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Subject: Mary Vandenack's Notes from the NYU Institute on Federal Taxation

The **80th Annual NYU Institute on Federal Taxation** was held November 13 through November 18, 2022 at Hotel Del Coronado, Coronado, California. Members should click this link to review the meeting agenda:

https://custom.cvent.com/593A2B80B8EB4FC99A6EB3EEFDE8D458/files/event/4de2aad6c21b48d0ae86b018a4b20ecf/ce1e4b7a72d6405b8fef15b6aac15b4c.pdf

Mary E. Vandenack attended the NYU Institute on Federal Taxation and agreed to share her notes.

Mary E. Vandenack, J.D., ACTEC, CAP®, COLPM®, Accredited Estate Planner® (Distinguished) Nominee, is founding and managing member of **Vandenack Weaver Truhlsen** in Omaha, Nebraska. Mary is a highly regarded practitioner in the areas of tax, trusts and estates, private wealth planning, asset protection planning, executive compensation, business and business succession planning, tax dispute resolution, and tax-exempt entities. Mary's practice serves businesses and business owners, executives, real estate developers and investors, health care providers, and tax-exempt organizations. Mary is a member of the American Bar Association Real Property Trust and Estate Section where she serves as on Council. Mary is a member of the American Bar Association Law Practice Division where she currently serves as Chair Elect. Mary has been named to ABA LTRC Distinguished Women of Legal Tech, received the James Keane Award for e-lawyering, and serves on ABA Standing Committee on Information and Technology Systems. Mary is a frequent writer and speaker on tax, benefits, asset protection planning, and estate planning topics as well as on practice management topics including improving the delivery of legal services, legal ethics, technology in the

practice of law and process automation. Mary hosts a podcast called Legal Visionaries. https://vwtlawyers.com/news-knowledge/podcasts/

NOTES:

First of all, I think it is worth mentioning the organizations that sponsored the NYU Federal Institute of Taxation. Gold sponsors included KPMG, EY, and LEXIS-NEXIS. Silver sponsors included Fox Rothschild LLP, Eversheds Sutherland Tax, Kostelanetz & Fink, LLP, Caplin and Drysdale, Meltzer Lippe, Skadden, Hochman Salkin Toscher Perez PC.

CURRENT DEVELOPMENTS

Legislative Update – Chair, John M. Gimigliano, Esq., Principal in Charge, Federal Tax Legislative and Regulatory Services, KPMG, Washington D.C.

Major new provisions enacted included renewable energy credits, new corporate alternative minimum tax, stock a buyback excise tax, and noncorporate loss limitations.

For possible extenders, see:

https://www.jct.gov/publications/2022/jcx-1-22/

The treasury's regulatory agenda includes the foreign tax credit, various energy credits, the corporate minimum tax, and the stock buyback excise tax.

For a list of TCJA expiring items, see:

https://www.jct.gov/publications/2022/jcx-1-22/

FROM THE EXPERTS: TAX CONTROVERSY AND TAX LITIGATION – CIVIL AND CRIMINAL UPDATE

Moderators: Sandra R. Brown, Esq., Principal, Hochman, Salkin, Toscher & Perez, PC, Beverly Hills, CA; Melissa L. Wiley, Esq., Member, Caplin & Drysdale, Chartered, Washington DC.

Speakers: Larry A. Campagna, Esq.; Guinvere M. Moore, Esq.,; Lindsey D. Stellwagen

Damon Rowe, Director, Office of Fraud Enforcement, Internal Revenue Service, Washington, D.C.; Melissa Wiley, Esq., Member, Caplin & Drysdale, Chartered, Washington, D.C.; Zhanna A. Ziering, Esq., Member, Moore Tax Law Group, New York, NY

General IRS Updates

"If you've ever had to call the IRS, you know exactly how the tax agency should use some of the $80 billion it will soon be getting from Congress. Deliver taxpayers from the circle of hell they are subjected to when calling IRS toll-free help lines."

IRS funding will be used as follows:

- $45.6b to hire more agents and acquire investigative technology.
- $25.3b to cover routine costs like rent, facilities, printing, postage, security, and IT.
- $4.8b to upgrade systems used to administer taxpayer services, operations and cybersecurity.
- $3.2b to improve filing and account services, prefiling assistance and education.

Operational Updates:

- Current status can be found at: https://www.irs.gov/newsroom/irs-operations-during-covid-19-mission-critical-functions-continue.
- Return processing delays:

    - As of September 23, 2022, 6.2 million unprocessed individual returns that were received this year
    - 1.5 million unprocessed Forms 1040-X
    - 3.6 million unprocessed Forms 941
    - Form 1139 “Quickie Refund” no longer quick (> 90 days)
    - U.S. residency certifications and ITIN requests taking ~4 months
    - POAs: “Currently, we cannot provide a time frame”
- Notice 2022-36: Failure to file penalty relief for 2019 and 2020:
    - 1.5m+ taxpayers will receive more than $1.2b in refunds or credits.
    - Eligible income tax returns include 1040, 1041, 1120, 1065, 1066, 5471 and 5472, 3520 and 3520-A, 990-PF and T.

Electronic signatures extended through October 31, 2023.

- Form 706 series – U.S. Estate (and Generation-Skipping Transfer) Tax Return
- Form 709 – U.S. Gift (and Generation-Skipping Transfer) Tax Return
- Form 1042 – Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
- Form 1066 – U.S. Income Tax Return for Real Estate Mortgage Investment Conduit
- Form 1120 series not eligible to be e-filed – 1120-C, -FSC, -H, -IC DISC, -L, -ND, -PC, -REIT, -RIC
- Form 1128 – Application to Adopt, Change or Retain a Tax Year
- Form 3115 – Application for Change in Accounting Method
- Form 3520 – Annual Return to Report Transactions with Foreign Trusts/Receipt of Certain Foreign Gifts
- Form 3520-A – Annual Information Return of Foreign Trust with a U.S. Owner
- Form 4768 – Application for Extension of Time to File a Return and/or Pay U.S. Estate Taxes
- Form 8283 – Noncash Charitable Contributions
- Form 8453 series, Form 8878 series, and Form 8879 series – IRS e-file Signature Authorization Forms
- Form 8802 – Application for U.S. Residency Certification

- Form 8832 – Entity Classification Election
- Elections made pursuant to Internal Revenue Code section 83(b)

https://www.irs.gov/newsroom/details-on-using-e-signatures-for-certain-forms

Acceptable electronic signatures include images of documents with original signatures (scanned or photographed). Digital signatures include "encryption techniques that provide proof of original and unmodified documentation when transmitted by an approved secure messaging or file transfer system or by email."

IRS has provided two digital alternatives for submitting third-party authorizations (Forms 2848 and 8821). Submit Forms 2848 and 8821 online and through Tax Pro account.

Tax Pro accounts have been launched. Authorization request can be submitted to taxpayer's online account. If more than one POA, all representatives must be submitted on same day. Prior authorizations are revoked upon submission of new authorization for same tax matters or periods. Forms 2848 and 8821 can be submitted online with electronic signatures with authentication of taxpayer identity.

IRS Exam (What's New?)

Areas of focus include self-employed persons, small businesses with assets of less than $10m, filers of employment, excise, estate and gift tax returns, Office of Fraud Enforcement and Office of Promoter Investigations.

Office of Fraud Enforcement

Office of Fraud Enforcement (OFE) focus is enforcement on agency wide compliance issues involving fraud enforcement, strategic plans, programs and policy. Fraud Enforcement Advisors (FEA) – formerly known as Fraud Technical Advisors (FTA) – assist Exam and Collections in identifying the proper treatment for a case that presents indicators of fraud.

Office of Promoter Investigations

The Office of Promoter Investigations was formed in 2021. Its mission is to strengthen the IRS response to promoters and enablers of abusive tax avoidance transactions by:

- Identifying promoters and enablers (including return preparers)
- Coordinating service-wide enforcement activities against

promoters, enablers and participants in abusive transactions

- Cultivating internal and external partnerships to identify abusive

tax transactions and their promoters/enablers

Methods include:

- Investigate promoters and enablers of abusive tax transactions and assess all applicable civil penalties
- Refer promoters and enablers to the Office of Professional Responsibility, IRS Criminal Investigation or the Department of Justice

2022 Dirty Dozen

- Use of charitable remainder annuity trusts (CRAT) to eliminate taxable gain
- Maltese (or other foreign) pension arrangements misusing tax treaties
- Puerto Rican and other foreign captive insurance companies
- Monetized installment sales
- COVID-19 related scams
    - Economic Impact Payment and tax refund scams
    - Unemployment fraud leading to inaccurate taxpayer 1099-Gs
    - Fake employment offers posted on social media
    - Fake charities
- Unscrupulous tax professionals
- Text message, email phishing and phone scams targeted at taxpayers
- Spear phishing attacks that attempt to steal return preparer log-in credentials
- Concealing assets in offshore accounts and improper reporting of digital assets
- High-income individuals who don't file tax returns
- Individuals earning more than $100,000 a year
- Abusive syndicated conservation easements
- Abusive micro-captive insurance arrangements

Automated Underreporter (AUR) Program

- Program matches income and deductions from information returns against amounts reported by taxpayers on their tax returns. If there is a discrepancy, taxpayer is contacted by mail and given opportunity to address
- COVID-19 delays and mail issues resulted in high volume of cases where SNODs were issued before taxpayer correspondence was addressed

LB&I Campaigns & Settlement Initiatives

An active list of LB&I campaigns can be found at: https://www.irs.gov/businesses/corporations/lbi-active-campaigns

Current priorities include high income non-filers, pass-throughs, green energy credits, and research credit claims. Focus on pass-throughs is aimed at larger partnership cases.

IRS has requested comments on the green energy provisions in the Inflation Reduction Act.

Research Credit Refund claims are being pursued. Other campaigns are distribution in excess of partner's basis and partnership losses in excess of partner's basis.

22 campaigns have been retired although it is not clear what "retired" means.

Micro-captive insurance campaign and syndicated conservation easements remain on the list.

Captive Insurance

A captive is an insurance company that insures the risks of its shareholders or persons related to its shareholders. Types of captive structures include parent-subsidiary captive arrangements, brother-sister captive arrangements, group captives and micro-captives.

Insureds take deductions for insurance premiums if premium is a business expense. Captive is taxed under Subchapter L.

Captives made the list of the IRS “dirty dozen” list of tax scams in 2015. IRS Notice 2016-66 identified certain transaction relation to small captive insurance companies as transactions of interest. Participants identified in such notice are required to report under Treas. Reg. §301.6111-3. Material advisors are also required to report.

IRS concerns with micro-captives include:

- The captive transaction may have been marketed or promoted.
- Insurance policies may not constitute insurance if the captive was formed and operated for tax purposes.
- Insurance risk may be lacking, or pricing of premiums may not be ordinary and necessary where risks are implausible or do not match insured’s business needs.
- Risk pooling arrangements may lack risk distribution.
- Potential claims may not be filed or a claims procedure may not be followed.
- Captive may engage in related party financing.

There is no bright line rule.

IRS offered a settlement for certain taxpayers. Approximately 80% of taxpayers who were issued offer letters accepted settlement.

IRS made second limited time settlement offer in October 2020. New audit teams were formed. There are approximately 500 cases docketed in Tax Court.

Syndicated Conservation Easements

A conservation easement is an interest in real property established by agreement between landowner and qualified organization. The agreement restricts the use of property for conservation purposes. Ownership remains with landowner subject to use restriction. The easement is recorded. Purposes of easement include achieving environmental objectives, land enjoyment objectives and obtaining a charitable tax deduction. Examples of properties over which conservation easements can be placed include golf course, undeveloped land, and farmland.

Charitable deduction for qualified conservation contribution is in §170(f)(3)(B)(iii). Qualified conservation contribution is defined in §170(h)(1)

to include a qualified property interest to a qualified organization exclusively for conservation purposes.

An example of a conservation easement would be where taxpayer contributes money to a partnership which buys undeveloped land and places conservation easement over part of the land. Appraiser determines highest and best use is a residential development, which is legally permissible. Partnership donates the conservation easement and deducts the value.

In Notice 2017-10, syndicated conservation easements were designated as listed transactions. In 2018, transactions were added to list of LB&I's compliance campaign. In 2019, transactions were added to the IRS "dirty dozen" list of scams to avoid. In June 2020, IRS announced time-limited settlement offer for certain taxpayers. In December 2020, DOJ announced first ever guilty pleas based on abuse of syndicated conservation easements.

The Senate Finance Committee investigated syndicated conservation easements.

https://www.finance.senate.gov/chairmans-news/finance-committee-releases-report-on-syndicated-conservation-easement-transactions

Office of Chief Counsel issued memo on determining fraud penalty in syndicated conservation easements. https://www.irs.gov/pub/irs-wd/202044009.pdf https://www.irs.gov/pub/irs-wd/202044010.pdf

Publication 5125 Examination Procedures

The LB&I examination process is outlined in Publication 5125. The link to that publication is:

https://www.irs.gov/pub/irs-utl/p5125.pdf

Early resolution opportunities include pre-filing agreements, compliance assurance process, advance pricing agreements, industry issue resolution.

Joint Strategic Emerging Issues Team

Focus is on developing issues in tax compliance, not transactions that are already deemed to be abusive. The team seeks to establish communication vehicles to identify areas that should be looked at in more detail by the

various IRS divisions. Additionally, the team seeks to message taxpayers about transactions. Referrals come from social media posts, Chief Counsel and the public.

Appeals

There is automatic consideration by Appeals of docketed Tax Court cases if taxpayer has not gone to Appeals. Appeals will attempt to settle a case on factual hazards that were not fully developed at Examination. Appeals will return non-docketed cases to Exam but will retain jurisdiction of docketed cases.

Cryptocurrency Enforcement

IRS Notice 2014-21 provides that the IRS will treat virtual currency as property for federal tax purposes and provides guidance on how general federal tax principles apply to virtual currency transactions. In July 2018, the IRS announced a Virtual Currency Compliance campaign:

https://www.irs.gov/businesses/irs-lbi-compliance-campaigns-july-2-2018

In June 2020, guidance was issued regarding Microtask:

https://www.irs.gov/pub/irs-wd/202035011.pdf

Convertible virtual currency received by an individual for performing a microtask through crowdsourcing or similar platform is taxable income.

Cryptocurrency enforcement is occurring through the issuance of John Doe Summons and ensuing Summons Enforcement proceedings. IRS has issued John Doe Summons to various cryptocurrency companies including Coinbase, Kraken, Circle and SFOX.

The IRS is believed to also have information obtained through Third Party Settlement Organization (TPSO) required by the Form 1099-K reporting system, as to cryptocurrency transactions. In general, a third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and their customers is a TPSO. A TPSO is required to report payments made to a merchant on a Form 1099-K when certain requirements are met.

IRS began sending “soft letters” to taxpayers in July 2019. The letters are one of three variations: Letter 6173, Letter 6174, Letter 6174-A. IRS indicates that the goal of these letters is to educate taxpayers about filing obligations. Form 1040 for the 2020 tax year includes a question on virtual currency.

Virtual currency is an ongoing focus area for IRS criminal investigation. IRS is employing data analytics to uncover transactions that crypto users assumed were hidden.

Collections

IRS has paused most balance due notices as well as most of the enforcement programs such as automated lien and levy programs. Field collection revenue officers assigned to specific taxpayer cases are operating in their normal capacities. IRS is transmitting certifications of seriously delinquent tax debt to the State Department per normal procedures.

Phone bots have been deployed in collection process. The bots can assist all taxpayers with debts less than $25,000, which is 93% of collection calls. Taxpayer Advocate Service is also exploring the use of voice bots.

Passport Revocation

FAST Act of December 2014 requires the denial and authorizes the revocation or limitation of passports of taxpayers certified to the Department of State as having seriously delinquent tax debt. Seriously delinquent tax debt is an unpaid amount greater than $54,000 for which a notice of federal tax lien has been filed and the taxpayer’s right to a hearing has been exhausted or a levy has been made under IRC 6331.

John Doe Summonses

IRC 7609(c)(3) and (f) authorize the IRS to issue a John Doe summons pursuant to an investigation of a specific, unidentified person or an ascertainable group or class of persons believed to be violating the tax laws. The government must obtain prior judicial approval from the U.S. District Court to issue a John Doe summons. Prior judicial approval is requested ex parte. The matter is ripe for the court’s consideration as soon

as it is filed. A proposed order will generally be lodged with the filing of the John Doe Petition and supporting declaration and authorities.

Taxpayer Advocate Service

The Taxpayer Advocate Service (TAS) is an independent organization within the IRS. The TAS is led by Erin M. Collins, National Taxpayer Advocate and Bridget T. Roberts, Deputy National Taxpayer Advocate. 1-877-777-4776

https://www.taxpayeradvocate.irs.gov/

https://www.irs.gov/taxpayer-advocate

Form 911 Filing Requirements:

Financial Difficulties

Immediate Threat

No Response from the IRS

CONTINUING TAX ISSUES FOR "WORK FROM HOME" PROGRAMS: ANOTHER DOZEN COMMONLY ASKED QUESTIONS AND ANSWERS

Presenter: Mary B. Hevener, Esq., Partner, Morgan, Lewis & Bockius, Washington DC

The pandemic has resulted in a different set of several tax problems. Employers are currently dealing with various arrangements that may include a hybrid of working from home and working at the office locations. These arrangements have continued beyond the pandemic and are affecting what is meant by the term tax home, which then affects one commuting occurs.

Employers are continuing to design benefits intended to attract employees. Such benefits might include wellness benefits, student loan forgiveness, improvements in childcare offerings, and leave sharing.

The possible need to file multistate payroll tax withholding and reporting has become an even bigger issue for employers since the pandemic. This

is true whether or not employees are based in states with convenience of employer rules.

Important duration is the effects of identifying an employee's tax home. Does an employee's "tax home" change when an employee has been working mostly from home for 12 months?

Will potential exclusions for personal expense reimbursements increase if an employee has a "home office" under Code 280A?

Do the rules change for hybrid work programs, work in "convenience of employer" states, or work by top company executives?

Tax Home in General

The following factors are considered in determining an employee's principal place of business:

i. total time ordinarily spent by the employee at every business location;

ii. the employee's degree of business activity at each such business location;

iii. whether the financial return with respect to each business location is significant or insignificant;

iv. whether employment at a particular location is expected (or known) to be only temporary;

and

v. whether the employee might have multiple regular places of business during a single year.

See Rev. Rul. 54-147, 1954-1 C.B. 51; Rev. Rul. 93-86, 1993-2 C.B. 71; C.C.A. 200020055 (May 19, 2000); and 2000 FSA Lexis 240 (Mar. 31, 2000).

The principal place of business test is more difficult to apply for employers who have designed the work from home policies that allow employees to work remotely a majority of the time in their homes. If an employee has no office that is a "principal place of the," an employee's "tax home" may be

the area within which the employee's primary residence is located. Two of the following three tests must be met:

i. Is the employee performing a portion of the employee's business in the vicinity of the residence and also uses such residence for lodging while performing such business there?

ii. Are the living expenses incurred by the employee at the employee's residence duplicated when the employee's business requires the employee to be away from the residence?

iii. Has the employee:

1. abandoned the vicinity in which the employee's historical place of lodging and claimed abode are both located (e.g., maintain community, social, religious or civic ties),

2. has a member or members of the employee's family currently residing at the employee's residence, or

3. frequently uses the residence for lodging.

See Rev. Rul. 73-529, 1973-2 C.B. 37.

Does the tax home change after 12 months of work at home?

There was an amendment in 1993 to IRC section 162 A that provided that if a taxpayer works in a single geographic location for over a year, than any travel expenses of working in that location are denied. The IRS has interpreted this one-year rule to require a change in tax home. The interesting question is if an employee has been working primarily at home for 12 months does the home then become the tax home? OPM guidelines released in November 2021 recognize that a remote working employee may have a residence as an official worksite.

https://www.telework.gov/guidance-legislation/telework-guidance/telework-guide/guide-to-telework-in-the-federal-government.pdf

Code 280A Home Office

Code §280A (enacted in 1976 and amended thereafter) has long allowed an income tax deduction for any portion of a dwelling unit used exclusively

and on a “regular basis” for business. In addition, a portion of a personal residence will only qualify as a Code §280A home office if:

i. The home office is the taxpayer’s principal place of business;

ii. With respect to employees, the use of the residence for business is for the “convenience of the [employee’s] employer,” and not the convenience of the employee; and

iii. there is “no other fixed business location of such trade or business where the [taxpayer] conducts substantial administrative or management activities of such trade or business.”

• See Code §280A(c)(1)(A) and Tokh v. Comm’r, T.C. Memo. 2001-45 (citing Comm’r v. Soliman, 506 U.S. 168, 174 (1993)).

More specifically, in Commissioner v. Soliman, 113 S. Ct. 701 (Jan. 12, 1993), the Supreme Court clarified the factors to be considered as to whether any employee’s home office is the employee’s “principal place of business” for purposes of the office-in-the-home deduction.

Two primary factors to support a 280A home office: (1) The relative importance of the activities performed at each business location; and (2)

The amount of time spent at each location.

•After Soliman, the IRS promptly withdrew proposed regulations under 280A and revised Publication 457.

In 1997, Congress amended 280A(c)(1)(A), to provide that “"For purposes of subparagraph (A), the term “principal place of business” includes a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business."

After all these changes, it is clear that a deduction is allowed for a “home office” under Code section 280A only when the residence is the most important or significant place of business.

The two primary considerations remain are the relative importance of business activities performed at each business location and the time spent

at each place. See Strohmaier v. Comm'r, 113 T.C. 106, 112 (1999). There have been no rulings or cases on 280A after 2017, because no employee can claim an itemized deduction on Form 1040 for a home office for the years between 2018 and 2025, due to the TCJA suspension such employee itemized deductions. See Code 67(g). But, if these tests are met, more reimbursements can be paid (i.e., for expenses the "office" part of the home, and for "commuting" – since per Rev. Rul. 99-7, 1991-1 C.B. 361, no person with a "home office" ever has a non-deductible commute.

It likely is difficult for executives to establish a "tax home" at a location

other than company headquarters, because courts have generally concluded that (a) an executive's motivation to work other than at the company's headquarters is personal in nature, and (b) the executive could always demand office space.

•See, e.g., *David W. Karp v. Comm'r*, T.C. Memo 1976-325 (1976).

Definition of a Commute

The IRS re-defined "commute" in the 1990s, changing the definition from, generally, "a trip between home and principal place of business," or "first and last trip of the day in the area of the tax home" (explained in Rev. Rul. 55-109, 1955-1 C.B. 261) to a complex set of rules.

The current questions concerning commuting included just what is a commute? Our commute is excludable if I work in the car, or have a broken leg, or in some serving or? To special valuation rules apply? Can all or part of a commute ever be excludable? When is a commute deductible?

Rev. Rul. 99-7, 1991-1 C.B. 361, preceded by Rev. Rul. 90-23, 1990-1 C.B. 28, as modified by Rev. Rul. 94-47, 1994-2 C.B. 18, provides that:

1. If a taxpayer has a "regular work location" away from the taxpayer's residence, daily transportation expenses between the residence and any "temporary work location" are deductible, regardless of distance.

2. Trips between home and any "regular work location" are personal commutes, regardless of distance.

3. If the taxpayer has a Code § 280A qualifying home office, all daily

transportation expenses between residence and any other work location are deductible, regardless of whether the work location is regular or temporary.

Under this general rule, if a taxpayer has a regular place of business, trips between home and a “temporary place of business” are deductible (and thus excludable under Code § 132(d) if reimbursed). Employees with §280A home offices have all their commutes treated as deductible and excludable.

Also, if an employee has a security risk, and there is either an “outside security study” or 24/7 security protection, the value of the car bulletproofing and chauffeur is excludable. A commute cannot be excluded simply because an employee is working in the car or an employee has a provision that prevents the employee from driving.

The purchase of airplanes has been a common practice in recent years. Practitioners have taken the position that exclusions apply when there is a bona fide business oriented security concern. A generalized concern for an employee security will not typically trigger application of a security exclusion. Where a bona fide concern exists, it is generally advisable to obtain a security study by an outside firm.

It also might be possible to exclude the value of commutes in company provided cars and aircrafts for trips between the office and remote work locations if such commutes by private car or company jets are provided so that executives can avoid potential exposure.

CORPORATE TAX

Chair: David M. Rievman, Esq., Partner, Skadden, Arps, Slate, Meagher & Flom, New York, NY

S Corporation Acquisitions

What is an S corporation?

An S corporation is an entity that elects S status for US federal income tax purposes. Any entity that is taxable as a C corp can elect to be an S corp if

it meets the eligibility requirements. Additionally, an LLC can elect S corp tax status.

Potential advantages of an S corp include being "flowthrough" entities that are generally not subject to corporate-level tax. S corps are corporations for purposes of the tax-free reorganization provisions. For non-tax purposes, the formation of a separate entity will generally provide limited liability to shareholders.

Potential disadvantages of using an S corp include limited flexibility as to capital structure and shareholder base (think of ownership as generally being individuals), the single class of stock rule, limitations on who can be S corp shareholders, inability to adjust inside asset basis on the sale of an interest, and the challenges of extracting appreciated assets on a tax-free basis is much more difficult than for a partnership.

S corps remain the most prevalent type of corporation. Many S corps are old, large and family controlled, making them common acquisition targets.

Eligibility Requirements

An S corp cannot have more than 100 shareholders (§ 1361(b)(1)(A)). Members of one family are generally counted as one shareholder (§ 1361(c)(1)(A)). Shareholders must typically be individuals, with certain exceptions (§ 1361(b)(1)(B)). Corporations and partnerships cannot be shareholders. Certain tax-exempt entities can be, but this may result in UBTI issues. Estates can be shareholders during a reasonable period of administration. Certain trusts (including certain grantor and former grantor trusts) can be shareholders. Shareholders cannot be foreign §1361(b)(1)(C)).

An S corp must have a single class of stock (§ 1361(b)(1)(D)). For purposes of the single class of stock rule, differences in voting power are disregarded (§ 1361(c)(4)). "Straight debt" will not be treated as a separate class of stock (§ 1361(c)(5)). More generally, all shares should be entitled to receive identical amounts from the S corp to ensure there is no disparate distribution (or deemed distribution) that could create a separate class of stock. An S corp cannot be an ineligible corporation (*i.e.*, certain financial institutions, insurance companies and DISCs) (§ 1361(b)(2)).

Termination of S corp

An S corp's failure to adhere to all requirements will cause its S election to terminate. Termination of an S corp election is effective “on and after the date” of the non-qualifying event. Accordingly, deductions that accrue on the date of a third-party acquisition that invalidates the S election will appear on a C corp return and benefit Buyer.

In the acquisition context, if the buyer is not an eligible S corp shareholder, then Selection terminates on the date that buyer purchases S corp. The S corp would file an S corp for the period prior to purchase and a C corp return thereafter.

Taxation of S corporation

S corps pass through items of income and loss to their shareholders. The S corp is generally not subject to income tax. Corporate-level tax is imposed in the case of BIG Tax and Sting Tax. Losses may be used only to the extent of the shareholder’s basis in its S corp stock (and any S corp debt owed to the shareholder). To avoid duplication of income and loss, S corp shareholders adjust the basis of the S corp shares by increasing for items of income/gain and capital contributions and decreasing for items of deduction/loss and distributions. In addition, distributions by an S corp to its shareholders of S corp earnings will generally not be taxed again. Each S corp tracks its historic S corp earnings through an account called an “accumulated adjustments account” or “AAA”. Amounts distributed in excess of AAA will be taxable to shareholders if the S corp has accumulated *C* corp earnings and profits (“E&P”) (from a previous history as a C corp or an M&A transaction involving a C corp). Similarly, distributions in excess of the shareholder’s basis in its S corp shares will be taxable as capital gain. Unlike partnerships, an S corp’s shareholder’s share of S corp debt *does not* increase outside basis in S corp stock.

Although an S corp may not have a corporate shareholder, it may have a corporate subsidiary. If that subsidiary is wholly owned, the S corp may elect to treat it as a Q-Sub. In effect, a Q-Sub election treats the subsidiary as a disregarded entity, so its assets, liabilities, items of income, deductions and credits are treated as belonging to the S corp parent.

S corps may be subject to corporate-level tax in certain other circumstances. For example, states vary significantly in terms of how S

corps are treated. Some states and localities impose entity-level taxes on S corps, similar to those on C corps.

S corps may be subject to corporate-level tax called the BIG Tax. Corporate-level tax may apply when an S corp was formerly a C corp and it recognizes gain with respect to the sale of property that it owned before it converted from a C corp (§ 1374). BIG Tax will apply to any net unrecognized built-in gain (NUBIG) in the C corp's assets as of its conversion to an S corp. Similar rules apply with respect to C corporation property acquired by an S corporation in a carryover-basis transaction. This rule applies only if the sale occurs within five years of the conversion/acquisition.

S corps may be subject to corporate-level tax referred to as Sting Tax/Termination of S Election.

S corporations with significant passive income that also have accumulated C corporation earnings may be subject to corporate-level tax on their "net passive income". Corporate passive income tax applies in years where an S corp has passive investment income representing more than 25% of its gross receipts. In addition, the S corp has passive investment income representing more than 25% of its gross receipts for three consecutive years, then its S corp election terminates. The simplest thing to do typically in this situation is to distribute the C corporation earnings.

Stock Sale vs. Asset Sale

Buyer typically wants step-up in basis that comes from asset purchase. Seller typically wants after tax proceeds that represents seller's expected purchase price at a capital gains rate. A stock sale will trigger capital gain, while the sale of certain assets could trigger ordinary income (*e.g.*, depreciation recapture, accounts receivable, gain in inventory). Ordinary income generally is taxed at a higher rate and may cause shareholders to have an ordinary income/capital loss mismatch. Consideration should be given to how purchase price is allocated to reduce overall tax cost and meet expectations and interests of buyer and seller. The ability to restructure may depend on the mix of Seller assets. Possible state taxes should be considered as well as differences in inside-outside basis for S corp shareholders. Also consider S corp assets subject to BIG Tax, which

may increase costs associated with asset sale. If any seller shareholders are rolling part of their interest, this can be problematic if not pro rata.

The incremental cost of an asset sale may be pushed to buyers through adjustment to purchase price. If an asset sale is preferable from a tax perspective, the parties may still choose to structure as a stock sale from a legal perspective. A true (or "hard") asset sale may present non-income tax costs and complexities (*e.g.*, real estate transfer taxes, contract novation issues, license/IP transfer issues, regulatory issues).

<u>S Corp Stock Sale</u>

The consequences to Buyer include Buyer taking a cost basis in the S-Target shares; no gain or loss is triggered inside of S-Target ensuring no BIG Tax is triggered and S-Target's basis in its assets does not change. If Buyer is not an eligible S corporation shareholder, the transaction will cause S-Target's S election to terminate and S-Target will become a corporate subsidiary of Buyer.

Seller will recognize capital gain or loss on sale.

<u>Asset Acquisition</u>

Buyer takes a cost basis in S-Target's assets equal to the amount of cash paid plus any liabilities assumed. Assuming the assets constitute a trade or business, Buyer's cost basis will be allocated among the assets in accordance with the rules under Section 1060.

The S Target Shareholders will have gain or loss on the asset sale that will pass through to S-Target shareholders pro rata, which will increase or decrease their basis in the S Target stock. The distribution of cash to the S-Target shareholders in liquidation will generate no further gain or loss at S-Target. Although S-Target shareholders will recognize capital gain or loss upon the liquidation (equal to the difference between the cash received and their basis in the S-Target stock), the basis adjustment described above generally ensures that there is no such gain or loss (assuming no inside-outside basis difference). S-Target will have to satisfy any BIG Tax liability triggered by the asset sale.

There are ways to treat a stock sale as an asset sale. An election can be made under Section 338(h)(10) and Section 336(e) to create a deemed

asset sale for tax purposes. This election is available when a corporate (§ 338(h)(10)) or non-corporate (§ 336(e)) Buyer acquires 80% or more (by vote or value) of S-Target's outstanding shares in one or more taxable transactions over a 12-month period. Section 336(e) election is also available where those shares are exchanged or distributed in a taxable disposition. S-Target is treated as having sold its assets to a new corporation ("New Target") owned by Buyer for deal consideration plus assumption of any S-Target liabilities. Notwithstanding the deemed asset sale, New Target remains liable for S-Target's historic tax liabilities (including any BIG Tax liabilities). Effectiveness of election depends on S corp election being valid.

Buyer may also purchase S-Target after it has converted to a disregarded LLC through an "F reorganization" (§ 368(a)(1)(F)). Sellers will own a newly formed S corporation that is a successor to S-Target ("New S-Target"). This achieves basis step-up even if S-Target's election is later challenged and found invalid (but results in double tax in that case). The new S-Target will retain historic income tax liabilities of S-Target (if any), although S-Target LLC will likely remain liable for those amounts under state-law successor liability. The merger of S-Target into Buyer (or an LLC subsidiary of Buyer) achieves similar result.

Stock Acquisition With 338(h)/336(e) election

Buyer takes a cost basis in the S-Target shares. Gain or loss is triggered inside of S-Target, potentially resulting in BIG Tax liability that New Target will inherit. S-Target's basis in its assets will generally equal the amount Buyer paid for the S-Target stock plus any liabilities deemed to be assumed by New Target.

As a result of the Section 338(h)(10)/336(e) election, S-Target recognizes gain or loss on the deemed disposition of its assets to New Target. The gain or loss will pass through to the S-Target shareholders pro rata, which will increase or decrease their basis in their S-Target stock. S-Target is deemed to distribute all of its assets (*i.e.*, cash received from Buyer) to the S-Target shareholders in liquidation. The deemed liquidation will generate no further gain or loss at S-Target. Although S-Target shareholders will recognize capital gain or loss upon the deemed receipt of the cash equal to the difference between the cash received and their basis in their S-Target

stock, the basis adjustment described above generally ensures that there is no such gain or loss.

Rollover of Seller Ownership Interest

It is common for Key shareholders of an S corporation target entity to "roll" all or a part of their equity as part of an acquisition. In transactions where Buyer does not receive a basis step-up in S-Target assets, it is generally possible to structure the rollover so that it is tax-free with respect to the rolled S-Target equity. Transaction may qualify as tax-free under Section 351 (if Buyer is a corporation, especially if newly formed) or Section 721 (if Buyer is a partnership). If rolling S-Target shareholders also receive part cash, consider having a different legal entity acquire shares for cash to ensure "boot within gain" rule does not apply.

In transactions where Buyer does receive a basis step-up in S-Target assets, achieving a roll that is *completely* tax-free is more difficult. If >20% of S-Target's equity is rolled, parties cannot make a Section 338(h)(10) or 336(e) election. Even if ≤20% of S-Target's equity is rolled, the election would trigger gain on *all* of S-Target's assets, effectively causing the roll to be taxable. If S-Target instead uses an F reorganization structure, gain will only be triggered on the sale of a portion of its assets, but that gain will be allocated pro rata to all S-Target shareholders. This may cause certain S-Target shareholders to be allocated more gain than the cash consideration they receive. S-Target shareholders may seek tax distributions from Old S-Target LLC to ensure they are not out-of-pocket for taxes from the deal. Achieving a basis step-up with a rollover may cause issues under the anti-churning rules.

Overview of Anti-Churning Rules

If Buyer and S-Target are considered related after combined asset and stock purchase, the anti-churning rules may prevent amortization of basis step-up for § 197 intangibles. Section 197(a) generally permits a taxpayer to amortize goodwill, going concern value and various other intangible assets ("§ 197 intangibles"). Before Section 197(a) was enacted on 8/10/1993, these intangibles were not amortizable. Section 197(a)'s benefits are therefore limited to assets acquired after its enactment or, if an election is made, after 7/25/1991 (this is known as the "applicable date").

Section 197(f)(9) contains an "anti-churning" rule that prevents taxpayers from gaining Section 197(a)'s benefits unless the applicable assets are acquired after the applicable date *in a transaction giving rise to a significant change in ownership or use.* In particular, the "anti-churning" rule prevents amortizing any of these assets if:

- the asset was held or used at any time during the transition period by the taxpayer or a related person
- the asset was acquired from a person who held the asset during the transition period and, as part of the transaction, the user of the asset does not change
- the taxpayer grants the right to use the asset to a person (or a person related to such person) who held or used the asset during the transition period if the acquisition and grant of rights are part of a series of related transactions.
- The "transition period" is 7/25/1991 – 8/10/1993 or, if the election referenced above was made, 7/25/1991
- Persons are "related" if they have a relationship described in Sections 267(b), 267(f) or 707(b)
- (applying a 20% instead of a 50% threshold), or if they are trades or businesses under common control.
- Relatedness is tested both before and after the acquisition or, in the case of a series of related transactions, before thefirst one and after the last one.

Tax insurance is a newer trend in mergers and acquisitions. Tax insurance covers tax costs, including penalty and interest, if the tax consequences of transaction are other than as expected.

PARTNERSHIPS, LLCs AND REAL ESTATE

Chair: Andrea M. Whiteway, Esq., Principal, EY, Washington, DC

Hot Topics in Partnership and Real Estate Taxation

Speakers: Ryan P. McCormick, Esq., Senior Vice President and Counsel, The Real Estate Roundtable, Washington DC; Hans Famularo, Associate Area Counsel, Office of Chief Counsel, Small

Business/Self Employed Division, Internal Revenue Service, Laguna Niguel, CA

Hans Famularo provided an update on IRS related to partnership tax issues. Hans reminded all that amended partnership returns can no longer be filed but rather an administrative adjustment request is required. Hans indicated that many practitioners are requesting that amended returns should be permitted and suggested that those who have thoughts on the issue can submit comments.

IRS will be providing some guidance on the at-risk rules. Economic risk of loss does not mean that at risk test will not be met.

Because of tax basis capital account reporting, the IRS is identifying that deemed distributions are not being included as gain. IRS is also looking at gain on the deemed sale of a partnership interest. IRS is also looking at final partnership return and situations where there are liabilities that have not been taken into account. One issue is the negative capital account that hasn't been brought back to zero.

The priority guidance plan is considering how partners are taking account of liabilities in determining whether there has been a disguised sale. If property is contributed to a partnership and cash or property is going to be distributed to the contributing partner, there is an issue as to whether there is a disguised sale.

IRS is also looking at debt financed distributions. In particular, IRS is looking at large distributions (Tribune case). If liability is properly allocated to selling partner, deferral can be achieved.

Terminations under 708 – there are no more technical terminations. Under b1, there is an issue as to how transactions should be treated.

There have been requests on how to handle multi-partner transition to second partner.

Positive basis adjustments under 754 involving related parties is being reviewed by the IRS. Comments are invited.

SALT cap remains. Notice 2020-75 held that state and local income taxes paid by partnership will be allowed. There are a lot of questions on how this works and the IRS is seeking to address the questions.

The Inflation Reduction Act ('IRA") provides a variety of energy tax credits. The IRA improved the availability of 179D credit. The IRA also improved the Energy Investment Tax Credit. The IRA reinstated the credit of Clean Energy Tax Incentives such as EV charging stations. Energy efficient homes credit was improved by IRA. Such credit is primarily paid to developer.

Disguised Sale Planning

Andrea M. Whiteway, Esq., Principal, EY, Washington, DC

Contributions to and distributions from a partnership are generally non-recognition transactions. If A contributes property with a $600 value and $300 basis and B contributes $600 cash and $200 cash is then distributed to A, the transaction is a disguised sale (1/3 of interest for $200). If there is a delay in distribution of cash (but within 24 months), transaction may be treated as an installment sale. A will be deemed to have sold less of A's property because there will be an element of imputed interest. If distribution is outside 24 months, IRS has the burden to show a disguised sale.

The key is that the presumption changes after 24 months. Another key is whether contribution was subject to entrepreneurial risk. Also considered is whether the distribution was planned to be made at the time of contribution.

There are some exceptions to the disguised sale rule. There are safe harbor distributions even if made within two years:

- Distributions of operating cash flow
- Reasonable preferred returns on capital – 150% of AFR rule (somewhat useless in current environment)
- Reasonable guaranteed payments for capital.
- Reimbursement of preformation expenditures – incurred within 2 years; 20/120% rule.

Contribution of encumbered property can also result in a disguised sale. Assume A contributes property with $600 value, $300 basis and $200 liability. A borrowed $200 from bank. B contributes $400 cash. The issue with respect to A is whether the liability is a qualified liability. If liability is qualified, then there is no disguised sale.

Qualified liability:

- Debt is more than 2 years old and has encumbered the property throughout the period.
- Debt is secured.
- Debt is traceable to capital expenditures with respect to property.
- Debt is incurred in ordinary course of trade or business.
- Debt is not incurred in anticipation of transfer to partnership and is contributed in connection with trade or business of which all material assets contributed. See PLR 27-1428.

If you have a distribution of a property contributed by one partner to another, the built-in gain will be allocated back to contributing partner. By way of example, A contributes property with $600 value and $100 basis. B contributes $600 cash. Property contributed by A is distributed to B within 7 years of contribution. A would recognize the gain.

Distribution of marketable securities is treated like distribution of cash. If A contributes property worth $600 and basis of $100 and B contributes cash $600. B cash is used to purchase marketable securities which are distributed to B. A recognizes $500 gain.

There are opportunities to cherry pick property you are going to contribute. A bona fide loan to partner should not be treated as a disguised sale.

Partial cash redemption is a powerful exit strategy and deferral technique. A and B both contribute property with $300 in value and $100 in basis. They borrow $297 from bank and distribute $297 to A and reduce A's partnership interest from 50% to 1%. This will result in a negative capital account for A. In order to prevent gain on negative capital account, there needs to be a debt allocation to A. In this case, there would need to be an allocation of debt to A of at least $197. Partnership books up under 704(b) regs. A could guarantee debt but if not, A will keep enough debt in basis to avoid gain on distribution. You can maximize recourse debt in an exit transaction.

If non-qualified recourse debt is involved related to pre-contribution borrowing, if debt after contribution is allocated to both partners, contributing partner will be subject to disguised sale. If debt is allocable to contributing partner, disguised sale does not apply.

In Tax Court case regarding Canal Corporation, Canal and Georgia Pacific each contributed operating businesses to a partnership. One entity borrowed from bank. Other entity provided indemnity. Indemnity was not respected as recourse.

Bottom payment obligations are no longer recognized. Limitations on bottom guarantees have not really ended leveraged partnerships. Debt financed distributions with recourse debt still work based on Tribune Media (Cubs case).

Recourse Liabilities Anti-Abuse Factors 65

- Partner not subject to commercially reasonable contractual restrictions protecting payment likelihood.
- Partner not required by lender to provide commercially reasonable financial information.
- Term of obligation ends prior to term of partnership liability.
- There exists a plan or arrangement in which obligor or related person holds money or liquid assets in an amount exceeding reasonably foreseeable needs.
- Obligation does not permit prompt pursuit of payment following a payment default.
- Terms of liability substantially same had there been no guarantee.
- Creditor did not receive executed documents.

Hot Like Kind Exchange Issues

Speakers: Anne Andrews, Partner, PWC, San Jose, CA; Robert D. Schachat, Esq., Managing Director, BDO USA, Washington, DC

To qualify for tax free deferral under 1031, relinquished property must be exchanged for replacement property. This can be viewed as four requirements: Real property; like-kind; held for investment or use in a trade or business; exchange.

Gain realized in a like-kind exchange is still recognized to the extent taxpayer receives cash or other property that is not of a like-kind (“boot”).

Even if an exchange qualifies as tax free under 1031, ordinary income recapture can be triggered.

Replacement property takes a substituted basis, plus additional cash, if any, with adjustments:

- The adjusted basis or relinquished property.
- Adjusted for debt on relinquished property versus debt on replacement property and other boot paid/received.

Aggregate basis of replacement property is:

- Aggregate basis of relinquished property.
- Increased by amount of gain recognized.
- Increased by amount of liabilities assumed.
- Increased by amount of cash paid.
- Decreased by cash received.
- Decreased by liabilities transferred.

There are final regs addressing depreciation of relinquished and replacement property. Treas. Reg. Section 1.168(i)-6. The general approach is the "step-in-the-shoes" approach to extent of carryover basis, but taxpayer can elect out.

Section 1031 is restricted to real property exchanges. Regulations define real property. Gain or loss is not recognized on the exchange of real property held for productive use in a trade or business or for investment ("Relinquished Property") if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment ("Replacement Property"). Generally, the existing 45-day identification and 180-day receipt, boot recognition, and related party rules were retained. The regulations have the goal of being consistent as to what is considered real estate for purposes of the like-kind exchange rules.

The regulations include in the definition of "real property" land and improvements that are inherently permanent structures and structural components thereof. Unsevered natural products of land, including growing crops, plants, timber; mines; wells; and other natural deposits, generally are treated as real property.

Status of real property is tested on date property is transferred in an exchange. Certain exceptions apply to intangible property.

The final regs originally included real property under state or local law Reg. 1.1031(a)-3(a)(1).; however, this became an issue when considering such things as a pipeline that goes under four states.

Building includes houses, apartments, hotels, motels, barns, enclosed garages, stores, warehouses, enclosed stadiums and arenas, enclosed shopping malls, enclosed transportation stations, factories and office buildings pursuant to the final regulations.

Real property excludes stock, other securities, interests in a partnership, and certificates of trust or beneficial interests.

The Definition of real property for Section 1031 purposes is different than the definition of real property for Section 167/168 depreciation purposes. See Treas. Reg. Section 1.1031(a)-3(a)(7). For example, fixtures and machinery may be real property for Section 1031 purposes, but personal property for depreciation purposes. This can lead to recapture considerations if subsequently sold as relinquished property in a future Section 1031 exchange.

The recapture provisions of Sections 1245, 1250, or 1254 may cause gain to be recognized and the gain to be characterized as ordinary income.

Cost segregation may result in property classified as real property for Section 1031 purposes being depreciated as Section 1245 personal property for depreciation purposes. Taxpayer needs to consider amount of Section 1245 property sold as relinquished property and amount of Section 1245 property acquired as replacement property. Valuation and allocation of purchase price needs to be considered.

An interest in real property includes a license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure in the nature of a leasehold, easement or similar right; and not to engage in or operate a business on real property, regardless of its classification under state of local law.

Leasehold interests can be exchanged. Reg. Section 1.1031(a)-1(c); example in PLR 8453034. A 30-year leasehold is required.

Early cases held that a sale-leaseback for a term of at least 30 years is an exchange without focusing on whether the leaseback had value.

- *Century Electric Co. v. Commissioner*, 192 F.2d 155 (8th Cir. 1951), *cert. denied* 342 US 954 (1952)

Later cases held that there is an exchange only if the leaseback has value.

- *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453 (2d Cir. 1959)
- *Leslie Co. v. Commissioner*, 64 TC 247 (1975), *nonacq*., 1978-2 CB 3, *aff'd* 539 F.2d 943 (3d Cir. 1976)

You cannot do a self-exchange. Construction of new building on land already owned by taxpayer is not like-kind. Bloomington Coca-Cola Bottling Co. v. Commissioner, 189 F.2d (7th Cir. 1951); Rev. Rul. 67-255, 1967-2 CB 270.

Sale for cash followed by reinvestment of cash in like-kind property does not qualify under §1031. Crandall v. Commissioner, T.C. Summary Opinion 2011-14 (failure to use qualified intermediary or qualified escrow, discussed below, resulted in actual receipt).

Underwater property can be exchanged. PLR 201302009. Lender cooperation is helpful. There should not be a sales contract in foreclosure. To minimize cash portion of replacement property, taxpayer may acquire credit net lease property.

Taxable loss is disallowed in a 1031 exchange. Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968). To avoid loss disallowance, use different taxpayers to transfer and receive property, use separate agreements and separate closing dates.

Section 1031 has a "Held For" Requirement with respect to both relinquished and replacement properties. This requires that the properties are:

- Held for investment
- Used in a trade or business

Thus, the "held for" requirement is violated if either relinquished or replacement property is:

- Ordinary income (dealer) property
- Personal use property

Sale for cash followed by reinvestment of cash in like-kind property does not qualify under Section 1031.

- *Crandall v. Commissioner*, T.C. Summary Opinion 2011-14 (failure to use qualified intermediary or qualified escrow, discussed below, resulted in actual receipt)
- Buyer of relinquished property is unlikely to hold property that taxpayer wishes to acquire.
- Long ago, taxpayers began to use a "straw" to perform the exchange.

If property is exchanged through an agent, the agent's receipt of cash from sale of relinquished property is imputed to the taxpayer. Taxpayer's receipt of cash will generally bust the exchange. Regulations issued in 1991 provide a "safe harbor" for exchanges through a qualified intermediary ("QI"). Certain security or guarantee arrangements, a qualified escrow account or qualified trust are also permitted and can be combined with QI arrangement. Reg. Section 1.1031(k)-1(g).

Replacement property must be identified within 45 days. The IRS position is that there is no extension for weekends or holidays.

There are limitations on the number and value of replacement properties identified:

- Three replacement properties with any value
- Unlimited number, but fair market value no more than 200% of relinquished property
- Unlimited number and value; taxpayer actually acquires 95% by value
  • Property acquired within 45-day identification period.

There must be an unambiguous description of each replacement property. Notice must be delivered to seller or certain other non-disqualified parties to the transaction. Reg. Section 1.1031(k)-1(c).

<u>Partnership Audit Rules: What You Need to Know and Do Now</u>

Speakers: Michael J. Desmond, Esq., Partner, Gibson, Bunn & Crutcher, Los Angeles, CA; Sheri A. Dillon, Partner, Morgan, Lewis & Bockius, Washington DC

Structuring the Buy-out of a Partner

Speakers: Kelsey Lemaster, Esq., Partner, Goodwin Procter, San Francisco, CA; Cecily XI, Esq., Goodwin Proctor, New York, NY

It is important to understand inside and outside tax basis and how they are calculated. Tax basis is calculated under IRC sections 705, 722, 733, 742 and 752.

In general, an outside tax basis is increased by cash contributions by the partner, tax basis property computed, deemed the capital contributions for increases in allocated partnership liabilities, allocations of net taxable income, amount paid to purchase partnership interest from existing partner.

Outside tax basis is decreased by cash distributed to a partner, tax basis to the partner property distributed, deemed the distributions on account of decreases in allocated partnership liabilities under section 752, and allocations of net taxable loss. Tax basis may not be negative.

IRC Section 734 provides rules for adjusting the inside basis of partnership property upon a distribution to a partner that result in gain or loss to the partner under IRC section 731(a). IRC section 755 provides rules for determining the appropriate allocation of basis adjustments under IRC section 734 or 743 to partnership assets.

The IRC rules apply holding period rules to partnership interests. The partnership rules also include a set of rules referred to as the hot asset rules. Such rules are designed to prevent a partner from converting rights to partnership ordinary income into capital gain upon disposition of a partnership interest.

The partnership rules also contain a set of rules referred to as the mixing bowl roles. If a partner receives a distribution of property that was contributed to the partnership by another partner within 10 years of the contribution and, the contributing partner will recognize any remaining IRC 704(c) gain in the contributed property at the time of distribution.

Another set of rules are referred to as the anti-churning rules. Such rules prohibit amortization of stepped-up basis in goodwill arising from related party transactions.

The framework for purchasing the interest of a retiring or deceased partner are included in section 736. To the extent a payment is made in liquidation for the partner's interest in partnership property, the payment is treated as a distribution. In such case, the payment will be taxable under IRC section 731. To the extent a payment made in liquidation is not in exchange for the partner's interest in partnership property, the payment is treated either as a distributed share of partnership income or as a guaranteed payment.

Local law can affect of the treatment of a payment to a partner. There is some uncertainty as to whether IRC section 736 is limited to prayers of individuals or whether such section also applies to partners that are entities.

Revenue Ruling 99 – 6 provides guidance on the sales of partnership interests in a 2-partner partnership. The principles of this revenue ruling may be applied to other transactions that are substantially similar.

Carried Interest Tax Planning and Considerations and Section 1061

Speakers: Julie A. Divola, Esq., Partner, Pillsbury Winthrop Shaw Pittman, San Francisco, CA; Jennifer Sabin, Esq., Of Counsel, Gibson, Dunn & Crutcher, New York, NY

Background

Compensatory issuances of partnership interests are divided into two types by reference to "liquidation value":

- **Capital Interest:** Provides a right to a share of proceeds in a hypothetical liquidation of the partnership on the grant date.
- **Profits Interest:** Entitles holder to share in only post-grant partnership income and gain (or appreciation).

Court Decisions

- *Diamond v. Commissioner* (7th Cir. 1974). Finding the value of profits interest readily determinable were sold soon after receipt, and receipt of a profits interest was taxable.
- *Campbell v. Commissioner* (8th Cir. 1991). Holding profits interest had speculative value, and thus profits interest had no fair market value for income tax purposes and could not be valued.

Rev Proc 93-27:

- Receipt of *profits* interest for services provided to or for the benefit of partnership is not a taxable event to partner or partnership.
- This rule does not apply if:
  - Profits interest relates to a substantially certain/predictable stream of income from partnership assets (*e.g.*, debt securities).
  - Recipient disposes of the interest within 2 years of receipt.
  - Profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of § 7704(b).
  - Use savings language allowing threshold amount to be increased.

Rev. Proc. 2001-43:

- Clarifies Rev. Proc. 93-27 with respect to profits interests that are substantially nonvested on grant.
- Still not a taxable event to the partner or partnership, provided that:
  - The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant
  - 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
  - Neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest upon the grant of the interest or at the time that the interest becomes substantially vested
  - All other conditions of Rev. Proc. 93-27 are satisfied.

Proposed regulations (70 FR 29675, REG-105346-03) issued May 24, 2005 – these have remained proposed.

- All compensatory partnership interests (capital interests and profits interests) are subject to § 83
- Income and deduction timing governed by § 83
- Compensatory transfer would not trigger gain to partnership
- Forfeiture allocations required if interest is forfeited
- Safe harbor election to treat FMV of a partnership interest issued in exchange for services as being equal to the liquidation value of the interest. Many practitioners continue to use this safe harbor despite the fact that the regulations remain proposed.

Catch up Allocations and Fee Waivers

Some agreements provide for catch-up allocations, whereby income or gain is first allocated to the service provider until the service provider's capital account is proportionate to other partners. The moment at which proportionality is reached is often referred to as "equitization". Allocations are often made only from gain on the sale of all or substantially all of the assets or "book-ups". Catch-up allocations are a common feature of private equity fund waterfalls.

A disguised payment for services exists where the service provider receives an equity interest in the partnership in exchange for providing services, but allocations are designed to provide a pre-determined sum to the service provider. An arrangement in which an allocation and distribution to a service provider are subject to **significant entrepreneurial risk** as to amount will generally be recognized as a distributive share, although other factors are also relevant.

Example #1: Partnership ABC constructed a building projected to generate $100,000 of gross income annually. Architect (A) performs services for Partnership ABC, waives his normal fee of $40,000, and contributes cash in an amount equal to the value of a 25% interest in the partnership. In exchange, A will receive a 25% distributive share for the life of the partnership and a special allocation of $20,000 of partnership gross income for the first two years of the partnership's operations. The capped

allocations of income and gross income allocations are presumed to lack significant entrepreneurial risk.

Example #2: Stockbroker (A) effects trades for Partnership ABC and waives his brokerage commission. A contributes 51% of partnership capital for a 51% interest in residual partnership profits and losses. A also receives a special allocation of gross income that approximates A's waived commissions, which is computed by a formula similar to a normal brokerage fee and varies with the value and amount of services rendered, rather than with the income of the partnership. It is reasonably expected that Partnership ABC will have sufficient gross income to make this allocation. The key issue that the IRS will look at is whether there is significant entrepreneurial risk. That is, is there a real chance that the partner will not receive anything?

Background of the Fee Waiver

Fund would typically pay a fee to private equity firm and a portion of that would be used to fund capital commitment to fund. Because this approach is tax inefficient, fee waiver approaches developed. Fee waivers are widely used in private equity context. You always waive the fee prior to services being provided. The standard is to waive the fee at the start of the fund; however, it is generally considered acceptable to waive the fee in the fall for the next year.

The fee waiver works as follows: The fee is reduced. Then, the capital contribution required is reduced. General partner vehicle receives a catch-up allocation in addition to carry.

Proper design and execution of a fee waiver and priority profits interest is critical to avoid treatment as a taxable grant of an interest.

Congress has been giving attention to the carried interest and has tried a variety of approaches to limit the carried interest. **In 2017**, the Tax Cuts and Jobs Act (H.R. 1, 115th Congress) enacted § 1061, which, for taxable years beginning after December 31, 2017, recharacterizes certain net long-term capital gains of a partner that holds one or more applicable partnership interests as short-term capital gains. Note the use of "applicable partnership interests" rather than investment services partnership. Congress is focusing on entrepreneurial risk to get to long term

capital gain. The 2017 Act treats anything held less than three years will be short-term capital gain. The regs on this issue are extremely complex and unclear.

The regulations under 1061 are divided into six different sections.

- Reg. § 1.1061–1 provides general definitions and terms which are referenced throughout the Final Regulations
- Reg. § 1.1061–2 provides the rules related to APIs and ATBs
- Reg. § 1.1061–3 provides exceptions to the definition of an API
- Reg. § 1.1061–4 provides operational rules, such as rules related to tiered structures
- Reg. § 1.1061–5 provides rules related to transfers of one or more APIs to certain related persons
- Reg. § 1.1061–6 provides certain reporting rules

"Applicable Partnership Interest" ("API") means, subject to various exceptions, any interest in a partnership that, 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 ("ATB"). Once a partnership is classified as an API, it never loses that classification.

Services are provided to private equity firm itself, not to the fund. Typically, the carried interests are provided through the GP vehicle. The average private equity fund typically holds assets longer than three years. The average hedge fund holds assets very short-term.

IRS takes position you can't be a partner and an employee. What is done to deal with this rule is to set up management companies. One structure is that there will be a Holdco and "partner" can be employee of Holdco. Partner's interest will be held at a level above Holdco.

Leveraged distributions in lieu of sale can avoid the capital gain. There is some interest cost to this structure. Ultimate buyer can come in as a partner and have interest recapitalized into preferred.

Partnership can distribute long term capital gain property to sponsors and investors have whatever remains. To have this respected for tax purposes,

you will have to let it age. Sloan indicated this is very difficult to do and get right.

Increasing the Income and Estate Tax Benefits of the Preferred Partnership with Encumbered Real Estate by Future Leveraging

Chair: Stephen M. Breitstone, Esq., Partner, Meltzer, Lippe, Goldstein & Breitstone, Mineola, NY & NY, NY

Speaker: Jerome M. Hesch, Esq., Counsel, Meltzer, Lippe, Goldstein & Breitstone, Boca Raton, FL

What Can the Preferred Freeze Partnership Provide that Gifts, GRATS and Installment Sales to Grantor Trusts Cannot Provide?

- A Freeze Partnership provides one partner a preferred interest with a fixed cash flow. The other partner receives an interest that will receive the future growth. Such a partnership can, over time, transfer a significant amount of value to the junior owners in a tax efficient manner.
- Financial Leverage is important. Gifts, GRATs, Installment Sales and Preferred Partnerships all shift a portion of a partnership's annual income to trusts. This is the financial leverage.
- All of these strategies shift appreciation in the value of partnership assets to irrevocable trusts not exposed to the transfer taxes (the "freeze").
- The burn is the most important technique. This means that the grantor pays the income taxes on all partnership income including what goes to the holder of the common interests (the "burn"). All of these strategies can use grantor trusts.
- **Only the preferred partnership, by retention of the preferred interest, can use the tax-free step-up in basis at death. GRATs and installment sales have fixed payment terms.** You don't get a step-up in basis on an installment sale.
- Only the preferred partnership can provide decedent with a guaranteed payment for life.

- Only the preferred partnership interest can qualify for § 6166 because it is included in the gross estate (15-year payout of estate tax). If you do the installment sale, the promissory note won't qualify for §6166. This should not be overlooked in selecting the approach used.
- Arrangement can be modified based on client objectives. Some may have no interest in getting anything back. Others may want to have an income interest.

What is a Freeze Partnership?

- A freeze partnership has two classes of interests.
  - One class is a preferred interest which has a priority return and a liquidation preference. The preferred has preference with respect to distribution and liquidation.
  - The second class, common interest, will benefit from all income after the preferred return and all appreciation. There is no liquidation preference. The common interest can be gifted or sold to a grantor trust.

If you are going to fully terminate a partnership, the preferred partner's capital interest must be fully redeemed prior to redemption of the common partner's capital contribution. It is not clear whether this only applies upon termination of the partnership. What do you do in the event of a refinancing and distribution? It is not totally clear whether a non-liquidating distribution must go to the preferred units first.

It is very important to address with clients both what they can and cannot do. The partnership agreement should include detailed provisions addressing this. When drafting partnership agreements, the partnership tax accountant should be included in structuring the preferred partnership.

Key Objectives:

- Obtain an income tax free step-up in basis at death when including encumbered real estate in the gross estate.
- Avoid the "leaky freeze" by minimizing the hurdle rate paid on the retained preferred interest. Make sure retained interest is providing a rate that is not too high. If too much comes back, it is called a "leaky freeze."

- Seek to lock in valuation discounts with respect to the common interest.
- The common interest is allocated all excess income and all appreciation in value. Freeze the discounted value of the common interest. Shift income allocated to common interest to a trust that is not exposed to estate tax. The typical strategy used to achieve this is by a sale of the common interest to a trust in exchange for a promissory note.
- The “Burn”. Structure so that the grantor pays all income taxes on partnership income on the common interest.

Impact of 7520 and 1274

- Preferred is not an interest in a trust.
- Preferred is not a debt obligation.
- As an equity interest in a partnership, the preferred must use market rates. See Rev. Rul. 83-120.
- Market rates are typically higher than the 7520 rate (5.4% for December 2022) and the long-term AFR (4.3% for December 2022).
- An objective to have a low preferred rate of return.
- An argument made against the preferred partnership is that too much is included in the estate.

Example of a Preferred Partnership

- Senior creates a partnership and contributes business valued at $20 million. Senior receives a preferred interest with a $10m capital account and common interest with a $10m capital account. Priority allocation of partnership profits to preferred interest is 6% of capital account. Appreciation in value of assets is allocated to the common interest. Partnership income in excess of the $600,000 is allocated to the common interest. Senior sells common interest to irrevocable grantor trust in exchange for a promissory note at the 4.43% long-term AFR for December 2022. (This could be effectuated by a gift.)
    - To the extent of the sale, the freeze is achieved by putting a promissory note in the grantor’s estate and the growth into a trust that won’t be included in the grantor’s estate.

- Only income in excess of priority income can be allocated to common partner. Prior to any redemption of common, all distributions must be made to preferred partner. Any income shortfalls must be accumulated in arrears. Partnership is not required to redeem preferred partner's capital contribution. Risk of loss is first born by common partner.
    - If income goes up to $1,000,000, common interest receives $400,000.
    - If partnership profits are less than the preferred allocation, the shortfall must accumulate in arrears. All arrears must be satisfied before any profit allocations can be made to the common partner.
- Partnership is not required to redeem the preferred partner's capital contribution.
- Risk of loss is typically born by the common partner. Losses typically cannot be allocated to preferred partner until common partner's capital account is exhausted.
- Primary benefit of preferred partnership strategy is the step-up in basis. When you capitalize, you structure so that liabilities stay with the preferred.

Using the Preferred Partnership for Encumbered Real Estate

- Senior purchased a commercial office building in 1984 for $20 million. $16 million was depreciated over 18 years using ACRS. Senior took out substantial funds out of building income tax-free. This was achieved by refinancing the mortgage. Real estate might also have a low basis as a result of utilizing 1031 exchanges.
- Current Status:
    - Value $54m
    - Adj. Basis $4m
    - Mortgage $44m
    - Equity $10m
- Phantom Gain $40m is generated by liabilities in excess of basis. This is "negative capital account." If you sold building subject to mortgage, your amount realized would be $54m and basis is $4m. You have $50m of gain but only $10m of cash. If Senior is subject to California state income taxes, total taxes could be $18,550,000.

- Income taxes can exceed the $10m netted from the sale.
- The advantage of this real estate being included in decedent's gross estate is elimination of the $50m in gain. If this encumbered real estate is subject to estate tax, $10m is subject to estate tax for an estate tax cost of $4m. If real estate sold immediately after death, income taxes saved can be $14.4m. Crane v. Commissioner – Upon death, basis is $54m.
- If building continues to be held, basis step-up can be allocated to building and depreciated against ordinary income. This saves as much as $20m of income taxes over time. (This will vary based on applicable state income tax rate.)
- Of course, the downside is that to the extent the real estate is held until death, all appreciation will be included in the estate and subject to estate tax at the current estate tax rate.
- Alternative 1:
  - Reorganize partnership into preferred and common. Senior disposes of common interest by gift or sale to an irrevocable grantor trust that is not exposed to estate tax. Senior uses the minimum 90%/10% capital account allocation permitted under 2701. At least 10% has to be allocated to common.
  - All tax attributes must also be allocated 90/10.
  - The common interest should not be gifted directly to child or non-grantor trust if there are liabilities. Doing so results in grantor being deemed to have sold a portion of the common interest in exchange for the debt.
  - Structure:
    - Preferred – Tax Basis $3.6m; Gross Value $48.6m; Liability 39.6m; Phantom Gain $36m; Capital account $9m
    - Common - Tax Basis $400k; Gross Value $ 5.4m; Liability $4.4m; Phantom Gain $ 4m ; Capital account $1m
  - Senior dies with only the frozen preferred partnership interest included in Senior's gross estate. Estate tax value for the preferred interest is $9m. Because preferred is still allocated 39.6 of liabilities, estate's income tax basis is $48.6m. Common interest will still have $4m of phantom gain.

    - The issue with this alternative is that 10% of the liabilities did not receive a step-up in basis.
- Alternative 2
    - Senior contributes $10m of other assets for a common interest and the $10m is later converted to a preferred interest or child or trust can make the capital contribution for the common interest. This is a contribution of unencumbered assets for the common and encumbered assets for the preferred. If a market-based approach can result in a preferred priority return in the 5 to 6% range, the "leaky freeze" has been minimized.
        - A preferred 9% priority return was used when 10% of partnership capital was allocated to the common interest.
        - You should have a non-disregarded entity from the start. Typical structure has someone other than Senior own a very small interest. This ensures subchapter K applies.
    - This structure has a 50/50 result. You can justify lower rate of return on preferred.
    - If you create a 90/10, appraiser will assign more value to the preferred because it has less risk.

What is a Preferred Priority Return?

- A priority return is a priority allocation of partnership income.
- If a preferred priority return is 9%, partnership income must be allocated to the preferred interest based on 9% of the preferred capital account.
- Using more common coverage reduces the preferred risk. That is, if more of the capital is allocated to common, the risks of underperforming the preferred return are less.
- Rev. Rul. 83-120 requires market-based approach for priority return. Such a return will result in a rate greater than the 7520 rate used for GRATs and installment sales.

Estate Tax Advantage of Transferring the Common Interest to A Grantor Trust

- Example: Senior contributes $10m of assets to a partnership and receives a preferred interest of $6m and common interest of $4m. Preferred interest provides 6% return.

- Grantor pays income taxes on the trust income. This is the "burn". That is, income cannot be distributed to grantor, but grantor pays the income taxes.
- Senior sells the common interest to a grantor trust for $3m (using a 25% valuation discount) taking back the grantor trust's promissory note at the long-term AFR (assume 2%), paying $60,000 interest annually with all note principal due in 20 years.
- Assume that the partnership's income gradually increases each year.
- Assume Senior's income tax rate is 40%.
- If the income increases gradually each year, over time, Senior receives the same preferred allocation and note interest while the income to the grantor trust, on which Senior pays the tax, increases. Initially, this may result in a positive net amount to Senior but as income increases and the excess income is allocated to the common, net to senior can be negative (burn).
- Presenters indicated that they think there is a significant issue with toggling off a grantor trust. If Trustee "toggles off", Trustee is releasing the grantor from obligation to pay the income taxes. Trustee fiduciary obligation runs to beneficiaries. Presenters think IRS is looking at this issue.

Factors to Consider After Formation of Preferred Partnership

- Real estate partnerships are likely to continue to refinance.
- The increase in partnership liabilities can increase the phantom gain in the preferred interest.

Partnership Disguised Sale Regulations

IRC 707 includes a presumption that a disguised sale occurs when a member contributes appreciated property to a partnership and cash or other property is distributed to such contributing member within two years. There are various safe harbor approaches to avoiding a disguised sale. One approach would be to structure the preferred right to restrict the amount of the payment for the first two years with a true-up payment in Year 3. An alternate would be to have full coupon payments begin in Year 3. An additional safe harbor is one that does not result in distributions in excess of partnership's cash flow from operations. It is possible to create a

structure for payments that does not satisfy a safe harbor but is a reasonable preferred payment.

Section 2036(a)(1) and the Common Interest

Compliance with Section 2701 should meet bona fide sale exception.

Section 2036(a)(2)

Section 2036(a)(2) results in estate tax inclusion if decedent has “the right, either alone or in conjunction with any other person to designate the persons who shall possess or enjoy the property or the income therefrom. The safe approach is to structure the preferred interest to have no vote on any partnership matters.

CLOSELY HELD BUSINESSES

Chair: Jerald David August, Esq., Partner, Fox Rothschild, Philadelphia, PA

Entity Classification – The Check the Box Regulations

Chair: C. Wells Hall, Esq., Nelson Mullins, North Carolina, stepped in for Jerome David August, Esq., who was not able to attend.

Overview of the Regulations

Federal regulations control entity classification.

A business entity is an entity recognized for federal tax purposes that is not a trust or a special tax treatment entity.

A business entity with more than one owner is classified as either a partnership or a corporation.

A business entity with only one owner, it is classified as a corporation or disregarded entity.

If single member entity has employees, it is not disregarded with respect to employment taxes. The same is true if the entity is subject to excise taxes. A single member entity is not disregarded with respect to certain federal tax liabilities such as taxes of another entity for which the single member entity

is responsible. Additionally, a single member entity is not disregarded with respect to banks.

Pierre v. Commissioner – “Petitioner’s transfers to the trusts should be valued for Federal gift tax purposes as transfers of interests in Pierre LLC and not as transfers of a proportionate share of the underlying assets of Pierre LLC.”

Per se corporations include a business entity formed as a corporation, a business entity formed as a joint stock company, an insurance company, a state organized bank, a business entity solely owned by a state or local government, a business entity taxes as a corporation under the Code; and the 87 foreign entities listed in the regulations. One option in this case is to liquidate the entity.

If an eligible entity has 2 or more owners, it may elect to be classified as either a Corporation or Partnership. If an entity has only one owner, it may elect to be classified as either a Corporation or a DRE.

The default provisions treat an entity with two or more entities as a partnership and a single member entity is a DRE. Unless a valid election is made, a “foreign” eligible entity, by default, is a Partnership if it has 2 or more Owners and at least 1 Owner has limited liability, a corporation if all Owners have limited liability, or a Disregarded Entity if it only has 1 Owner and that Owner does not have limited liability.

Nuts and Bolts

Election is made on Form 8832. If all information is not completed, you may have an invalid election. A copy of 8832 is supposed to be attached to entity return for year for which election is made. If no return is required, owner is supposed to attach 8832 to their individual tax return.

Effective date may be specified. If no effective date is specified, the date of filing is the effective date. Effective date can be retroactive up to 75 days. Effective date can be prospective up to 12 months.

Who must sign the form? Person authorized to sign the form can sign. If a retroactive effective date is elected, all Owners from effective date through filing date must sign. If prospective effective date is selected, only the owner as of the date of filing must sign.

Once an entity changes its tax classification, it typically cannot do so again for 60 months. There are a few exceptions. A change out of a default election is ignored for the 60 month rule. The Commissioner an waive the 60 month rule. A change solely due to a change of number of owners is ignored.

Changing classifications can be a timebomb for the unwary. Just because you can check the box doesn't mean it should be done. Consider the tax consequences of any change.

Late Elections

Treasury Reg. 301.9100

Rev Proc 2009-41. This provides relief for late initial filing or late change of election.

1. This provides automatic relief if the only defect is the late filing; 2. The eligible entity has not filed a federal tax return for the first year in which the election was to be effective because the due date has not passed, or it filed its return but did so in a manner consistent with the election; 3. The eligible entity has reasonable cause for failing to timely file the election; and 4. Less than three years and 75 days have passed since the intended effective date.

When you file under this Rev Proc, attach a clear statement that the filing is made under 2009-41. Generally, there should not have been inconsistent returns filed.

Rev Proc 2013-30 allows for late filings in other circumstances.

1. Entity must be an eligible entity; 2. Entity intended to be an S corporation as of the effective date of the tax classification election; 3. Less than 3 years and 75 days have passed; 4. The only defect is untimely filing; 5 The eligible entity only failed to qualify as an S corporation because the S election was untimely; 6. All federal returns since the intended effective date have been filed consistent with S status; 7. Reasonable cause exists; and 8. Income has been reported by the Owners consistent with S status.

Deemed Elections

Do you really need to file 2553 and 8832? Presenter's opinion is that filing both is redundant.

Deemed elections: tax exempt entities, REITs, S corporations

Elective Changes

Types:

- Partnership to corporation
- Corporation to partnership (not a per se corporation)
- Corporation to disregarded entity
- Disregarded entity to corporation – This is a simple 351 transaction.

Rev Proc 2002-69

Rev. Proc. 2002-69 provides that if a qualified entity is owned by a married couple as community property, the owners of the entity can treat it as a disregarded entity for federal tax purposes, the IRS will accept the position that it is a disregarded entity. If a qualified entity, and a married couple as the owners of the entity, treat it as a partnership for federal tax purposes, the IRS will accept the position that it is a partnership for federal tax purposes.

Married taxpayers who wholly own an LLC in a community property state will not have to file a partnership return if the business is a qualified entity and they treat it as a disregarded entity. If the business is not held in a state law entity, married taxpayers may elect out of partnership treatment under Sec. 761(f). If, however, a married couple files a partnership return for their wholly owned business, they cannot then say it is not a partnership when confronted with penalties for late filing of the partnership return.

Employer Identification Numbers

Entity retains EIN when it changes classification. An eligible foreign entity must obtain an EIN when it makes an election. A disregarded entity may have its own EIN.

Not So Obvious Issues

LLC Taxed as an S corporation – Presenter does not think electing S corp status for an LLC is a good idea. 704 capital accounts don't apply to

corporations. How does this work in the event of a conversion from S corp to partnership or vice versa?

There may be a variety of unwanted tax consequences with change of elections. If 351 applies, be sure to have the control requirement applied. Section 357 may be an issue if there are excess liabilities. If S election is made, be sure that all the requirements of S election are met. If you don't meet the requirements, the entity will be a C corporation. Agreement should specify how state law applies. Most state statutes do not provide a pro rata liquidation. If you have a profits interest and you converted entity to S status, the rights of the profits interest are not identical to the other owners and you likely have two classes of stock. If you do have an LLC making an S election, be sure to revise the operating agreement to be S compliant. Additionally, pay close attention to state law and how it applies.

Shareholders Agreements Involving S corporations

Speaker: Stephen R. Looney, Esq., Shareholder, Dean Mead, Orlando, FL

A Shareholder Agreement is simply an agreement among the shareholders of an entity as to the ownership of shares and what happens in certain situations such as death, disability, retirement, termination of employment with the business and sale of the entity. It is important to consider who you are representing when you draft a shareholder agreement.

A Shareholder Agreement can create a market for what is otherwise an unmarketable interest in a closely-held corporation. Shareholder agreement provides a means for determining a fair price of the shares of stock of a closely-held corporation in light of the goals sought to be achieved by the shareholders of the closely-held corporation.

A Shareholder Agreement may be used to establish a control mechanism for the transfer of stock and to exclude or remove inactive or potentially dissident shareholders depending upon the circumstances and desires of the shareholders.

A Shareholder Agreement may provide a means of transferring control of a closely-held corporation upon the death, disability or termination of employment (through retirement or otherwise) of a shareholder to other shareholders. This is business succession purposes.

A Shareholder Agreement may be used to reduce the financial pressure on a decedent's heirs to pay estate taxes and other expenses by providing for a mandatory repurchase of a deceased shareholder's shares or by giving the estate (or the decedent's heirs) the option to sell such shares to the closely-held corporation. This may be particularly useful when there is an absence of liquid assets.

A well drafted shareholder agreement can substantially reduce the risk of shareholder disputes. Shareholder agreement can also create evidence of value for estate and gift tax purposes.

With respect to S corporations, it is important to have an agreement that prohibits transfers to ineligible shareholders. Agreement can also agree when there will be an election to close the books when there is a termination of an interest.

An agreement can provide for operating distributions. A tax distribution provision is typically very important.

There are essentially three types: Cross Purchase Agreement; Redemption Agreement; Hybrid Agreement. In a cross purchase agreement, shareholders buy from each other. In a redemption agreement, entity purchases. In a hybrid, corporation may redeem but if corporation does not, shareholders have option to purchase.

Income tax planning for a redemption has more pitfalls that a cross purchase.

In C corporation context, redemption that doesn’t satisfy 302, the redemption will be taxed as a dividend. Dividends from C corporations are potentially exposed to NIIT. The reason to seek redemption treatment for the selling shareholder is recovery of basis and qualification for installment gain treatment. To qualify as a redemption, structure must not be essentially equivalent to a dividend.

To satisfy redemption rules of substantially disproportionate, the shareholder's percentage of the total outstanding ***voting stock*** immediately after the redemption must be less than 80% of his percentage of ownership of such stock immediately before the redemption (i.e., the post-redemption ratio must be less than 80% of the pre-redemption ratio). The shareholder's post-redemption ratio of the total outstanding ***common stock*** immediately after the redemption must be less than 80% of his pre-redemption ratio of such stock.

• Reg. Section 1.302-3(a) – Redemption of Non-Voting Stock.

• Rev. Rul. 77-237 – Redemption of Constructively Owned Voting Stock.

• Rev. Rul. 81-41 – Red

To qualify as a Complete Termination, under Section 302(b)(3), sale or exchange treatment applies if a shareholder terminates his or her entire proprietary interest in the corporation as a result of the redemption. Under Section 318(a)(1)(A), an individual is considered as owning the stock owned, directly or indirectly, by or for his spouse, children, grandchildren and parents. A family member can file a waiver of family attribution rules.

Qualifying a redemption under either Section 302(b)(2) or 302(b)(3), especially in the context of a family corporation, may be difficult because of the application of the constructive ownership rules of Section 318.

The three requirements to waive family attribution are:

- Look Back Rule
- Look Forward Rule
- Notification Requirement

Redeemed shareholder cannot continue as a director, officer or employee. Redeemed shareholder cannot serve as an unpaid consultant.

Hurst case – Redemption of stock qualified as a complete termination because taxpayer did not retain any interest in the corporation other than his interest as a creditor. Creditor interest was secured.

Entities can also waive family attribution rules, if both the entity and the related individual join in the waiver and agree not to acquire a prohibited

interest, and if both agree to be jointly liable for any deficiency caused by the subsequent acquisition of a prohibited interest. Section 302(c)(2)(C).

NIIT may apply to the sale of stock.

The same rules governing shareholders in C corporations under Section 302 (and 303) also apply to distributions in redemption of stock of an S corporation, including the stock attribution rules in Section 318.

Characterization of a distribution as a redemption under Section 302(a) or as a distribution under Section 1368(a) may make little difference to the redeeming shareholder because of the distribution rules governing S corporations having no earnings and profits.

Unless the purchase price is to be paid over a period of years (where the shareholder will need exchange treatment to qualify for the installment sales rules), it essentially makes no difference to the redeeming shareholder whether the transaction is a redemption under Section 302(a) or a distribution under Section 1368. This indifference as to whether a distribution is characterized as a Section 302 redemption or a Section 1368 distribution ***may*** also apply to S corporations having earnings and profits.

Consider including in your shareholder agreement that if the majority of shareholders want to make a 1368 election, then all shareholders will do so.

Distributions out of earnings and profits do not reduce shareholder basis. It may be possible to distribute some C corp earnings and profits and offset with NOLs.

Impact on Redeemed Shareholder:

That portion of the distribution that does not exceed AAA is tax-free to the extent of the shareholder’s stock basis – Sections 1368(c)(1) and 1368(b)(1);

That portion of the distribution that does not exceed AAA, but that does exceed the shareholder’s stock basis, is capital gain - Sections 1368(c)(1) and 1368(b)(2);

That portion of the distribution that exceeds AAA is a dividend to the extent of the S corporation's accumulated Subchapter C earnings and profits - Sections 1368(c)(2) and 301;

That portion of the distribution that exceeds AAA and the accumulated Subchapter C earnings and profits of the S corporation is tax-free to the extent of the shareholder's residual stock basis - Sections 1368(c)(3) and 1368(b)(1); and

That portion of the distribution that exceeds AAA, the accumulated Subchapter C earnings and profits of the S corporation, and the shareholder's residual stock basis, is capital gain - Sections 1368(c)(3) and 1368(b)(2).

Distributions not exceeding AAA – no difference in results whether dividend or redemption. Distributions exceeding AAA – different tax treatment if dividend or redemption.

Application of NIIT tax to sale of S corporation

It is possible to avoid application of NIIT in sale of S corporation stock. This requires material participation of owner. There is a look-through method. There is a primary method and optional method to determine the amount subject to NIIT, if any.

Before determining the tax treatment of distributions to S corporation shareholders, the basis of the distributee shareholder in his S corporation stock must be adjusted under Section 1367:

• Increase by Income Items.

• Determine Tax Effect of Distribution.

• Decrease by Loss and Deduction Items.

Under Section 1368(e)(3), an S corporation which has Subchapter C earnings and profits can make an election to change the ordinary distribution rules discussed above. If a Section 1368(e)(3) election (which is referred to as a "AAA bypass election") is made, the distributions from the corporation to its shareholders will first be treated as coming out of the corporation's accumulated Subchapter C earnings and profits to the extent thereof, then out of the corporation's AAA.

A Section 1368(e)(3) election can be a useful tool for an S corporation with Subchapter C earnings and profits that wishes to purge such earnings and profits:
• Avoids the “sting” tax of Section 1375. • Avoids possible termination of S corporation status under Section 1362(d)(3)

Planning Opportunities and Pitfalls in Connection with Termination elections.

- The elective nature of Section 1377(a)(2) can be a useful planning tool.

Life Insurance

Have termination of shareholder effective as of date of death. That is, the purchase of the deceased’s shareholder’s interest is made as of the date of death. Then, when proceeds are paid to entity, allocation can be made to basis of remaining shareholders. PLR 200409010. Slide 121

Provisions to Include in Agreement

Tax Distributions.

Impose Liquidated Damages if a transfer is made that impacts S election.

Insert a provision that all shareholders will consent to a 338(h)(10) election.

Structuring Mergers, Acquisitions, and Private Equity Recaps When the Target is an S Corporation

Speaker: C. Wells Hall, III, Esq., Partner, Nelson Mullins Riley & Scarborough, Charlotte, NC

Basic Structures:

- Tax-Free Reorganizations
- Taxable Asset Acquisitions and Stock Purchases and Dispositions Treated as Asset Acquisitions – Section 338(h)(10) and Section 336(e)
- Private Equity Recapitalizations

- Using Section 351 as Acquisition Vehicle

Tax Free Reorganizations

Seller treatment is a nontaxable reorganization. Buyer treatment results in a carryover of asset basis and tax attributes with no step-up. The buyer also inherits old tax history and no amortizable goodwill.

Disregarded entities resulted in some proposed regulations in 2000. Pursuant to such regulations the merger of a disregarded entity into a corporation would not be a Type A reorganization because the emerging entity is not a tax corporation. Many of the mergers of a disregarded entity under such regulations would result in a taxable transaction.

In Rev. Rul. 2000-5, the Service held that a Type A merger must involve the transfer of the assets of a target corporation to a single transferee corporation ceasing to exist as a result of the "merger." Rev. Rul. 2000-5 implied that a merger of a DRE (single member) owned by a corporation (including a QSub), cannot be a Type A reorganization because it will be divisive and will not necessarily result in the termination or liquidation of the member. 2003 final regulations defined a disregarded entity as a business entity is disregarded as an entity separate from its owner for federal tax purposes. Following such regulations, a disregarded entity can be merged in a tax-free transaction.

Taxable Asset Acquisitions and Stock Purchases and Dispositions Treated as Asset Acquisitions – Section 338(h)(10) and Section 336(e)

Seller treatment in such transaction results in no double tax. In addition, installment sales treatment is likely available. The buyer will have a step-up in the basis of assets and will generally avoid inheriting exposure for pre-closing taxes.

Taxable Stock Acquisition – no 338(h) election

Seller will generally recognize capital gain or loss and will have no double tax. Installment sale treatment me possible. The buyer will have a carryover of asset basis. There will be some carryover of tax attributes. The buyer will inherit old tax history.

Taxable Acquisition of S corporation – with 338(h)(10)

Seller may qualify for installment sales treatment there is potential for timing and character mismatch. From the buyer perspective, the transaction will be treated like an asset purchase. Seller and buyer may be exposed to BIG tax an entity level state income tax.

Taxable Acquisition of S corporation – Qualified Stock Disposition 336(e)

This structure is a deemed asset sale/deemed liquidation. S Corp Target shareholders must consent to 336(e) election. The purchaser in a qualified stock disposition is not required to be a corporation, as in the case of a qualified stock purchase under section 338(h)(10). There is potential for timing and character mismatch. From buyer perspective, the transaction will be treated like an asset purchase and asset basis will be adjusted to purchase price.

Alternatives to Section 1031 Issues

Speaker: Terence Floyd Cuff, Esq., Of Counsel, Loeb & Loeb, Los Angeles

Installment sales can result in the deferment of paying taxes on gain. To use an installment gain structure, there are a variety of requirements that must be met. One restriction is the interest charge on deferred tax liabilities. Another important rule is that borrowing on an installment sale obligation will accelerate deferred gain. There is also a rule that accelerates recapture income to the year of sale.

In general, the installment sale results in a matching of gain with payments being received. Gain is spread out over period over which payments are made.

To qualify as an installment sale, at least one payment must be received after the taxable year in which the sale occurred. If there are only two payments with one being a large one in the year of sale and a very small one in the second year, there may be an issue as to whether the transaction qualifies.

Each installment payment consists of three parts: principal; gain; interest. Interest and gain are taxed when received.

Seller's gross selling price will be amount paid to seller for property, any debts assumed by buyer related to the property and any expenses of seller

paid by buyer. Selling price less seller adjusted basis equals gain. The portion of each payment that is gain is total principal payments times gross profit percentage. Gross profit percentage is gross profit divided by total contract price. Seller reports as gain an amount that is total payments received during a year times gross profit percentage.

There may be an interest charge on deferred tax liability if the selling price is greater than $150,000 and the amount due at end of taxable year is greater than $5m. There is a special rule that applies to farmers.

An example of a monetized installment sale looks like the following:

- Slim enters into agreement to sell property to Buyer for $10m cash.
- Slim then sells the property to A Co for $10m installment note to be paid over 30 years at AFR rate with balloon payment at the end of term.
- A Co steps into Slim's shoes and sells property to Buyer for $10m cash.
- A Co deposits $10m with Bank in escrow.
- Bank makes a loan to Slim for $9.2m that is secured by guarantee from A co and cash from sale held at Bank.
- The loan to Slim is non-recourse.

FAA 20123401F (July 18, 2012) discusses a monetized installment sale. The Internal Revenue Service advised that substance-over-form and step transaction doctrines would not prevent gain deferral in the monetized installment sale. Each step of the transaction had independent economic significance. FAA 20123401F deals with a limited exception that applies only to installment sales of farm properties. Some authorities have cited FAA 20123401F as authority for more general approval of monetized installment sales without recognizing that the reasoning of FAA 20123401F is expressly limited to sales of farm property.

The Executive Plan AKA "The Greenbook": Closely Held Business Planners Beware!!!!!

One of the issues behind many current proposals is that there is too much untaxed wealth. As recently as 2022, the federal estate tax exemption was $675,000.

There is an administrative attack on grantor trusts. The same is true regarding GRATs, particularly zeroed out GRATs.

One of the Greenbook proposals is to increase the corporate income tax rate. The proposal is an increase to 28% with some application of a 35% rate.

The top marginal individual rate would revert to 39.6%. Capital gains rate would increase from 20% to 37%.

A 20 percent minimum tax on unrealized capital gain would be imposed on all individuals with net wealth in excess of $100,000,000.

Section 1031 exchanges would be limited to $1,000,000 for married filing jointly taxpayers, $500,000 for all other taxpayers.

<u>The Anti-Accumulation of Wealth Transfer Tax Proposals</u>

The following are the key tax proposals aimed at accumulation of wealth:

- The duration of the generation skipping transfer tax exemption would be limited to lives in being of 2 generations plus 21 years.
- The remainder interest of a grantor retained annuity trust would be increased to at least 25%, thereby eliminating the "Zeroed Out GRAT, a key estate planning technique which the administration perceives as "too good to be true".
- The attack on Grantor Trusts.

Notable Exclusions from the Greenbook

- The current exemptions of $10,000,000 indexed for inflation are not reduced.
- The current estate, gift and generation skipping transfer tax rates of 40% are not increased.
- Section 1014 adjustment to basis – commonly known as "step-up in basis" – is maintained.

A grantor trust is a trust whereby all the income is taxed to the grantor even though the grantor doesn't have access to the income. IRC Sections 671-679. There are various provisions that cause income of a grantor trust to be taxed to the grantor. For example, if the grantor has the right to substitute property with assets of the trust of equal value, the trust will be treated as a grantor trust.

Revocable grantor trusts will be included in the estate of the grantor; however, planners routinely use grantor trusts that are irrevocable and to which transfers are completed gifts. The growth on transfers to such a trust will be outside the estate of the grantor while grantor remains responsible for the income tax on the income earned by the trust. These types of irrevocable trusts are intentionally structured to be grantor trusts and are generally referred to as "intentionally defective grantor trusts or IDGTs."

Estate planners have been using transfers to IDGTs and GRATs "on steroids" to transfer well more than the exemption via these strategies. The grantor trust is very much subject to attack currently.

The proposals being suggested include:

- Any appreciated asset owned by an IDGT would be subject to capital gain taxation on death.
- Any transfer of an appreciated asset to an IDGT would be subject to capital gain at the time of the gift.
- Any sale or exchange of assets between a grantor and the IDGT of which he or she is the grantor would be a taxable sale or exchange.
- The payment of income tax by the grantor with respect to the income earned by the IDGT would be deemed a gift for gift tax purposes.

Circular 230 indicates that a practitioner "must not, in evaluation of a federal tax matter, take into account the possibility that the tax return will not be audited or that the matter will not be raised on audit." Circular 230, §10.37(a)(2).

TRUSTS & ESTATES

Chair: John Porter stepped in for Sanford J. Schlesinger, Esq.

<u>Current Developments in Estate Planning and Taxation</u>

Speaker: David Pratt, Esq., Partner, Proskauer Rose, Boca Raton, FL

Inflation adjusted numbers for 2023 are out but the House passed bill could impact some of the numbers that have been published.

Greenbook (presidential wish list)

Greenbook includes proposals to increase corporate and individual income taxes, which also affects trust.

There is a concept of a death or a gift resulting in a recognition event. The proposal provides for an exclusion for up to $5m.

Zeroed out GRATs would be eliminated. Grantor trust strategy would be impacted by proposal to have transactions between grantor and trust recognized and taxes paid by grantor being a gift. This essentially gets rid of the grantor trust. Assets of grantor trust would be included in grantor's estate.

The Greenbook provides for a limitation on the period of trusts. Every trust would be subject to federal limitation every 50 years in that transfer tax would apply.

<u>Proposed Regs re Clawback</u>

Clawback generally refers to the way the estate tax is calculated. This is an issue when the estate tax exemption is less at the time a decedent dies is less than when a gift was made during life. "Clawback" has become an issue as a result of the Tax Cuts and Jobs Act of 2017, under which the lifetime exemption is increased through 2025 and in 2026 the amount will be cut in half. Final regulations were issued in 2019 that addressed the majority of clawback related issues. The Internal Revenue Service recently proposed additional regulations designed to address an issue that the Service determined to be a possible "loophole."

Initially, this computational quirk occurs in the manner the estate and gift taxes are integrated. Estate taxes are imposed when the value of the estate exceeds the applicable exclusion (indexed for inflation) in the year of death. The amount is set to be cut in half after 2025 if no action is taken.

To the extent that the value of a testator or donor’s estate (to which is added lifetime gifts) exceeds the amount of the applicable exclusion in the year of a testator’s death, the estate tax is imposed at a rate of forty (40%) percent. The regulations were issued to avoid a taxpayer being in a position where the taxpayer’s gifts would be clawed back into his estate if the taxpayer died in a year when the exemption has decreased.

These clawback rules resulted in taxpayers using strategies that seek to lock in the higher applicable exclusion without the taxpayer truly parting from the taxpayer’s funds. These strategies have included intentional inclusion of transfers to preferred partnerships and grantor retained income trusts.

The recently Proposed Regulations attempt to prevent this type of strategy. In the Proposed Regulations, the IRS uses as an example a “gift” of a promissory note. Suppose an individual with a $15,000,000 estate wants to make a gift in a year the applicable exclusion is $12,000,000 but does not really want to give anything away. The individual donor makes a promise to repay $12,000,000 by signing a legally binding promissory note and gifts the promissory note to his/her child so that the child is entitled to the $12,000,000 under the note. The donor files a gift tax return (Form 709) with the IRS reporting that they have made a gift of the $12,000,000 promissory note. The theory is that the donor would hold the entire $15M in assets and at passing, when the exclusion is reduced to say, $6M repay the $12M promissory note. The taxable estate would be $3M ($15M total reduced by the $12M debt) and the tax would only be imposed on the $3M because the estate would attempt to take advantage of the 2019 Regulations allowing the use of the $12M BEA in the year of the gift. The donor would have theoretically “gifted” a large amount but in substance would not have parted with his/her assets.

The Proposed Regulations indicate that, to prevent this type of abuse, the gift would be ignored for gift tax purposes. There is an exception where the promissory note is actually, in fact, paid by the decedent more than 18 months before death.

The operative rules of the Proposed Regulations deny the taxpayer’s estate the use of the applicable exclusion in the year of gift in the following circumstances:

- If the gifted assets are taxable to the estate under one of the "string" provisions of IRC 2035 through 2042.
- The transfer is a promissory note.
- The transaction is based on the provisions of IRC 2701 or 2702.

There are several examples in the proposed regulations that provide illustrations of how the proposed regs work.

In the first example, the taxpayer gifts a $9M promissory note. The IRS says that the note is "included" in the estate and thus, the gift is ignored, unless the note is repaid more than 18 months before death.

The second example changes the facts to a cash gift of $2M followed by a gift of a $9M note. The cash gift is respected but the note is not.

Proposed Regs 2053

The proposed regulations provide guidance on the use of present-value principles in determining the amount deductible by an estate for funeral expenses, administration expenses, and certain claims against the estate. In addition, the proposed regulations provide guidance on the deductibility of interest expense accruing on tax and penalties owed by an estate, and interest expense accruing on certain loan obligations incurred by an estate. The proposed regulations also amend and clarify the requirements for substantiating the value of a claim against an estate that is deductible in certain cases. Finally, the proposed regulations provide guidance on the deductibility of amounts paid under a decedent's personal guarantee. The proposed regulations will affect estates of decedents seeking to deduct funeral expenses, administration expenses, and/or certain claims against the estate under section 2053.

The proposed regs require discounting to present value of any claims or amounts to be paid that will not be paid by three years from the date of death. The regs provide a general formula but permit any reasonable assumptions or methodology.

The IRS proposes to amend the regulations under §2053 regarding the deductibility of interest accruing on a loan obligation entered into by the decedent's estate to facilitate the payment of the estate's taxes and other liabilities or the administration of the estate.

Graegin loans (see Estate of Graegin v. Commissioner, T.C. Memo. 1988-477), have a set interest rate for a set number of years and prohibit prepayment of either principal or interest, because the amount of interest is fixed and determinable. Graegin (and many subsequent cases) have allowed a full upfront undiscounted estate tax deduction for the payment of interest that might be deferred up to 15 years.

The combined effect of the present value and interest limitations under the proposed regulations is that the expense deduction for interest paid on Graegin loans will be significantly restricted.

Portability

IRS issued Revenue Procedure 2022-32 on July 8, 2022. The Rev Proc supersedes Revenue Procedure 2017-34 and now allows for a late estate tax exemption portability election to be made up to five (5) years from a deceased spouse's death. The previous timeframe was two years.

The requirements pursuant to Revenue Procedure 2022-32 are the same as under the prior Revenue Procedure and include the following: (A) the decedent: (i) was survived by a spouse; (ii) died after December 31, 2010 and (iii) was a citizen or resident of the United States on his or her death; (B) the estate must not be required to file an Estate Tax Return; (C) an Estate Tax Return was not timely filed; and (D) all the requirements for relief under Revenue Procedure 2022-32 are satisfied. If the five (5) year window in Revenue Procedure 2022-32 has passed, the surviving spouse can still request late election relief in a Private Letter Ruling ("PLR") from the IRS.

Baty case

Taxpayer funded a GRAT with shares of a publicly traded company using high/low median valuation approach espoused by the IRS with respect to shares of publicly traded companies. At the time, taxpayer served on the board and merger negotiations were in process. IRS took the position that the valuation should have taken into consideration the potential merger. Baty filed a motion for summary judgment and the IRS conceded prior to hearing. The motion included, among other arguments, that the valuation approach utilized had long-standing acceptance, the hypothetical "willing

buyer" would not have known about the merger negotiations, and that events subsequent to a valuation can't be used in hindsight to value a gift.

Levine case

The Levine case involved a split-dollar life insurance estate-planning arrangement. Marion Levine entered into a transaction in which her revocable trust paid premiums on life insurance policies taken out on her daughter and son-in-law that were purchased and held by a separate and irrevocable life-insurance trust that was settled under South Dakota law. Levine's revocable trust had the right to be repaid for the premiums. Decisions for investments could be made only by its investment committee, which consisted of one person—Levine's long-time friend and business partner. Levine died, and the policies had not terminated or paid out at that time as her daughter and son-in-law were still living. The question was what was required to be included in Levine's taxable. The options were: (1) the value of her revocable trust's right to be repaid in the future (i.e., $2,282,195), or (2) the cash-surrender values of those life-insurance policies at the time of Levine's death (i.e., $6,153,478).

Primary Holdings:

The split-dollar arrangement met the requirements of the Treasury Regulations. Thus, the inclusion of cash surrender value in the Levine estate is not required.

Rather, Levine possessed a receivable created by the split-dollar life insurance. The receivable was the right to receive the greater of premiums paid or the cash surrender values of the policies when they are terminated.

The transaction was for a legitimate business purpose. The trust's investment committee owed fiduciary duties to the trust and beneficiaries other than Levine, Levine's daughter, and son-in-law. Levine had no power to alter, amend, revoke or terminate the irrevocable trust such that its assets should be included in Levine's estate pursuant to Sections 2036(a)(2) or 2038.

The only asset from the split-dollar arrangement that Levine's revocable trust owned at the time of her death was the split-dollar receivable.

Smaldino case

In Smaldino v. Commissioner, T.C. Memo. 2021-127, husband wanted to transfer up to 50% of his interest in an LLC. So, he was going to transfer 49%. His spouse had $5.25 million of gift exemption amount. Prior to making gift, appraiser was hired. Transfer was made seeking to use a “Wandry” clause transferring number of units as determined for federal gift tax purposes equal to $5.25 million.

The parties ultimately conceded they didn’t really treat this as a Wandry transfer but rather as a 41% transfer to spouse that was accomplished in August but dated in April. The wife signed a document the effective the next day (April 15) transferring her interest to dynasty trust. Husband also signed a document transferring an interest to dynasty trust.

Husband filed a 709 but did not report gift to wife and did not treat gift to trust as a split gift. At trial, the wife admitted that next day transfer was made because she made a promise to her husband that she would transfer the LLC units to the dynasty trust. The entity documentation never reflected the wife as an owner. The court said that the Wife never really had the ability to exercise any ownership rights and based on overall facts, there was never an effective transfer to Wife.

Estate Planning Implications of the Ruling

Estate planners should keep in mind that the transaction optics matter. Complete all the steps. Consider whether there should be time between the various steps.

If documents are being signed on a date other than on the date of the transaction, specify the same.

Coordinate with accountants and other professionals to ensure that all aspects of a transaction are coordinated. Entity documents should reflect the transaction in the entirety.

Take a fresh look at the transaction at some point after it was accomplished. Check for any gaps and review to be sure entire transaction was completed and documented.

Corporate Transparency Act

The Corporate Transparency Act was passed on January 1, 2021. The rationale for the Act is to target money laundering and funding of terrorism.

The Corporate Transparency Act basically is a new reporting requirement that is going to impact most existing entities.

Final regulations establish filing dates. January 1, 2025 is the initial filing deadline for entities existing as of January 1, 2024.

There are three basic concepts that you need to become familiar with under the Corporate Transparency Act or three terms. Those terms are: a reporting company, a beneficial owner of a reporting company, and a company applicant. So, why is the concept of a reporting company important? Because the reporting company is the entity upon whom the reporting obligation falls. This Act does not impose a filing obligation upon lawyers or CPAs or other advisors, it provides a filing requirement for a reporting company. That means our clients are going to be the ones with the obligation, which means, in turn, if they don't know about it or they're non-compliant based on ignorance, they're going to be turning to us to say "Why did I not know about this?"

Reporting Company in the Corporate Transparency Act

What is a reporting company? And this is where the title "Corporate Transparency Act" becomes a little misleading. A reporting company is a corporation, a limited liability company, or any similar entity that is formed by the filing of a document with the Secretary of State or a similar state agency or an Indian tribe. So, basically all of your corporations that you have sitting out there, all the LLCs that you have sitting out there, they are all reporting companies. And generally, these filing requirements or reporting requirements are going to be applicable to them. There are exemptions that were listed in the Act itself.

There are 23 exemptions from being a reporting company. Most of them deal with large, operating companies that are already the subject of other regulations. For example, large, publicly traded accounting companies are exempt basically because they're already reporting under Sarbanes–Oxley. Large operating companies with at least 20 employees and revenues for the preceding year of $5 million are exempt. So, large operating companies, many of whom are already regulated and reporting elsewhere, are exempted from this. Notably, family offices that we may be dealing with often have revenues in excess of that amount but quite often do not have 20 employees, so they are not an exemption from a reporting company.

Beneficial Owners in the Corporate Transparency Act

Once you have a reporting company, what is required to be reported? There's the basic information required to be reported about the entity itself; so, basically its name, its identifying number, its address, et cetera, but then more importantly it's required to report information on its beneficial owners. That's where the meat of this issue lies. What is the beneficial owner? Basically, that is one of a couple of things. If you own at least 25% of the reporting company, and there are underlying issues with regard to ownership that we have to dive into when we get into the weeds on that; but basically, if you own 25% or more, you're a beneficial owner.

But that's not the end of the test. Even if you don't own 25% or more, if you can exercise substantial control, whether direct or indirect, over the company or key decisions of the company, or selection of officers of the company, you too may be a beneficial owner. This is where this crawled into our planning world greatly. A trust on estates is not a reporting company because, at least in almost all cases to form a trust, you are not filing a document with the Secretary of State or a similar state agency. So, a trust is not a reporting company.

A trust, however, in many cases, is going to be deemed a beneficial owner because, as we know, many of these entity interests in our plans are held by trusts, which then gets down to a sub-issue of "Okay, once I have a trust with a beneficial owner, what information am I required to report?" So, in almost all cases, that's going to be information with regard to the trustee, and then in more limited circumstances, it's even going to be information with regard to beneficiaries of the trust. Side note: this does not only apply to domestic companies, it also applies to foreign companies who have registered to do business in the U.S.

And those of you with cross-border clients, they may be deemed beneficial owners for whom information is going to need to be disclosed. That information includes their name, their residential address, and information from an identifying document; so, a driver's license or a specified identifying number that you apply for from FinCEN. So, those folks who are out there thinking that they have privacy within their plan, including entities that you formed in states that provide for silence with regard to beneficial ownership. Suddenly, we're going to be reporting information on those

beneficial owners. That information is going to be reported to FinCEN, the same agency that we've been providing information to for foreign bank accounts with the FBAR filings.

Company Applicant in the Corporate Transparency Act

The third category is a company applicant, which basically means the individual who was involved or responsible for the filing of the document that formed the reporting company entity. This is one area where we got a little bit of relief under the final regulations compared to what the proposed regulations said. Under the proposed regulations, we were going to have to report on company applicants for all pre-existing entities. So, all of those 26 million pre-existing entities, we were going to have to report that information. Under the final regulation, they've given us relief in that regard. So, the reporting with regard to a company applicant will only be applicable for entities formed after January 1, 2024.

Existing entities in existence as of January 1, 2024, the effective date will be required to report within one year of that date. Newly formed entities after January 1, 2024 will be required to report within 30 days of formation. Thereafter, there is 30 days to report when there are changes to beneficial ownership.

Practitioners should consider updating engagement letters to cover the responsibilities for filings and obligations under the Act. In operating agreements or shareholder agreements, practitioners should consider including language that requires incoming to agree to provide the information that's needed to report on them as a beneficial owner.

Practitioners should start communicating with clients about the requirements of this Act.

Common Pitfalls In Estate Planning with Investment Real Estate

Speakers: Mary P. O'Reilly, Esq.; Andrew L. Baron, Esq.

The first pitfall is "the ruining the family" pitfall. As tax planners, we may tend to focus on all the amazing tax things that we can do rather than on

how the structures we design may affect the family. In facilitating planning, it is important to understand the family business and the roles of the various family members.

The roles in real estate management include property manager. If a family member is taking on this role, it is fairly easy to find fair market value amounts. Another role is that of leasing agent. It is also easy to find fair market value information. The third role is the asset manager. This role oversees the property manager and leasing agent.

To the extent there is a child in business that is active where others are not, parent might provide carried interest to the most active child. This might also be considered where one child is involved and others are not.

Agreements for children should cover possible various interests. There might be two children who aren't active and two who are. Discuss with senior family members whether the non-active children should be able to get out. If all children are active, should they be required to sell if one becomes inactive? Consider right of first offer, discounts, lock out periods, tag along rights, and typical buy/sell provisions. Can children transfer their interests to spouses/children/whoever they want?

Freeze Partnership

Advantages

- Approach can resolve negative capital account balance.
- There is a basis step-up for frozen interest (including negative capital).
- There are statutory guidelines for structure under 2701.
- Section 6166 estate tax deferral may be achievable.

Considerations and Risks

- Highest hurdle rate
- Possible section 2701 deemed gift

There remains uncertainty with respect to the treatment of installments sales upon the death of the grantor.

Section 2701 is a special valuation role that is applicable to freeze partnerships. The most aggressive freeze partnership might try to value the

common interest at zero but the likelihood is that there is some real value being transferred.

Preferred Interest

- Preferred interest involves a period cash distribution fixed or cumulative return.
- Preferred interest has a liquidation preference.
- Dividend rate and liquidation preference is determined at the time of contribution to the entity (or recapitalization)
- The value of the preferred interest is frozen as of date created.

Common interest

- Preferred return distributions must be made prior to any being made to common.
- Common is entitled to all future increases in the income from the underlying assets.
- Appreciation in excess of preferred return inures solely to the common interest holder.

Zero Value Rule

- If there is a transfer under Section 2701, the retained interest will be valued at zero for gift tax purposes. Exceptions:
  - Transferor retains a Qualified Payment Right; or
  - A liquidation, put, call or conversion right.

<u>Joint Revocable Trust Structure</u>

Basic Structure

- Two spouses created and fund a jointly established revocable trust, with each spouse owning a separate share of the trust.
- Each spouse has the right to amend and/or revoke his or her portion of the trust (without the consent of the other) while both are living.
- The first spouse to die is granted a testamentary general power of appointment (i.e. the right to appoint principal among a class including such spouse, his or her creditors, his or her estate or the creditors of his or her estate.)

- Upon the death of the first spouse, the entire corpus of the Joint Revocable Trust is includable in the estate of the first spouse to die pursuant to Code Section 2041 and should qualify as property acquired from a decedent under Code Section 1014.

Structure of the Mechanism

- The Joint Revocable Trust relies on Section 1014 of the Code.
- Section 1014(a)(1) states, "[e]xcept as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall…be the fair market value of the property as of the decedent's death."
- Section 1014(b)(4) further states that "Property Acquired from the Decedent" includes "[p]roperty passing without full an adequate consideration under a general power of appointment exercised by the decedent by will.

Potential Obstacles

- Section 1014(e) prevents a basis step up if there is property acquired by the decedent within one year of death and such property is then transferred to the original donor of such property upon the decedent's passing.
- It has been the IRS position in private letter rulings and also a Technical Advice Memorandum that while joint trusts may be used to pull assets into the estate of the first-to-die spouse and be available to fund credit shelter and/or marital trusts, a basis step-up is not permitted due to the application of Code Section 1014(e).
- A potential solution is to have property pass in trust to the surviving spouse as the plain language of 1014(e) implies it is applicable only to outright transfers back to the surviving spouse.

Estate Planning With Digital Assets: An Introduction to Crypocurrencies and NFTs

Speaker: Anthony L. Engel, Esq., Principal and Fiduciary Counsel, Bessemer Trust, Chicago, IL

An early issue was double spending. For system to work, cash has to transfer at the time of transaction. Otherwise, buyer can double spend amounts.

There is a limited amount of digital currency that will be mined. Once all has been mined, the thought is that transactions will continue for a fee.

An early digital currency is bitcoin. It is a decentralized network. Early view of potential uses included means of exchange, access to investment opportunities, tool to raise capital.

Ethereum was developed in 2014 essentially following bitcoin. Ethereum can be used for smart contracts concepts in code form. Anything you can program on a computer can potentially be employed on a computer. Smart contracts are designed to bring some traditional contract concepts into the crypto world.

Decentralized finance is a concept of taking traditional finance notions and moving them into the crypto world. Examples are derivatives trading, insurance, stable coins.

NFT means non-fungible tokens (NFTs), which are generally created using the same type of programming used for cryptocurrencies. In simple terms these cryptographic assets are based on blockchain technology. They cannot be exchanged or traded equivalently like other cryptographic assets. A digital work of art “Everydays: The First 5000 Days” by Beeple sold for over $69m through Christie’s in March 2021. Christie’s seems to have taken on a significant interest in this space. NFTs cannot be replaced or interchanged because of its unique attributes.

Other NFT examples: Bored Ape Yacht Club, 10,000 Bored Apes, Median sale $95.6k. Ownership of a bored ape grants access to an online community.

US Regulation of Crypto Assets

<u>IRS</u>

- Notice 2014-21 – Virtual Currencies are property.
- Notice 2019-24 – A permanent change in blockchain is a hard fork. If a taxpayer receives a new cryptocurrency in exchange, it is a taxable event.

SEC

- SEC has taken position that cryptocurrencies are securities.

FDIC and Federal Reserve

Common concerns

- Financial stability
- Money laundering
- Consumer protection

OCC

- Banks may provide cryptocurrency custody services.
- Banks may hold dollar wallets.

Practical Concerns for Investors

- If you lose your key, you lose your investment.

Tax Reporting is important. There has been a question on the 1040 since 2020.

Mining has become more complex and difficult. Thus, equipment gets outdated quickly.

Tax and Estate Planning Issues

- Valuation – You will typically need an appraisal. You will want to seek an appraiser who has familiarity with crypto assets. Analogies can be made to other securities.
- Reporting on 709 or 706 will require meeting adequate disclosure rules.
- Charitable Contributions
    - Planning Opportunities – When “crypto winter” ends, there may be appreciated crypto that can be used as a charitable vehicle.
    - Valuation Issues
    - Direct to Charity vs. CRT. Some charities can receive directly. There are some DAFs that can.
- Gift Planning
    - Possible concern with direct gifts from individual to individual.
    - Potential use of GRATs – GRATs are useful for volatile assets.

- LLC wrapper may be helpful to trustees and in relation to transfer of interests.
- Institutional trustees may want directed trust with respect to crypto. They may be more comfortable with LLC owning crypto than holding crypto itself.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Mary Vandenack

CITE AS: