sample general clause (not geared toward the QSST sale issue) as well as the regulations governing such allocations.
[5967] See part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.
[5968] See part III.B.4 Adequate Disclosure on Gift Tax Returns.
[5969] Code § 677.
[5970] See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.
[5971] A partnership is not an eligible owner of a S stock. Code § 1361(b)(1)(B); see part II.A.2.e.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity.
[5972] If the transferor is the sole owner or all owners have the same estate planning goals, the S corporation itself could contribute its assets to a preferred partnership. See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

More recently, I have been including in the trust the authority for an independent trustee to make distributions for the surviving spouse's welfare. If the surviving spouse is the trustee, he or she may appoint as a co-trustee a person who is not a related or subordinate party,[5973] who could make a distribution for welfare and then resign.

Suppose the decedent's estate tax exemption is insufficient to cover all of the decedent's S corporation stock. Some S corporation stock is allocated to a trust excluded from the estate tax system (a "nonmarital trust"), and the rest is allocated to a marital deduction trust (a "marital trust"). The surviving spouse elects QSST treatment for each trust.[5974] The marital trust distributes its S corporation stock to the surviving spouse, who then sells it to the nonmarital trust in exchange for a promissory note.

If the client has an independent trustee who is quite comfortable with the surviving spouse and the remainderman, one might consider using *Clayton*-QTIP planning.[5975] *Clayton*-QTIP planning is where the portion that is not elected QTIP goes to a trust that has different dispositive provisions than the portion that is elected QTIP.[5976] In the nonmarital trust, an independent trustee would be able to distribute income for the surviving spouse's welfare (in addition to any other desirable discretionary distributions for the surviving spouse). This would help address a particular drawback to sales to QSSTs.[5977]

III.A.3.e.vi.(e). Converting Existing Trust to a QSST to Obtain Beneficiary Deemed-Owned Trust Status

Suppose the client is the beneficiary of an existing GST-exempt trust with discretionary distributions. Consider converting the trust into a QSST, by whatever legal means are available to do so. Consider the ideas discussed in parts III.A.3.e.iv Flexible Trust Design and III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs.

Then the client can sell the client's S corporation stock to the QSST.

If the client does not have an S corporation, the client could contribute assets to an S corporation and then sell the S corporation stock to the trust. Alternatively, an existing GST-exempt trust with only one beneficiary might simply form an S corporation and the beneficiary make a QSST election, effectively converting the trust to a beneficiary deemed-owned trust.[5978] However, in either case, be sure to consider exit strategies upon the client's death, as described in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Deemed-Owned Trusts.

[5973] As fn. 6511 explains, the spouse's power to appoint a trustee who can distribute for the spouse's welfare will not cause the spouse to hold a general power of appointment if the trustee is not a related or subordinate party, as defined in Code § 672(c) (see fn. 2458).

[5974] Using this strategy, a QSST election is required for the nonmarital trust but not for the marital trust. However, making such an election for the marital trust tends to simplify income tax issues.

[5975] Authorizing an independent trustee to be the executor with authority to make the QTIP election should avoid any attack the IRS might make whether a spouse who is the executor had made a gift to the extent that failure to make a QTIP election causes the surviving spouse to lose his or her mandatory income rights.

[5976] Reg. § 20.2056(b)-7(d)(3) authorizes this in response to case law.

[5977] See fn. 5961.

[5978] This would be ideal if the trust is already a mandatory income trust. If the trust is not a mandatory income trust, then complying with the requirement to distribute all income might be tricky.

III.A.3.e.vi.(f). QSST to Convert Terminating Trust to GST-Exempt Life Trust

Suppose the client created a trust for children that terminates at various ages. The client could create a QSST for each adult child.

See part III.A.3.e.vi.(e) Converting Existing Trust to a QSST for considerations involved in using this strategy.