**Planning for Business Exits from C Corporations;**

**Inter-Family Business Transactions;**

**Other Developments**

**(excerpted from**
**Structuring Ownership of Privately-Owned Businesses:**
**Tax and Estate Planning Implications)**

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## TABLE OF CONTENTS

**Page**

**Planning for Business Exits from C Corporations;**

**Inter-Family Business Transactions;**

**Other Developments**

by Steven B. Gorin*

## I. Introduction

This document is excerpted from, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," over 2,100 pages in a fully searchable PDF that discusses how federal income, employment and transfer taxes and estate planning and trust administration considerations affect how one might structure a business and then transition the business through ownership changes, focusing on structural issues so that readers can plan the choice of entity or engage in estate planning with an eye towards eventual transfer of ownership in the business.

***The author sends a link to the most recent version in his free electronic newsletter (roughly quarterly), called "Gorin's Business Succession Solutions." If you would like to receive this newsletter, please complete https://www.thompsoncoburn.com/forms/gorin-newsletter or email the author at sgorin@thompsoncoburn.com with "Gorin's Business Succession Solutions" in the subject line; the newsletter email list is opt-in only. Please include your complete contact information; to comply with the anti-spam laws, we must***

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

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## II.E. Recommended Structure for Entities

### II.E.1. Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities

Below is a comparison of annual federal and state income tax burdens when the owners are in the highest or in a modest tax bracket, based on calculations shown in Parts II.E.1.a Taxes Imposed on C Corporations and II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships. The assumptions made in putting together the chart can be criticized, but hopefully reviewing them helps one understand the post-2017 paradigm.

| Moderate State Income Tax | Individual in Top Bracket | Individual in Modest Bracket |
|---|---|---|
| Distributing 100% of Corporate Net Income After Income Tax | 47.3% | 40.8% |
| Distributing 50% of Corporate Net Income After Income Tax | 36.7% | 33.4% |
| Distributing None of Corporate Net Income After Income Tax | 26.0% | 26.0% |
| S Corporation, Partnership, or Sole Proprietorship (Pass-Through) | 34.6%-45.8% | 27.4%-46.2% |

***Note, however, that distributing less than 100% of corporate net income after tax does not reflect the true tax cost, because additional tax will often be incurred when extracting the earnings later through a dividend or sale.*** For a discussion of the extent to which that is true and how choice of entity affects exit strategies, see part II.E.2.a Transferring the Business.

Also consider that the excess of pass-through income tax rates over corporate rates is at an all-time high.

A partnership or S corporation that does business in many states incurs extra state compliance obligations, because states often require withholding on nonresident owners, require all owners to file in all of those states, or require both. Also note that individuals or trusts owning pass-

through businesses will be able to deduct little or no of the state income tax on their business income, whereas C corporations are not subject to such limitations.[677]

For a start-up entity, consider that most businesses lose money initially, and some never get into the black. An LLC taxed as a sole proprietorship or partnership is a much better vehicle for deducting losses[678] than is an S corporation[679] or C corporation.[680] If one is enamored with corporate income taxation, one might start as an LLC and then contribute the LLC to a corporation when one becomes sufficiently profitable to save taxes.[681] The disadvantage of such an approach occurs when the owner is in a low tax bracket, so that losses provide little, if any, benefit; in that case, having the C corporation carry forward its losses to offset them against income that would otherwise have been taxed at a higher rate – and relying on Code § 1244 for ordinary loss treatment if the business is unsuccessful[682] – might be of greater benefit.

Incentive pay and deferred compensation can be more difficult in a corporate setting than in a partnership setting.[683] However, C corporations provide better fringe benefits.[684]

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

For taxable years beginning after December 31, 2017, all C corporations pay tax at a flat 21% rate, unless some industry-specific exclusions, such as those for insurance companies, apply.[685] However, if a C corporation receives a dividend from another corporation, only part of

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[677] See text accompanying fn 21 in part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment.

[678] See part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner, especially part II.G.4.e Basis Limitations for Partners in a Partnership.

[679] See part II.A.2 S Corporation.

[680] See parts II.G.4.b C Corporations: Losses Incurred by Business, Owner, or Employee and II.G.4.f Comparing C Corporation Loss Limitations to Those for Partnership and S Corporation Losses.

[681] Although one could just "check the box" by filing Form 8832 or 2553, as the case may be, contributing an interest in the LLC sets one up for an ideal entity structure and avoids possible (remote) self-employment tax issues. See parts II.E Recommended Structure for Entities and II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election, respectively. For entity conversion issues, see part II.P.3 Conversions.

[682] See parts II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244 and II.J.11.b Code § 1244 Treatment Not Available for Trusts.

[683] See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.

[684] See part II.P.2 C Corporation Advantage Regarding Fringe Benefits.

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

(1) section 594 (relating to mutual savings banks conducting life insurance business),
(2) subchapter L (sec. 801 and following, relating to insurance companies), or
(3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts).

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

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

that dividend is taxed,[686] reducing the effective tax rate to 10.5% for dividends from unrelated companies or zero or 7.35% for dividends from affiliates.

In addition to taxes on annual operations, consider:

- Dividends to shareholders, which are distributions out of a corporation's current or accumulated earnings and profits, are subject to regular tax at capital gain rates[687] (if qualified dividends)[688] and the 3.8% tax on net investment income.[689]

- A corporation that does not pay dividends may become subject to the 20% accumulated earnings tax. See part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax.

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[686] See fns. 10-14 in part II.A.1.a C Corporations Generally.

[687] Code §§ 1(h)(3), 1(h)(11)(A).

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

(i) *In general*. The term "qualified dividend income" means dividends received during the taxable year from-
  (I) domestic corporations, and
  (II) qualified foreign corporations.

(ii) *Certain dividends excluded*. Such term shall not include-
  (I) any dividend from a corporation which for the taxable year of the corporation in which the distribution is made, or the preceding taxable year, is a corporation exempt from tax under section 501 or 521,
  (II) any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.), and
  (III) any dividend described in section 404(k).

(iii) *Coordination with section 246(c)*. Such term shall not include any dividend on any share of stock-
  (I) with respect to which the holding period requirements of section 246(c) are not met (determined by substituting in section 246(c) "60 days" for "45 days" each place it appears and by substituting "121-day period" for "91-day period"), or
  (II) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

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

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

(i) *Amounts taken into account as investment income*. Qualified dividend income shall not include any amount which the taxpayer takes into account as investment income under section 163(d)(4)(B). [My note: This relates to income against which investment interest may be deducted. See part II.G.21.a Limitations on Deducting Business Interest Expense, which mentions in passing investment interest expense.]

(ii) *Extraordinary dividends*. If a taxpayer to whom this section applies receives, with respect to any share of stock, qualified dividend income from 1 or more dividends which are extraordinary dividends (within the meaning of section 1059(c)), any loss on the sale or exchange of such share shall, to the extent of such dividends, be treated as long-term capital loss.

(iii) *Treatment of dividends from regulated investment companies and real estate investment trusts*. A dividend received from a regulated investment company or a real estate investment trust shall be subject to the limitations prescribed in sections 854 and 857.

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

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

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

Let's examine the effects of earning $100,000 taxable income inside the corporation and distributing various proportions of the net after-tax profits, assuming the taxpayer lives in a state that imposes moderate (5%) income tax on corporations and individuals. The individual in a top bracket is assumed taxed at a rate of 28.8%, consisting of 20% capital gain tax, 3.8% net investment income tax, and 5% state income tax. The individual in a modest bracket is assumed taxed at a rate of 20%, consisting of 15% capital gain tax, no net investment income tax, and 5% state income tax.

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

Note that the tax rates above seem somewhat high – 47.312% or 40.8%, depending on whether the shareholder is in a high or modest bracket. The corporation might try paying more compensation to avoid double taxation, but compensation income is taxed at ordinary income rates, and the employer's and employee's share of FICA combines to add tax equal to 2.5%-13.3%.[690] So, add that tax to the employee's federal, state, and local income tax rate and compare to the above. Consider, however, that a corporation cannot deduct more than reasonable compensation - see part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment – and in 2017 the IRS has instructed its examiners how to prevent taxpayers from contesting the issue in Tax Court.[691]

[690] The tax hit is 2.9%-15.3%, as described in part II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships, text accompanying fn 695-697. However, the employer's deduction for half of this amount at an assumed 26% rate lowers the effective rate to 2.5%-13.3%.
[691] See fns. 93-95 in part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax.

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

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

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

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

| Distributing 100% of Corporate Net Income After Income Tax | |
|---|---|
| Corporate Taxable Income | $100,000 |
| Federal and State Income Tax | -29,800 |
| Net Income after Income Tax | $70,200 |
| Income Taxes at 28.8% or 20% | -26,044 |
| Net Cash to Owner | $44,156 |

Note that the effective annual tax rate above seems somewhat high at just under 56%. The corporation might try paying more compensation to avoid double taxation, but compensation

income is taxed at ordinary income rates, and the employer's and employee's share of FICA combines to add tax equal to 2.5%-13.3%.[692] So, add that tax to the employee's federal, state, and local income tax rate and compare to the above. Consider, however, that a corporation cannot deduct more than reasonable compensation - see part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment – and in 2017 the IRS has instructed its examiners how to prevent taxpayers from contesting the issue in Tax Court.[693]

| Distributing 50% of Corporate Net Income After Income Tax | |
|---|---|
| Corporate Taxable Income | $100,000 |
| Federal and State Income Tax | -29,800 |
| Net Income after Income Tax | $70,200 |
| Distribution to Owner | $35,100 |
| Income Taxes at 28.8% or 20% | -13,022 |
| Net Cash to Owner | $22,078 |
| Corporate Cash Plus Shareholder Cash | $57,178 |

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

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

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

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

- Accumulated earnings tax. Generally, a C corporation that accumulates funds could be subject to the 20% accumulated earnings tax on its excess undistributed accumulated

[692] The tax hit is 2.9%-15.3%, as described in part II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships, text accompanying fn 695-697. However, the employer's deduction for half of this amount at an assumed 26% rate lowers the effective rate to 2%-13%.
[693] See fns. 93-95 in part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax.

earnings and profits. The corporation needs to articulate specific reasons why its needs to reinvest its earnings. For details, see part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax. This tax does not apply to personal holding companies (as used in the preceding bullet point). If the company not a personal holding company but is a mere holding or investment company, the tax kicks in if undistributed earnings exceed $125,000.[694]

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

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

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

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

An owner of a partnership or sole proprietorship also generally pays tax self-employment ("SE") tax on income from a trade or business, subject to various exceptions; see part II.L Self-Employment Tax (FICA). SE tax is 15.3% OASDI and Medicare taxes until the taxpayer reaches the taxable wage base ($132,900 in 2019 and $137,700 in 2020),[695] then is 2.9% Medicare tax until it reaches 3.8%, when the supplemental Medicare tax (employee's portion) kicks in.[696] The employer's portion of SE tax, which is 7.65% up to the taxable wage base and 1.45% thereafter, is deductible in determining adjusted gross income (not as an itemized deduction).[697]

An owner of an S corporation or partnership may pay the 3.8% tax on net investment income ("NII"); see part II.I 3.8% Tax on Excess Net Investment Income (NII). SE income is excluded from NII.[698] The deduction for the employer's share of SE tax makes SE tax preferable to NII tax, except to the extent that the income would be below the taxable wage base.

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[694] See fn 4377 in part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax.

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

[696] See fns 3064-3066 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.

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

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

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

[698] As to SE income being excluded from NII, see fn 2090 in part II.I.5 What is Net Investment Income Generally.

To the extent that an owner's distributive share of a partnership's or S corporation's income is reinvested, the owner's basis in the partnership interest[699] or stock[700] increases. Generally, an owner can withdraw the earnings tax-free, merely reducing basis in the owner's partnership interest or stock. See parts II.Q.8.b.i Distribution of Property by a Partnership and II.Q.7.b Redemptions or Distributions Involving S Corporations. However, an S corporation that distributes property triggers tax on the gain,[701] which gain is taxed at its shareholders' respective income tax rates and in many cases does not qualify for favorable capital gain rates.[702]

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

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

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

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

- 22.4%-28% ordinary income tax (depending on whether the Code § 199A 20% deduction is available, and the wage limitations[703] and restrictions on types of businesses do not apply to modest income taxpayers)
- zero-13.2% SE tax income tax (after considering the deduction for one-half of SE tax)
- 5% state income tax.

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

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

[699] Code § 705.
[700] Code § 1367.
[701] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.
[702] See parts II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).
[703] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

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

### II.E.5. Recommended Long-Term Structure for Pass-Throughs – Description and Reasons

#### II.E.5.a. Strategic Income Tax Benefits of Recommended Structure

To maximize basis step-up of assets used in a business[997] and promote tax-efficient exit strategies,[998] the main entity should be a partnership. A partnership often is a better exit vehicle than a C corporation, notwithstanding part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation;[999] if the exclusion of gain on sale of a C corporation is particularly compelling, consider instead starting as an LLC taxable as a partnership then later converting to a corporation.[1000] However, corporate structure has some advantages:

- The partnership audit rules are becoming onerous and may artificially increase tax.[1001] Even though S corporations generally are pass-throughs, Congress has not targeted them, and the IRS needs to consider the burdens of making adjustments at both the entity and shareholder level.[1002]

- If the owners find a corporate buyer and can, on a tax-free basis, merge the business into the buyer and receive the buyer's stock, and they don't mind having low basis publicly-traded stock, then note that a tax-free merger or similar reorganization under Code § 368 is

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[997] See parts II.H.2 Basis Step-Up Issues, II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation, and II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

[998] See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis, for how to save capital gain tax on the seller-financed sale of an interest in a business. Also compare part II.Q.7.f Corporate Division into More Than One Corporation (including the cumbersome requirements of Code § 355 mentioned in parts II.Q.7.f.ii Code § 355 Requirements and II.Q.7.f.iii Active Business Requirement for Code § 355), with part II.Q.8 Exiting From or Dividing a Partnership (partnership divisions are generally tax-free, subject to certain rules about shifting unrealized gain in property whose value had been used to determine partnership percentage interests). Also, corporate redemptions might be recharacterized as distributions (see part II.Q.7.a.iii Redemption Taxed Either as Sale of Stock or Distribution; Which Is Better When) and lose installment sale treatment, whereas partnership redemptions are nontaxable until basis is fully recovered (see part II.Q.7.b.ii Redemptions or Distributions Involving S corporations Compared with Partnerships).

[999] See parts II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill and II.Q.1.a.ii.(h) Partnership Use of Same Earnings as C Corporation – No Federal Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation in Sale of Goodwill (California)Partnership Use of Same Earnings as C Corporation – No Federal Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation in Sale of Goodwill (California).

[1000] See part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? (especially the text accompanying fns. 4796-4804).

[1001] See part II.G.20.c Audits of Partnership Returns.

[1002] See part II.G.20.b Audits of S Corporation Returns.

available only to corporations. Forming a corporation immediately before the sale might not work;[1003] I am unsure whether checking-the-box to elect corporate treatment helps any.

- If the owners would like for a qualified retirement plan to own the business, then an S corporation owned by an ESOP would be the ideal structure;[1004] on the other hand, an entity can start in the structure set forth below and then easily assign the interests in the operating LLCs to the S corporation general partner, in what generally would be a tax-free transaction.[1005]

Also, incentive pay and deferred compensation can be more difficult in a corporate setting than in a partnership setting.[1006]

Furthermore, a partnership often is a better vehicle for deducting start-up losses.[1007] However, using a partnership may knock one out of the small business exception to the limitations on deducting business interest.[1008]

### II.E.5.b. Self-Employment Tax and State Income Tax Implications of Recommended Structure

To avoid self-employment tax, the entity should be a limited partnership, since an interest as a limited partner is not subject to self-employment (SE) tax.[1009] One should involve a local tax expert regarding any state or local taxes on pass-through entities in the states in which the entity does business.[1010]

### II.E.5.c. Operating the Recommended Structure

### II.E.5.c.i. General Considerations

This paradigm might not work well if owner compensation is needed to get the full Code § 199A deduction. See part II.E.5.c.ii Code § 199A Deduction under Recommended Structure. This concern applies only if the ultimate taxpayer computing the deduction has taxable income in excess of certain thresholds. See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

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[1003] See part and II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations, especially fn. 3198.
[1004] See part II.G.22 Employee Stock Ownership Plans (ESOPs, which also explains that a partnership interest does not qualify as employer stock.
[1005] See parts II.M.2.c Contribution of Partnership Interest to Corporation and II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations.
[1006] See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.
[1007] See part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner.
[1008] See fn 1699 in part II.G.21.a Limitations on Deducting Business Interest Expense.
[1009] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner.
[1010] See part II.G.3 State Income Taxation.

To protect any real estate from business losses, maximize protection from creditors, and facilitate future restructuring of the business:

- Operations should be conducted in one or more LLCs, wholly owned by the limited partnership.

- Real estate should be held in one or more LLCs, wholly owned by the limited partnership. However, it would also be fine for the real estate to be held in a separate LLC outside of the limited partnership structure,[1011] if the owner materially participates in the business.[1012] Note that keeping the real estate inside the master LP umbrella would take the place of or facilitate grouping under the passive loss rules,[1013] which might be more important in the case of a real estate professional, because grouping does not help with the real estate professional test under part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity, although those rules do provide a separate aggregation election.[1014]

- The real estate LLC(s) should lease the property to the operating LLC(s) for fair rental, which will be ignored for tax purposes but should allow the LLCs' respective assets to be segregated for purposes of protection from creditors.

The individuals involved in the business would own:

- An S corporation[1015] that is a 1% general partnership, and

- In the aggregate, the remaining 99% interest as limited partners.

To respect the S corporation's role as a general partner and to prevent the 3.8% tax from applying to their distributive shares of the S corporation's 1% interest as a general partner, the

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[1011] The 2012 proposed regulations on the 3.8% tax on net investment income called into question the treatment of real estate rented to one's business. However, under the final regulations, any rental income considered nonpassive income under the self-charged rental rules would not be subject to the 3.8% tax. However, self-rental might not fully work, in that ownership of the real estate and the operating business might change over time. See parts II.I.8.c Application of 3.8% Tax to Rental Income. These issues can be addressed through special allocations and preferred returns inside the partnership structure.

[1012] The self-charged rental rules require that the landlord materially participate in the tenant's business (which the landlord must also own at least in part). See part II.I.8.c Application of 3.8% Tax to Rental Income and II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity. If a business owner wants to rely on the more-than-100-hour significant participation rules rather than the material participation rules (which generally require more than 500 hours of work), then the business owner will not be able to rely on the self-rental exception and needs to keep the real estate inside the limited partnership umbrella so that the rent is disregarded for income tax purposes.

[1013] See part II.K.1.b.ii Grouping Activities – General Rules, particularly fn. 2821.

[1014] See fns. 2879-2880.

[1015] The entity being an LLC taxed as an S corporation would facilitate material participation of any trust that is or might eventually become an owner of the general partner. See part II.K.2.b Participation by an Estate or Nongrantor Trust. (Material participation is important to avoid the 3.8% tax on net investment income that might otherwise apply. See part II.I.8 Application of 3.8% Tax to Business Income.) If one is concerned that an LLC taxed as an S corporation might be subjected to self-employment tax because of some regulations that appear to be obsolete (see part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election), using a statutory close corporation might be a safer approach. See text accompanying fn. 3002 within part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.

individuals would be employees of the S corporation and receive reasonable compensation for the services they perform. The employment arrangement also keeps the individual owners from tainting their limited partnership interests. The individuals' participation would be attributed to both the corporation (if applicable) and themselves.[1016]

On a daily basis, the operation is simple:

- The S corporation, as general partner of the limited partnership, controls each LLC subsidiary, because the limited partnership is the LLC's sole member.

- In this capacity, the S corporation appoints its owners as the LLC's managers (and can give them more traditional titles, such as president, chief financial officer, etc.) who sign documents on behalf of the LLC showing their capacity as the LLC's managers or other officers.

- Each LLC subsidiary pays the S corporation a management fee to the S corporation to pay for the cost of the services provided by the owners and any other employees leased to the LLC. To protect each LLC's separateness from the other LLCs (if the partnership has more than one LLC subsidiary), it would be best for each LLC to have its own employees and not simply use the S corporation as a central payroll master; however, this might not be practical, depending on how the business is run. An entity that is disregarded for income tax purposes is also disregarded for self-employment tax purposes, notwithstanding that it is treated as a separate entity for payroll tax purposes.[1017] ***Caution***: See part II.E.5.c.ii Code § 199A Deduction under Recommended Structure. Also note that the reasonableness of the management fee (in terms of deducting the fee) depends on the reasonableness of the compensation of those whose services generated the management fee.[1018] Carefully document each employee-owner's employment agreement with the corporation.[1019]

- Only the S corporation and limited partnership file federal income tax returns. No matter how many LLC subsidiaries the partnership owns, the partnership files one federal income return to report all of their activity. (These materials do not attempt to cover state income or other tax issues in any systematic way that would help with state issues here.)

The tiered structure comes into play more when quarterly distributions are made to pay taxes or otherwise provide investment return to the owners. The LLCs would distribute part or all of their profits to the limited partnership, which then makes appropriate distributions to the limited partners and the S corporation general partner.

### II.E.5.c.ii. Code § 199A Deduction under Recommended Structure

The S corporation general partner ("GP") of the limited partnership ("LP") receives a K-1 with QBI, wages, and UBIA. However, because the GP is a separate RPE from the LP, any activity

[1016] See part II.K.1.c Limited Partnership with Corporate General Partner, particularly fn. 2856.
[1017] See part II.B Limited Liability Company (LLC), fns. 329-330.
[1018] See fn 43 and the accompanying text in part II.A.1.b.i Compensating Individuals.
[1019] See fn 1782 in part II.G.25 Taxing Entity or Individual Performing Services.

on the K-1 the GP receives is siloed from the GP's own activities.[1020] In other words, K-1 income is QBI of the RPE that issues the K-1, not QBI of a business carried on by the K-1 recipient.

Thus, the GP needs to conduct its own trade or business for any wages it pays to count as being related to QBI.[1021] Guaranteed payments for services are not QBI.[1022]

When the GP receives a management fee and pays compensation to those working for the LP, those wages can be attributed back to the LP, but only if the W 2 wages were paid to the LP's common law employees or officers of the individual or RPE for employment by the LP – in other words, the GP leased the employees to the LP.[1023] Thus, compensation for services rendered by the limited partners themselves would not qualify, because they cannot be common law employees of the LP.

### II.E.5.d. Net Investment Income Tax and Passive Loss Rules Under Recommended Structure

If any individual participates no more than 500 hours per year, that person might be subjected to the 3.8% tax more readily as a limited partner than as the owner of an S corporation, because limited partners have fewer ways to satisfy the material participation test than do other owners of pass-through entities.[1024] On the other hand, if one is concerned only about avoiding the 3.8% tax on net investment income and not about disallowing passive losses or credits,[1025] then a limited partner who works for more than 100 hours generally would avoid the 3.8% tax.[1026]

### II.E.5.e. Estate Planning Aspects of Recommended Structure

### II.E.5.e.i. Family Conflicts

When some family members are in the business and others outside the business, conflicts can develop. The insiders want to reinvest earnings to grow the business and would like compensation commensurate with the value they view they bring to the business, including incentive equity compensation. The outsiders want to distribute earnings for their own use and believe that they should share in the business' growth because that is part of the ownership legacy their parents left to them.

The first generation might want to put a long-term lease on real estate used in the business and bequeath the real estate to the outsiders. That allows the outsiders to have significant cash flow locked in for a while and allows more (or all) of the business to be bequeathed to the insiders.

The cleanest break would be for any LLCs holding real estate to be distributed from the limited partnership and then bequeathed. Generally, such a distribution would not generate any

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[1020] See Reg. § 1.199A-6(b), reproduced shortly before fn 721 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.
[1021] See Reg. § 1.199A-2(b)(1), reproduced in part II.E.1.c.vi.(a) W-2 wages under Code § 199A.
[1022] Reg. § 1.199A-3(b)(2)(ii)(I), (J), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.
[1023] See Reg. § 1.199A-2(b)(2)(ii), reproduced in part II.E.1.c.vi.(a) W-2 wages under Code § 199A.
[1024] See part II.K.1.a.ii Material Participation.
[1025] See part II.K.1.i.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.
[1026] For more details, see part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

income tax.[1027] To maximize income tax planning opportunities, all of the real estate LLCs might stay under one partnership umbrella.[1028]

If insiders are pitted against insiders, generally a partnership structure is easier to divide than a corporate structure.[1029]

### II.E.5.e.ii. Estate Tax Deferral Using Recommended Structure

If long-term estate tax deferral is required,[1030] deferring estate on a partnership interest involves more uncertainty than deferring estate on stock.[1031]

### II.E.5.e.iii. Grantor Trust Planning

When a business is sold, clients may wish to turn off grantor trust status[1032] so that the income tax burden does not deplete their assets more than they are comfortable with.

For a grantor trust owning an S corporation, generally grantor trust status should be turned off before January 1 of the year of the sale if the grantor wishes to avoid all tax on the gain on sale. This concern is diminished or may not even exist for a partnership. See part III.B.2.j.i Changing Grantor Trust Status, especially the text accompanying fns. 6270-6272.

### II.E.5.e.iv. Code § 2036

The IRS has attacked (and courts have agreed) a donor's retention of control when transferring a business entity, unless the grantor can prove a legitimate and significant nontax reason for forming the entity.[1033]

However, retaining voting stock and transferring nonvoting stock does not cause Code § 2036 inclusion.[1034] Using an S corporation general partner may help address this issue.

### II.E.5.f. Recommended Structure with C Corporation

Because 2017 tax reform caused C corporation annual income taxation to be quite attractive, one might the S corporation shown in the structure to instead be a C corporation, and give the corporation more than 1%.

See part II.E.4 Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure.

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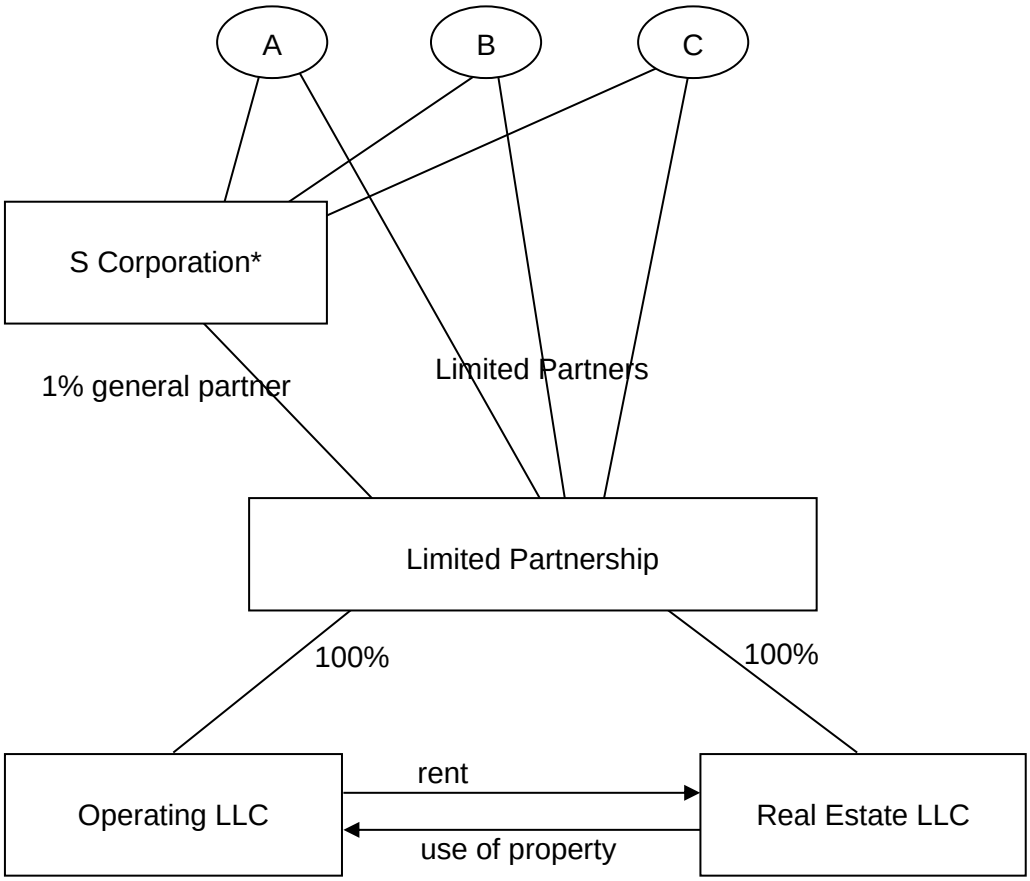
[1027] See part II.Q.8 Exiting From or Dividing a Partnership.
[1028] See part II.Q.8.a Partnership as a Master Entity.
[1029] See parts II.Q.7 Exiting from or Dividing a Corporation (especially part II.Q.7.f Corporate Division into More Than One Corporation) and II.Q.8 Exiting From or Dividing a Partnership.
[1030] See part III.B.5.d.ii Code § 6166 Deferral.
[1031] See part III.B.5.d.ii.(b) Tiered Structures.
[1032] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
[1033] See fn 99 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders.
[1034] See fn 229 in part II.A.2.i.i.(b). Why Nonvoting Shares Are Needed for Estate Planning.

### II.E.5.g. Other Aspects of Recommended Structure

Parts II.E.7 Migrating into Partnership Structure discusses moving to the recommended structure. Consider not only it but also part II.E.9 Real Estate Drop Down into Preferred Limited Partnership for real estate, long-lived tangible personal property, or intangible assets. The latter might generate royalty income subject to the 3.8% tax on net investment income, but in the recommended structure royalties would be disregarded the same way rent would be.

If the client would prefer not to have an S corporation general partner, see part II.E.8 Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary. Note, however, that a corporation transitioning into that structure (instead of retaining a preferred partnership interest) would pay tax; see parts II.P.3.a From Corporations to Partnerships and Sole Proprietorships and II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially parts II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property and II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

### II.E.6. Recommended Partnership Structure – Flowchart




* See part II.E.5.f. Recommended Structure with C Corporation.

If no real estate is ever held and the client balks at creating what the client perceives as too many entities, this structure could simply be a limited partnership without the LLCs. However, it

would be much easier to start the operating business in its own LLC and later simply add other LLCs than it would be for the limited partnership to later transfer all of its business operations into a new LLC when real estate or a separate location or line of business is acquired.

### II.E.7. Migrating into Partnership Structure

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

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

Forming the S corporation and the limited partnership are not taxable events,[1035] so long as the liabilities are not shifted (or reallocated) too much from the members of the LLC to the corporate general partner.[1036] Any gain inherent in the contributed assets will be taxed to the original owners when those assets are sold.[1037] The work-in-process, appreciated inventory, and accounts receivable would tend to be the assets to watch, and accounts receivable would not be a concern if the LLC's income was reported using the accrual method. Given that the S corporation would probably have been formed with a modest cash contribution and therefore would have not contributed such assets, the only gain likely to receive a special allocation would be those inherent in the LLC. If reallocation of liability becomes an issue, the original members can guarantee the debts to get the debts allocated to them.

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

This migration would be much more involved if the business is operated inside a corporation. Converting a corporation into a partnership would trigger gain.[1038] Instead, generally the corporation would move its assets into an LLC and then contribute that LLC to the limited partnership.[1039] The corporate partner would receive a preferred return on this invested capital (for which it receives a capital account),[1040] with at least 10% of the value of its equity being an

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[1035] See part II.M.1. Taxation on Formation of Entity: Comparison between Partnership and Corporation.

[1036] If formed as described above, the concern would be that the reallocation of liabilities from a partner would be a deemed cash distribution that would generate gain if and to the extent that it exceeds the basis of that partner's partnership interest; see part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions. If formed as described below, where the partners contribute to the S corporation their interests as general partner, then, in addition to the issue described above, a shareholder would have gain to the extent that the debt the corporation assumed exceeds the basis of the partnership interest the shareholder contributes to the corporation; see part II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities.

[1037] See part II.P.1.a.i Allocations of Income in Partnerships.

[1038] See part II.P.3.a From Corporations to Partnerships and Sole Proprietorships.

[1039] The corporation would do this either gradually or in one fell swoop, as described in part II.E.7.c.i Corporation Forms New LLC, including parts II.E.7.c.i.(a) Direct Formation of LLC and II.E.7.c.i.(b) Use F Reorganization to Form LLC.

[1040] The exchange for a capital account (not intended to be redeemed in any manner in the first several years) and preferred payments (made from operating cash flow) can easily be done in a nontaxable manner that prevents the disguised sale rules from applying. See part II.M.3 Buying into or Forming a

interest in the residual profits (the "common interest"), and the individuals would receive the rest of the common interest as limited partners; although receiving only a pure preferred partnership interest would not violate the disguised sale rules,[1041] providing a significant interest in common helps support the corporate partner's role as a true partner, especially if the preferred payments are, for all practical purposes, extremely likely to occur. The considerations about debt reallocation described above would also apply. In some cases a C corporation might retain certain assets, collect them in due course, and then make an S election. For more information on this conversion, see part II.Q.7.h.viii Value Freeze as Conservative Alternative, especially fn 4644 (explaining why we recommend a common interest equal to at least 10% of the contributed equity). However, this 10% recommendation does not apply where other factors prevail, such as a marketplace business model or where the preferred partner has significant economic risk of loss from operations.

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

Finally, if a business entity lacks a noncompete binding those with the key client/customer contacts, they can also migrate over time by letting the old entity wind down and doing business in a new entity taxed as a partnership, with the new entity leasing equipment from the old entity until the new entity is ready to buy new equipment to replace the old equipment as the latter becomes obsolete. Practical issues in collecting receivables in the old entity vs. doing business in the new entity require close consultation with the corporate/partnership's income tax preparer.

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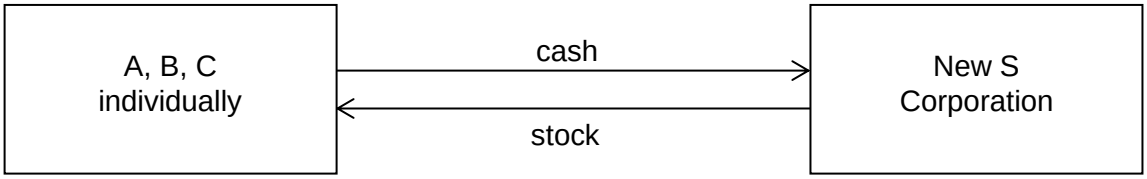
Partnership, particularly part II.M.3.e Exception: Disguised Sale. If any owners are members of the same family or if any owner might split up his ownership in the corporate general partner from his interest as a limited partner when making transfers to family members, see parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

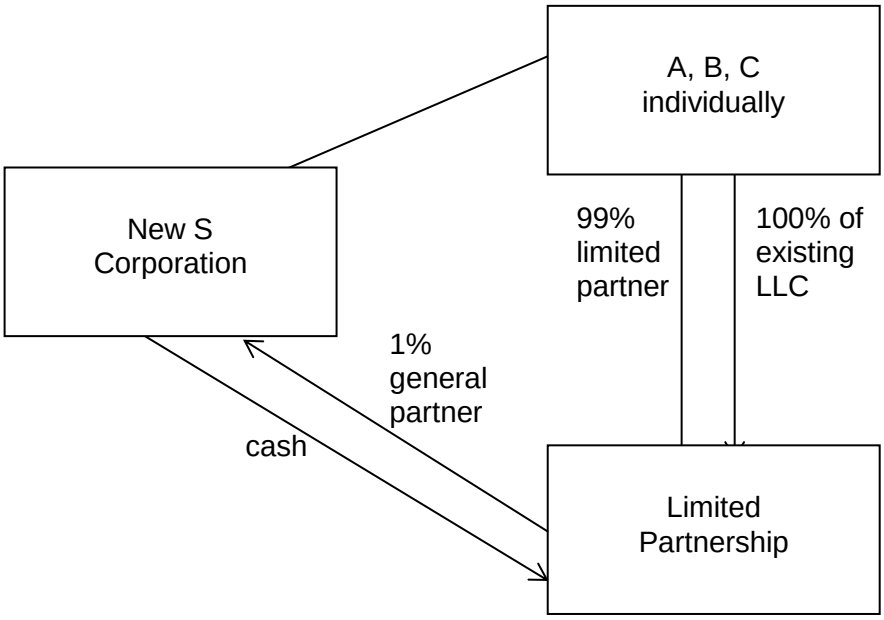
[1041] As illustrated in part II.E.7.c.ii Moving New LLC into Preferred Structure.

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

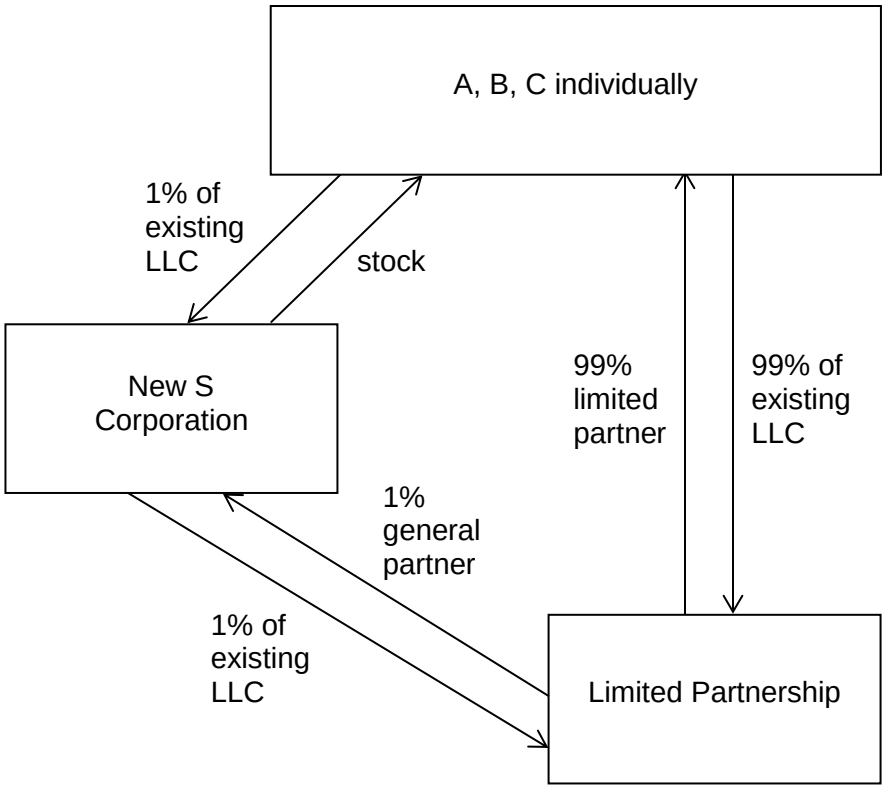
**II.E.7.b. Flowcharts: Migrating LLC into Preferred Structure**

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



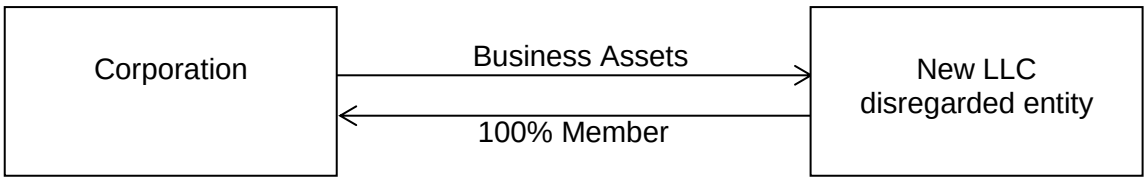
**II.E.7.b.ii. Using LLC to Fund New S Corporation**




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

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

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




<u>Advantages</u>

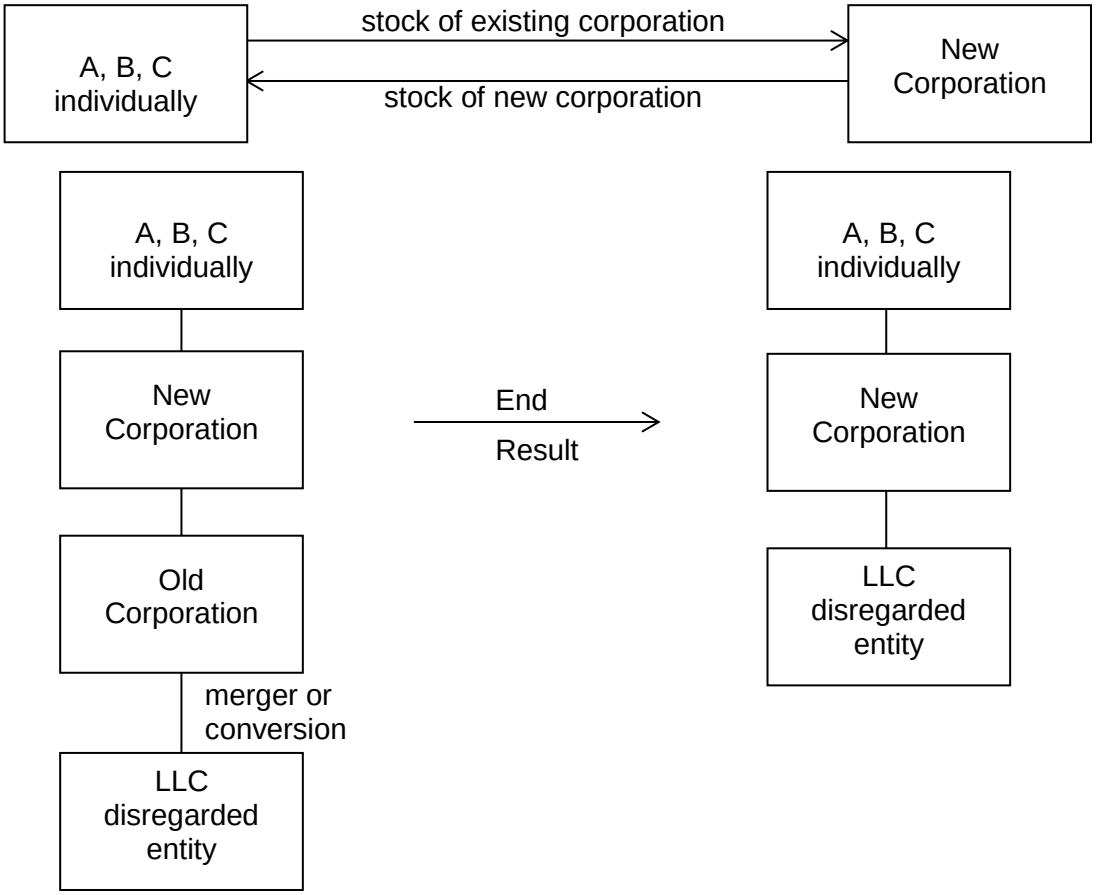
- Corporation can keep nonbusiness assets
- Corporation can keep business assets that would generate complications if transferred to the limited partnership structure and then had income recognition event
- New LLC can stay as a disregarded entity for a while as transition to new structure and get everyone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

<u>Disadvantages</u>

- Piecemeal transfer of assets

- Some assets not readily transferable

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




<u>Advantage</u>

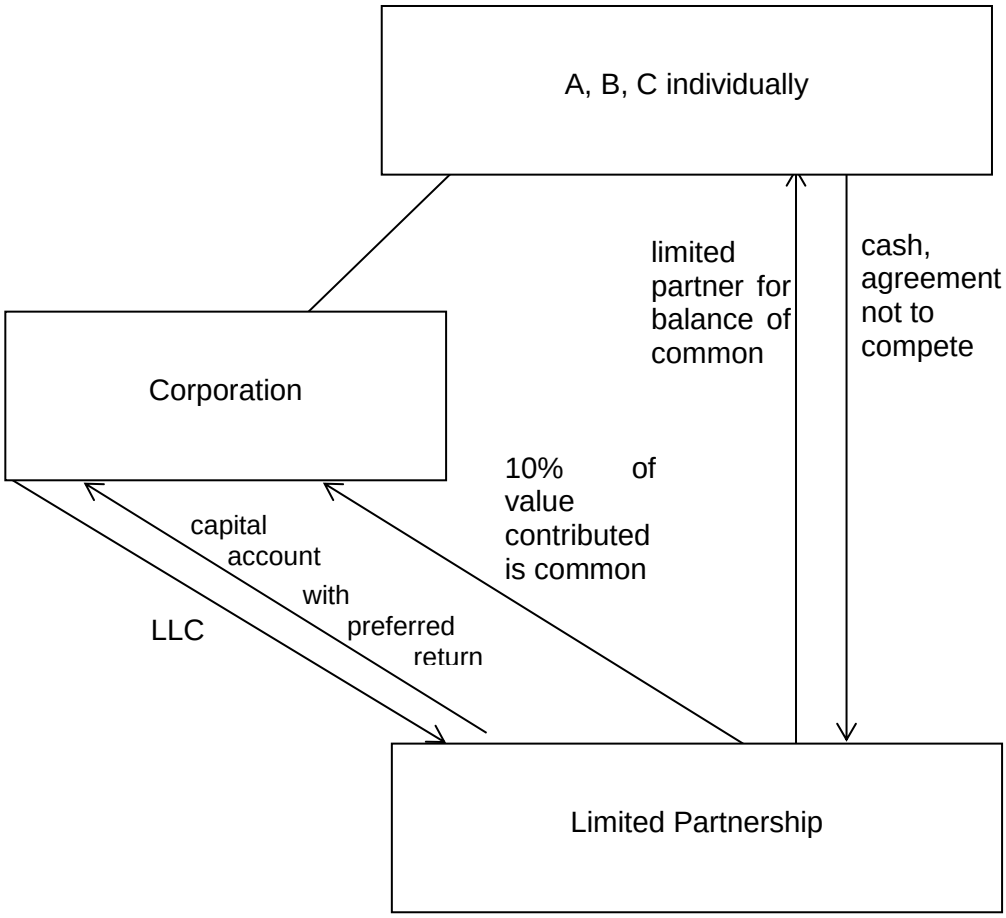
- Moves all assets in one fell swoop

<u>Disadvantages</u>

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

See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. For an S corporation, see also part II.A.2.g Qualified Subchapter S Subsidiary (QSub), especially fn. 196.

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




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

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

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

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

The company might reinvent itself over time through a sister company that is held in the business structure recommended in this part II.E Recommended Structure for Entities. For example, the senior generation makes gifts or loans to new trusts that establish this structure.

The new trusts own the S corporation and limited partnership (or LLC, in the case of a state such as Tennessee).

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

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

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

### II.G.7. Deferral or Partial Exclusion of Capital Gains (Even from Investment Assets) Invested in Opportunity Zones

Code § 1400Z-2(a)(1) provides with respect to any sale or exchange before January 1, 2027:[1407]

> *Treatment of gains*. In the case of gain from the sale to, or exchange with, an unrelated person of any property held by the taxpayer, at the election of the taxpayer -
>
> (A) gross income for the taxable year shall not include so much of such gain as does not exceed the aggregate amount invested by the taxpayer in a qualified opportunity fund during the 180-day period beginning on the date of such sale or exchange,
>
> (B) the amount of gain excluded by subparagraph (A) shall be included in gross income as provided by subsection (b), and
>
> (C) subsection (c) shall apply.

In other words, the exclusion is only a deferral to the extent that Code § 1400Z-2(b) taxes it. If the taxpayer dies, amounts recognized under Code § 1400Z-2 are includible in gross income as income in respect of a decedent (IRD) if not properly includible in the decedent's gross income.[1408]

Proposed regulations, [REG-115420-18], together with a link to comments, are at https://www.federalregister.gov/documents/2018/10/29/2018-23382/investing-in-qualified-opportunity-funds. ACTEC's comments are at https://www.actec.org/assets/1/6/ACTEC-comments-to-Treasury-re-Qualified-Opportunity-Funds-2018-12-27.pdf.

IRS training, "Opportunity Zones and Qualified Opportunity Funds," is at https://www.irs.gov/pub/newsroom/tcja-training-opportunity-zones-qualfied-opportunity-funds.pdf.

Code § 1400Z-2(b), "Deferral of gain invested in opportunity zone property," provides:

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[1407] Code § 1400Z-2(a)(2) provides that no Code § 1400Z-2(a)(1) election may be made:
(A) with respect to a sale or exchange if an election previously made with respect to such sale or exchange is in effect, or
(B) with respect to any sale or exchange after December 31, 2026.

[1408] Code § 1400Z-2(e)(3). See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

(1) *Year of inclusion*. Gain to which subsection (a)(1)(B) applies shall be included in income in the taxable year which includes the earlier of -

(A) the date on which such investment is sold or exchanged, or

(B) December 31, 2026.

(2) *Amount includible*.

(A) *In general*. The amount of gain included in gross income under subsection (a)(1)(A) shall be the excess of-

(i) the lesser of the amount of gain excluded under paragraph (1) or the fair market value of the investment as determined as of the date described in paragraph (1), over

(ii) the taxpayer's basis in the investment.

(B) *Determination of basis*.

(i) *In general*. Except as otherwise provided in this clause or subsection (c), the taxpayer's basis in the investment shall be zero.

(ii) *Increase for gain recognized under subsection (a)(1)(B)*. The basis in the investment shall be increased by the amount of gain recognized by reason of subsection (a)(1)(B) with respect to such property.

(iii) *Investments held for 5 years*. In the case of any investment held for at least 5 years, the basis of such investment shall be increased by an amount equal to 10 percent of the amount of gain deferred by reason of subsection (a)(1)(A).

(iv) *Investments held for 7 years*. In the case of any investment held by the taxpayer for at least 7 years, in addition to any adjustment made under clause (iii), the basis of such property shall be increased by an amount equal to 5 percent of the amount of gain deferred by reason of subsection (a)(1)(A).

Code § 1400Z-2(c), "Special rule for investments held for at least 10 years," provides:

> In the case of any investment held by the taxpayer for at least 10 years and with respect to which the taxpayer makes an election under this clause, the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged.

How do we determine "aggregate amount invested by the taxpayer in a qualified opportunity fund"?

"Qualified opportunity fund" means any investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90% of its assets in qualified opportunity zone property, determined by the average of the percentage of qualified opportunity zone

property held in the fund.[1409] The 90% test is measured on the last day of the first 6-month period of the taxable year of the fund, and on the last day of the taxable year of the fund.[1410]

If a qualified opportunity fund fails to meet the 90% requirement, a penalty applies to the fund or its owners.[1411]

"Qualified opportunity zone property" means qualified opportunity zone stock, a qualified opportunity zone partnership interest, or qualified opportunity zone business property.[1412]

Generally,[1413] the term "qualified opportunity zone stock" means any stock in a domestic corporation if the stock is acquired by the qualified opportunity fund after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash, as of the time that stock was issued, that corporation was a qualified opportunity zone business (or, in the case of a new corporation, that corporation was being organized for purposes of being a qualified opportunity zone business), and during substantially all of the qualified opportunity fund's holding period for such stock, such corporation qualified as a qualified opportunity zone business.[1414]

A "qualified opportunity zone partnership interest" is any capital or profits interest in a domestic partnership if:[1415]

(i) such interest is acquired by the qualified opportunity fund after December 31, 2017, from the partnership solely in exchange for cash,

(ii) as of the time such interest was acquired, such partnership was a qualified opportunity zone business (or, in the case of a new partnership, such partnership was being organized for purposes of being a qualified opportunity zone business), and

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[1409] Code § 1400Z-2(d)(1),

[1410] Code § 1400Z-2(d)(1),

[1411] Code § 1400Z-2(f), "Failure of qualified opportunity fund to maintain investment standard," provides:

(1) *In general*. If a qualified opportunity fund fails to meet the 90-percent requirement of subsection (c)(1), the qualified opportunity fund shall pay a penalty for each month it fails to meet the requirement in an amount equal to the product of -
   (A) the excess of-
      (i) the amount equal to 90 percent of its aggregate assets, over
      (ii) the aggregate amount of qualified opportunity zone property held by the fund, multiplied by
   (B) the underpayment rate established under section 6621(a)(2) for such month.

(2) *Special rule for partnerships*. In the case that the qualified opportunity fund is a partnership, the penalty imposed by paragraph (1) shall be taken into account proportionately as part of the distributive share of each partner of the partnership.

(3) *Reasonable cause exception*. No penalty shall be imposed under this subsection with respect to any failure if it is shown that such failure is due to reasonable cause.

[1412] Code § 1400Z-2(d)(2)(A).

[1413] However, Code § 1400Z-2(d)(2)(B)(ii), "Redemptions," provides that a rule similar to the rule of Code § 1202(c)(3) shall apply for purposes of Code § 1400Z-2(d)(2)(B). Code § 1202(c)(3) is described in fns 4721-4733 of part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[1414] Code § 1400Z-2(d)(2)(B)(i).

[1415] Code § 1400Z-2(d)(2)(C).

(iii) during substantially all of the qualified opportunity fund's holding period for such interest, such partnership qualified as a qualified opportunity zone business.

"Qualified opportunity zone business property" means tangible property used in a trade or business of the qualified opportunity fund if:[1416]

(I) such property was acquired by the qualified opportunity fund by purchase (as defined in section 179(d)(2))[1417] after December 31, 2017,

(II) the original use of such property in the qualified opportunity zone commences with the qualified opportunity fund or the qualified opportunity fund substantially improves the property, and

(III) during substantially all of the qualified opportunity fund's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone.

Code § 1400Z-1 provides rules for designating a "qualified opportunity zone." Notices 2018-48 and 2019-42 (7/15/2019) list the population census tracts the Secretary of the Treasury designates as qualified opportunity zones (QOZs).[1418] The IRS' Opportunity Zones Resources are at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx, including a map of all QOZs.

Property is treated as "substantially improved" by the qualified opportunity fund only if, during any 30-month period beginning after the date of acquisition of that property, additions to basis with respect to the property in the hands of the qualified opportunity fund exceed an amount equal to the adjusted basis of the property at the beginning of that 30-month period in the hands of the qualified opportunity fund.[1419] When a qualified opportunity fund (QOF) invests in real estate in a qualified opportunity zone (QOZ), Rev. Rul. 2018-29 asserts:

(1) If a QOF purchases an existing building located on land that is wholly within a QOZ, the original use of the building in the QOZ is not considered to have commenced with the QOF for purposes of §1400Z-2(d)(2)(D)(i), and the requirement under § 1400Z-2(d)(2)(D)(i) that the original use of tangible property in the QOZ commence with a QOF is not applicable to the land on which the building is located.

(2) If a QOF purchases a building wholly within a QOZ, under § 1400Z-2(d)(2)(D)(ii) a substantial improvement to the building is measured by the QOF's additions to the adjusted basis of the building.

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[1416] Code § 1400Z-2(d)(2)(D)(i).

[1417] [footnote not in statute] Code § 1400Z-2(d)(2)(D)(iii) provides that the related person rule of Code § 179(d)(2) is applied pursuant to Code § 1400Z-2(d)(8) of in lieu of the application of such rule in Code § 179(d)(2)(A).

[1418] IRS summary: "Notice 2019-42 amplifies Notice 2018-48, 2018-28 I.R.B. 9, which lists the population census tracts that the Secretary of the Treasury designated as qualified opportunity zones. Specifically, this notice adds two additional census tracts in Puerto Rico that have been designated as qualified opportunity zones under § 1400Z-1(b)(3) of the Internal Revenue Code."

[1419] Code § 1400Z-2(d)(2)(D)(ii).

(3) Under § 1400Z-2(d), measuring a substantial improvement to the building by additions to the QOF's adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located.

A "qualified opportunity zone business"[1420] is a trade or business in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property,[1421] which satisfies certain definitional requirements of "qualified business entity" under the enterprise zone rules, and which is not a sinful business.[1422] In the prior sentence, tangible property that ceases to be a qualified opportunity zone business property continues to be treated as a qualified opportunity zone business property for the lesser of (i)5 years after the date on which that tangible property ceases to be so qualified, or (ii) the date on which that tangible property is no longer held by the qualified opportunity zone business.[1423]

If only a portion of any investment in a qualified opportunity fund consists of investments of gain to which a Code § 1400Z-2(a) election is in effect, then that investment is treated as two separate investments, consisting of one investment that only includes amounts to which the Code § 1400Z-2(a) election applies (to which Code § 1400Z-2(a), (b) and (c) apply), and a separate investment consisting of other amounts to which Code § 1400Z-2 does not apply.[1424]

In applying Code § 1400Z-2, persons are related to each other if such persons are described in Code § 267(b)[1425] or 707(b)(1),[1426] determined by substituting 20% for 50% each place it occurs there.

### II.G.8. Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy

Except for a small allowance for individuals[1427] and the exception provided in part II.G.4.m Code § 1341 Claim of Right Deduction,[1428] capital losses are deductible only against capital gain.[1429] In addition to limiting the amount of loss that any taxpayer can take, for individuals (including owners of S corporations and partnerships) this rule causes such losses to offset favorably taxed capital gain,[1430] which is not as beneficial as offsetting highly taxed ordinary income. This part II.G.7 explains that abandoning a capital asset generates an ordinary loss, which is more favorable than selling a capital asset for a capital loss, so much so

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[1420] Code § 1400Z-2(d)(3)(A).
[1421] Determined by substituting "qualified opportunity zone business" for "qualified opportunity fund" each place it appears in Code § 1400Z-2(d)(2)(D).
[1422] Code § 1400Z-2(d)(3)(A)(iii) refers to Code § 144(c)(6)(B), which requires that "no portion of the proceeds of such issue is to be used to provide (including the provision of land for) any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises."
[1423] Code § 1400Z-2(d)(3)(B).
[1424] Code § 1400Z-2(e)(1).
[1425] Code § 267(b) is described in part II.G.4.l.iv Code § 267 Disallowance of Related-Party Deductions or Losses.
[1426] Code § 707(b) is described in part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.
[1427] $1,500 for married filing separately and $3,000 for all other individuals. Code § 1211(b)(1).
[1428] Especially text accompanying fn 1334.
[1429] Code § 1211.
[1430] Code § 1(h).

that a taxpayer turned its back on $20 million cash to generate an ordinary loss deduction worth much more than that.[1431]

Generally, a loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, is a Code § 165(a) deduction for the taxable year in which the loss is actually sustained.[1432] The IRS views abandonment for purposes of claiming an ordinary loss as requiring "(1) an intention to abandon the asset, and (2) an affirmative act of abandonment."[1433] If a partnership interest subject to liabilities is abandoned, the partnership interest is treated as having being sold for the liabilities rather than abandoned.[1434]

Code § 1234A was enacted to reduce opportunities to use abandonment to deduct what otherwise would have been a capital loss (although not necessarily in the example above),[1435]

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[1431] See fns. 1441-1442.

[1432] Reg. § 1.165-2(a).

[1433] CCA 200637032, citing:

A.*J. Industries, Inc. v. United States*, 503 F.2d 660, 670 (9th Cir. 1974); Rev. Rul. 93-80; Rev. Rul. 2004-58, 2004-1 C.B. 1043. *See also Echols v. Commissioner*, 935 F.2d 703, 706-08 (5th Cir. 1991) (finding both an intent to abandon and an affirmative act of abandonment when taxpayers called a partnership meeting at which they tendered their partnership interest to another partner, or anyone else, "gratis," and announced that they would contribute no further funds to the partnership), *reh'g denied*, 950 F.2d 209 (5th Cir. 1991).

Rev. Rul. 2004-58 explains what the IRS views as insufficient affirmative acts to constitute abandonment.

[1434] Rev. Rul. 93-80, Situation 1. *Watts v. Commissioner*, T.C. Memo. 2017-114, held:

Subject to the prohibition on sales or exchanges giving rise to ordinary abandonment losses, partnership interests may be abandoned. *Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991), *rev'g and remanding* 93 T.C. 553 (1989); *Citron v. Commissioner*, 97 T.C. at 213.

When a partner is relieved of his or her share of partnership liabilities, the partner is deemed to receive a distribution of cash. Sec. 752(b). Section 731(a) requires distributions to partners to be treated as payments arising from the sale or exchange of a partnership interest. Secs. 752(b), 731(a); *Citron v. Commissioner*, 97 T.C. at 214-215 n.11. Thus, ordinary abandonment losses may arise only in a narrow circumstance where the partner: (1) was not personally liable for the partnership's recourse debts or (2) was limited in liability and otherwise not exposed to any economic risk of loss for the partnership's nonrecourse liabilities. See sec. 752(b), (d); sec. 1.752-3, Income Tax Regs.; see also *Commissioner v. Tufts*, 461 U.S. 300 (1983).

Respondent determined petitioners' disposal of their Partnership interests did not fall within these narrow exceptions. Accordingly, respondent recharacterized petitioners' losses from ordinary abandonment losses to capital losses on the sale or exchange of the interests.

In contesting this determination, petitioners were tasked with the burden of proving respondent's determination incorrect. Petitioners have not met this burden. Petitioners presented no documentary or testimonial evidence to establish their eligibility for an abandonment loss deduction. Petitioners failed to prove their individual shares of any Partnership liabilities, capital restoration obligations, or lack thereof, in the light of documentary evidence suggesting otherwise. Additionally, petitioners did not offer any evidence or analysis as to how their actions constituted an intentional and overt manifestation of abandoning their Partnership interests.

[1435] The Senate Finance Committee Report on P.L. 97-34 (ERTA 1981) explained:

**Treatment of Gain or Loss From Certain Terminations**

*Present Law*.—The definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset. Court decisions have interpreted this requirement to mean that when a disposition is not a sale or exchange of a capital asset, for example, a lapse,

but the relevant committee report focused on futures contracts.[1436] Code § 1234A taxes as a capital gain or loss the "cancellation, lapse, expiration, or other termination" of (1) certain rights or obligations[1437] "with respect to property which is (or on acquisition would be) a capital asset in

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cancellation, or abandonment, the disposition produces ordinary income or loss.[1] This interpretation has been applied even to dispositions which are economically equivalent to a sale or exchange of a capital asset. If a taxpayer can choose the manner of disposing of a capital asset, he may sell or exchange it, if it has appreciated in value, to realize capital gains. However, a transaction in which a taxpayer has suffered an economic loss may be terminated in a manner which produces a fully deductible ordinary loss, even though the loss in substance is the equivalent of a loss from the disposition of a capital asset.

[1] See *Leh v. Comm'r*, 260 F2d 489 (9th Cir., 1952) and *Comm'r v. Pittston Co.*, 252 F2d 344 (2d Cir., 1958), *cert. denied*, 357 U.S. 919 (1958).

*Reasons for Change*.—The committee believes that the change in the sale or exchange rule is necessary to prevent tax-avoidance transactions designed to create fully-deductible ordinary losses on certain dispositions of capital assets, which if sold at a gain, would produce capital gains. These transactions already cause significant losses to the Treasury.

Some taxpayers and tax shelter promoters have attempted to exploit court decisions holding that ordinary income or loss results from certain dispositions of property whose sale or exchange would produce capital gain or loss. These decisions rely on the definition of capital gains and losses in section 1222 which requires that there be a sale or exchange of a capital asset.

As a result of these interpretations, losses from the termination, cancellation, lapse, abandonment and other dispositions of property, which are not sales or exchanges of the property, are reported as fully deductible ordinary losses instead of as capital losses, whose deductibility is restricted. However, if such property increases in value, it is sold or exchanged so that capital gains, long-term when the holding period requirements are met, are reported.

[1436] The Senate Finance Committee Report on P.L. 97-34 (ERTA 1981) explained:

Some of the more common of these tax-oriented ordinary loss and capital gain transactions involve cancellations of forward contracts for currency or securities.

The committee considers this ordinary loss treatment inappropriate if the transaction, such as settlement of a contract to deliver a capital asset, is economically equivalent to a sale or exchange of the contract. For example, a taxpayer may simultaneously enter into a contract to buy German marks for future delivery and a contract to sell German marks for future delivery with very little risk. If the price of German marks thereafter declines, the taxpayer will assign his contract to sell marks to a bank or other institution for a gain equivalent to the excess of the contract price over the lower market price and cancel his obligation to buy marks by payment of an amount in settlement of his obligation to the other party to the contract. The taxpayer will treat the sale proceeds as capital gain and will treat the amount paid to terminate his obligation to buy as an ordinary loss.

*Explanation of Provision*.—In order to insure that gains and losses from transactions economically equivalent to the sale or exchange of a capital asset obtain similar treatment, the bill adds a new section 1234A to the Code providing that gains or losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property which is, or which would be if acquired, a capital asset in the hands of the taxpayer shall be treated as gains or losses from the sale of a capital asset. Property subject to this rule is any personal property (other than stock) of a type which is actively traded (sec. 1092(d)(1)).

[1437] Other than a "securities futures contract," as defined in Code § 1234B. Code § 1234B(c) provides the following definition (brackets quoted from RIA Checkpoint) and then authorizes certain regulations:

For purposes of this section, the term "securities futures contract" means any security future (as defined in section 3(a)(55)(A) of the Securities Exchange Act of 1934, as in effect on the date of the enactment [12/21/2000] of this section).

the hands of the taxpayer," or a qualified straddle[1438] "which is a capital asset in the hands of the taxpayer." The right to a Code § 1231 asset[1439] does not qualify for Code § 1234A treatment, notwithstanding that the underlying asset's sale would have triggered long-term capital gain treatment.[1440]

When a taxpayer abandoned stock to obtain an ordinary loss rather than sell the stock for $20 million and have a capital loss, the Tax Court held that Code § 1234A applied to make the loss a capital loss,[1441] but the Fifth Circuit allowed an ordinary loss.[1442] The Tax Court's decision

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[1438] A "section 1256 contract," which § 1256(b) provides includes any "regulated futures contract," "foreign currency contract," "nonequity option," " dealer equity option," or "dealer securities futures contract" but under Code § 1256(b)(2) does not include:

(A) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, or

(B) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.

[1439] A Code § 1231 asset is not a capital asset. See part II.G.6.a Code § 1231 Property.

[1440] *CRI-Leslie, LLC v. Commissioner*, 147 T.C. 217 (2016), *aff'd* 882 F.3d 1026 (11th Cir. 2018).

[1441] *Pilgrim's Pride Corp. v. Commissioner*, 141 T.C. 533 (2013). The official Tax Court Summary is:

> P is the successor in interest to G. G was contractually obligated to purchase, and in 1999 did purchase, securities from S and T for $98.6 million. The securities were capital assets of G. In 2004 S offered to redeem the securities for $20 million. G's board of directors decided to abandon the securities for no consideration because a $98.6 million ordinary loss would produce tax savings greater than the $20 million offered by S. On June 24, 2004, G voluntarily surrendered the securities to S and T for no consideration. On its Federal income tax return for the tax year ending June 30, 2004, G reported a $98.6 million ordinary abandonment loss deduction under I.R.C. sec. 165(a) pursuant to sec 1.165-2(a), Income Tax Regs.
>
> An abandonment loss cannot be claimed on a sale or exchange of property. Sec. 1.165-2(b), Income Tax Regs. Pursuant to I.R.C. sec. 165(f) losses from sales or exchanges of capital assets are subject to the limitations on capital losses under I.R.C. secs. 1211 and 1212. I.R.C. sec. 1234A requires gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right with respect to property that is (or on acquisition would be) a capital asset in the hands of a taxpayer to be treated as gain or loss from the sale of a capital asset.
>
> *Held*: the securities are intangible property comprising rights that G had in the management, profits, and assets of S and T. Those rights were terminated when G surrendered the securities.
>
> *Held*, further, the $98.6 million loss on the surrender of the securities is attributable to the termination of G's rights with respect to the securities, which are capital assets, and pursuant to I.R.C. sec. 1234A the loss is treated as a loss from the sale or exchange of capital assets.
>
> *Held*, further, G is not entitled to an ordinary loss deduction for abandonment, because the loss is treated as a loss from the sale or exchange of capital assets pursuant to I.R.C. sec. 1234A. See sec. 1.165-2(b), Income Tax Regs.
>
> *Held*, further, pursuant to I.R.C. sec. 165(f), P's losses from the surrender of the securities, deemed to be a sale or exchange under I.R.C. sec. 1234A, are subject to the limitations on capital losses under I.R.C. secs. 1211 and 1212.

[1442] *Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311 (5th Cir. 2015). The court held that Code § 1234A(1) did not apply:

> The primary question in this case is whether § 1234A(1) applies to a taxpayer's abandonment of a capital asset. The answer is no. By its plain terms, § 1234A(1) applies to the termination of rights or obligations with respect to capital assets (*e.g.* derivative or contractual rights to buy or sell capital assets). It does not apply to the termination of ownership of the capital asset itself. Applied to the facts of this case, Pilgrim's Pride abandoned the Securities, not a "right or obligation ... with respect to" the Securities. 26 U.S.C. § 1234A(1).

seems consistent with the motivation for Code § 1234A, but the Fifth Circuit followed the statute's actual language.

When a contract right, commonly referred to as "phantom stock," passed to the employee's surviving spouse, who then contributed it to a partnership, the contribution to the partnership triggered taxation as income in respect of a decedent,[1443] converting the contract right to a capital asset in the partnership's hands; when the former employer paid on the contract, Code § 1234A applied to the proceeds.[1444] The contract right was a capital asset because it was not excluded from the definition of capital asset.[1445] Furthermore, the substitute-for-

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[The court then explained why the IRS' position would have made Code § 1234A(2) meaningless.]

For the foregoing reasons, we hold that 26 U.S.C. § 1234A(1) does not apply to Pilgrim's Pride's abandonment loss.[8]

[8] Two administrative actions lend further support to Pilgrim's Pride's position. In Revenue Ruling 93-80, the IRS held that a taxpayer is allowed an ordinary loss on the abandonment of a partnership interest, even if the abandoned partnership interest is a capital asset. This Ruling directly contradicts the Commissioner's position in this case. Although the Commissioner asserts that Revenue Ruling 93-80 was superseded by a 1997 amendment to the statute at issue here, this begs the question presented in this case and is odd considering that the IRS never has formally revoked the Ruling and has relied on the Ruling since the statutory amendment.

[1443] Code § 691(a)(2). See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[1444] *Hurford Investments No 2, Ltd. v. Commissioner*, Docket No. 23017-11 (4/17/2017), https://www.ustaxcourt.gov/UstcDockInq/DocumentViewer.aspx?IndexID=7090068. This case related to the surviving spouse's estate in *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278, which is cited in fn. 5929 in part III.B.1.g.i Private Annuities: Estate Planning Implications. The surviving spouse failed to report the contribution to the partnership on her income tax return, and it was too late to assess her return. T.C. Memo. 2008-278 held that the contract right was included in her estate directly, so the partnership received a basis step-up to its value on her estate tax return; but for Code § 2036 inclusion, the partnership would have needed to make a Code § 754 election, as described in part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000 (Code § 2036 exception is described in fn 5169.

[1445] *Hurford Investments No 2, Ltd. v. Commissioner*, fn. 1444, held:

*Section 1221*. Section 1221 defines the term "capital asset." It's a very broad section, and defines the term as all property that isn't specifically excluded by one of a list of exceptions. I.R.C. § 1221(a); 26 C.F.R. § 1.1221-1(a). Importantly, the character of property can change depending on who holds it. A car dealership's cars, for example, are inventory to the dealership, so the cars would fall into the category of non-capital assets in the hands of a car dealer. But a car becomes a capital asset in the hands of the usual car buyer because it no longer fits one of the non-capital asset definitions in section 1221. *See*, *e.g.*, *David Taylor Enters., Inc. v. Commissioner*, 89 T.C.M. (CCH) 1369 (2005). The same holds true in more complicated cases, such as inventory of a sole proprietorship which become capital assets in the hands of the business owner's estate. *Estate of Ferber v. Commissioner*, 22 T.C. 261 ( 1954); see also *Berry Petroleum Co. v. Commissioner*, 104 T.C. 584, 650 n. 48 (1995) (noting that the character of property for one company may be different for a successor company). HI-2's interest in the phantom stock doesn't fit into one of the exceptions listed in section 1221,[2] so it seems it's a capital asset.

[2] The phantom stock is not (a) stock in trade (*i.e.*, dealer property), (b) depreciable property used in a trade or business, (c) a copyright or other similar item, (d) an account or note receivable acquired in the ordinary course of business, (e) a U.S. Government publication, (e) a commodities derivative financial instrument, (f) a hedging transaction, or (g) supplies used or consumed in the ordinary course of business. I.R.C. § 1221(a).

ordinary-income doctrine did not apply.[1446] Finally, the employer's paying the contract was a qualifying ""cancellation, lapse, expiration, or other termination."[1447]

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[1446] *Hurford Investments No 2, Ltd. v. Commissioner*, fn. 1444, held:

> But caselaw throws another exception at us that we must consider – the substitute-for-ordinary-income doctrine. Sometimes something must be taxed as ordinary income even if it doesn't fit one of the exceptions specifically listed in section 1221. The classic example of this doctrine is the sale of a winning lottery ticket. Lump-sum payments or annuity payments for winning the lottery are taxed as ordinary income. But what if a taxpayer sells his right to future annuity payments? The IRS always argues that a sale of such property doesn't produce a capital gain. *See*, *e.g.*, *Davis v. Commissioner*, 119 T.C. 1, 5-6 (2002). The courts agree. We noted in *Davis* that the Supreme Court said "[w]hile a capital asset is defined . . . as 'property held by the taxpayer,' it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset." *Id.* At 7 (quoting *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134 (1960)). Should the phantom stock receive similar treatment? If Gary had lived to see the liquidation of the phantom account it would've been deferred compensation, and taxed as ordinary income. Why should that change now?
>
> The reason is that HI-2 isn't Gary Hurford and the phantom stock isn't the same as a winning lottery ticket. We've already said the character of property can change when it's transferred to another party, so the character in the hands of Gary or Thelma shouldn't automatically be applied to HI-2. In *Davis* we said that "[i]t is well established that the purpose for capital-gains treatment is 'to afford capital gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year.'" 119 T.C. at 7 n. 9 (quoting *Gillette Motor Transp.*, 364 U.S. at 134). The winning lottery ticket doesn't fit this description because it represents the right to guaranteed future payments of a set amount. The phantom stock, on the other hand, could increase or decrease in value over time, similar to ordinary stock. Once HI-2 acquired it, its value was inextricably linked to the value of Hunt Oil, which was far from set in stone. Unlike Gary, HI-2 couldn't do anything to affect its value, but rather simply held it and hoped it would appreciate in value. This distinguishing characteristic is enough for us to conclude that it is a capital asset of HI-2's.

[1447] *Hurford Investments No 2, Ltd. v. Commissioner*, fn. 1444, discussed the issue:

> Winning capital-asset status is only half the battle for HI-2. To receive capital-gains rates, the income must be from a "sale or exchange" of that capital asset. I.R.C. § 1222. "The touchstone for sale or exchange treatment is consideration. If in return for assets any consideration is received, even if nominal in amount, the transaction will be classified as a sale or exchange." *LaRue v. Commissioner*, 90 T.C. 465, 483 (1988). The Commissioner argues that even if we find the phantom stock is a capital asset, HI-2 never sold or exchanged it. Instead, Hunt Oil simply fulfilled a contractual obligation. The Commissioner points us to *Pounds v. United States*, 372 F.2d 342 (5th Cir. 1967).

After discussing *Pounds*, the court noted:

> HI-2 doesn't dispute that under *Pounds* it would have a big problem. HI-2 argues instead that Founds has been superseded by a new Code section – section 1234A. Section 1234A says that "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of . . . a right or obligation . . . with respect to property which is . . . a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset." If a transaction meets the definition in section 1234A, it counts as capital gain or loss from a sale.
>
> HI-2 argues that when its right to participate in the phantom-stock plan ended in 2006 and Hunt Oil paid out the value of the phantom account, HI-2's interest in the phantom stock was cancelled, lapsed, expired, or was otherwise terminated. HI-2 thinks this means that there was a sale or exchange in 2006, so it should receive capital-gains treatment under section 1234A. This motion

TAM 200427025 asserted that Code § 1234A did not apply to the termination of a long-term power purchase agreement.

Code § 1234A, by its own terms, does not apply to "the retirement of any debt instrument (whether or not through a trust or other participation agreement)."

Code § 1234A has reportedly been used to obtain capital gain treatment on the surrender of a life insurance policy.[1448]

Code § 1234A has attracted attention in the merger and acquisition arena.[1449]

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> is thus affected by the Fifth Circuit's decision in *Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311 (5th Cir. 2015), *rev'g* 141 T.C. 533 (2013).

The court then reviewed the Fifth Circuit's decision in *Pilgrim's Pride*:

> It held that section 1234A(1) applies only to the termination of rights or obligations to buy or sell capital assets, not the termination of their ownership. *Pilgrim 's Pride*, 779 F.3d at 315. So, a contractual right to buy or sell a capital asset would fall into section 1234A(1) under the Fifth Circuit's interpretation. The Fifth Circuit tells us that if there's no sale or exchange and there's no termination of a right or obligation to buy or sell, then there can't be capital-gains treatment. *Id.*
>
> So which category are we dealing with here--the termination of a right to buy or sell or the termination of ownership? Remember that both parties to the phantom-stock arrangement had the right to liquidate the account at any time. When Hunt Oil liquidated the phantom stock and distributed the proceeds, it ended HI-2's right to sell the phantom stock when it chose. We think that means there was a termination of a right to buy or sell a capital asset, and not an abandonment of property, under the Fifth Circuit's interpretation of 1234A(1). HI-2 still owned the rights to the phantom stock or, after the liquidation, to the cash proceeds. We therefore conclude that the transaction was a sale or exchange of a right to sell a capital asset under section 1234A(1) and HI-2 is entitled to capital-gains treatment.

[1448] See fn. 3967, found in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy).

[1449] For more about Code § 1234A, see Schnee and Seago, "The Application of Section 1234A: Explanation, Revision or Expansion?" *Journal of Taxation* (4/2017), also citing *Alderson v. U.S.*, 686 F.3d 791 (9th Cir. 2012); *Patrick v. Commissioner*, 142 T.C. 124 (2014); Letter Rulings 200823012 and 201123044, FAA 20163701F; and ILM 201642035. The article concluded:

> Recently, IRS rulings and cases have considered the application of Section 1234A. They appear to have expanded its scope to include M&A transactions but limit the definition of capital assets to those that would be treated as capital based on the historic cases and rulings. This includes applying Section 1221 exactly as enacted to the extent it lists assets as non-capital assets except if the court-created narrow definitional approach applies. The application of Section 1234A to M&A transactions is very significant since corporations pay ordinary income tax on capital gains but have limited deductions for capital losses.

A panel (including governmental) at the American Bar Association Section of Taxation's January (Midyear) 2017 meeting discussed these issues, including the observation that CCA 201642035 included a footnote disagreeing with the conclusion of Letter Ruling 200823012 that a termination fee was ordinary income. Slides are saved as Thompson Coburn doc. 6555254. Panelists suggested that regulations under Code § 263(a) capitalized expenditures investigating a possible acquisition as a general intangible asset under *Indopco, Inc. v. Commissioner*, 503 U.S. 79 (1992), without identifying the intangible asset or dealing with its later being rolled into a stock purchase or being abandoned; they said that Treasury had intended to address those issues later but never got around to it.

## II.P. Operations

Taxation of operations focuses on whether income from operations is taxed to the entity or to its owner(s), effect of contributed property on taxation of operations, to what extent are FICA taxes imposed, and miscellaneous issues.

### II.P.1. Income Taxation of Operations

#### II.P.1.a. Allocations of Income in Partnerships and S Corporations

Partnership income taxation of owners is more complex but more flexible than S corporation income taxation of owners. Defining the ownership in a partnership can be challenging.[3467] Although receiving K-1s after the original due date of a return is aggravating, a taxpayer who uses estimates rather than actual K-1 amounts can be penalized.[3468]

Also see part III.B.2.j Tax Allocations upon Change of Interest.

#### II.P.1.a.i. Allocations of Income in Partnerships

##### II.P.1.a.i.(a). General Rules for Allocations of Income in Partnerships

Allocation of income, gain, loss, deductions and credits among partners are governed by Code § 704(b) and Reg. § 1.704-1. These provisions set up a rule that requires the allocation of such income, gain, loss, deduction, or credit to have substantial economic effect or to be in accordance with the partner's interest in the partnership. These rules are set up to ensure that, when a partner is allocated income, the partner is able to enjoy the economic benefit associated with that income, or that when he is allocated economic loss, the partner suffers the burden of that loss. This allocation is usually achieved through the use of partner capital accounts, that, in most basic terms, are increased by a partner's contributions or share of income and are decreased by distributions or the partner's share of a loss.[3469] The goal of the capital account is to track the distribution amount a partner would receive if the partnership sold all of its assets at book value, paid off all liabilities, and then distributed any remaining cash to the partners in liquidation of the partnership.

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[3467] See Banoff, FAQ-Filled Guidance on Computing a Partner's Interest in Profits, Losses, and Capital, *Journal of Taxation*, April and May 2009 (two-part article). See also Banoff, "Identifying Partners' Interests in Profits and Capital: Uncertainties, Opportunities and Traps," *Taxes* (CCH) 3/1/2007.

[3468] *Sampson v. Commissioner*, T.C. Memo. 2013-212.

[3469] Reg. § 1.704-1(b)(2)(iv). A partner's capital account is increased by the fair market value, not basis, of assets that partner contributes. Reg. § 1.704-1(b)(2)(iv)(d). The fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that (1) such value is reasonably agreed to among the partners in arm's-length negotiations, and (2) the partners have sufficiently adverse interests. Reg. § 1.704-1(b)(2)(iv)(h)(1). In calculating book-tax differences under Code § 704(c), A partnership may use different methods with respect to different items of contributed property, provided that the partnership and the partners consistently apply a single reasonable method for each item of contributed property and that the overall method or combination of methods are reasonable based on the facts and circumstances and consistent with the purpose of Code § 704(c). Reg. § 1.704-3(a)(2). For events causing accounts to be revalued, see part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts), especially fn. 494.

Allocations of gross income in preferred partnerships would tend to be based on the ratio of a partnership's overall distributive share of profit for the year, divided by all partners' distributive share of profit for the year, unless special allocations with substantial economic effect provide otherwise.[3470]

Losses that generate or exacerbate a negative capital account complicate the issue. If a partner's capital account has a deficit balance following the liquidation of the partnership interest,[3471] the partner must be unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year,[3472] which amount shall, when the partnership liquidates, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances.[3473] In most cases, however, those wanting partnership income taxation use a limited liability company or other entity that blocks personal liability and do not wish to have such a deficit restoration obligation (DRO). Instead of a DRO, a partnership agreement may contain a "qualified income offset."[3474] A "qualified income offset" is a provision that a partner who unexpectedly receives an adjustment, allocation, or distribution described in Reg. § 1.704-1(b)(2)(ii)(d)(4),[3475] (5),[3476] or (6)[3477] will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible.[3478] (However, I am unsure that there is a consensus about what it means to unexpectedly receive such an adjustment, allocation, or distribution.) Allocations of items of income and gain made pursuant to the qualified income offset are deemed to be made in accordance with the partners' interests in the partnership if the

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[3470] See Banoff, FAQ-Filled Guidance on Computing a Partner's Interest in Profits, Losses, and Capital, *Journal of Taxation*, April 2009 (part one of two-part article) (see discussion of IRS FAQ1); see also Banoff, Identifying Partners' Interests in Profits and Capital: Uncertainties, Opportunities and Traps, *TAXES - The Tax Magazine* (3/1/2007).

[3471] As determined after taking into account various capital account adjustments for the partnership taxable year during which such liquidation occurs.

[3472] Or, if later, within 90 days after the date of such liquidation.

[3473] Reg. § 1.704-1(b)(2)(ii)(b)(3).

[3474] Reg. § 1.704-1(b)(2)(ii)(d)(3).

[3475] Reg. § 1.704-1(b)(2)(ii)(d)(4) provides for:

> Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership.

[3476] Reg. § 1.704-1(b)(2)(ii)(d)(5) provides for:

> Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of § 1.751-1.

[3477] Reg. § 1.704-1(b)(2)(ii)(d)(6) provides for:

> Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner's capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made (other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section or under § 1.704-2(f); however, increases to a partner's capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain.

[3478] Reg. § 1.704-1(b)(2)(ii)(d)(6).

partnership determines and maintains capital accounts under Reg. § 1.704-1(b)(2)(iv)[3479] and liquidating distributions are made in accordance with the positive capital account balances of the partners, as determined after taking into account various capital account adjustments[3480] for the partnership taxable year during which such liquidation occurs.[3481] (Once a loss is allocated, the partner also needs to satisfy various other rules to deduct the loss.[3482])

Special allocation rules govern contributions of property and the income, gain, loss, and deductions associated with contributed property. Under Code § 704(c), a contributed property's income, gain, loss, and deductions[3483] are allocated to all partners to account for differences between the partnership's basis in the property and the fair market value of the property at the time of its contribution.[3484] This allocation ensures that the right person, the contributing partner, will realize any net pre-contribution gain or loss.[3485]

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[3479] Reg. § 1.704-1(b)(2)(ii)(b)(1).
[3480] Reg. § 1.704-1(b)(2)(ii)(b)(2).
[3481] Reg. § 1.704-1(b)(2)(ii)(d)(6).
[3482] See generally part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner.
[3483] Regarding book-tax depreciation differences, see Reg. §§ 1.704-1(b)(2)(iv)(g)(3) (book depreciation) and 1.704-3 (accounting for book-tax differences). Amoni and Schmalz, Section 704(c): The Disparity Offset Method Provides Answers to Difficult Questions, *Journal of Taxation* (WG&L), Vol. 114, No. 4 (Apr. 2011), suggests a way to apply the mechanics of existing regulations in this area. For the impact on allocating depreciation deductions and a basic overview of some tax planning flexibility on that issue, see Lawson, Using Curative and Remedial Allocations to Enhance the Tax Benefits of FLPs, 36 *Estate Planning*, No. 8, 12 (August 2009); however, note that remedial allocations might be attacked under Reg. § 1.701-2(b) or under Reg § 1.704-3(a)(1), the latter added by T.D. 9485 (6/8/2010). Note also that special allocations for book purposes might raise Code § 2701 issues, an issue that is not discussed in that article, which focuses on allocations for income tax purposes. See III.B.7.b Code § 2701 Overview, and III.B.7.c, Code § 2701 Interaction with Income Tax Planning, for a discussion of Code § 2701.
[3484] Code § 704(c)(1)(A).
[3485] The purpose of Code § 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Reg. § 1.704-3(a)(1), which further provides:

> Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. Notwithstanding any other provision of this section, the allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). For this purpose, an allocation method includes the application of all of the rules of this section (*e.g.*, aggregation rules). An allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability. Paragraphs (b), (c), and (d) of this section describe allocation methods that are generally reasonable. Other methods may be reasonable in appropriate circumstances. Nevertheless, in the absence of specific published guidance, it is not reasonable to use an allocation method in which the basis of property contributed to the partnership is increased (or decreased) to reflect built-in gain (or loss), or a method under which the partnership creates tax allocations of income, gain, loss, or deduction independent of allocations affecting book capital accounts. See § 1.704-3(d). Paragraph (e) of this section contains special rules and exceptions. The principles of this paragraph (a)(1), together with the methods described in paragraphs (b), (c) and (d) of this section, apply only to contributions of property that are otherwise respected. See for example § 1.701-2. Accordingly, even though a partnership's allocation method may be described in the literal language of paragraphs (b), (c) or (d) of this section, based on the particular facts and circumstances, the Commissioner can recast the contribution as appropriate to avoid tax results inconsistent with the intent of

Except for personal property included in the same general asset account of the contributing partner and the partnership under Code § 168,[3486] personal property with a basis equal to zero,[3487] certain inventory,[3488] and a securities partnership making certain reverse-Code § 704(c) allocations[3489] to gains and losses from qualified financial assets,[3490] Code § 704(c) and Reg. § 1.704-3 apply on a property-by-property basis.[3491] A partnership may use different methods with respect to different items of contributed property, provided that the partnership and the partners consistently apply a single reasonable method for each item of contributed property and that the overall method or combination of methods are reasonable based on the facts and circumstances and consistent with the purpose of Code § 704(c).[3492] Using one method for appreciated property and another method for depreciated property may be unreasonable.[3493] A new partnership formed as the result of the termination of a partnership under Code § 708(b)(1)(B) is not required to use the same method as the terminated partnership with respect to Code § 704(c) property deemed contributed to the new partnership by the terminated partnership under Reg. § 1.708-1(b)(1)(iv).[3494]

Code § 704(c)(1)(B) prevents a partner from avoiding Code § 704(c) gain or loss by contributing property and having the partnership turn around and distribute it to another partner.[3495]

A partner cannot erase the Code § 704(c) taint by transferring the partner's interest to a third party. When a partnership interest is transferred, any tax attributes associated with the interest travel from the old partner to the new partner, and the new partner becomes the "contributing partner."[3496]

In addition to allocating gain or loss, Code § 704(c) also requires allocations of depreciation and amortization related to contributed property.

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subchapter K. One factor that may be considered by the Commissioner is the use of the remedial allocation method by related partners in which allocations of remedial items of income, gain, loss or deduction are made to one partner and the allocations of offsetting remedial items are made to a related partner.

[3486] Reg. § 1.704-3(e)(2)(i).

[3487] Reg. § 1.704-3(e)(2)(ii).

[3488] Reg. § 1.704-3(e)(2)(iii) excludes:

For partnerships that do not use a specific identification method of accounting, each item of inventory, other than qualified financial assets (as defined in paragraph (e)(3)(ii) of this section.).

[3489] For a description of reverse-Code § 704(c) allocations of gain on sale, see part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 4926-4929.

[3490] See part II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships.

[3491] Reg. § 1.704-3(a)(2).

[3492] Reg. § 1.704-3(a)(2).

[3493] Reg. § 1.704-3(a)(2).

[3494] Reg. § 1.704-3(a)(2).

[3495] See part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

[3496] Reg. § 1.704-4(d)(2).

Partnerships may revalue assets for book purposes when certain events occur, so that partners' capital accounts better reflect the partners' economic interests at the time of those events. The events may include: [3497]

- a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership,
- the liquidation of the partnership,
- a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or
- the grant of an interest in the partnership (other than a de minimis interest), as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner.[3498]

When the partnership adjusts capital accounts to reflect such an event:[3499]

- The adjustments must be based on the fair market value of partnership property on the date of adjustment.
- The adjustments must reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date.
- The partnership agreement must require that the partners' capital accounts be adjusted (as provided in regulations) for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property.
- The partnership agreement must require that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property be determined so as to take account of the variation between the adjusted tax basis and book value of such property in the same manner as under Code § 704(c).
- The adjustments must be made principally for a substantial non-tax business purpose on account of one of the events described above.

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[3497] Reg. § 1.704-1(b)(2)(iv)(f)(5). See part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts), especially fn. 494.

[3498] This last bullet point generally refers to the issuance of a profits interest, as discussed in II.M.1 Taxation on Formation of Entity: Comparison between Partnership and Corporation.

[3499] Reg. § 1.704-1(b)(2)(iv)(f), which is reproduced in fn. 494 in part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts).

When this revaluation occurs, book-tax differences arise, not necessarily because of the contribution of property, but rather because the book value of the partnership's property has changed. Allocating the responsibility for these new book-tax differences is called a reverse-Code § 704(c) allocation.[3500] Partnerships are not required to use the same allocation method for reverse-Code § 704(c) allocations as for contributed property, even if at the time of revaluation the property is already subject to Code § 704(c) and Reg. § 1.704-3(a).[3501] In addition, partnerships are not required to use the same allocation method for reverse-Code § 704(c) allocations each time the partnership revalues its property.[3502] A partnership that makes allocations with respect to revalued property must use a reasonable method that is consistent with the purposes of Code § 704(b), (c).[3503] A partnership making adjustments under Reg. § 1.743-1(b) or 1.751-1(a)(2) must use Reg. § 1.704-3 to account for built-in gain or loss under Code § 704(c).[3504] Special rules apply to such allocations when goodwill or similar assets are being amortized.[3505]

If one partner transfers a partnership interest to another person, the transferee receives the transferor's capital account. Also see part III.B.2.j.iii Tax Allocations upon Change of Interest in a Partnership.

Because of very complicated estate and gift tax rules governing family businesses,[3506] generally family partnerships should be set up with one class of partnership interests. In other words, each partner's capital account is proportionate to that partner's percentage in interest in profits and losses.[3507] However, businesses not involving family members can be more flexible, allocating different tiers of income as rewards for each partner's relative contributions of capital or services. In any event, the tax allocations need to be consistent with the economic arrangements; the tax jargon is that tax allocations must have a "substantial economic effect."

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[3500] Reg. § 1.704-3(a)(6)(i) provides:

> The principles of this section apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to § 1.704-1(b)(2)(iv)(f) or 1.704-1(b)(2)(iv)(s) (reverse section 704(c) allocations).

For a description of reverse-Code § 704(c) allocations of gain on sale, see part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 4926-4929.

[3501] Reg. § 1.704-3(a)(6)(i).

[3502] Reg. § 1.704-3(a)(6)(i).

[3503] Reg. § 1.704-3(a)(6)(i).

[3504] Reg. § 1.704-3(a)(6)(ii).

[3505] Rev. Rul. 2004-49 held:

> If, pursuant to § 1.704-1(b)(2)(iv)(f), a partnership revalues a section 197 intangible that was amortizable in the hands of the partnership, then the § 197 anti-churning rules do not apply and the partnership may make reverse § 704(c) allocations (including curative and remedial allocations) of amortization to take into account the built-in gain or loss from the revaluation of the intangible. If the revalued section 197 intangible was not amortizable in the hands of the partnership, then the partnership may make remedial, but not traditional or curative, allocations of amortization to take into account the built-in gain or loss from the revaluation of the intangible, provided that such allocations are not limited by § 1.197-2(h)(12)(vii)(B).

[3506] See parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

[3507] See part III.B.7.b.ii Certain Exclusions from Code § 2701, fns. 6694-6695.

Whether the partnership has one or multiple classes of equity, issues arise when a partner contributes property whose value exceeds its basis. This excess value is known as Code § 704(c) responsibility. When contributed property is subjected to depreciation or amortization or is later sold, the contributing partner receives a special allocation to properly take into account that partner's Code § 704(c) responsibility. Beware if the contribution and corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the direct and indirect partners' aggregate tax liability.[3508]

Hedge funds are complicated partnership tax structures.[3509]

### II.P.1.a.i.(b). Special Rules for Allocations of Income in Securities Partnerships

Below is a discussion about allocating income in securities partnerships. This discussion focuses on a subset of allocations described in part II.P.1.a.i.(a) General Rules for Allocations of Income in Partnerships, which upon any distribution from a partnership may have the tax consequences described in part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value. If securities partnerships have money flowing and out, they should consider not only those rules but also the rules described in parts II.M.3.e Exception: Disguised Sale (exception to the general idea that the formation of a partnership is not a taxable event) and II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner, as well concerns that distributions of securities from a partnership to a partner may be treated as cash distributions, as described in part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them). The disguised sale rules generally look to entrepreneurial risk, and the risk of disguised sales from a partnership with many investors may be smaller than that with many investors; however, in any event, a contribution of cash or property and a distribution of cash or property that occur within two years tends to trigger a disguised sale reporting requirement, even if the transaction does not constitute a disguised sale.[3510]

Reverse-Code § 704(c) responsibility means tracking the built-in gain or loss of the partnership's property when partnership interests change (which is common when a new partner is admitted to an existing partnership).[3511]

Tracking Code § 704(c) and reverse-Code § 704(c) responsibility often is administratively cumbersome. Rev. Proc. 2007-59, § 2 points out:

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[3508] Reg. § 1.704-3(a)(10), added by T.D. 9485 (6/8/2010). For the regulation's text, see fn. 3516 in part II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships.

[3509] Miller and Bertrand, "Federal Income Tax Treatment of Hedge Funds, Their Investors, and Their Managers," *Tax Lawyer*, pp. 309-397, Vol. 65, No. 2 (Winter 2002).

[3510] See part II.M.3.e.i.(c) Disclosure Requirements, incorporated by reference by parts II.M.3.e Exception: Disguised Sale and II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner

[3511] For a description of reverse-Code § 704(c) allocations of gain on sale, see part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 4926-4929.

.01. To prevent the shifting of tax consequences among partners with respect to precontribution gain or loss, section 704(c) requires partnerships to allocate income, gain, loss, and deductions with respect to property contributed by a partner so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of the contribution. These allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). Section 1.704-3(a)(6) provides that similar rules apply to differences between book value and tax basis that are created by a revaluation of partnership assets pursuant to § 1.704-1(b)(2)(iv)(f) (reverse section 704(c) allocations).

.02. Section 1.704-3(a)(2) provides that section 704(c) allocations are generally made on a property-by-property basis. Therefore, built-in gains and losses from different items of contributed or revalued property generally cannot be aggregated.

See part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts), especially fn. 494 (quoting the regulation governing revaluations).

For purposes of making reverse-Code § 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach that is consistent with the purpose of Code § 704(c).[3512] Once a partnership adopts an aggregate approach, that partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a securities partnership.[3513] Further below are approaches for aggregating reverse-Code § 704(c) gains and losses that are generally reasonable.[3514] Other approaches may be reasonable in appropriate circumstances.[3515] In some circumstances, various Code § 704(c) methods, including the aggregate approaches described further below, are not reasonable.[3516] A partnership using an aggregate approach must separately account for any built-in gain or loss from contributed property.[3517]

When getting into details on the two aggregate approaches below, one finds that they limit the assets that can be aggregated and require one to go to an asset-by-asset approach if one later fails to qualify. Consider using one of the approaches without formally adopting it. For

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[3512] Reg. § 1.704-3(e)(3)(i).

[3513] Reg. § 1.704-3(e)(3)(i), expressly overriding Reg. § 1.704-3(a)(2) and (a)(6)(i).

[3514] Reg. § 1.704-3(e)(3)(i), referring to Reg. § 1.704-3(e)(3)(iv) and (v).

[3515] Reg. § 1.704-3(e)(3)(i).

[3516] Reg. § 1.704-3(e)(3)(i), referring to Reg. § 1.704-3(a)(10), titled, "Anti-abuse rule," which provides:

(i) *In general*. An allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. For purposes of this paragraph (a)(10), all references to the partners shall include both direct and indirect partners.

(ii) *Definition of indirect partner*. An indirect partner is any direct or indirect owner of a partnership, S corporation, or controlled foreign corporation (as defined in section 957(a) or 953(c)), or direct or indirect beneficiary of a trust or estate, that is a partner in the partnership, and any consolidated group of which the partner in the partnership is a member (within the meaning of § 1.1502-1(h))…. [The rest provides details on controlled foreign corporations and Code § 951(a).]

[3517] Reg. § 1.704-3(e)(3)(i).

example, one might use an aggregate approach in practice for marketable securities and an asset-by-asset approach for unmarketable assets. Given that Reg. § 1.704-3(e)(3)(i) permits using any reasonable approach and given that the IRS views an aggregate approach as reasonable for marketable securities (or it would not have provided it), such a hybrid approach would seem to allow one to comply with the regulations without hamstringing one with the artificial rules that are imposed on using an aggregate method as a safe harbor. As a practical matter, given that using an aggregate method is intended as a reasonable shortcut to avoid laborious asset-by-asset tracking, an IRS examiner might need to do laborious asset-by-asset tracking to show that this method is unreasonable, going into such an ordeal with no reason to believe it would be productive.

A "qualified financial asset" is any personal property (including stock) that is actively traded.[3518] For a management company, it includes various additional assets, even if not actively traded.[3519] A "qualified financial asset" does not include a partnership interest, but a partnership (upper-tier partnership) that holds an interest in a securities partnership (lower-tier partnership) must take into account the lower-tier partnership's assets and qualified financial assets.[3520]

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[3518] Reg. § 1.704-3(e)(3)(ii)(A), which continues:

> Actively traded means actively traded as defined in § 1.1092(d)-1 (defining actively traded property for purposes of the straddle rules).

Reg. § 1.1092(d)-1(a) provides:

> *Actively traded*. Actively traded personal property includes any personal property for which there is an established financial market.

Reg. § 1.1092(d)-1(b)(1) provides:

> *In general*. For purposes of this section, an established financial market includes—
> (i) A national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);
> (ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934;
> (iii) A domestic board of trade designated as a contract market by the Commodities Futures Trading Commission;
> (iv) A foreign securities exchange or board of trade that satisfies analogous regulatory requirements under the law of the jurisdiction in which it is organized (such as the London International Financial Futures Exchange, the Marche a Terme International de France, the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, the Frankfurt Stock Exchange, and the Tokyo Stock Exchange);
> (v) An interbank market;
> (vi) An interdealer market (as defined in paragraph (b)(2)(i) of this section); and
> (vii) Solely with respect to a debt instrument, a debt market (as defined in paragraph (b)(2)(ii) of this section).

Reg. § 1.1092(d)-1(b)(2) defines various terms above. Reg. § 1.1092(d)-1(c) discusses notional principal contracts, and Reg. § 1.1092(d)-1(d) discusses debt linked to the value of personal property and may be part pf a straddle.

[3519] Reg. § 1.704-3(e)(3)(ii)(B), which lists those additional assets as:

> notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in, any security, currency, or commodity, including any option, forward or futures contract, or short position; or any similar financial instrument.

[3520] Reg. § 1.704-3(e)(3)(ii)(C), which continues:

> (1) In determining whether the upper-tier partnership qualifies as an investment partnership, the upper-tier partnership must treat its proportionate share of the lower-tier securities partnership's assets as assets of the upper-tier partnership; and

A partnership is a securities partnership if the partnership is either a management company that is registered with the SEC[3521] or an investment partnership, and the partnership makes all of its book allocations in proportion to the partners' relative book capital accounts (except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership).[3522] A partnership is an investment partnership if:[3523]

(i) On the date of each capital account restatement, the partnership holds qualified financial assets that constitute at least 90% of the fair market value of the partnership's non-cash assets; and

(ii) The partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach under Reg. § 1.704-3(e)(3), to make revaluations at least annually.

A partnership that establishes appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses may adopt the partial netting approach of making reverse-Code § 704(c) allocations.[3524] Reg. § 1.704-3(e)(3)(iv) further provides:

> Under the partial netting approach, on the date of each capital account restatement, the partnership:
>
> (A) Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;
>
> (B) Separately aggregates all tax gains and all tax losses from qualified financial assets since the last capital account restatement; and
>
> (C) Separately allocates the aggregate tax gain and aggregate tax loss to the partners in a manner that reduces the disparity between the book capital account balances and the tax capital account balances (book-tax disparities) of the individual partners.

Reg. § 1.704-3(e)(3)(ix), Example (1), illustrates the following under the partial netting approach:

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> (2) If the upper-tier partnership adopts an aggregate approach under this paragraph (e)(3), the upper-tier partnership must aggregate the gains and losses from its directly held qualified financial assets with its distributive share of the gains and losses from the qualified financial assets of the lower-tier securities partnership.

[3521] Reg. § 1.704-3(e)(3)(iii)(B)(1), provides:

> *Management company*. A partnership is a management company if it is registered with the Securities and Exchange Commission as a management company under the Investment Company Act of 1940, as amended (15 U.S.C. 80a).

[3522] Reg. § 1.704-3(e)(3)(iii)(A).

[3523] Reg. § 1.704-3(e)(3)(iii)(B)(2).

[3524] Reg. § 1.704-3(e)(3)(iv). Letter Ruling 201421001 (described more fully in fn. 363 in part II.B Limited Liability Company (LLC)) approved separate partnerships investing in equities or in fixed income funds using this method to track not only Code § 704(c) allocations but also reverse-Code § 704(c) allocations:

> provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

- Each partner has a single revaluation account that shows a net positive or negative book-tax difference.

- Recognized gains and recognized losses are accounted for separately in each of the next two bullet points.

- Recognized gains are allocated only to the partners with positive revaluation accounts, until the positive accounts are exhausted. After that, recognized gains are allocated in proportion to partnership interests.

- Recognized losses are allocated only to the partners with negative revaluation accounts, until the negative accounts are exhausted. After that, recognized losses are allocated in proportion to partnership interests.

A partnership that establishes appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses may also adopt the full netting approach of making reverse-Code § 704(c) allocations.[3525] Reg. § 1.704-3(e)(3)(v) further provides:

> Under the full netting approach, on the date of each capital account restatement, the partnership:
>
> (A) Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;
>
> (B) Nets tax gains and tax losses from qualified financial assets since the last capital account restatement; and
>
> (C) Allocates the net tax gain (or net tax loss) to the partners in a manner that reduces the book-tax disparities of the individual partners.

The character and other tax attributes of gain or loss allocated to the partners under these approaches must:[3526]

> (A) Preserve the tax attributes of each item of gain or loss realized by the partnership;
>
> (B) Be determined under an approach that is consistently applied; and
>
> (C) Not be determined with a view to reducing substantially the present value of the partners' aggregate tax liability.

Reg. § 1.704-3(e)(3)(ix), Example (2), illustrates the following under the full netting approach:

- Each partner has a single revaluation account that shows a net positive or negative book-tax difference.

- Recognized gains and losses are netted against each other.

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[3525] Reg. § 1.704-3(e)(3)(v).
[3526] Reg. § 1.704-3(e)(3)(vi).

- If the net is a gain, then this net recognized gains in allocated only to the partners with positive revaluation accounts, until the positive accounts are exhausted. After that, the recognized gain is allocated in proportion to partnership interests.

- If the net is a loss, then the recognized loss is allocated only to the partners with negative revaluation accounts, until the negative accounts are exhausted. After that, the recognized loss is allocated in proportion to partnership interests.

If a securities partnership adopts an aggregate approach under these rules and later fails to qualify as a securities partnership, it must make reverse-Code § 704(c) allocations on an asset-by-asset basis after the date of disqualification.[3527] However, it is not required to disaggregate the book gain or book loss from qualified asset revaluations before the date of disqualification when making reverse-Code § 704(c) allocations on or after the date of disqualification.[3528] A securities partnership revaluing its qualified financial assets pursuant to Reg. § 1.704-1(b)(2)(iv)(f) on or after the effective date of these rules may use any reasonable approach to coordinate with revaluations that occurred before these rules' effective date.[3529]

The IRS may, by published guidance or by letter ruling, permit aggregation of properties other than those described above, partnerships and partners not described above to aggregate gain and loss from qualified financial assets, and aggregation of qualified financial assets for purposes of making Code § 704(c) allocations in the same manner as that described above.[3530]

Letter Rulings have approved:

- Two separate partnerships, one holding equities and another holding fixed income, created on trust termination.[3531]

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[3527] Reg. § 1.704-3(e)(3)(vii).
[3528] Reg. § 1.704-3(e)(3)(vii).
[3529] Reg. § 1.704-3(e)(3)(viii).
[3530] Reg. § 1.704-3(e)(4).
[3531] In Letter Ruling 201421001, a trust used two series LLCs – one invested in equities (X) and the other in fixed income securities (Y) – to distribute its investment assets to remaindermen. The IRS ruled:
(1) Before the distribution of interests in X and Y to the remainder beneficiaries, X and Y will be disregarded entities as long as they remain single member series of a single-member limited liability company (wholly-owned by trust) and items of income, deduction, credit, gains and losses with respect to assets held within X and Y should be reported directly on the trust's federal income tax returns (as if Trust continued to hold X and Y assets directly).
(2) Upon the distribution of interests in X and Y to the remainder beneficiaries, X and Y will be converted from disregarded entities to partnerships for federal tax purposes, and distribution of X and Y interests by the trust shall be treated as (i) a non-taxable pro rata distribution of X and Y assets (subject to any related liabilities) to the remainder beneficiaries (in accordance with the fractional share of Trust residue to which each remainder beneficiary, respectively, is entitled), as if such assets had been distributed outright from Trust to the remainder beneficiaries; followed by (ii) a deemed capital contribution of those same assets by the remainder beneficiaries to X and Y in a non-taxable exchange for interests in X and Y.
(3) Once X and Y become partnerships for federal tax purposes, to avoid taxation under Code § 721(b) any later in-kind trust distribution of a diversified portfolio of stocks and securities that is transferred as an addition to X or Y on behalf of some or all remainder beneficiaries who hold or thereby acquire membership interests in X or Y shall be treated as: (i) a non-taxable pro rata distribution of such trust assets (subject to any related liabilities) to the remainder beneficiaries holding or thereby acquiring

- Partnerships between a voluntary employees' beneficiary association (VEBA) and plans providing for pension and welfare benefits of a common employer and its current and former subsidiaries.[3532]

- A partnership was allowed to apply this rule to Code § 704(c) allocations when applying the usual Code § 704(c) rules would have been two cumbersome, if a contribution or revaluation of the property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.[3533]

- Use of the partial netting approach when three partnerships merged.[3534]

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membership interests in X or Y (in accordance with the proportionate fractional share of the trust residue to which each remainder beneficiary, respectively, is entitled), as if such assets had been distributed outright from the trust to such remainder beneficiaries; followed by (ii) a deemed capital contribution of those same assets by such remainder beneficiaries to X or Y in a non-taxable exchange for membership interests in X or Y. See part II.M.3 Buying into or Forming a Partnership.

(4) X's and Y's use of the partial netting approach as defined in Reg. § 1.704-3(e)(3)(iv) for aggregating gains and losses from qualified financial assets for the purpose of making reverse Code § 704(c) allocations is reasonable within the meaning of Reg. § 1.704-3(e)(3). See part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

(5) X and Y have permission to aggregate built-in gains and losses from qualified financial assets contributed to X and Y by a partner with built-in gains and built-in losses from revaluations of qualified financial assets held by X and Y for purposes of making allocations under Code § 704(c)(1)(A) and Reg. § 1.704-3(a)(6). See parts II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 4926-4929 (describing reverse-Code § 704(c) allocations, which is where a partner makes a disproportionate contribution or receives a disproportionate distribution when the partner has assets with values not equal to basis, which book-tax difference needs to be accounted for) and II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships.

(6) After X and Y become partnerships for federal tax purposes, in-kind distributions of qualified financial assets from X and Y to one or more of its members will not be deemed a distribution of money under Code § 731(c). As a result, an in-kind distribution will not be treated as a "sale or exchange" and the distributee member should not recognize any gain or loss in connection therewith. Further, both (i) the "aggregate built-in gain or loss" at the partnership level, and (ii) the portion of such "aggregate built-in gain or loss" allocable to the partner receiving such distribution, may be adjusted by the full amount of net unrealized gain or loss in the assets so distributed.

See part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions. For rules on revaluing capital accounts on certain events, see part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts), especially fn. 494.

[3532] Letter Rulings 201028016 and 201028017.

[3533] Letter Ruling 201032003.

[3534] Letter Ruling 201710008 held:

> … Surviving Partnership's use of the partial netting approach for making reverse § 704(c) allocations is a reasonable approach within the meaning of § 1.704-3(e)(3), provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the tax consequences of built-in gain or loss

Rev. Proc. 2007-59 allows certain partnerships to aggregate gains and losses from an expanded class of qualified financial assets in applying the above rules. It provides special rules for a "Qualified Partnership," which is a partnership that satisfies the following requirements:[3535]

(1) the partnership makes all of its book allocations in proportion to the partners' relative book capital accounts (except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership);

(2) the partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach under this revenue procedure, to make revaluations of qualified financial assets at least four times annually;

(3) on the date of each capital account restatement during the taxable year, the partnership holds qualified financial assets that constitute at least 90 percent of the partnership's non-cash assets;

(4) the partnership reasonably expects, as of the first day of each taxable year for which the partnership seeks to aggregate under this revenue procedure, that the partnership

   (a) will have at least 10 unrelated partners at all times during the taxable year; and

   (b) will make at least 200 trades of qualified financial assets during the taxable year, the aggregate value of which will comprise at least 50% of the book value of the partnership's assets (including cash) as of the first day of the taxable year; and

(5) the application of the aggregation method to reverse section 704(c) allocations under this revenue procedure is not made with a view to shifting the tax consequences of

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among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability….

… if Surviving Partnership uses the partial netting approach to make § 704(c) allocations, including reverse § 704(c) allocations, this will be a reasonable method within the meaning of § 1.704-3(a)(1), and is permitted by the Commissioner under § 1.704-3(e)(4)(iii), provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

This ruling is limited to allocations of gain or loss from the sale or other disposition of qualified financial assets made under § 704(b), § 704(c)(1)(A), and § 1.704-3(a)(6). Specifically, no opinion is expressed concerning allocations of items other than items of gain or loss from the sale or other disposition of qualified financial assets, or the aggregation of built-in gains and losses from qualified financial assets contributed to Surviving Partnership by any person other than Terminating Partnership A and Terminating Partnership B. Surviving Partnership must maintain sufficient records to enable it and its partners to comply with § 704(c)(1)(B) and § 737. Additionally, this ruling applies only to the contributions to Surviving Partnership made in connection with the mergers of Terminating Partnership A and Terminating Partnership B into Surviving Partnership and not to any other contributions or any other future partner.

Letter Ruling 201710007 seemed to be the same as Letter Ruling 201710008.

[3535] § 3.01.

built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

In applying the above definition, "partners are treated as related if they are related within the meaning of sections 267(b)[3536] or 707(b)."[3537]

In applying Rev. Proc. 2007-59, "qualified financial assets" are:[3538]

(1) those assets described in § 1.704-3(e)(3)(ii)(A) and (B);

(2) any interest in a partnership that is traded on an established securities market or readily tradable on a secondary market or the substantial equivalent thereof within the meaning of § 1.7704-1(c); and

(3) any interest owned by the partnership (the upper-tier partnership) in a partnership (the lower-tier partnership) that represents it is a securities partnership or a Qualified Partnership, provided that such interest is

(i) less than 10 percent of the capital and profits of the lower-tier partnership and that the upper-tier partnership does not actively or materially participate in the management or operations of the lower-tier partnership; and

(ii) less than 5 percent of the total book value of the upper-tier partnership's assets (including cash) as of the first day of the taxable year.

Rev. Proc. 2007-59 grants permission to any Qualified Partnership to aggregate built-in gains and losses from qualified financial assets for purposes of making reverse-Code § 704(c) allocations under Reg. § 1.704-3(e)(3).[3539] Once a partnership adopts an aggregate approach under this revenue procedure, that partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a Qualified Partnership.[3540] However, a partnership may choose not to aggregate all of the partnership's qualified financial assets if such qualified assets do not exceed in the aggregate 30% of the book value of the partnership's non-cash assets at the time any such qualified financial assets is acquired.[3541]

A Qualified Partnership that adopts an aggregate approach under Rev. Proc. 2007-59 and later fails to qualify as a Qualified Partnership must make reverse-Code § 704(c) allocations on an asset-by-asset basis after the date of disqualification.[3542] The partnership, however, is not required to disaggregate the book gain or book loss from qualified asset revaluations before the

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[3536] Code § 267(b) is reproduced in part II.G.4.l.iv Code § 267 Disallowance of Related-Party Deductions or Losses.
[3537] § 3.01. For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.
[3538] § 3.02.
[3539] § 4.01.
[3540] § 4.01, citing Reg. § 1.704-3(e)(3)(i).
[3541] § 4.01.
[3542] § 4.02.

date of disqualification when making reverse-Code § 704(c) allocations on or after the date of disqualification.[3543]

Rev. Proc. 2001-36 grants automatic permission for certain securities partnerships to aggregate contributed property for purposes of making Code § 704(c) allocations.[3544] Rev. Proc. 2001-36[3545] provides that a Qualified Master-Feeder Structure (QMFS) may "aggregate built-in gains and losses from contributed qualified financial assets for purposes of making section 704(c) and reverse section 704(c) allocations."[3546] Section 4.02 provides:

> A QMFS is created where two or more investors contribute cash or qualified financial assets to a Master Portfolio in exchange for beneficial interests in the Master Portfolio. To qualify as a QMFS, the following requirements must be met:
>
> (1) Each partner in the Master Portfolio is a Feeder Fund, or an investment advisor, principal underwriter, or manager of the Master Portfolio;
>
> (2) Each Feeder Fund contributes only cash and/or a portfolio of diversified stocks and securities that satisfies the 25 and 50 percent tests of section 368(a)(2)(F)(ii) in exchange for beneficial interests in the Master Portfolio;
>
> (3) Each partner in the Master Portfolio that is an investment advisor, principal underwriter, or manager, contributes only cash and/or services in exchange for beneficial interests in the Master Portfolio;

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[3543] § 4.02.

[3544] It also described the information that must be included with ruling requests for permission to aggregate contributed property for purposes of making Code § 704(c) allocations submitted by partnerships that do not qualify for automatic permission, but Rev. Proc. 2002-3, § 6.06, titled "Section 704(c)," superseded that part, providing that private letter rulings will not ordinarily be issued regarding:

> Contributed Property-Requests from Qualified Master-Feeder Structures, as described in section 4.02 of Rev. Proc. 2001-36, 2001-23 I.R.B. 1326, for permission to aggregate built-in gains and losses from contributed qualified financial assets for purposes of making § 704(c) and reverse § 704(c) allocations.

[3545] §§ 2.07 and 2.08 describe the Rev. Proc.'s purpose:

> .07. In a typical Master-Feeder Structure, two or more Feeder Funds or one or more Feeder Funds and an investment advisor, principal underwriter, or manager contribute their assets, consisting primarily of cash or financial investments, to a single Master Portfolio in exchange for beneficial interests in the Master Portfolio. In these cases, each Feeder Fund and the Master Portfolio is registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (1940 Act). The shares of these Feeder Funds are typically publicly offered and widely held by individuals, corporations, and institutional investors. Generally, each Feeder Fund is an open-end mutual fund, which continuously offers to sell new shares or redeem existing shares for a price equal to the net asset value of their proportionate interest in the portfolio.
>
> .08. The IRS and Treasury Department have determined that it is in the best interest of sound tax administration to reduce the burden on taxpayers of submitting ruling requests by granting to certain Master-Feeder Structures automatic permission to aggregate built-in gains and losses from contributed securities.

[3546] § 4.01.

(4) The Master Portfolio is treated as a partnership for federal tax purposes and qualifies as a securities partnership under section 1.704-3(e)(3)(iii);

(5) Each Feeder Fund is a publicly offered regulated investment company, as defined in section 67(c)(2)(B) and section 1.67-2T(g)(3)(iii);

(6) The Master Portfolio is registered as an investment company under the 1940 Act.

(7) The Master Portfolio makes section 704(c) and reverse section 704(c) allocations under the partial netting approach or the full netting approach as described in section 1.704-3(e)(3)(iv) or section 1.704-3(e)(3)(v), respectively, and;

(8) The contributions to the Master Portfolio and the corresponding allocations of tax items with respect to the property contributed to the Master Portfolio are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

### II.P.1.a.ii. Allocations of Income in S Corporations

As described further below, S corporations generally must have a single class of stock. Income is always allocated in proportion to stock ownership.[3547] Special allocations of profits are not permitted, and Code § 704(c) responsibility does not exist. However, trusts cannot use the Code § 179 expensing of equipment, etc., so if the corporation reports Code § 179 expense and has a nongrantor trust shareholder then the corporation will need to separately track as an asset the trust's share of Code § 179 expense and specially allocate to the trust depreciation from that asset.[3548]

Also described further below are ways to creatively compensate employees, providing incentive that is the same as, or similar to, the results one can attain from partnerships.

S corporations are superior to C corporations in that undistributed S corporation income adds to the basis of the shareholders' stock.

Also see part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

### II.P.1.a.iii. Advantages of C and S corporation Reporting of Owners' Compensation on Forms W-2

C and S corporations must withhold taxes and file quarterly forms 941 and annual Forms W-2 for owners' compensation, whereas partnerships and sole proprietorships are not involved in withholding taxes regarding owner compensation.

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[3547] Code § 1377(a)(1). For allocations of income when ownership changes, see part III.B.2.j Tax Allocations upon Change of Interest, particularly III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

[3548] See part II.J.11.a.i Code § 179 Disallowance for Estate or Nongrantor Trust.

Timely filing Forms W-2 helps support the 20% deduction for qualified business income ("QBI") for owners of partnerships,[3549] but W-2 income itself does not constitute QBI.[3550]

Filing W-2 forms for owners provides some minor benefits:

(a) Unless the employee elects otherwise, federal income tax withheld is deemed paid evenly throughout the year. If the owner falls behind during the year, the owner may withhold large amounts at year-end, which generally will be deemed paid evenly throughout the year.

(b) Qualified retirement plans have a cap on compensation that can be considered in allocating contributions to the plans. Owners of corporations could adjust their W-2 income to reduce their compensation in good years and increase it in bad years to plan around this cap. Partners and sole proprietors do not have this flexibility. Of course, all businesses on the cash basis could delay or accelerate billings or disbursements.

(c) Providing a better base for the special deduction for domestic manufacturing.[3551]

### II.P.2. C Corporation Advantage Regarding Fringe Benefits

Only a C corporation may deduct the following items without including them in the recipient's income:

(a) Dependent care (child care) assistance payments for owners subject to a dollar cap (generally $5,000).

(b) The owners' meals and lodging for the employer's convenience without including them in the owner's income.[3552]

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[3549] See part II.E.1.c.vi.(a) W-2 wages under Code § 199A.

[3550] See parts II.E.1.c.ii.(b) Trade or Business of Being an Employee (Excluded from QBI) and II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

[3551] Note the W-2 limitation mentioned in part II.G.26 Code § 199 Deduction for Domestic Production Activities especially fn. 1785.

[3552] Code § 119. See Campbell and Mitchell, The Exclusion for Meals and Lodging, *The Tax Adviser* (April 2015) (also discussing the partnership issue described below), saved as doc. no. 6206076.
However, this exclusion might apply beyond the C corporation context. See McKee, Nelson & Whitmire, ¶14.02. Partners Acting in Nonpartner Capacities: Section 707(a) Transactions, *Federal Taxation of Partnerships & Partners* (WG&L), citing a Fifth Circuit case looking with favor on the Code § 119 exclusion for a partner:

> *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968) (remanding for determination whether partner was in fact employee of his partnership, and therefore entitled to exclude under § 119 value of meals and lodging furnished by the partnership). *Contra Wilson v. United States*, 376 F.2d 280 (Ct. Cl. 1967). The courts generally applied aggregate principles under the 1939 Code. See *Commissioner v. Doak*, 234 F.2d 704 (4th Cir. 1956) (partner may not be employee of his partnership); *Commissioner v. Moran*, 236 F.2d 595 (8th Cir. 1956) (same); *Commissioner v. Robinson*, 273 F.2d 503 (3d Cir. 1959) (cert. denied) (same); Rev. Rul. 53-80, 1953-1 CB 62 (same). See also *George A. Papineau*, 16 T.C. 130 (1951) (nonacq.); Tech. Adv. Mem. 9134003 (May 6, 1991) (incorporation of farming business; shareholder/employees claim benefits of § 119; § 269 not applicable because same benefits available if partnership had been formed). But *cf. Dilts v. United States*, 845 F.Supp. 1505 (D. Wyo. 1994) (§ 119 not available to shareholders of

(c) Non-discriminatory premiums for up to $50,000 in group-term life insurance covering the owners without including them in the owner's income.[3553]

Partners' fringe benefits are summarized by McKee, Nelson & Whitmire;[3554] RIA has prepared summaries of fringe benefits that partners and S corporation shareholders can and cannot claim.[3555] Any partner who performs services for a partnership is considered employed by the partnership for purposes of Code § 132(a)(1) (relating to no-additional-cost services) and Code § 132(a)(2) (relating to qualified employee discounts),[3556] as well as Code § 132(a)(3) (relating to working condition fringes)[3557] and Code § 132(h)(5) (relating to on-premises athletic facilities).[3558] Partners are eligible for educational assistance programs under Code § 127.[3559] Qualified transportation fringe benefits under Code § 132(f) are available to partners only if they are entirely below the limits for the working condition and de minimis fringe exclusions under Code § 132(a)(3), (4).[3560]

Code § 162(*l*), "Special rules for health insurance costs of self-employed individuals," provides:

> (1) *Allowance of deduction*. In the case of a taxpayer who is an employee within the meaning of section 401(c)(1) , there shall be allowed as a deduction under this section an amount equal to the amount paid during the taxable year for insurance which constitutes medical care for -
>
> (A) the taxpayer,
>
> (B) the taxpayer's spouse,
>
> (C) the taxpayer's dependents, and
>
> (D) any child (as defined in section 152(f)(1)) of the taxpayer who as of the end of the taxable year has not attained age 27.

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family-owned S corporation; result of *Armstrong v. Phinney* justified on grounds that taxpayer only 5 percent partner).

For more on *Armstrong v. Phinney* and when a partner may be considered as being compensated for services not in his or her capacity as a partner under Code § 707(a)(2), as contrasted as compensation for services rendered in his or her capacity as a partner under Code § 707(c), see fns. 534, 511 in part III.B.7.c.viii Creative Bonus Arrangements. Reg. § 1.707-1(c) provides that "partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d)."

[3553] The arrangement must truly be group term and not some bundled package of various separate life insurance policies. See part II.Q.4.f Split-Dollar Arrangements, especially fn. 3995.

[3554] Federal Taxation of Partnerships & Partners (WG&L), ¶2.04 Qualified Plans and Other Fringe Benefits.

[3555] See "Fringe benefits partners and more-than-2% S shareholder employees can and can't claim," *Federal Taxes Weekly Alert Newsletter* (RIA) (5/25/2017) and *Pension & Benefits Week Newsletter* (RIA) (7/3/2017), the latter saved as Thompson Coburn doc. no. 6591733. See also part II.P.1.a.iii Advantages of C and S corporation Reporting of Owners' Compensation on Forms W-2.

[3556] Reg. § 1.132-1(b)(1).

[3557] Reg. § 1.132-1(b)(2)(ii).

[3558] Reg. § 1.132-1(b)(3).

[3559] Code § 127(c)(2), (3).

[3560] Reg. § 1.132-9, A-24 (adopted in 2001 and amended in 2006); see Notice 94-3, Q-5(b).

(2) *Limitations*.

(A) *Dollar amount*. No deduction shall be allowed under paragraph (1) to the extent that the amount of such deduction exceeds the taxpayer's earned income (within the meaning of section 401(c)) derived by the taxpayer from the trade or business with respect to which the plan providing the medical care coverage is established.

(B) *Other coverage*. Paragraph (1) shall not apply to any taxpayer for any calendar month for which the taxpayer is eligible to participate in any subsidized health plan maintained by any employer of the taxpayer or of the spouse of, or any dependent, or individual described in subparagraph (d) of paragraph (1) with respect to, the taxpayer. The preceding sentence shall be applied separately with respect to -

(i) plans which include coverage for qualified long-term care services (as defined in section 7702B(c)) or are qualified long-term care insurance contracts (as defined in section 7702B(b)), and

(ii) plans which do not include such coverage and are not such contracts.

(C) *Long-term care premiums*. In the case of a qualified long-term care insurance contract (as defined in section 7702B(b)), only eligible long-term care premiums (as defined in section 213(d)(10)) shall be taken into account under paragraph (1).

(3) *Coordination with medical deduction*. Any amount paid by a taxpayer for insurance to which paragraph (1) applies shall not be taken into account in computing the amount allowable to the taxpayer as a deduction under section 213(a).

(4) *Deduction not allowed for self-employment tax purposes*. The deduction allowable by reason of this subsection shall not be taken into account in determining an individual's net earnings from self-employment (within the meaning of section 1402(a)) for purposes of chapter 2 for taxable years beginning before January 1, 2010, or after December 31, 2010.

(5) *Treatment of certain S corporation shareholders*. This subsection shall apply in the case of any individual treated as a partner under section 1372(a), except that -

(A) for purposes of this subsection, such individual's wages (as defined in section 3121) from the S corporation shall be treated as such individual's earned income (within the meaning of section 401(c)(1)), and

(B) there shall be such adjustments in the application of this subsection as the Secretary may by regulations prescribe.

An individual who is a 2-percent shareholder of an S corporation pursuant to the attribution of ownership rules under Code § 318 is entitled to the deduction under Code § 162(*l*) for amounts that are paid by the S corporation under a group health plan for all employees and included in

the individual's gross income, if the individual otherwise meets the requirements of Code § 162(*l*).[3561]

### II.P.3. Conversions

Conversion to a C corporation is less taxing than conversion from a C corporation. Often, start-up businesses open as a pass-through entity (partnership or S corporation) to enable the owner to deduct initial losses, and then convert to a C corporation when they become profitable. To the extent that timing is discussed below, it is when changes in entity arise from check-the-box elections, which elections generally may be effective up to 75 days before the date of filing.[3562]

An eligible entity may elect to be classified other than its default classification or to change its classification, by filing Form 8832.[3563] If an eligible entity makes an election under the preceding sentence to change its classification (other than an election made by an existing entity to change its classification as of the effective date of this section), the entity cannot change its classification by election again during the 60 months succeeding the effective date of the election.[3564] However, the IRS may permit the entity to change its classification by election within the sixty months if more than 50% of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election.[3565] An election by a newly formed eligible entity that is effective on the date of formation is not considered a change for purposes of the 60-month rule.[3566]

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[3561] CCA 201912001.

[3562] Reg. § 301.7701-3(c)(1)(iii) provides:

> *Effective date of election*. An election made under paragraph (c)(1)(i) of this section will be effective on the date specified by the entity on Form 8832 or on the date filed if no such date is specified on the election form. The effective date specified on Form 8832 can not be more than 75 days prior to the date on which the election is filed and can not be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days prior to the date on which the election is filed, it will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, it will be effective 12 months after the date it was filed. If an election specifies an effective date before January 1, 1997, it will be effective as of January 1, 1997. If a purchasing corporation makes an election under section 338 regarding an acquired subsidiary, an election under paragraph (c)(1)(i) of this section for the acquired subsidiary can be effective no earlier than the day after the acquisition date (within the meaning of section 338(h)(2)).

[3563] Reg. § 301.7701-3(c)(1)(i).

[3564] Reg. § 301.7701-3(c)(1)(iv). T.D. 8697 (12/18/1996) provides:

> The sixty month limitation only applies to a change in classification by election; the limitation does not apply if the organization's business is actually transferred to another entity.

The preamble to the proposed regulations, PS-43-95 (5/1996), followed a sentence similar to the above with:

> For example, an organization could liquidate into its parent, terminate and reform as another entity (e.g., by merger), or contribute its business to another organization without restriction.

[3565] Reg. § 301.7701-3(c)(1)(iv).

[3566] Reg. § 301.7701-3(c)(1)(iv). The preamble to the proposed regulations, PS-43-95 (5/1996), commented:

> The sixty month limitation only applies to a change in classification by election. Thus, if a new eligible entity elects out of its default classification effective from its inception, that election is not a change in the entity's classification.

Regarding taxpayer identification numbers, Reg. § 301.6109-1(h), "Special rules for certain entities under § 301.7701-3," provides:

(1) *General rule*. Any entity that has an employer identification number (EIN) will retain that EIN if its federal tax classification changes under § 301.7701-3.

(2) *Special rules for entities that are disregarded as entities separate from their owners*.

(i) *When an entity becomes disregarded as an entity separate from its owner*. Except as otherwise provided in regulations or other guidance, a single owner entity that is disregarded as an entity separate from its owner under § 301.7701-3, must use its owner's taxpayer identifying number (TIN) for federal tax purposes.

(ii) *When an entity that was disregarded as an entity separate from its owner becomes recognized as a separate entity*. If a single owner entity's classification changes so that it is recognized as a separate entity for federal tax purposes, and that entity had an EIN, then the entity must use that EIN and not the TIN of the single owner. If the entity did not already have its own EIN, then the entity must acquire an EIN and not use the TIN of the single owner.

(3) *Effective date*. The rules of this paragraph (h) are applicable as of January 1, 1997.

### II.P.3.a. From Corporations to Partnerships and Sole Proprietorships

If an entity that elected taxation as a corporation that has more than one owner elects under Reg. § 301.7701-3(c)(1)(i) to be classified as a partnership, the corporation is deemed to distribute all of its assets and liabilities to its owners, who immediately contribute all of the distributed assets and liabilities to the partnership.[3567] The deemed transactions are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective on January 1, the deemed transactions are treated as occurring immediately before the close of December 31 and must be reported as of December 31. Thus, the last day of the corporation's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1.[3568]

If an entity that elected taxation as a corporation that has only one owner elects under Reg. § 301.7701-3(c)(1)(i) to be classified as a disregarded entity, the corporation is deemed to distribute all of its assets and liabilities to its single owner in liquidation of the corporation.[3569] The deemed transaction is treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective on January 1, the deemed transaction is treated as occurring immediately before the close of December 31 and must be reported as of December 31. Thus, the last day of the corporation's taxable year will be December 31 and the first day of the individual's taxable year

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Letter Ruling 201516034 confirmed that electing out of default classification is not a change in the entity's classification. The ruling permitted corporate subsidiaries to convert to LLCs under their original state law and for those LLCs to elect corporation taxation, after which the LLCs converted to LLCs governed by a different state's laws, and the newest LLCs were also permitted to elect corporation taxation.

[3567] Reg. § 301.7701-3(g)(1)(ii).

[3568] Reg. § 301.7701-3(g)(3).

[3569] Reg. § 301.7701-3(g)(1)(iii).

regarding the activity will be January 1.[3570] If a parent corporation converts a wholly-owned subsidiary corporation to a single member LLC that is disregarded for tax purposes, the conversion constituted a tax free liquidation of the subsidiary under Code § 332.[3571]

The liquidation of a corporation is a taxable event.[3572] The corporation (or its shareholders through K-1s if it is an S corporation) is taxed on the extent by which any asset's fair market value (FMV) exceeds its basis.[3573] Each shareholder generally realizes capital gain or loss on the difference between the FMV received and the stock's adjusted basis. This double tax can be expensive.[3574]

### II.P.3.b. Conversion from C Corporation to S Corporation

Converting from a C corporation to an S corporation can trigger LIFO recapture for companies that carry an inventory[3575] or built-in gain tax when assets are sold with a certain number of years after the S election.[3576]

Any S corporations that have not cleansed themselves of C corporation earnings and profits encounter constraints regarding too much investment income[3577] and reduced benefits from tax-exempt interest.[3578]

#### II.P.3.b.i. LIFO Recapture

If a C corporation inventoried goods under the LIFO method immediately before making an S election, it shall include in income the LIFO recapture amount in its last taxable year as a C corporation (for which its inventory then receives appropriate basis adjustments.[3579]

The corporation pays tax imposed on this conversion in its last C year and first three S years.[3580]

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[3570] Reg. § 301.7701-3(g)(3).
[3571] Letter Ruling 201452016.
[3572] See Code §§ 336 and 337.
[3573] Contributing property with a built-in loss within 2 years of liquidation so as to avoid gain on liquidation generally would not work. Code § 336(d)(2).
[3574] See, *e.g.*, Everett, Hennig, and Raabe, Converting a C corporation into an LLC: Quantifying the Tax Costs and Benefits, *Journal of Taxation* (Aug. 2010).
[3575] See part II.P.3.b.i LIFO Recapture.
[3576] See part II.P.3.b.ii Built-in Gain Tax.
[3577] See part II.P.3.b.iii Excess Passive Investment Income.
[3578] See part II.P.3.b.iv Problem When S corporation with Earnings & Profits Invests in Municipal Bonds.
[3579] Code § 1363(d)(1).
[3580] Code § 1361(d)(2). FSA 20153001F discussed the treatment of a consolidated group with a C corporation parent being acquired by an S corporation and became a Qualified Subchapter S Subsidiary. The FSA included the following clarification:

> The recapture date is the day before the effective date of the S election. Treas. Reg. § 1.1363-2(c)(1). However, with reference to transactions described in § 1.1363-2(a)(2) (including Qsub elections), there appears to be a typo in the regulations. Treas. Reg. § 1.1363-2(c)(1) states that for a nonrecognition transaction described in § 1.1363-2(a)(2) or (b)(2), the recapture date is the date of the transfer of the partnership interest to the S corporation. However, only section (b)(2) refers to a transfer of a partnership interest, (a)(2) refers to transfers of LIFO inventory assets by the C corporation to an S corporation. The LIFO recapture amount is determined as of the end of

Considering that any inventory on hand is likely to be sold during the recognition period for the built-in gain tax, this recapture avoids double taxation. On the other hand, the corporation might have been able to maintain its old layer of inventory for tax purposes during the entire built-in gain recognition period, and this might be viewed as an additional tax burden.

### II.P.3.b.ii. Built-in Gain Tax on Former C Corporations under Code § 1374

#### II.P.3.b.ii.(a). Explanation of Built-in Gain Tax on Former C Corporations under Code § 1374

When any asset is disposed of within 5 years of the S election,[3581] generally double taxation applies - normal taxation as a flow-through entity, plus a separate corporate level tax imposed on the lesser of the gain on disposition or the unrealized gain on the effective date of the S election.[3582] The corporation must disclose its unrealized built-in gain annually.[3583]

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the recapture date for S corporation elections described in § 1.1363-2(a)(1), and as of the moment before the transfer occurs for nonrecognition transactions (including Qsub elections) described in 1.1363-2(a)(2). Treas. Reg. § 1.1363-2(c)(2).

[3581] Code § 1374(d)(7) generally provides a 5-year recognition period, which was 7 years for a sale in 2009 or 2010 or 10 years for a sale before then. Code § 1374(d)(7) describes the recognition period as follows:

(A) *In general*. The term 'recognition period' means the 5-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation. For purposes of applying this section to any amount includible in income by reason of distributions to shareholders pursuant to section 593(e), the preceding sentence shall be applied without regard to the phrase '5-year'.

(B) *Installment sales*. If an S corporation sells an asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received shall be governed by the provisions of this paragraph applicable to the taxable year in which such sale was made.

Letter Ruling 201150023 includes some nuances as the 2011 transition rules related to an installment sale. The ABA Section of Taxation S corporations Committee meeting in May 2015 discussed various nuances to Code § 1374(d)(7) before the Protecting Americans from Tax Hikes Act of 2015 enacted the language quoted above; see Thompson Coburn document no. 6214396.

[3582] Code § 1374. For ways to minimize this tax using a charitable remainder trust, see part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax. Also, see generally, Dealing with the S corporation Built-In Gains Tax, Parts 1 and 2, *Journal of Taxation* (April and May 2008). Reg. § 1.1374-2(a) provides that an S corporation is taxed is the lesser of:

(1) Its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover (pre-limitation amount);

(2) Its taxable income determined by using all rules applying to C corporations as modified by section 1375(b)(1)(B) (taxable income limitation); and

(3) The amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior taxable years (net unrealized built-in gain limitation).

[3583] Form 1120S (2014), page 2, Schedule B, question 8. To avoid an understatement penalty, the taxpayer might consider hiring an appraiser to value the more significant items that have value that differs from basis. For a taxpayer to rely on a professional's advice, Reg. § 1.6664-4(c)(1)(i) provides;

*All facts and circumstances considered*. The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition,

Generally, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer.[3584] Assets subject to this tax include inventory (but see part II.P.3.b.i LIFO Recapture) and a cash basis taxpayer's accounts receivable,[3585] as well as goodwill;[3586] however, an accrual taxpayer's the receipt of franchise fees not constituting a sale or exchange of a capital asset under Code § 1253(a) are not subject to built-in gain tax.[3587] If a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method during or after the recognition period, that income is subject to built-in gain tax.[3588]

This gain can be offset by built-in losses,[3589] such as a cash basis taxpayer's accounts payable.[3590] Thus, a cash basis taxpayer with accounts receivable at the time of the S election

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> the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

If the taxpayer obtains more than one opinion of value, the taxpayer does not need to provide the tax return preparer with an earlier appraisal if a later appraisal was obtained to correct errors and incorporate more current data. *The Ringgold Telephone Company v. Commissioner*, T.C. Memo. 2010-103 (no penalty assessed for underpayment of built-in gain tax). The court also rejected the IRS' criticism of the taxpayer's failure to give the tax return preparer a copy of a memorandum suggesting a value, because the memorandum was prepared primarily as a marketing tool, not as an objective valuation.

[3584] Reg. § 1.1374-4(b)(1). This determination disregards any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation. Reg. § 1.1374-4(b)(3), Example (4) discusses deferred prepayment income, and Example (5) discusses changes in accounting methods. For further discussion of various items of built-in gain, see McMahon and Simmons, Where Subchapter S Meets Subchapter C, *Tax Lawyer*, vol. 67, No. 2 (Winter 2014), saved as Thompson Coburn LLP doc. no. 6177833.

[3585] For accounts receivable, the S corporation takes them account in full when it collects them, but it takes into account no more than their fair market value at the time of the S election if it sells them to a third party instead. Reg. § 1.1374-4(b)(3), Example (1). For long-term contracts accounted for under the completed contract method, income that would have been earned before the S election under the percentage of completion method is built-in gain. Reg. § 1.1374-4(g).

[3586] Reg. § 1.1374-3(c), Example (1).

[3587] Letter Ruling 200411015 involved the following situation:

> Franchisees pay [taxpayer] a license fee upon grant of the license and monthly royalty fees which are composed of a fixed fee portion and a variable fee portion. Except for the limited use allowed by the Agreements, [taxpayer] retains a significant power, right, or continuing interest in the franchise and terminates any Agreement in violation of the terms and conditions of the license grant. The grant or transfer of franchise rights pursuant to an Agreement does not constitute a sale or exchange of a capital asset under section 1253(a).

The ruling held:

> The income of [taxpayer] with respect to the receipt of the license fees and royalty fees from franchisees after the Conversion Date will not be treated as recognized built-in gain within the meaning of section 1374(d).
>
> We express no opinion about the tax treatment of the license fees or royalty fees under other provisions of the Code and regulations or the tax treatment of any conditions existing at the time of, or the effects resulting from, the license fees and royalty fees that are not specifically covered by the above ruling. We also express no opinion about the tax treatment under 1374 of any income or gain that may be realized by [taxpayer] during the recognition period except as specifically provided above.

[3588] Reg. § 1.1374-4(h). Also watch out for acceleration as described in part II.G.16 Limitations on the Use of Installment Sales

[3589] Reg. § 1.1374-2(a)(1).

[3590] Reg. § 1.1374-4(b)(2) provides that, generally:

should be able to offset that built-in gain by its board of directors declaring a bonus, constituting reasonable compensation, before the S election, which bonus is payable while an S corporation.[3591]

An accrual taxpayer's deductions deferred by reason of the economic performance rules count as built-in losses.[3592]

Regulations prevent avoiding this tax merely by dropping assets into a partnership.[3593] However, if the corporation owns the partnership at the time of the S election, valuation discounts might reduce the amount of built-in gain.

### II.P.3.b.ii.(b). Consider S Election Even If Plan to Sell Within 5 Years

Even if one plans to sell the corporation within five years, one might find an S election useful and then revert back to a C corporation if the sale does occur during that time, if all of the following are present:

- The corporate stock is not eligible for the exclusion from gain on sale of the stock under Code § 1202 described in part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the

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> …any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation).

Under an accrual method of accounting, a liability is incurred and generally is taken into account in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Reg. § 1.461-1(a)(2)(i). For example, if the corporation is involved in a lawsuit at the time of the S election, amounts paid as a result of the lawsuit are built-in losses only if a judgement had been awarded at the time of the S election. Reg. § 1.1374-4(b)(3), Examples (2) and (3). If an accrual method taxpayer would have been able to deduct amounts owed to related parties before making the S election and Code § 267(a)(2) suspended the deduction until after the S election was made, those expenses might be built-in losses under Reg. § 1.1374-4(c)(1). A similar rule applies to compensation appropriately accrued before the S election but suspended under Code § 404(a)(5) until after the S election was made. Reg. § 1.1374-4(c)(2).

[3591] S. Rep. No. 445, 100th Cong., 2d Sess. 65 (1988), states:

> As an example of these built-in gain and loss provisions, in the case of a cash basis personal service corporation that converts to S status and that has receivables at the time of the conversion, the receivables, when received, are built-in gain items. At the same time, built-in losses would include otherwise deductible compensation paid after the conversion to the persons who performed the services that produced the receivables, to the extent such compensation is attributable to such pre-conversion services. To the extent such built-in loss items offset the built-in gains from the receivables, there would be no amount subject to the built-in gains tax.

Eustice & Kuntz, ¶ 7.06[4][f] Computation of Tax; Use of Certain Losses and Deductions to Reduce Tax Base, Federal Income Taxation of S corporations, views this as an accurate statement of current law.

[3592] Reg. § 1.1374-4(b)(2) provides that:

> In determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer for purposes of this paragraph, section 461(h)(2)(C) and § 1.461-4(g) (relating to liabilities for tort, worker's compensation, breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts, taxes, and other liabilities) do not apply.

[3593] Reg. § 1.1374-4(i).

Sale of Certain Stock in a C Corporation. Being an S corporation for any significant period would blow the exclusion.[3594]

- The company does not have too much inventory subject to tax under part II.P.3.b.i LIFO Recapture. Note that any tax imposed on LIFO recapture is spread over several years.

- The company does not expect to dispose of significant assets subject to built-in gain tax.[3595] If the company reports on the cash receipts and disbursements method, then its accounts receivable and other accrued income in excess of its accounts payable and other accrued expenses would be subject to built-in gain tax; however, if it is on the accrual method, the income would already have been recognized and the built-in gain tax would not apply.[3596]

Making the S election would allow the shareholders to extract earnings during that period income-tax free, whether those earnings are extracted through distributions or when selling their stock.

If stock in the company is sold as just a straight stock sale, then either the buyer keeps the S election going (and benefits from to) or terminates the S election. If the buyer requires a basis step-up on the corporation's assets as described in part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold, then the seller might need to revoke the S election to avoid the built-in gain tax. Either way, terminating the S election might very well be relatively straightforward so that this process of turning on and then off the S election might have few bad tax effects (if the three bullet points above work out) and are advantageous while the election is in effect. See parts II.P.3.d Conversion from S Corporation to C Corporation and II.A.2.k Terminating an S Election.

### II.P.3.b.iii. Excess Passive Investment Income

If a C corporation with accumulated earnings and profits (E&P)[3597] elects S status, it might be subject to a supplemental tax and lose its S status if it has excess passive investment income.[3598] The corporation can avoid this treatment by carefully planning its gross receipts or by distributing its E&P.[3599] Inadvertent termination relief may be available if the corporation distributes its E&P after violating the excess passive investment income test.[3600]

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[3594] See fn. 4734.

[3595] See part II.P.3.b.ii.(a) Explanation of Built-in Gain Tax on Former C Corporations under Code § 1374.

[3596] See fns. 3584-3592.

[3597] Reg. § 1.1375-1(b)(4) refers to Code § 1362(d)(3) and the regulations thereunder in determining E&P. E&P is based on C corporation principles under Code § 312 and taxed by Code § 316 when distributed. Code § 1371(c). E&P are the earnings and profits of any corporation, including the S corporation or an acquired or predecessor corporation, for any period with respect to which an S election was not in effect. Reg. § 1.1362-2(c)(3).

[3598] Code §§ 1362(d)(3), 1375. Certain S corporations may disregard pre-1983 earnings and profits. 2007 Small Business Act P.L. 110-28, Sec. 8235.

[3599] Planning before the conversion might also help. Starr and Sobol, *S corporations: Operations*, T.M. 731-2nd, suggests at IV.B:

> Comment: When a C corporation converts to an S corporation, accumulated E&P is likely to be overstated, since timing differences originating in C status will tend to reverse while in S corporation status. As a result, excessive dividend distributions will be necessary to fully

Some points on planning gross receipts to avoid excess passive investment income treatment include:

- Although the statute defines rent as tainted income,[3601] that characterization does not apply if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental activity.[3602] For this purpose, "rent" does not include

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deplete the account. Conversely, when an S corporation converts to a C corporation, these timing differences may prove advantageous in that the accumulated E&P would reflect the reversal in C status while not being affected by the origination of the item in S status.

Instances where timing differences come into play when switching from C to S or S to C status include:

- accelerated cost recovery deductions for taxable income, but straight-line for accumulated E&P;
- installment method elected for taxable income, but not allowed for accumulated E&P; and
- special LIFO inventory adjustments required for accumulated E&P, but generally not required for taxable income.

[3600] Letter Ruling 201710013.

[3601] Code § 1362(d)(3)(C)(i).

[3602] Reg. § 1.1362-2(c)(5)(ii)(B)(2), which provides:

> *Rents derived in the active trade or business of renting property*. Rents does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

When describing net leases, the regulation did not clarify whether it was referring to leases in which the tenant does everything to rather leases in which the tenant reimburses the landlord for expenses the landlord incurs. If the taxpayer has very significant concern about this issue, consider making the lease a fixed annual rent that is enough to cover annual expenses – which may or may not be acceptable to the landlord in that the landlord assumes the risk of unexpected expenses.

Rev. Rul. 81-197 addressed leasing aircraft. Reimbursing the renter's expenses under a one-year lease, where the tenant does all of the work, did not make rental be active. However, chartering aircraft was active, where (a) the owner provides all pilots, fuel, catering, and operating supplies, and pays for all hull and liability insurance, landing and parking fees, taxes, and governmental fees and charges, (b) pilots who are its employees have primary authority for the safety and actual operation of the aircraft, and (c) it enters into a management agreement with the aircraft manufacturer to secure assistance in maintaining the aircraft.

A corporation did not provide significant services or incur substantial costs when it provided furniture for the bungalows (used as vacation homes) and a recreation area maintained by the corporation, as well as tables and cards use in that area, sponsored bingo games for the adults and parties for the children at which small prizes were given, and sponsored parties for the adults, providing food and entertainment, all of which cost approximately 0.15% of revenue. *Feingold v. Commissioner*, 49 T.C. 461(1968).

Performing decorating, repair, maintenance and cleaning services at the lessee's separate expense did not make active the rental of stadium suites active, but income from concessions, stadium club membership fees and dues, and electronic scoreboard advertising was active. Letter Ruling 8247052 (GCM 38915 apparently provided the underlying analysis).

Letter Ruling 201725022 held that the following medical office lease was active:

> X contracts with an independent leasing agent to assist in soliciting prospective tenants for M, negotiating leases and renewals, and overseeing post-leasing activities such as build-outs and renovations of suite space. X, with the assistance of the independent leasing agent, drafts,

"income realized by a landowner under a share-farming arrangement where the landowner participates to a material degree in the production of farm commodities through physical work or management decisions, or a combination of both,"[3603] but the payment of costs may

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proposes, presents, and negotiates letters of intent to lease available suite spaces. Negotiation for leasing regularly requires the use of an independent space planner to design and tailor the spaces for prospective tenants. Once letters of intent are accepted, X, with the assistance of the independent leasing agent, prepares, finalizes, and executes the lease agreements with prospective tenants. Renewals of leases are similarly handled by X, which are often complicated by requests for concessions and renegotiation of the leasing rate. Renewals often require significant time and attention by X.

X, through its employees, its agents, and the agents' employees, provides certain services in maintaining and repairing of the buildings, common areas, and grounds of M. X utilizes a standard lease agreement for its tenants, and under the lease agreements X has the obligation to provide certain services with respect to the leasing of space within M and to maintain or repair the following items: the heat and air conditioning systems, plumbing, hot water heaters, exterior lighting, signs, lawn care and gardening, roofs and exterior walls, exterior walkways, courtyards, parking areas, electricity, water and sewer, drainage, and garbage pickup.

In addition, the following specific services are provided to M and its tenants by an employee or independent contractor/worker of X: daily walk-through inspections of M to report on water breaks, lighting outage, vandalism, damage to building exteriors and certain interior spaces; sweeping, cleaning and maintaining the common areas of M such as sideways, walkways, and parking lot; routine periodic inspection of building exteriors and interiors, including foundations, roofs, exterior lighting, grounds, and parking lot and engaging in maintenance and repairs as needed; treating the roofs of the buildings for moss growth yearly; recoating and resurfacing the parking lot; routine and periodic maintenance of the numerous heating and air conditioning units; renovating vacant suites for leasing; routine and periodic maintenance of the plumbing and sewer lines, and their repair and replacement as needed; maintenance, repair and replacement of exterior lighting and selected interior lighting; janitorial services for selected units and common areas; exterior window washing; regular maintenance of grounds and lawn care, and landscaping services when necessary; seasonal snow removal and ice control; weekly trash removal; periodic pest and vermin control; and emergency response and property access for public safety.

Additional authority is in *United States Tax Reporter* ANN ¶ 13,799.27 Rents; Bittker & Eustice, ¶ 6.04. Events Terminating Election, *Federal Income Taxation of Corporations & Shareholders* (WG&L); Eustice, Kuntz & Bogdanski, ¶ 5.04[2][b] Rents, *Federal Income Taxation of S Corporations*; Christian & Grant, ¶ 11.03 Rents, *Subchapter S Taxation* (WG&L).

[3603] Rev. Rul. 61-112. See Letter Rulings 8927039, 9003056, 9514005, 200002033, 200217045, and 200739008, all cited in Thompson Coburn LLP doc. no. 6513203 (which would need to be sanitized before sharing), which is the background for Letter Ruling 201812003 (which approved S corporation status and an ESBT election when the trust that was the sole shareholder was required to cause the corporation to distribute real estate to charity, facts that were present but were not discernible from the ruling). *Kennedy v. Commissioner*, T.C. Memo. 1974-149, held that crop-sharing was passive rental when the corporation furnished nothing except the use of the land and the tenant furnished all the management, labor, supplies, etc.

Citing Rev. Rul. 61-112, Rev. Rul. 67-423 held that, when a corporation owns farmland it leases to a tenant under a crop-sharing arrangement that generates government payments under acreage reserve and conservation reserve programs and the landlord materially participates in the management of the farm production, the payments which the landlord receives under the foregoing programs are not "rents" for personal holding company income tax purposes. TAM 6211239430A, which also cited Rev. Rul. 61-112, held that crop-sharing payments were "rents" for personal holding company income tax purposes where the corporation did nothing and the tenant furnishes all of the equipment and performs all of the work.

GCM 35957 (1974) cited Rev. Rul. 61-112, among other authority, in analyzing whether crop-sharing constituted unrelated business taxable income.

be sufficient to cause a farm arrangement to be nonpassive under this test.[3604] See also part II.G.27.b Real Estate as a Trade or Business.

- Gross receipts (rather than net income) of nonpassive income from partnerships in which the corporation is invested may be counted;[3605] some income from controlled foreign corporations might also count as nonpassive income.[3606] Investing in oil and gas partnerships frequently helps generate sufficient nonpassive gross receipts.[3607] Any gross receipts separately stated on such a K-1 would be reflected only in a worksheet provided in the Instructions for Form 1120S.[3608]

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GCM 35247 (1973) cited Rev. Rul. 61-112, among other authority, in analyzing whether crop-sharing constituted a business for purposes of estate tax deferral under Code § 6166.

[3604] Letter Ruling 201722019 approved as nonpassive both of the following:

> X is engaged in the business of farming and owns n acres in State. X has leased the land for sharecropping (Sharecropping Lease Arrangement) continuously beginning in Date 3. Beginning in Year, the land was leased to Y. Pursuant to the Sharecropping Lease Arrangement, all taxes, assessments or charges levied or assessed on products of the land must be paid by X and Y based in proportion to the percentage of crops to which X and Y are entitled. X and Y each pay one half of the actual cost of fertilizer and soil conditioner. X pays the cost of the power and fuel necessary to operate the drainage pumping plants as well as the cost of maintaining the irrigation and drainage canals and irrigation pipe line. X is also responsible for paying box rent and the grower's share of the state inspection fee. Any processing expenses incurred with the preparation of crops for sale, which are related to X's share of the crops, are paid by X. X also determines the percentage of Property to be farmed and the types of crops to be planted. Further, X is at risk for crop yields and marketing.
>
> In Year, X signed a new lease agreement (Rental Lease Arrangement) with Y for lease of Property. Under the lease, X's expenses are between o% and p% of X's rental income. X is responsible for providing and maintaining insurance on all improvements and fixtures owned by X. Further, X pays the costs and expenses associated with the repair, maintenance and replacement of the irrigation drainage pumps as well as the insurance, water reclamation tax, water rights fees, water coalition dues and property taxes.

[3605] Rev. Rul. 71-455; see also Reg. § 1.702-1(a)(8)(ii).

[3606] CCA 201030024.

[3607] For a summary of the issue, see 723 T.M. III.D.7.b.; see also part II.P.1.a.i Allocations of Income in Partnerships. Specific examples include Letter Rulings 200005012 (publicly traded partnership engaged in the purchasing, gathering, transporting, storage and resale of crude oil, refined petroleum products, and natural gas liquids, as well as some related activities), 200027037 (publicly traded limited partnerships engaged in the business of purchasing, gathering, transporting, trading, storage, and resale of crude oil, refined petroleum, and other chemical products), 200147034 (one publicly traded partnership's business consisted of purchasing, gathering, transporting, trading, storage and resale of crude oil and refined petroleum products and related activities, and the other's consisted of interstate and intrastate crude oil transportation, terminalling and storage, as well as crude oil gathering and marketing activities), 200240043 (publicly traded partnerships engaged in the business of purchasing, gathering, transporting, trading, storing, and reselling crude oil and refined petroleum products), 200309021 (publicly traded partnership engaged in the purchasing, gathering, transporting, trading, storage, and resale of crude oil, refined petroleum, and other mineral or natural resources), 200327004 (publicly traded partnership engaged in the purchasing, gathering, transporting, trading, marketing, storing, and reselling of crude oil, refined petroleum products, and natural gas liquids), and 200928024 (publicly traded partnerships engaged in the active trade of purchasing, gathering, transporting, trading, storage and/or resale of crude oil and refined petroleum products and related activities). It is best to document that the corporation's investment strategy is to provide for liquidity and also to diversify its investment risk.

[3608] The 2016 Instructions provide a worksheet to compute the excess net passive income tax for line 22a. The schedule computing the excess net passive income items includes+:

- In the case of sales or exchanges of stock or securities, gross receipts shall be taken into account only to the extent of the gains, without deduction for losses.[3609] For other capital assets, losses are netted against gains.[3610]

The corporation can distribute its E&P. Generally, distributions from an S corporation come first as generally[3611] nontaxable distributions of its accumulated adjustments account (AAA), then are treated as dividends to the extent of E&P, and then as a return of basis and gain on sale.[3612] However, an S corporation may, with the consent of all of its affected shareholders, elect to ignore AAA with respect to all distributions made during the taxable year for which the election is made.[3613]

Generally, a distribution of E&P must be effected using a distribution of money or other property.[3614] For these purposes, a distribution is taken into account on the date the corporation makes the distribution, regardless of when the distribution is treated as received by the shareholder.[3615] AAA at the close of the taxable year is applied to distributions during the taxable and pro-rated among them if they exceed AAA.[3616]

"Property" means money, securities, and any other property, but does not include stock in the corporation making the distribution (or rights to acquire such stock).[3617] However, no distribution of property is required if an S corporation elects to distribute all or part of its E&P through a deemed dividend, in which case: [3618]

- The corporation will be considered to elected to bypass AAA for that year.

- The deemed dividend may not exceed the E&P on the last day of the taxable year, reduced by any actual distributions of E&P made during the taxable year.

- The amount of the deemed dividend is considered, for all tax purposes,[3619] as if it were distributed in money to the shareholders in proportion to their stock ownership, received by the shareholders, and immediately contributed by the shareholders to the corporation, all on the last day of the corporation's taxable year.

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*Income and deductions on lines 1, 2, and 5 are from total operations for the tax year. This includes applicable income and expenses from page 1, Form 1120S, as well as those imported separately on Schedule K.

[3609] Code § 1362(d)(3)(B)(ii).

[3610] Code § 1362(d)(3)(B)(i).

[3611] If and to the extent that the basis of a shareholder's stock is less than the shareholder's allocable AAA, the distribution of AAA would be taxed as a capital gain. Code § 1368(c)(1), (b)(2).

[3612] Code § 1368(c).

[3613] Code § 1368(e)(3)(A). Affected shareholder means any shareholder to whom a distribution is made by the S corporation during the taxable year. Code § 1368(e)(3)(B).

[3614] Code § 316(a). See Reg. § 1.1368-1(c).

[3615] Reg. § 1.1368-1(b).

[3616] Reg. § 1.1368-1(b), (c).

[3617] Code § 317(a).

[3618] Reg. § 1.1368-1(f)(3).

[3619] However, the dividend deemed distributed to a qualified subchapter S trust does not constitute trust accounting income and therefore is not required to be distributed to the beneficiary. Letter Ruling 200446007.

A corporation makes an election for a taxable year by attaching a statement to a timely filed (including extensions) original or amended return required to be filed for that taxable year, which statement must include the amount of the deemed dividend that is distributed to each shareholder,[3620] as well as consent by each affected shareholder.[3621]

A deemed dividend might be attractive when dividend tax rates are low, if one expects to need to take distributions in excess of AAA is a future year. However, if the shareholder might later sell the stock to a third party or wait to have the stock redeemed until it obtains a basis step-up on death, then it's possible that distributions will never exceed AAA. In that case, investing in assets that generate nonpassive gross receipts might be a lot less painful than paying tax on a deemed dividend. If the majority shareholder does not want to mess with a closely-held business or active rental, then my experience has been that investing 1-3% of the corporation's assets in oil and gas partnerships will be sufficient to generate sufficient nonpassive gross receipts.[3622]

If a corporation does not know about the possible loss of its S election under the excess passive investment income rules and terminates its S election as a result of these rules, consider applying for inadvertent termination relief in which the corporation and shareholders agree to a retroactive deemed dividend described above.[3623]

### II.P.3.b.iv. Problem When S corporation with Earnings & Profits Invests in Municipal Bonds

Tax-exempt income does not increase AAA.[3624]

Therefore, any tax-exempt income, although not taxable to the shareholders when earned, would be taxable dividends when distributed to the shareholders to the extent that the corporation has no remaining AAA but has E&P.

Even if the corporation has plenty of AAA, a need for AAA might later arise, such as tax-free redemptions of part of a shareholder's stock.[3625]

These issues are spelled out more in part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations.

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[3620] Reg. § 1.1368-1(f)(5)(iii).
[3621] Reg. § 1.1368-1(f)(5)(ii).
[3622] See footnote 3607.
[3623] Letter Rulings 201351013, 201629001.
[3624] Code § 1368(e)(1)(A). This includes tax-free receipts beyond just muni bonds. See part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations and Letter Ruling 201440013.
[3625] If a state law redemption is treated as a distribution under Code § 302(b)(2) or (3) and Code § 302(c), then it is a tax-free distribution to the extent of AAA. See part II.Q.7.b. Redemptions or Distributions Involving S Corporations.

### II.P.3.b.v. Conversion from S Corporation to C Corporation then Back to S Corporation

CCA 201446021 asserted that, when an S election terminates, its accumulated adjustments account (AAA) is wiped out. Therefore, the IRS reasoned, if the corporation later becomes an S corporation, its AAA starts from scratch.

However, any distribution of ***money***[3626] by a corporation with respect to its stock during a post-termination transition period (generally, the first C corporation year after the S election terminate) is applied against and reduce the adjusted basis of the stock, to the extent that the amount of the distribution does not exceed AAA.[3627] Rev. Rul. 2019-13 clarifies that this treatment applies if and to the extent that a redemption if recharacterized as a Code § 301 distribution.[3628]

Thus, if the S corporation status is terminated, one should consider promptly distributing earnings as cash; although one might loan them back to the corporation if it needs the cash, the IRS may treat that as a step transaction that is a note distribution that does not qualify as a distribution of money.[3629] If one is planning a termination, consider distributing on the last day of the last S corporation taxable year a formula note equal to AAA as of that date. See

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[3626] The law refers to "money," and the 2017 legislative history refers to "distributions of cash."

[3627] Code § 1371(e)(1). Code § 1377(b)(1) and Reg. § 1.1377-2(b) determine the post-termination transition period.

[3628] See parts II.Q.7.a.iii Redemption Taxed Either as Sale of Stock or Distribution; Which Is Better When and II.Q.7.b Redemptions or Distributions Involving S Corporations. The facts of Rev. Rul. 2019-13 are:

> X is a corporation that once was a C corporation and later elected to be an S corporation under § 1362(a) of the Code. X's S election terminated under § 1362(d), such that it is now a C corporation. A, an individual, owns all 100 shares of the outstanding stock of X. X is a calendar-year taxpayer. At the time of its conversion to an S corporation, X had accumulated earnings and profits (E&P) of $600x and no current E&P. At the time of the termination of its S election, X's AAA was $800x and its accumulated E&P was still $600x. During X's post-termination transition period, X redeems 50 of A's 100 shares of X stock for $1,000x. X makes no other distributions during the post-termination transition period. Pursuant to § 302(d) of the Code, the redemption is characterized as a distribution subject to § 301. For the taxable period that includes the redemption, X has current E&P of $400x.

Rev. Rul. 2019-13 holds:

> If, during a former S corporation's post-termination transition period, the corporation distributes cash in redemption of a shareholder's stock, which is characterized as a distribution subject to § 301, the corporation should reduce its AAA to the extent of the proceeds of the redemption pursuant to § 1368. The redemption of 50 of A's 100 shares of X stock for $1,000x is characterized as a reduction of X's $800x of AAA with the remaining $200x characterized as a dividend under § 301(c)(1).

[3629] See *McKelvy v. United States*, 478 F.2d 1217 (Ct. Cl. 1973); *DeTreville v. United States*, 445 F.2d 1306 (4th Cir. 1971); *Fountain v. Commissioner*, 59 T.C. 696 (1973); and *Roesel v. Commissioner*, 56 T.C. 14 (1971). In the first three cases, the corporation did not have cash on hand to honor the checks, and the loan or other transaction was needed to avoid bouncing checks. In *Roesel*, 56 T.C. at 26, the court noted, "The conversations which were had between Milling's president or comptroller and the shareholders with respect to the purported loans, the degree of correspondence between the book overdrafts created by Milling's distributions and the amounts purportedly loaned back by its shareholders, the close proximity in time of the purported loans and the issuance of checks by Milling, and the correlation between the amounts purportedly loaned by each shareholder and his interest in Milling, all serve to establish that the purported distributions and loans were but parts of interrelated transactions which must be viewed as such for tax purposes."

part II.P.3.d Conversion from S Corporation to C Corporation for discussion about additional opportunities for former S corporations whose owners at the time of revocation are the same as those on December 22, 2017.

A better strategy might be for the S corporation to do a tax-free "F" reorganization,[3630] in which the existing S corporation becomes a wholly-owned subsidiary of a new parent S corporation, which parent is owned by the original S corporation's shareholders immediately before the reorganization. The parent makes an S election, and the subsidiary elects taxation as a Qualified Subchapter S Subsidiary (QSub).[3631] The original S corporation initially is disregarded from the parent, giving the parent all of the subsidiary's AAA.[3632] Later, the subsidiary's QSub election is revoked, keeping the AAA intact at the parent level, notwithstanding that the subsidiary is now taxed as a C corporation. That way, if the subsidiary later becomes a QSub, the AAA remain to help carry out distributions to the shareholders.

This strategy also might allow a faster conversion back to taxation as an S corporation, because the S election was never terminated and therefore the five year waiting period[3633] would appear not to apply.[3634] Because the QSub is wholly owned, the deemed liquidation when the QSub election is made again generally would be nontaxable.[3635]

Another alternative would be for the S corporation to transfer one or more businesses to one or more C corporations (or to separate LLCs, which elect C corporation treatment once the transfers are complete).

However, an S corporation may want to issue a promissory note before converting to C corporation, so that it can make payments to shareholders after the C corporation conversion without those payments being taxable dividends; this strategy seems appealing but may have some disadvantages relating to the related interest income and expense.[3636] The only way this accomplishes the intended result is if the C corporation subsidiary is the borrower. Unfortunately, the deemed issuance of a promissory note upon the deemed Code § 351 transaction may constitute "boot" that triggers income tax on formation.[3637] The corporation may try to borrow from a third party immediately before the conversion and distribute its AAA to its shareholders, followed by them loaning back to the corporation after it becomes a C corporation to repay the debt; however, this solution is subject to two caveats (among others referred to in fn 3637). First, liabilities in excess of debt on the deemed Code § 351 formation of the C corporation may trigger income tax on that excess; see part II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities. Second, consider whether such a tight sequence may constitute a step transaction, along the lines noted in fn 3629.

The "F" reorganization strategy is especially important when converting to a C corporation the stock of which generally would qualify for the exclusion described in part II.Q.7.k. Although a corporation that had been an S corporation cannot qualify for the exclusion, the S corporation

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[3630] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.
[3631] See part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3632] Reg. § 1.1368-2(d)(2).
[3633] See fn 310 in part II.A.2.k Terminating an S Election.
[3634] See fns 200-202 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3635] See fn 207 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3636] See part II.E.2.b Converting from S Corporation to C Corporation.
[3637] See fn 3194 and accompanying text in part II.M.2.a Initial Incorporation – Generally.

can form a C corporation whose stock does qualify for the exclusion,[3638] which generally requires a transfer of assets and liabilities to a new entity. This reorganization strategy facilitates a seamless transition as a matter of state law – the old corporation turns into a new C corporation for income tax purposes. However, if the old corporation becomes a C corporation directly, it retains its old tax ID,[3639] which will show a history of having been an S corporation. That history may lead the IRS to question whether the deemed brand-new C corporation is, in fact, a prior S corporation, even though the QSub regulations clearly say it is. To avoid such questions, the cumbersome asset/liability transfer may be the better way to go. Query whether one might convert the old corporation into an LLC on a tax-free and seamless state law basis, then the parent transfers the LLC into a new C corporation (or do some other equivalent seamless conversion).

Finally, consider the built-in gain tax described in part II.P.3.b.ii Built-in Gain Tax on Former C Corporations under Code § 1374. That tax is imposed when as asset with unrecognized built-in gain when the corporation converts from C to S is sold within five years. This can be pernicious when an S corporation converts to C and then back to S again. For example, an asset has a zero basis and a $1 million value before the corporation revokes its S election. The asset grows to be worth $1.3 million before the corporation switches back from C to S. The full $1.3 million of unrealized gain constitutes built-in gain, even though only $300,000 of the appreciation occurs while taxed as a C corporation.

To avoid the problem described in the preceding paragraph, consider not simply revoking the S election when first converting to C corporation. Instead, leave behind in an S corporation parent any highly appreciated assets and lease them to the C corporation, while contributing the rest of the business to a C corporation.

### II.P.3.c. Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations

Transfers from a sole proprietorship to a corporation, including a disregarded LLC electing corporate taxation,[3640] are generally nontaxable.[3641]

However, shifting from a partnership to a corporation might cause the partners to recognize gain or lose their suspended losses.[3642]

Consider what adjustments might be required to convert a partnership interest, which might have capital accounts disproportionate to profit and loss sharing and might have profit in loss sharing that is not “straight-up,” into shares, generally would have identical distribution and liquidation rights (and must have such rights in the case of an S corporation).

#### II.P.3.c.i. Formless Conversion

When an entity taxed as a partnership elects taxation as a corporation, the partnership is deemed to contribute all of its assets and liabilities to the corporation in exchange for stock in

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[3638] See fns 4734-4736 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[3639] Reg. § 301.6109-1(i)(3), reproduced in full in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3640] Reg. § 301.7701-3(g)(1)(iv).
[3641] See part II.M.2.a. Initial Incorporation – Generally.
[3642] See part II.M.2.c Contribution of Partnership Interest to Corporation.

the corporation; and, immediately thereafter, the partnership liquidates by distributing the stock of the corporation to its partners.[3643] The deemed transactions are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective on January 1, the deemed transactions are treated as occurring immediately before the close of December 31 and must be reported by the owners of the entity on December 31. Thus, the last day of the partnership's taxable year will be December 31 and the first day of the corporation's taxable year will be January 1.[3644]

A partnership can be converted directly into an S corporation; the corporation is not deemed formed until the partnership is deemed to have distributed its assets to the corporation:[3645]

- Suppose that, on January 1, 2009, X, a calendar year taxpayer, is taxed as a partnership. X elects to be taxed as a corporation for federal tax purposes, effective January 1, 2010. On February 1, 2010, X files an S election, effective January 1, 2010. Each person who held stock in X on January 1, 2010 also holds stock at the time the S election is made. When X elects to be taxed as a corporation, the following steps are deemed to occur: X contributes all of its assets and liabilities to the corporation in exchange for stock in the corporation, and immediately thereafter X liquidates by distributing the stock of the association to its partners. These deemed steps are treated as occurring immediately before the close of the day before the election is effective.[3646] Thus, the partnership's taxable year ends on December 31, 2009, and the corporation's first taxable year begins on January 1, 2010. Therefore, the partnership will not be deemed to own the stock of the corporation during any portion of the association's first taxable year beginning January 1, 2010, and X is eligible to elect to be an S corporation effective January 1, 2010. Additionally, because the partnership's taxable year ends immediately before the close of the day on December 31, 2009, and the corporation's first taxable year begins at the start of the day on January 1, 2010, the deemed steps will not cause X to have an intervening short taxable year in which it was a C corporation.

- On January 1, 2009, Y, a calendar year taxpayer, is taxed as a partnership. Y converts into a corporation under a state law formless conversion statute, effective January 1, 2010. As a result of the conversion, Y is classified as a corporation for federal tax purposes. On February 1, 2010, Y files an S election, effective January 1, 2010. Each person who held stock in Y on January 1, 2010 also holds stock at the time the S election is made. The result is the same as above.

Of course, the simplest way would be just to make the S election, by the partnership filing IRS Form 2553.[3647]

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[3643] Reg. § 301.7701-3(g)(1)(i). Under Rev. Rul. 2004-59, when a formless conversion occurs under state law, Rev. Rul. 84-111 does not apply. Rev. Rul. 84-111 describes the differences in the basis and holding periods of the various assets received by the corporation and the basis and holding periods of the stock received by the former partners provided the steps described are actually undertaken and the underlying assumptions and purposes for the conclusions in the revenue ruling are applicable. Except to the extent inconsistent with the above, see the text accompanying footnotes 4844-4932 for tax effects of liquidating a partnership.
[3644] Reg. § 301.770l-3(g)(3).
[3645] Rev. Rul. 2009-15.
[3646] Reg. § 301.7701-3(g)(3)(i).
[3647] See fn. 350.

Because S corporations can have only a single class of stock,[3648] capital accounts need to be made proportionate to interests in profits and losses before converting to an S corporation.[3649]

### II.P.3.c.ii. Transfer of Partnership Assets and Liabilities to a Newly Formed Corporation in Exchange for All of its Stock

If the conversion is not a formless conversion described above, the IRS provides for three scenarios.[3650] In each situation, the steps the partners and partnerships take are parts of a plan to transfer the partnership operations to a corporation organized for valid business reasons in exchange for its stock and were not devices to avoid or evade recognition of gain. Because the federal income tax consequences of the three situations are the same, each partnership is considered to made a nontaxable contribution of its assets and liabilities to a corporation in exchange for its stock,[3651] followed by a distribution of the stock to the partners in liquidation of the partnership.[3652]

In the first situation, the partnership transfers all of its assets to newly-formed corporation in exchange for all the outstanding stock of the corporation and the assumption by the corporation of the partnership's liabilities. The partnership then terminates by distributing all the stock of the corporation to the partners in proportion to their partnership interests. The tax results are:

- No gain or loss is recognized by the partnership when it transfers all of its assets to the corporation in exchange for the corporation's stock and the assumption by the corporation of the partnership's liabilities.[3653]

- The corporation's basis in the assets received from the partnership equals their basis to the partnership immediately before their transfer to the corporation.[3654]

- The partnership's basis of the stock received from the corporation is the same as the partnership's basis in the assets transferred to the corporation, reduced by the liabilities assumed by the corporation, which assumption is treated as a payment of money to the partnership.[3655]

- The corporation's assumption of the partnership's liabilities decreases each partner's share of the partnership liabilities, thus, decreasing the basis of each partner's partnership interest.[3656]

- On distribution of the stock to the partners, the partnership terminates.[3657]

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[3648] See II.A.2.i Single Class of Stock Rule, for a description of the single class of stock rules and those rules' surprising flexibility.
[3649] See fn 352 in part II.B Limited Liability Company (LLC).
[3650] Rev. Rul. 84-111. However, see fn 3643 in part II.P.3.c.i Formless Conversion.
[3651] Code § 351.
[3652] Rev. Rul. 70-239.
[3653] Code § 351.
[3654] Code § 362(a). However, Reg. § 1.362-3 reduces the basis of property acquired in loss importation transaction.
[3655] Code § 358.
[3656] See Code §§ 752 and 733.
[3657] Code § 708(b)(1)(A).

- The basis of the stock distributed to the partners in liquidation of their partnership interests is, with respect to each partner, equal to the adjusted basis of the partner's interest in the partnership.[3658]

- The partnership's holding period for the stock received in the exchange includes its holding period in the capital assets and Code § 1231 assets transferred (to the extent that the stock was received in exchange for such assets).[3659]

- To the extent the stock was received in exchange for neither capital nor Code § 1231 assets, the partnership's holding period for such stock begins on the day following the date of the exchange.[3660]

- The corporation's holding period in the assets transferred to it includes the partnership's holding period.[3661]

- When the partnership distributes the stock to its partners, the partners' holding periods includes the partnership's holding period of the stock.[3662]

In the second situation, the partnership distributes all of its assets and liabilities to its partners in proportion to their partnership interests, terminating the partnership. The partners then transfer all the assets received from the partnership to a new corporation in exchange for all the corporation's outstanding stock and the corporation's assumption of the partnership's liabilities that had been assumed by the partners. The tax results are:

- On the transfer of all of the partnership's assets to its partners:

    - The partnership terminates.[3663]

    - The basis of the assets (other than money) distributed to the partners in liquidation of their partnership interests is, with respect to each partner, equal to the adjusted basis of the partner's interest, reduced by the money distributed.[3664]

- The decrease in the partnership's liabilities resulting from the transfer to its partners was offset by the partners' corresponding assumption of such liabilities, so that the net effect on the basis of each partner's interest in the partnership, with respect to the liabilities transferred, was zero.[3665]

- No gain or loss is recognized by the partnership's former partners when the partnership transfers its assets and liabilities to the corporation in exchange for its stock.[3666]

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[3658] Code § 732(b),
[3659] Code § 1223(1).
[3660] See Rev. Rul. 70-598.
[3661] Code § 1223(2).
[3662] Code §§ 735(b) and 1223. Furthermore, such distribution will not violate the Code § 368(c) control requirement.
[3663] Code § 708(b)(1)(A).
[3664] Code § 732(b).
[3665] Code § 752.
[3666] Code § 351.

- The (former) partners' basis in the corporation's stock is the same as their basis in the assets received in the partnership's liquidation and the transfer to the corporation, reduced by the liabilities assumed by the corporation, which assumption is treated as a payment of money to the partners.[3667]

- The corporation's basis in the assets received from the (former) partners equals the (former) partners' basis immediately before the transfer to the corporation.[3668]

- The partners' holding periods for the assets the partnership distributes to them includes the partnership's holding period.[3669]

- The partners' holding periods for the stock received in the exchange includes the partners' holding periods in the capital assets and Code § 1231 assets transferred to the corporation (to the extent that the stock was received in exchange for such assets).[3670]

- However, to the extent that the stock received was in exchange for neither capital nor Code § 1231 assets, the holding period of the stock begins on the day following the date of the exchange.

- The corporation's holding period of the partnership's assets received in the exchange includes the partners' holding periods.[3671]

In the third situation, the partners transfer their partnership interests to a newly-formed corporation in exchange for all the corporation's outstanding stock. This exchange terminates the partnership, and all of its assets and liabilities became assets and liabilities of the corporation. The tax result is:

- No gain or loss is recognized by the partners on the transfer of the partnership interests to the corporation in exchange for the corporation's stock.[3672]

- When the transfer partners transfer their partnership interests to the corporation, the partnership terminates.[3673]

- The partners' basis of the stock received from the corporation in exchange for their partnership interests equals the basis of their partnership interests transferred to the corporation, reduced by the partnership's liabilities assumed by the corporation, the release from which is treated as a payment of money to the partners.[3674]

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[3667] Code §§ 358(a) and 732(b).
[3668] Code §§ 362(a) and 732(c). However, Reg. § 1.362-3 reduces the basis of property acquired in loss importation transaction.
[3669] Code § 735(b).
[3670] Code § section 1223(1).
[3671] Code § 1223(2).
[3672] Code § 351.
[3673] Code § 708(b)(1)(A).
[3674] Code §§ 358 and 752(d).

- The corporation's basis for the assets received in the exchange equals the basis of the partners in their partnership interests.[3675]

- The corporation's holding period includes the partnership's holding period in the assets.

- The holding period of the stock received by the former partners includes each respective partner's holding period for the partnership interest transferred,[3676] except that the holding period of the stock that was received by the partners in exchange for their interests in any unrealized receivables, inventory, or various depreciable or amortizable assets of the partnership that are neither capital assets nor Code § 1231 assets begins on the day following the date of the exchange.

### II.P.3.d. Conversion from S Corporation to C Corporation

Before discussing the consequences of such a conversion, consider forming an S corporation parent before converting an S corporation directly into a C corporation, or a similar transaction, for the reasons described in fns 3630-3638 in part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation and the closing comments in that part II.P.3.b.v.

See part II.A.2.k Terminating an S Election, which includes the fact that conversion from S status to C status requires an additional tax return if done mid-year and precludes an S election for 5 years.

Converting from an S corporation to a C corporation may require the corporation to switch from the cash receipts and disbursements method of accounting to the accrual method. Generally, a C corporation cannot use the cash method,[3677] unless the corporation conducts a qualified farming business,[3678] is a qualified personal service corporation,[3679] or has gross receipts that are no more than $25 million (after 2018 adjusted for inflation).[3680]

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[3675] Allocated under Code § 732(c).

[3676] Code § 1223(1).

[3677] Code § 448(a)(1).

[3678] Code § 448(d)(1), "Farming business," provides that a "qualified personal service corporation" is any corporation:

(A) *In general*. The term "farming business" means the trade or business of farming (within the meaning of section 263A(e)(4)).

(B) *Timber and ornamental trees*. The term "farming business" includes the raising, harvesting, or growing of trees to which section 263A(c)(5) applies.

[3679] Code § 448(d)(2), "Qualified personal service corporation," provides:

(A) substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and

(B) substantially all of the stock of which (by value) is held directly (or indirectly through 1 or more partnerships, S corporations, or qualified personal service corporations not described in paragraph (2) or (3) of subsection (a)) by-

(i) employees performing services for such corporation in connection with the activities involving a field referred to in subparagraph (A),

(ii) retired employees who had performed such services for such corporation,

(iii) the estate of any individual described in clause (i) or (ii), or

If a corporation was an S corporation on or before December 21, 2017, during the 2-year period beginning on December 22, 2017 revokes its S election, and the owners of the stock of which, determined on the date the revocation is made, are the same owners (and in identical proportions) as on December 22, 2017 (an "eligible terminated S corporation"), then any adjustment required by a change in accounting method under Code § 481(a)(2) which is attributable to that revocation is taken into account ratably during the 6-taxable year period beginning with the year of change.[3681] A taxpayer may also apply this rule if is not required to change from cash to accrual but does anyway.[3682]

Note that S corporation earnings might be extracted in cash tax-free in the first C corporation taxable period after the final S corporation yearend.[3683] Converting the corporation into a QSub before converting it to a C corporation might also be used to preserve the AAA of a corporation whose S election is revoked.[3684]

Additionally, after that first C Corporation taxable period, an eligible terminated S corporation's distribution is chargeable to accumulated earnings and profits, in the same ratio as the amount of such AAA bears to the amount of such accumulated earnings and profits.[3685]

### II.P.3.e. Conversion from Qualified Subchapter S Subsidiary to Single Member LLC

The merger of a Qualified Subchapter S Subsidiary ("QSub") into an LLC wholly owned by the QSub's parent has no income tax consequences.[3686]

### II.P.3.f. Conversions from Partnership to Sole Proprietorships and Vice Versa

When a sole proprietorship organized as an LLC adds a member, it becomes a partnership. If the original member sells part his or her interest in the LLC to a new member, then he or she is deemed to have sold a corresponding portion of the LLC's assets to the new member,[3687] as follows:[3688]

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(iv) any other person who acquired such stock by reason of the death of an individual described in clause (i) or (ii) (but only for the 2-year period beginning on the date of the death of such individual).

To the extent provided in regulations which shall be prescribed by the Secretary, indirect holdings through a trust shall be taken into account under subparagraph (B).

[3680] Code § 448(b), (c).

[3681] Code § 481(d).

[3682] Rev. Proc. 2018-44, modifying Rev. Proc. 2018-31, § 15.01(3).

[3683] See fn. 3627, found in part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation.

[3684] See part II.P.3.b.v Conversion from S Corporation to C Corporation then Back to S Corporation, especially fns. 3630-3632.

[3685] Code § 1371(f).

[3686] Reg. § 1.1361-5(b)(3), Example (2). See fn. 144 for details.

[3687] See T.D. 8844 (preamble to regulations on entity conversions) (11/29/99) and Rev. Rul. 99-5. See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. See also The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations *TM Memorandum* (BNA) (3/16/2009), and AICPA Comments to IRS on Rev. Rul. 99-5 on Disregarded Entities (6/5/2013), found at http://www.aicpa.org/advocacy/tax/partnerships/downloadabledocuments/comments-on-rev-ruling-99-5-v-6-5-13submit.pdf.

[3688] Rev. Rul. 99-5, Situation 1.

> In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.
>
> Under section 1001, A recognizes gain or loss from the deemed sale of the 50% interest in each asset of the LLC to B.
>
> Under section 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.
>
> Under section 722, B's basis in the partnership interest is equal to $5,000, the amount paid by B to A for the assets which B is deemed to contribute to the newly-created partnership. A's basis in the partnership interest is equal to A's basis in A's 50% share of the assets of the LLC.
>
> Under section 723, the basis of the property treated as contributed to the partnership by A and B is the adjusted basis of that property in A's and B's hands immediately after the deemed sale.
>
> Under section 1223(1), A's holding period for the partnership interest received includes A's holding period in the capital assets and property described in section 1231 held by the LLC when it converted from an entity that was disregarded as an entity separate from A to a partnership. B's holding period for the partnership interest begins on the day following the date of B's purchase of the LLC interest from A. See Rev. Rul. 66-7, 1966-1 C.B. 188, which provides that the holding period of a purchased asset is computed by excluding the date on which the asset is acquired. Under section 1223(2), the partnership's holding period for the assets deemed transferred to it includes A's and B's holding periods for such assets.

However, if the new member pays the LLC for a member interest, then the old and new member are deemed to have formed a partnership, which generally qualifies as a nontaxable transaction,[3689] as follows:[3690]

> In this situation, the LLC is converted from an entity that is disregarded as an entity separate from its owner to a partnership when a new member, B, contributes cash to the LLC. B's contribution is treated as a contribution to a partnership in exchange for an

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[3689] See T.D. 8844 (preamble to regulations on entity conversions) (11/29/99), Rev. Rul. 99-5, and part II.M.3 Buying into or Forming a Partnership (especially part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership). See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. Letter Ruling 200633019 discusses a large variety of tax issues when a trust contributes a diversified portfolio of marketable securities to a single-member LLC and then distributes LLC interests to the remaindermen; Letter Ruling 201628008 includes a more abbreviated discussion of such a transaction. See also The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations 201351018 (BNA) (3/16/2009).

[3690] Rev. Rul. 99-5, Situation 2.

ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest.

Under section 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.

Under section 722, B's basis in the partnership interest is equal to $10,000, the amount of cash contributed to the partnership. A's basis in the partnership interest is equal to A's basis in the assets of the LLC which A was treated as contributing to the newly-created partnership.

Under section 723, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A's hands. The basis of the property contributed to the partnership by B is $10,000, the amount of cash contributed to the partnership.

Under section 1223(1), A's holding period for the partnership interest received includes A's holding period in the capital and section 1231 assets deemed contributed when the disregarded entity converted to a partnership. B's holding period for the partnership interest begins on the day following the date of B's contribution of money to the LLC. Under section 1223(2), the partnership's holding period for the assets transferred to it includes A's holding period.

Thus, the parties can control whether the original owner is taxed and the new owner gets an inside basis step-up, or the original owner is not taxed and the new owner does not get an inside basis step-up.[3691] However, the parties can have their cake and eat it, too: in the latter case, the new owner can transfer the partnership interest to another partnership (or corporation) in a tax-free transaction and get an inside basis step-up.[3692]

When an LLC with more than one member is taxed as a partnership, and the number of members later is reduced to one, it becomes a sole proprietorship for tax purposes. When one member buys out the other(s), the selling member(s) is(are) taxed based on the rules for selling a partnership interest, and the remaining member (essentially the new sole proprietor) is deemed to have bought all of the LLC's assets on that date, with no tacking of holding period for

[3691] See part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue.

[3692] See parts II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss), II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000 and II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

any portion of the assets.[3693] Furthermore, payments that would have been deductible by a partnership had it continued in existence are deductible by the successors to the partnership.[3694]

*Pierre v. Commissioner*[3695] was a reviewed opinion holding that gifts and sales of interests in a single-member limited liability company (LLC) be treated for gift tax purposes as transfers of interests in an entity rather than transfers of the underlying assets.

Initially, the transferor was the LLC's sole owner. Some LLC interests were gifted, and the rest were sold. The IRS asserted that the transfers were of the LLC's underlying assets, not interests in the LLC. It tried to apply the principles of Rev. Rul. 99-5, Situation 1, which provides:

> In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

The Tax Court majority rejected the application of the check-the-box rules[3696] to this gift. Those provisions apply only "where not otherwise distinctly expressed or manifestly incompatible with the intent" of other provisions in the tax law.[3697] Fundamental gift tax precepts require that one look to the bundle of rights transferred.[3698] The Tax Court held that, under state law, an LLC interest (not an interest in the underlying assets) was transferred; applying the check-the-box regulations would be manifestly incompatible with fundamental gift tax precepts.[3699]

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[3693] Rev. Rul. 99-6; see also part II.Q.8 Exiting From or Dividing a Partnership; see Letter Ruling 201723009 when such a transaction is done inside a consolidated group. See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. See also "The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations," *TM Memorandum* (BNA) (3/16/2009). For a myriad of tax issues raised in this situation, criticizing Rev. Rul. 99-6, see AICPA Comments on Revenue Ruling 99-6 on Conversions from Partnerships to Disregarded Entities (10/1/2013), found at http://www.aicpa.org/advocacy/tax/partnerships/downloadabledocuments/comments-on-rev-ruling-99-6-submit.pdf. The AICPA points to very different results when a purchaser buys 99% instead of 100%.

[3694] Rev. Rul. 75-154.

[3695] 133 T.C. 24 (2009) (http://www.ustaxcourt.gov/InOpHistoric/Pierre.TC.WPD.pdf). For income tax treatment of a gift of the entire interest in a single member LLC, see fn. 334.

[3696] Reg. §§ 301.7701-1 through 301.7701-3.

[3697] Code § 7701(a) (introductory language).

[3698] The court reasoned:

> The multistep process of determining the nature and amount of a gift and the resulting gift tax under the Federal gift tax provisions described above, i.e., (1) the determination under State law of the property interest that the donor transferred, (2) the determination of the fair market value of the transferred property interest and the amount of the transfer to be taxed, and (3) the calculation of the Federal gift tax due on the transfer, is longstanding and well established. Neither the check-the-box regulations nor the cases cited by respondent support or compel a conclusion that the existence of an entity validly formed under applicable State law must be ignored in determining how the transfer of a property interest in that entity is taxed under Federal gift tax provisions.

[3699] The court held:

The court distinguished between classifying the entity and describing the nature of the assets that were transferred. This fine line might breed litigation in the transfer tax area.

### II.P.3.g. Rescissions, Including Rescinding Conversion of Entity

The IRS often respects rescissions for income tax purposes[3700] when a transaction is reversed in the same taxable year. The IRS explains:[3701]

> The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.

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> We note that Congress has enacted provisions of the Internal Revenue Code, see secs. 2701, 2703, that disregard valid State law restrictions in valuing transfers. Where Congress has determined that the willing buyer, willing seller and other valuation rules are inadequate, it expressly has provided exceptions to address valuation abuses. See chapter 14 of the Internal Revenue Code, sections 2701 through 2704, which specifically are designed to override the standard willing buyer, willing seller assumptions in certain transactions involving family members.
>
> By contrast, Congress has not acted to eliminate entity related discounts in the case of LLCs or other entities generally or in the case of a single-member LLC specifically. In the absence of such explicit congressional action and in the light of the prohibition in section 7701, the Commissioner cannot by regulation overrule the historical Federal gift tax valuation regime contained in the Internal Revenue Code and substantial and well-established precedent in the Supreme Court, the Courts of Appeals, and this Court, and we reject respondent's position in the instant case advocating an interpretation that would do so. Accordingly, we hold that 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.

[3700] The IRS does not have a clear policy for estate and gift tax law. However, *Neal v. U.S.*, 187 F.3d 626 (3rd Cir. 1999) allowed a rescission under Pennsylvania law and considered the gift incomplete because of it.

[3701] Rev. Rul. 80-58. Although the ruling is old, it is still viable. Rev. Proc. 2013-3, Section 5.02(1) indicated that the IRS was considering its position in the rescission area. Rev. Proc. 2014-3, Section 1.02(6) mentioned that Section 5.02(1) was deleted and that Section 3.02(8) was added, the latter providing that whether a completed transaction can be rescinded for Federal income tax purposes is an issue on which the IRS will not issue a private letter ruling. At the May 2014 meeting of the Sales, Exchanges & Basis Committee of the American Bar Association's Section of Taxation, a government representative informally stated that withdrawing its study of the area indicates that the IRS has reaffirmed its commitment to Rev. Rul. 80-58. Materials for that meeting prepared by Section practitioner members are saved as Thompson Coburn document 6044351. For more on Rev. Rul. 80-58, see New York State Bar Association Tax Section Report on the Rescission Doctrine (Report No. 1216) (8/11/2010) at www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1216-Report.pdf, citing Sheldon I. Banoff, Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud, *Taxes – The Tax Magazine* (Dec. 1984) at 942; and David H. Schnabel, Revisionist History: Retroactive Federal Tax Planning (2009) (unpublished manuscript), mentioning that an earlier version is published at 60 *Tax Lawyer* 685 (2007).

> The annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. That is, each taxable year is a separate unit for tax accounting purposes…..
>
> In Situation 1 the rescission of the sale … placed A and B at the end of the taxable year in the same positions as they were prior to the sale. Thus, … the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction…..
>
> In Situation 2, as in Situation 1, there was a completed sale in 1978. However, unlike Situation 1, because only the sale and not the rescission occurred in 1978, at the end of 1978 A and B were not in the same positions as they were prior to the sale….[T]he rescission in 1979 is disregarded with respect to the taxable events occurring in 1978.
>
> In both situations, the annual accounting period principle requires the determination of income at the close of the taxable year without regard to subsequent events.

*Gateway Hotel Partners, LLC v. Commissioner*[3702] upheld the requirement that the transaction cannot qualify for rescission unless undone by the end of the taxable year. *Blagaich v. Commissioner*[3703] also refused to apply rescission to a payment that the taxpayer returned over

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[3702] T.C. Memo. 2014-5.

[3703] T.C. Memo. 2016-2, holding:

> … In general, the annual accounting period principle reflected in section 451, considered in the light of the judicially articulated claim-of-right doctrine, limits application of the rescission exception such that, without regard to subsequent events, income received by the taxpayer under a claim of right and retained by her at the close of the taxable year must be included in gross income for that year. See [*Penn v. Robertson*, 115 F.2d 167, 175 (4th Cir. 1940)]; Rev. Rul. 80-58, Situation 2, 1980-1 C.B. at 182.
>
> ….
>
> The facts show that, in 2010, petitioner took possession of the whole amount in question, $400,000, without any substantial limitations or restrictions as to its disposition. She recognized no liability and made no provision to repay that amount until nearly three years later. None of the cases petitioner cites as allowing a relaxation of the same-year requirement for rescission is factually comparable to her own, and they provide no rationale for departing from the general rule.
>
> With respect to the equitable concerns petitioner raised in her motion—The equities in this case simply do not support strict adherence to the one-year guideline in the rescission doctrine.—we note only that our statutory mandate does not permit us to decide this case on the basis of general principles of equity. See *Knapp v. Commissioner*, 90 T.C. 430, 440 (1988) (citations omitted) (The Tax Court is a court of limited jurisdiction. *** We have only the powers expressly conferred on us by Congress, and may not apply equitable principles to expand our jurisdiction beyond the limits of section 7442.), *aff'd*, 867 F.2d 749 (2d Cir. 1989).

The court rejected the taxpayer's reliance on *Hope v. Commissioner*, 55 T.C. 1020, 1030 (1971), *aff'd*, 471 F.2d 738 (3d Cir. 1973), which the court said:

> suggests that the rescission doctrine may apply even when repayment of a gain does not formally occur in the year of receipt, but only if, before the end of the year, [the] taxpayer recognizes his liability under an existing and fixed obligation to repay the amount received and makes provisions for repayment.

The court rejected the taxpayer's reliance on *Guffey v. United States*, 339 F.2d 759 (9th Cir. 1964), which case the court described:

> In *Guffey*, the installment purchasers of the Guffeys' home sued to rescind the sale contract when, in the following year, they discovered dry rot, moved out, and refused to make further

three years later after payment, when she did so only after being order by a court to do so. However, in another case, a taxpayer was permitted to rescind a disclaimer based on erroneous tax advice, more than two years after the disclaimer, after joining the IRS as a party to a legal action to rescind.[3704]

The IRS approved a rescission of a conversion from partnership to corporation where everything happened in one year and the taxpayer had a good nontax reason.[3705] The IRS has also allowed a taxpayer to rescind a restructuring involving a subsidiary to reverse unintended adverse Federal income tax consequences.[3706] However, the IRS will not issue any more letter rulings in this area.[3707]

A taxpayer cannot unilaterally recast a transaction merely because the taxpayer decides that documenting it differently would have produced a better tax result.[3708]

For the rescission to be effective, both parties must be put back in their original positions.[3709] A January 2005 article further analyzes the rescission doctrine.[3710]

An S election may be rescinded until the last day on which the election could have been timely made.[3711] The IRS will not permit a revocation that is more retroactive than that.[3712] A

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> payments. A settlement was reached under which the purchasers' suit was dismissed and the Guffeys obtained a quitclaim deed and retained the previously received payments as rent.…While the Court of Appeals did state that it can fairly be said that the settlement with the *** original purchasers was, in substance, a reduction in the purchase price, *id.*, the Guffeys returned nothing to the original purchasers, the original purchasers apparently agreeing that the payments could be kept as rent. The sort of passive unwinding of the agreement that occurred in *Guffey* did not and could not occur in the case at bar; the only way Mr. Burns could be restored to status quo ante was if petitioner returned the $400,000.

[3704] *Breakiron v. Gudonis*, 106 A.F.T.R.2d 2010-5999 (D. Mass. 2010). The IRS was joined as a party when it attempted to collect gift tax. In another disclaimer case, the court dismissed the IRS as a party. *Van Vliet v. Van Vliet*, 115 A.F.T.R.2d 2015-803 (E.D. Va. 2015).

[3705] Letter Ruling 200952036.

[3706] Letter Ruling 201008033.

[3707] Rev. Proc. 2017-3, Section 3.02(8), listed as a no-rule area "whether a completed transaction can be rescinded for Federal income tax purposes."

[3708] *Makric Enterprises, Inc. v. Commissioner*, TC Memo 2016-44, 119 A.F.T.R.2d ¶ 2017-580 (5th Cir. 3/27/2017).

[3709] Citing *Hutcheson v. Commissioner*, T.C. Memo. 1996-127 for that proposition, *Fitch v. Commissioner*, T.C. Memo. 2012-358, rebuffed IRS arguments in favor of rescinding a sale of a CPA practice, which was followed by a repurchase shortly thereafter when the original buyer's health deteriorated unexpectedly:

> The repurchase agreement, by its own terms, effected a sale of the C.P.A. practice from Mr. Gronke to Mr. Fitch and not an unwinding of the earlier sale. There is no evidence that Mr. Fitch and Mr. Gronke intended to abrogate, cancel, or void the sale agreement. Furthermore, we do not believe that the repurchase agreement returned them to their original positions. The C.P.A. practice continued as a dynamic, ongoing enterprise for approximately 4-1/2 months after the sale transaction, and we cannot say that Mr. Fitch received the C.P.A. practice back in the exact same condition in which he had sold it. Accordingly, we find that the sale and repurchase transactions were not rescinded.

Query whether the court was just being sympathetic to the seriously ill parties and really would set such a high bar if the taxpayers had sought to rescind the agreement.

[3710] Morehouse, The Rescission Doctrine: Tax Do-Overs, Another Roll Of the Dice, *TM Real Estate Journal* (BNA) (1/7/2015).

corporation may rescind such a revocation at any time before the revocation becomes effective, but only with the consent of each person who consented to the revocation and each person who became a shareholder of the corporation within the period beginning on the first day after the date the revocation was made and ending on the date on which the rescission is made.[3713]

### II.P.3.h. Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization

When transferring a corporation's business to a new partnership, consider doing the following:

1. The shareholders form a new corporation with ownership identical to the old corporation's ownership.

2. The old corporation converts or is merged into a limited liability company that is a disregarded entity.

3. Either the new corporation then transfers its member interest in the LLC to a limited partnership, or the LLC itself admits one or more additional members to convert the LLC to an entity taxed as a partnership.

To qualify as an F reorganization[3714] nontaxable for federal income tax purposes (always check state income tax rules), this or any other transaction must result in a mere change in identity, form, or place of organization of one corporation.[3715] A transaction involving an actual or deemed transfer is a mere change only if:

- Immediately after the reorganization, all the stock of the resulting corporation, including any stock of the resulting corporation issued before the reorganization, must have been distributed (or deemed distributed) in exchange for stock of the transferor corporation;[3716]

- The same person or persons must own all of the stock of the transferor corporation, determined immediately before the reorganization, and of the resulting corporation, determined immediately after the reorganization, in identical proportions;[3717]

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[3711] Reg. § 1.1362-2(a)(2)(i).
[3712] Christian & Grant, ¶32.02. Revocation, *Subchapter S Taxation* (WG&L), cites varies IRS correspondence to that effect.
[3713] Reg. § 1.1362-2(a)(4).
[3714] Code § 368(a)(1)(F).
[3715] Reg. § 1.368-2(m)(1). For an analysis of the background to this regulation and its impact, see Kliegman and Chen, Some Ado About a Nothing: Final F Reorganization Regulations, *TM Memorandum* (BNA) (4/4/2016). The article suggests that Rev. Rul. 68-349 appears to violate the requirements of the text accompanying fns. 3716-3717; it has been suggested that informal comments at the January 2016 meeting of the American Bar Association's Section of Taxation indicate that the government might not have considered the regulations' impact on that ruling.
[3716] However, a de minimis amount of stock issued by the resulting corporation other than in respect of stock of the transferor corporation to facilitate the organization of the resulting corporation or maintain its legal existence is disregarded. Reg. § 1.368-2(m)(1)(i).
[3717] However, this requirement is not violated if one or more holders of stock in the transferor corporation exchange stock in the transferor corporation for stock of equivalent value in the resulting corporation, but having different terms from those of the stock in the transferor corporation, or receive a distribution of

- The resulting corporation does not hold any property or have any tax attributes[3718] immediately before the reorganization;[3719]

- The transferring corporation completely liquidates, for federal income tax purposes, in the reorganization;[3720]

- Immediately after the reorganization, no corporation other than the resulting corporation holds property that was held by the transferor corporation immediately before the reorganization, if such other corporation would, as a result, succeed to and take into account the items of the transferor corporation described in Code § 381(c);[3721] and

- Immediately after the reorganization, the resulting corporation does not hold property acquired from a corporation other than the transferor corporation if the resulting corporation would, as a result, succeed to and take into account the items of such other corporation described in Code § 381(c).[3722]

The last two bullet points emphasize that tax attributes cannot change in an F reorganization.[3723] Thus, when a corporation engages in an F reorganization, the part of the tax year before the reorganization and the part after constitute a single tax year,[3724] and the

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money or other property from either the transferor corporation or the resulting corporation, whether or not in exchange for stock in the transferor corporation or the resulting corporation. Reg. § 1.368-2(m)(1)(ii).

[3718] Including those specified in Code § 381(c).

[3719] However, this requirement is not violated if the resulting corporation holds or has held a de minimis amount of assets to facilitate its organization or maintain its legal existence, and has tax attributes related to holding those assets, or holds the proceeds of borrowings undertaken in connection with the potential F reorganization. Reg. § 1.368-2(m)(1)(iii).

[3720] However, the transferor corporation is not required to dissolve under applicable law and may retain a de minimis amount of assets for the sole purpose of preserving its legal existence. Reg. § 1.368-2(m)(1)(iv).

[3721] Reg. § 1.368-2(m)(1)(v). The preamble, T.D. 9739, explains:

> Thus, a transaction that divides the property or tax attributes of a Transferor Corporation between or among acquiring corporations, or that leads to potential competing claims to such tax attributes, will not qualify as a Mere Change.

[3722] Reg. § 1.368-2(m)(1)(vi). The preamble, T.D. 9739, explains:

> Thus, a transaction that involves simultaneous acquisitions of property and tax attributes from multiple transferor corporations (such as the transaction described in Rev. Rul. 58-422, 1958-2 CB 145) will not qualify as a Mere Change.

[3723] The preamble, T.D. 9739, says:

> From a federal income tax perspective, F reorganizations are generally neutral, involving no change in ownership or assets, no end to the taxable year, and inheritance of the tax attributes described in section 381(c) without a limitation on the carryback of losses. See, for example, Rev. Rul. 96-29 (discussed in section 3.B.ii. of the Background); § 1.381(b)-1(a)(2).

[3724] Reg. § 1.381(b)-1(a)(2) provides:

> *Reorganizations under section 368(a)(1)(F)*. In the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the acquiring corporation shall be treated (for purposes of section 381) just as the transferor corporation would have been treated if there had been no reorganization. Thus, the taxable year of the transferor corporation shall not end on the date of transfer merely because of the transfer; a net operating loss of the acquiring corporation for any taxable year ending after the date of transfer shall be carried back in accordance with section 172(b) in computing the taxable income of the transferor corporation for a taxable year ending before the date of transfer;

resulting corporation must file a single full-year return using the same EIN;[3725] however, if the old corporation was domestic and the new one is foreign, the F reorganization does close the tax year.[3726] In a purely domestic F reorganization, the new corporation's filing a tax return runs the statute of limitations for the old corporation's activity that was reported on the new corporation's return.[3727]

Continuity of the business enterprise and a continuity of interest are not required to qualify as an F reorganization.[3728]

Subject to certain limitations, an F reorganization might consist of a series of related transactions that together result in a mere change of one corporation.[3729]

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and the tax attributes of the transferor corporation enumerated in section 381(c) shall be taken into account by the acquiring corporation as if there had been no reorganization.

[3725] Rev. Rul. 73-526, Situation (3) described these facts:

> Corporation R was chartered in state X. It reincorporated in state Y as corporation S, a new corporate entity under the laws of state Y. The assets and liabilities of R were transferred to corporation S. Prior to the reincorporation, corporation R had been assigned an identifying number. Except for the technical difference of forming a new corporate entity chartered in state Y, the surviving corporation, S, is the same corporation as the transferor corporation, R. The same business with the same assets and the same stockholders is continued in the newly chartered entity. Consequently, the reincorporation constitutes a reorganization within the meaning of section 368(a)(1)(F) of the Internal Revenue Code of 1954. Under section 1.381(b)-1(a)(2) of the Income Tax Regulations, the acquiring corporation is treated just as the transferor corporation would have been treated in the absence of a reorganization, and the taxable year of the transferor does not close on the date of transfer. Thus, a final return is not required of corporation R in this transaction.

Rev. Rul. 73-526 concluded:

> Since the surviving corporation, S, is for Federal income tax purposes treated as the same corporation as the transferor corporation, R, the identifying number assigned to corporation R should be continued in use by corporation S after the transaction.

[3726] Reg. § 1.367(a)-1(e).

[3727] *New Capital Fire, Inc. v. Commissioner*, T.C. Memo. 2017-177, rejecting the IRS' contention that failing to file a return for the old corporation kept the statute of limitations open. The new corporation's return properly disclosed the F reorganization. The court held:

> New Capital's 2002 return purported to and did include Old Capital's income from January 1 through December 4, 2002. Respondent has not alleged, and we do not find, that New Capital's 2002 return was false or fraudulent with intent to evade tax as it pertains to Old Capital. It was respondent's duty to determine, within the period of limitations provided by section 6501(a), whether New Capital's 2002 return, as it pertains to Old Capital, was erroneous in any respect. The exception under section 6501(c)(3) does not apply. Accordingly, assessment of the determined deficiency and additions to tax is barred by the statute of limitations.

[3728] Reg. § 1.368-2(m)(2).

[3729] Reg. § 1.368-2(m)(3), which provides:

> *Series of transactions*. A potential F reorganization consisting of a series of related transactions that together result in a mere change of one corporation may qualify as a reorganization under section 368(a)(1)(F), whether or not certain steps in the series, viewed in isolation, could be subject to other Code provisions, such as sections 304(a), 331, 332, or 351. However, see paragraph (k) of this section for transactions that qualify as reorganizations under section 368(a) and will not be recharacterized as a mere change as a result of one or more subsequent transfers of assets or stock.

The preamble, T.D. 9739, explains:

It has been suggested that substantive changes of ownership that were not allowed before these regulations are now allowed:[3730]

- Exchanging stock for stock of equivalent value but with different terms, or
- Either the old or new corporations distributing cash or other property.

Sometimes a conversion generally involves a direct or indirect merger of a corporation into an unincorporated entity taxed as a corporation.[3731] For example, an LLC that is taxed as an

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> In some cases, business or legal considerations may require extra steps to complete a transaction that is intended to qualify as a Mere Change. As discussed in section 3.B.i. of the Background, the Treasury Department and the IRS concluded that the words however effected in the statutory definition of F reorganization reflect a Congressional intent to treat a series of transactions that together result in a Mere Change as an F reorganization, even if the transfer (or deemed transfer) of property from the Transferor Corporation to the Resulting Corporation occurs indirectly. The Final Regulations confirm this conclusion by providing that a Potential F Reorganization consisting of a series of related transactions that together result in a Mere Change may qualify as an F reorganization, whether or not certain steps in the series, viewed in isolation, might, for example, be treated as a redemption under section 304(a), as a complete liquidation under section 331 or section 332, or as a transfer of property under section 351. For example, the first step in an F reorganization of a corporation owned by individual shareholders could be a dissolution of the Transferor Corporation, so long as this step is followed by a transfer of all the assets of the Transferor Corporation to a Resulting Corporation. However, see § 1.368-2(k) for completed reorganizations that will not be recharacterized as a Mere Change as a result of one or more subsequent transfers of assets or stock, such as where a Transferor Corporation transfers all of its assets to its parent corporation in liquidation, followed by the parent corporation's retransfer of those assets to a new corporation. See also Rev. Rul. 69-617, 1969-2 CB 57 (an upstream merger followed by a contribution of all the target assets to a new subsidiary corporation is a reorganization under sections 368(a)(1)(A) and 368(a)(2)(C)).

The preamble further discussed such a reorganization's role in a larger transaction:

> As discussed in section 3.B.ii. of the Background, the Treasury Department and the IRS recognized that an F reorganization may be a step, or a series of steps, before, within, or after other transactions that effect more than a Mere Change, even if the Resulting Corporation has only a transitory existence following the Mere Change. In some cases an F reorganization sets the stage for later transactions by alleviating non-tax impediments to a transfer of assets. In other cases, prior transactions may tailor the assets and shareholders of the Transferor Corporation before the commencement of the F reorganization. Although an F reorganization may facilitate another transaction that is part of the same plan, the Treasury Department and the IRS have concluded that
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> step transaction principles generally should not recharacterize F reorganizations because F reorganizations involve only one corporation and do not resemble sales of assets.

[3730] McMahon, Recent Developments in Federal Income Taxation of Corporations and Partnerships, 64th Annual Montana Tax Institute (10/14/2016).

[3731] A direct approach is found Reg. § 1.368-2(m)(4), Example (8), and the logistics are explained in Letter Ruling 200839017. See Riser, Hiding Your Stuff in Plain Sight (Without Trusts): Dr. FUnbundle (or How I Learned to Stop Worrying and Love Sec. 368(a)(1)(F)), American Bar Association Section of Real Property, Trust & Estate Law, 2009 Spring Symposia, discussing Letter Ruling 200701017. See also Rev. Ruls. 64-250, 73-256, and 2008-18 and Letter Rulings 200528021, 200622025, and 200719005. See also Kalinka, Transfer of an Interest in an LLC Taxed As an S corporation Raises Many Questions, p. 23 *Taxes-The Tax Magazine* (October 2007); Christian & Grant, ¶29.07. 'F' Reorganizations, *Subchapter S Taxation* (WG&L); and Gassman, Crotty, and O'Leary, The Estate Planner's Guide to New Parent F Reorganizations, *Estate Planning Journal* (WG&L), May 2008. These issues were discussed at the Asset Protection Committee Meeting of the American College of Trust & Estate Counsel (ACTEC) in

S corporation can move assets comprising one line of business into a new parent LLC taxed as an S corporation that assumes its tax attributes and then under Code § 355 distribute assets comprising another line of business into another LLC taxed as an S corporation.[3732] Generally, for an S corporation, I recommend that the LLC file a new Form 2553, election to be taxed as an S corporation, which converts the LLC to a corporation and makes an S election at the same time;[3733] however, when an existing S corporation passes its S corporation tax attributes to a

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the Fall of 2009, which included some practical materials for LLCs taxed as S corporations that are available to ACTEC Fellows. For whether a new employer identification number (IRS tax ID) is needed, see fns 191-194 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub). Although Rev. Rul. 2008-18 says that the new entity retains the new entity's S election, I had suggested that the new entity file IRS Form 2553. However, Form 8869, line 14 asks, "Is this election being made in combination with a section 368(a)(1)(F) reorganization described in Rev. Rul. 2008-18, where the subsidiary was an S corporation immediately before the election and a newly formed holding company will be the subsidiary's parent?" and provides the following instructions:

> This box should be checked "Yes" if this election is being made pursuant to a reorganization under section 368(a)(1)(F) and Rev. Rul. 2008-18. This occurs when a newly formed parent holding company holds the stock of the subsidiary that was an S corporation immediately before the transaction and the transaction otherwise qualifies as a reorganization under section 368(a)(1)(F). No Form 2553, Election by a Small Business Corporation, is required to be filed by the parent. See Rev. Rul. 2008-18, 2008-13 I.R.B. 674, for details.

Letter Ruling 199947034, found in fn. 6663, ruled that Code § 2701 did not apply to such a reorganization.

See fn. 350 in part II.B Limited Liability Company (LLC) if the new entity is an LLC electing taxation as an S corporation and fn. 195 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub) regarding the timing of an LLC electing S corporation status before acquiring a QSub.

[3732] Letter Ruling 201638004. The facts were:

(1) The X members will contribute all of their X equity units to Y, a newly formed-State X limited liability company, in exchange for all of the Y equity units.
(2) X will elect to become, or by default will become, a disregarded entity or qualified subchapter S subsidiary for Federal tax purposes. After this step, Y expects to continue X's S corporation election.
(3) X will distribute the assets comprising the Retained Business to Y in a transaction that it expects to be disregarded for Federal income tax purposes. After this step, X would continue to hold the assets comprising the Distributed Business.
(4) Y will transfer all of the equity units of X to Z, a newly-formed State X limited liability company, solely in exchange for all of the Z equity units. After this step, Z will hold only the equity units in X, which continues to hold the assets comprising the Distributed Business.
(5) Y will distribute pro rata all of the equity units of Z to Y's members in a transaction intended to qualify under section 355 of the Internal Revenue Code (the Distribution).

After reciting various representations, the ruling held:

(1) For purposes of determining whether Steps 1 and 2, viewed together, result in the realization of gain or loss under section 1001 (see *Weiss v. Stearn*, 265 U.S. 242 (1924)), or a reorganization under section 368(a)(1)(F) (see Rev. Rul. 72-206, 1972-1 C.B. 104), Steps 3 through 5 shall be disregarded.
(2) For U.S. Federal income tax purposes, Steps 3 through 5 will be treated as a direct transfer of the Distributed Business by Y to Z in exchange for all of the equity units of Z and the assumption of associated liabilities, followed by the pro rata distribution by Y of all of the equity units of Z to Y's members.
(3) X's S election will not terminate as a result of the completion of Steps 1 and 2, but continues for Y.

[3733] See fn. 350 and the accompanying and following text. Also consider what happens if there is some defect in Form 2553 that might make its filing invalid. Is converting into a partnership or a C corporation the lesser of two evils? If the latter, consider filing Form 8832 before Form 2553.

new parent through a Code § 368(a)(1)(F) reorganization in which the old corporation becomes a qualified subchapter S subsidiary (QSub), only a QSub election is made, which results in the parent becoming an S corporation, as described in fn 3731. Query whether one wants to file Form 2553 for the new parent anyway, in case the Code § 368(a)(1)(F) reorganization is somehow deficient. Regarding tax IDs of those involved in Code § 368(a)(1)(F) reorganizations, see fns 3731-3733 and parts II.G.1 How and When to Obtain or Change an Employer Identification Number (EIN) and II.P.3 Conversions.

Consider a different approach when the corporation has sold all of its business assets. See part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale.

## II.Q. Exiting from or Dividing a Business

### II.Q.1. General Principles When Selling Ownership of a Business

A business' value is the present value of the expected future cash flows to its owners. A buyer uses these cash flows to pay the purchase price:

- ***Third-Party Financing***. A third-party lender provides cash to pay the purchase price in a lump sum. Business risk is shared between the buyer and the third-party lender, with the buyer assuming substantially all of the risk. Because the seller receives all cash up-front, the seller's risk is minimal.

- ***Seller Financing***. A series of payments from the buyer to the seller is evidenced through a promissory note. From a technical legal viewpoint, the buyer has all of the risk. However, as a practical matter, the seller is subject to business risk because the buyer is much less likely to pay if the business' cash flow is insufficient to service this debt. At any given point in time, the buyer is likely to withhold part or all of the remaining payments if the business' cash flow is less than expected. From an income tax viewpoint, the seller might be able to use the installment method to defer income tax on the gain on sale,[3734] subject to limitations if and to the extent that the business interest sold is a partnership interest with "hot assets,"[3735] as well as acceleration in various events.[3736]

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[3734] Even though stock was generally listed on the stock market, taxpayers who were affiliates as defined in Rule 144 under the 1933 Act and could not sell their unregistered shares of stock in Company on the Market, except pursuant to the volume limitations and other restrictions imposed by Rule 144 could sell their shares on the installment method. Letter Ruling 9803021. Furthermore, stock in an S corporation was eligible for installment sale treatment even though it held marketable securities. Letter Ruling 9306003 reasoned:

> Application of section 453(k)(2) to the S Common Stock is inappropriate. The flush language of section 453(k) provides the Secretary with the authority to provide for the application of section 453(k) in whole or in part for transactions in which the rules of the section would be avoided through use of related parties, pass-thru entities, or intermediaries. Because the Secretary has not issued regulations pursuant to this authority, however, the flush language may not be applied to the sale of the S Common Stock. Thus, because the S Common Stock is neither traded on an established securities market nor convertible into such publicly traded property, section 453(k)(2) does not apply to the sale of the S Common Stock.

However, the legislative history to the Tax Reform Act of 1986, PL 99-514, authorized the issuance of retroactive regulations disallowing the avoidance of the rules regarding publicly traded stock through use of related parties or other intermediaries.

[3735] See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests.

- ***Equity Financing***. The seller receives payments based on the business' performance over a short period of time following the transfer, or the timing of buyer's payments depends on the business' profitability. The taxation of contingent sales proceeds in the corporate arena[3737] is more uncertain than in the partnership arena.[3738]

When the buyer uses debt to pay for the business, two layers of tax are imposed:

- First, the buyer pays income tax on the earnings used to repay the debt.
  - For a partnership or S corporation, if owners are taxed on income from operations at a 34.6%-45.8% ordinary federal and state income tax rate, the business must earn $153-185 of profits to fund a $100 principal payment on the debt. [3739]
  - A C corporation structure exacerbates this. If dividends are taxed at a 28.8% combined federal and state income rate, a $140 dividend generates $100 after tax. To distribute $140 to its shareholders, a C corporation that is subject to taxes on income from operations at a 26% ordinary federal and state income tax rate must generate over $189 of income. Thus, over $189 of business earnings are required to fund a $100 principal payment on the debt.
  - The interest component is easier to finance, assuming the interest is fully deductible.[3740] For a partnership or S corporation, only $100 of earnings is necessary to make a $100 interest payment. However, for a C corporation that is subject to taxes on income from operations at a 26% ordinary federal and state income tax rate, earnings of $189 are required to pay a $100 dividend.[3741]
- The seller pays tax on the sale. For example, if the seller has a combined 30% federal and state income tax rate, the seller nets $70 on every $100 of purchase price that constitutes

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[3736] See part II.G.16 Limitations on the Use of Installment Sales.

[3737] Skinner, Earn-Outs in Public Company Acquisitions: New CVRs Raise Unsettled Tax Issues, Journal of Taxation (Dec 2010).

[3738] See part II.Q.8.b.ii, Partnership Redemption – Complete Withdrawal Using Code § 736.

[3739] However, if the owner is a partner who must pay self-employment tax on the earnings, additional earnings are required to pay the self-employment tax. Holding the partnership interest through an S corporation should avoid this issue.

[3740] See part II.G.21.a Limitations on Deducting Business Interest Expense. Also see part III.A.3 Trusts Holding Stock in S Corporations, for a discussion of various types of trusts that can hold stock in an S corporation, including part III.A.3.e.iii Comparing QSSTs to ESBTs, which addresses deducting interest on a loan to buy such stock in footnotes 5655-5597.

[3741] If an individual buyer/shareholder itemizes deductions, the buyer would deduct the interest as investment interest expense. Investment interest expense is deductible to the extent of net investment income. Code § 163(d). Preferably, the buyer would have ordinary interest or nonqualified dividends sufficient to generate this net investment income. Otherwise, the qualified dividends would need to be taxed at ordinary rates to constitute investment income; however, investment interest deducted at ordinary income tax rates generally would offset dividend income taxed using ordinary income tax rates. This comparison is not totally accurate, however, in that the dividend income is included in adjusted gross income (AGI) and can result in reduced itemized deductions and have other adverse AGI-related tax effects. If the buyer is a C corporation, these concerns are not present, and the corporation may also benefit from a dividends received deduction that can reduce or eliminate the tax on the dividends; however, the buyer's own shareholders would be taxed when the buyer distributes whatever return it receives on its investment.

capital gain. However, the seller would pay ordinary income tax on any interest component, so that $100 of interest payments would net only $50 to a seller subject to taxes on income from operations at a 50% ordinary federal and state income tax rate. Note that, although capital gain rates apply to the sale of stock in a C corporation or an S corporation, ordinary income tax rates apply to the portion of the sale of a partnership interest attributable to "hot assets."[3742]

From these examples, some principles emerge:

- ***Paying Principal***. Principal payments can require from $153[3743]-$189[3744] of income to be generated to provide the seller with $71[3745]-$100[3746] after tax. Thus, the tax cost of principal payments represents 35%-62% of the earnings.

- ***Paying Interest***. Interest payments provide a deduction, which is less expensive for the buyer to pay than principal.

- ***Efficiency of Entity***. The tax cost is lowest for:

  - Interest or other deductible payments on the sale of a partnership or S corporation, or

  - Principal payments to the extent of the seller's basis.

  - Reinvested earnings increase the basis of S corporation stock or a partnership interest but not increase the basis of C corporation stock.[3747]

### II.Q.1.a. Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis

To minimize a sale's tax bite illustrated below, as discussed in the discussion after the illustrations tax planners seek structures with characteristics similar to interest or other deductible payments on the sale of a partnership or S corporation.[3748] The discussion below shows that seller-financed sales of partnership interests can avoid capital gain tax relative to a sale of stock in an S corporation (or a C corporation). Furthermore, the partnership sale

[3742] See part II.Q.8.e.ii.(b) Character of Gain.
[3743] $153-$185 for a partnership or S corporation.
[3744] For a C corporation.
[3745] For the gain component of principal payments, net of capital gain tax.
[3746] For the portion of principal payments representing a return of basis.
[3747] See part II.E.2.a Transferring the Business, especially fns 970-971 regarding basis increases for partnerships and S corporations.
[3748] This is a little simplistic, in that partnerships also have unique benefits (earlier use of basis in installment sales; if considering such a sale, see part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests) and detriments (look at partnership's underlying assets to determine the character of gain on sale). See II.Q.8 Exiting From or Dividing a Partnership, especially II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736 and II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner.

structure allows goodwill to be sold later subject to capital gain rates, whereas a sale of goodwill generates slow deductions and may cause disadvantages for the future sale of that goodwill.[3749]

As noted earlier, reinvested earnings increase the basis of S corporation stock or a partnership interest but not increase the basis of C corporation stock.[3750] Thus, the gain component for a C corporation is likely to be much larger than that for a sale of S corporation stock or a partnership interest. Note, however, that some or all of up to $10 million of the gain on the sale of C corporation stock might be excluded from taxable income under part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation; this exclusion is increased to ten times the greater of the adjusted basis or fair market value of property contributed with respect to original issue stock.[3751] Thus, starting as a partnership and later converting to a C corporation may increase this exclusion, but the partnership cannot be worth more than $50 million when converted.[3752]

Further below is a discussion of special opportunities to shift towards a partnership structure,[3753] which generally is the best overall structure, the structure of which[3754] and a summary of ways to shift[3755] were described earlier in these materials.

For now, let's focus on ways to extract value that any entity can try to use.

### II.Q.1.a.i. Scenario for Moderate State Tax

Consider the portion of the business' equity representing internally generated goodwill, and assume the following tax rates, which might or might not be attained:

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

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

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[3749] For more details, see part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.
[3750] See part II.E.2.a Transferring the Business, especially fns 970-971 regarding basis increases for partnerships and S corporations.
[3751] Code § 1202(b)(1). For this purpose, basis includes the fair market value of property contributed. See fns 4691-4699of part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[3752] See fns 4739-4743 of part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[3753] See II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill, regarding how a corporation might shift future appreciation to a partnership.
[3754] See parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart.
[3755] See part II.E.7 Migrating into Partnership Structure.

The individual in a top bracket is assumed taxed at a rate of 28.8%, consisting of 20% capital gain tax, 3.8% net investment income tax, and 5% state income tax.

Sale of Goodwill - Assumptions

| | | |
|---|---|---|
| C corp. income tax rate: | 26.0% | federal and state |
| Individual capital gain rate: | 20.0% | federal |
| | 5.0% | state |
| | 3.8% | NII tax |
| | 28.8% | |
| Pass-through income rate: | 29.6%-37% | federal income tax |
| | 5.0% | state |
| | Zero-3.8% | NII or SE tax |
| | 34.6%-45.8% | |

The capital gain rate for individuals might be overstated when a person sells stock in an S corporation, because the 3.8% tax on net investment income would not apply with respect to the business assets allocable to that stock when a shareholder who is active in the business sells the stock.[3756] The partnership income tax rate might be overstated, either if the partner is a limited partner not subject to self-employment tax[3757] or if the payment is neither self-employment income[3758] nor attributable to business assets allocable to the partnership interest when a partner who is active in the business sells the partnership interest.[3759]

The scenario in the left column below assumes that the buyer uses after-tax dollars to buy the seller's interest in the business. The tax to the buyer in the left column is based on the ordinary income rates, because the buyer is using income generated by operations to fund the payments to the seller. The seller is receiving income at capital gain rates.

| | Capital Gain to Seller | Ordinary Income to Seller |
|---|---|---|
| Profit | $ 153-185 | $109-131 |
| Tax to Buyer | -(53-85) | -0 |
| | $ 100 | $109-131 |
| Tax to Seller | - 29 | 38-60 |
| Net to Seller | $ 71 | $ 71 |

The tax in the right-hand column assumes that the buyer deducts payments to the seller, which is essentially what happens when one pays off a seller by allocating current partnership income to the seller.

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[3756] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

[3757] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner, which one might apply to avoid self-employment tax using the structure described in part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and illustrated in part II.E.6 Recommended Partnership Structure – Flowchart.

[3758] See part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.

[3759] See parts II.I.8.d Partnership Structuring in Light of the 3.8% Tax on Net Investment Income and II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

The following pages illustrate this concept, showing that it takes a C corporation $189 in earnings to do a cross-purchase (one owner sells to another)[3760] and $135 to do either a redemption (entity buys from seller)[3761] or a cross-purchase using an exclusion that applies to the sale of certain stock,[3762] an S corporation $153-185 in earnings,[3763] and a partnership only $109-131 in earnings[3764] to get $71 to the seller.

[3760] See part II.Q.1.a.i.(a) C Corporation Triple Taxation

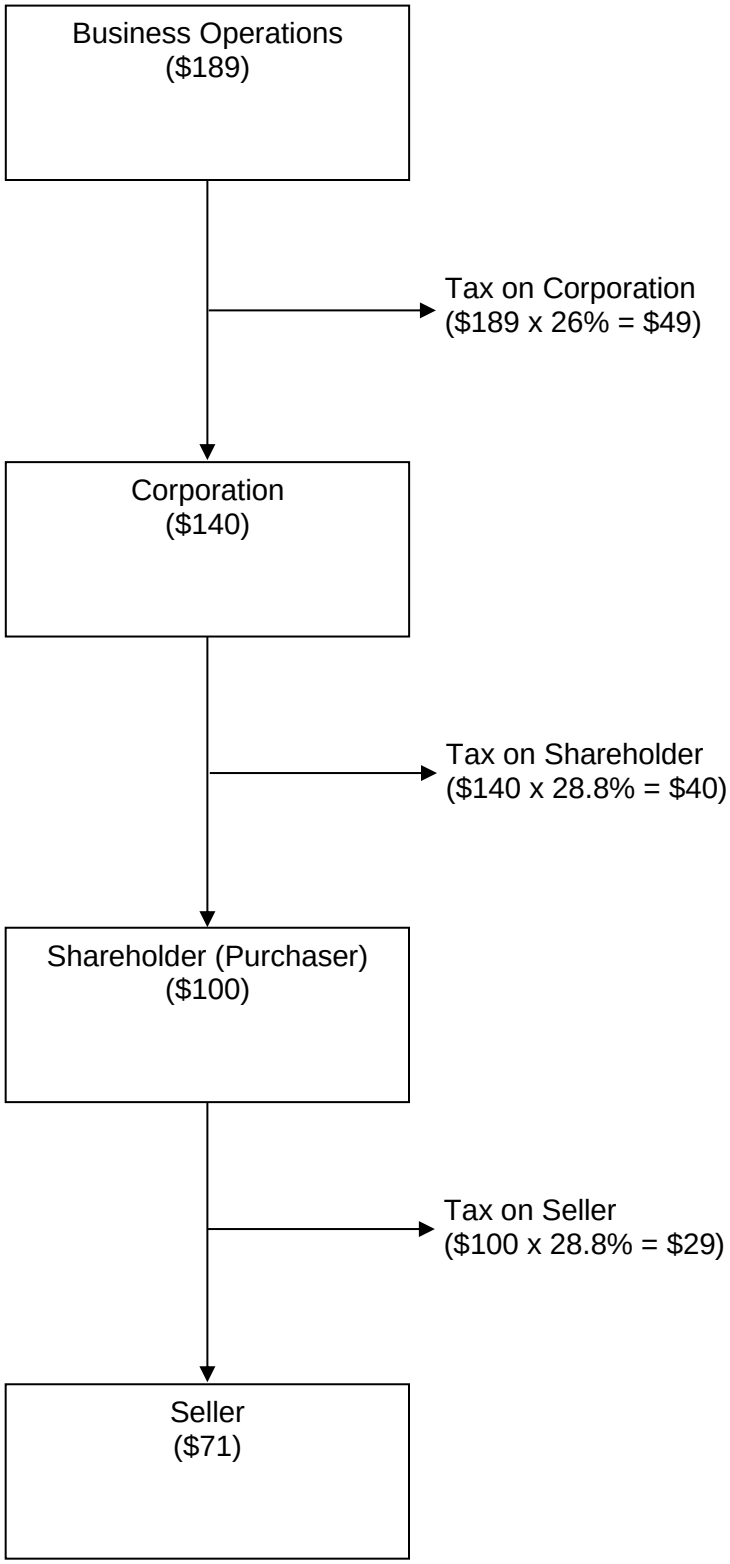
[3761] See part II.Q.1.a.i.(b) C Corporation Redemption. Redeeming the seller entirely might work if buying out one owner and increasing the other owners' interests in proportion to each other. However, if the sole owner is selling, or if the remaining owners are not increased in proportion to each other, then a cross-purchase or a stock issuance is needed to get the remaining owners' interests in the correct proportion, followed by the redemption. For approval of combining a cross-purchase with a redemption, see part II.Q.7.a.ii Hybrid Between Redemption and Cross-Purchase When Selling to New Shareholder or Other Shareholders.

[3762] See part II.Q.1.a.i.(c) C Corporation Double Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation.

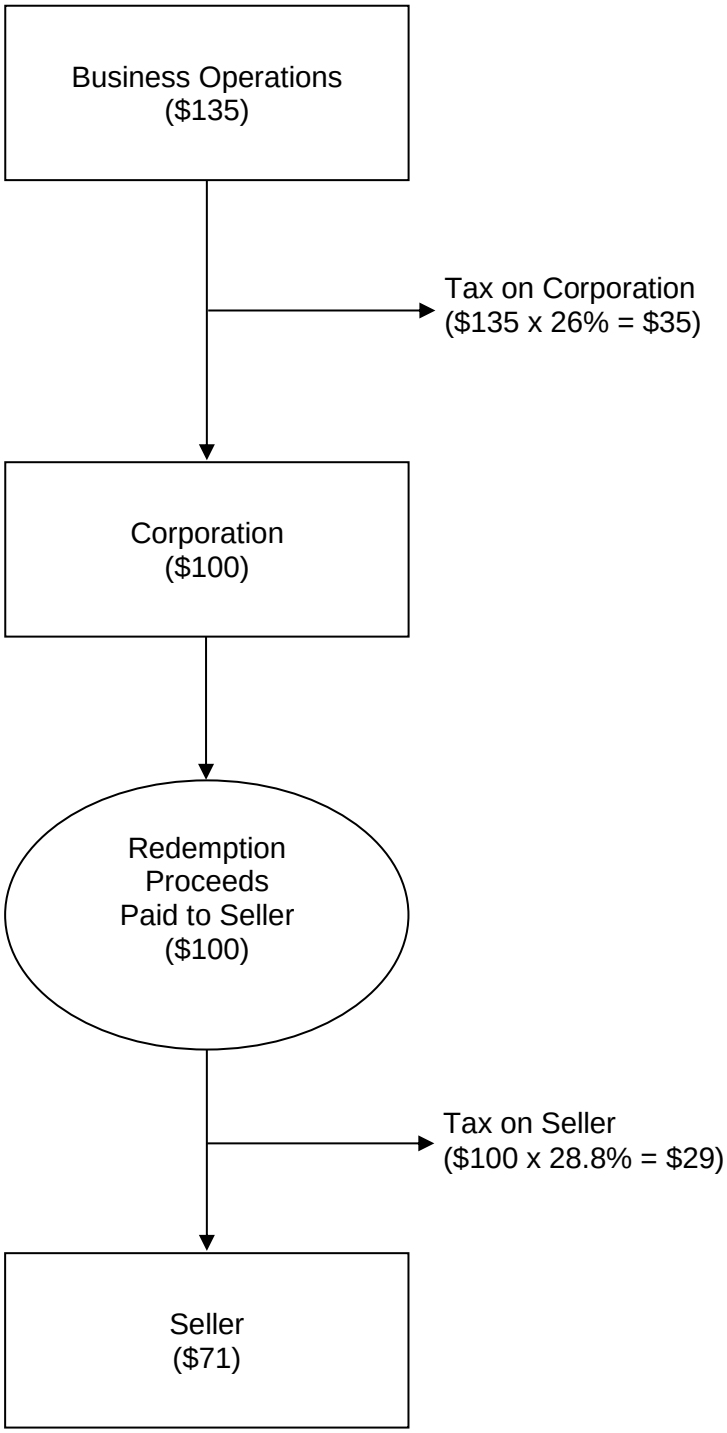
[3763] See part II.Q.1.a.i.(d) S Corporation Double Taxation.

[3764] See part II.Q.1.a.i.(e) Partnership Single Taxation of Goodwill.

**II.Q.1.a.i.(a). C Corporation Triple Taxation**

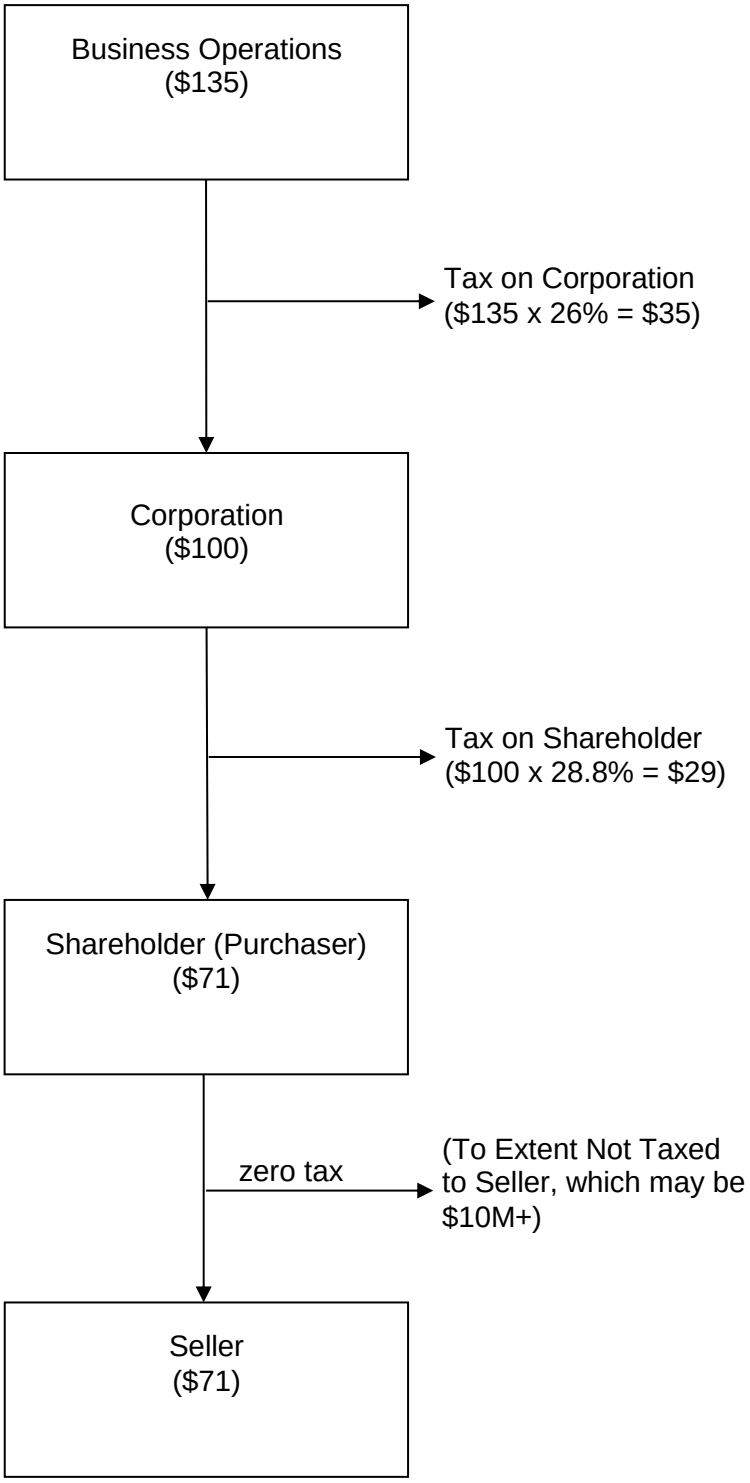


**II.Q.1.a.i.(b). C Corporation Redemption**



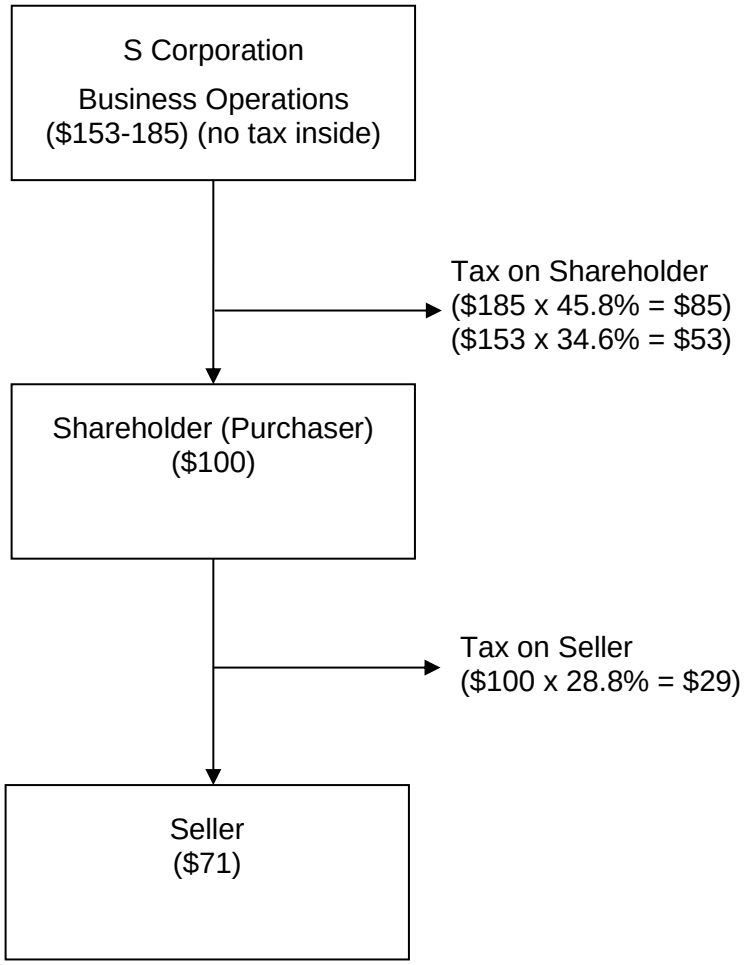

See part II.Q.7.a.ii Hybrid Between Redemption and Cross-Purchase When Selling to New Shareholder or Other Shareholders. The buyer may benefit more from buyer's future sale if buys from corporation more than two years before the seller is redeemed. See part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation.

**II.Q.1.a.i.(c). C Corporation Double Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation**




This structure may be required to avoid the anti-redemption rules described in the text accompanying and preceding fn 4727 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

**II.Q.1.a.i.(d). S Corporation Double Taxation**




Notes:

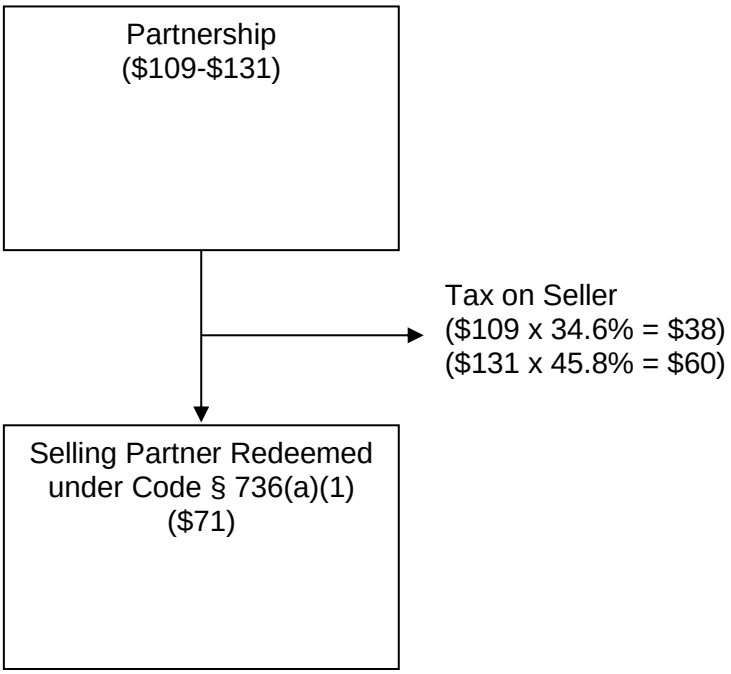
The buyers might very well have lower income tax rates than the seller, resulting in a decreased amount of earnings needed to buy out the seller. For example, a 40% income tax rate would require only $167 of earnings (40% of $167 is $67 tax).

Although an S corporation buyout might be perceived as the same as a Code § 736(b) buyout, it is not. Each year's Code § 736(b) payment creates a new goodwill asset that can amortized over 15 years. This option is not available to S corporations.

This scenario assumes corporate goodwill. Personal goodwill can be dealt with more effectively than corporate goodwill.

If and to the extent sale price is based on accumulated earnings rather than goodwill, sale price is not taxable and exclusion under part II.Q.1.a.i.(c) is not more favorable.

### II.Q.1.a.i.(e). Partnership Single Taxation of Goodwill



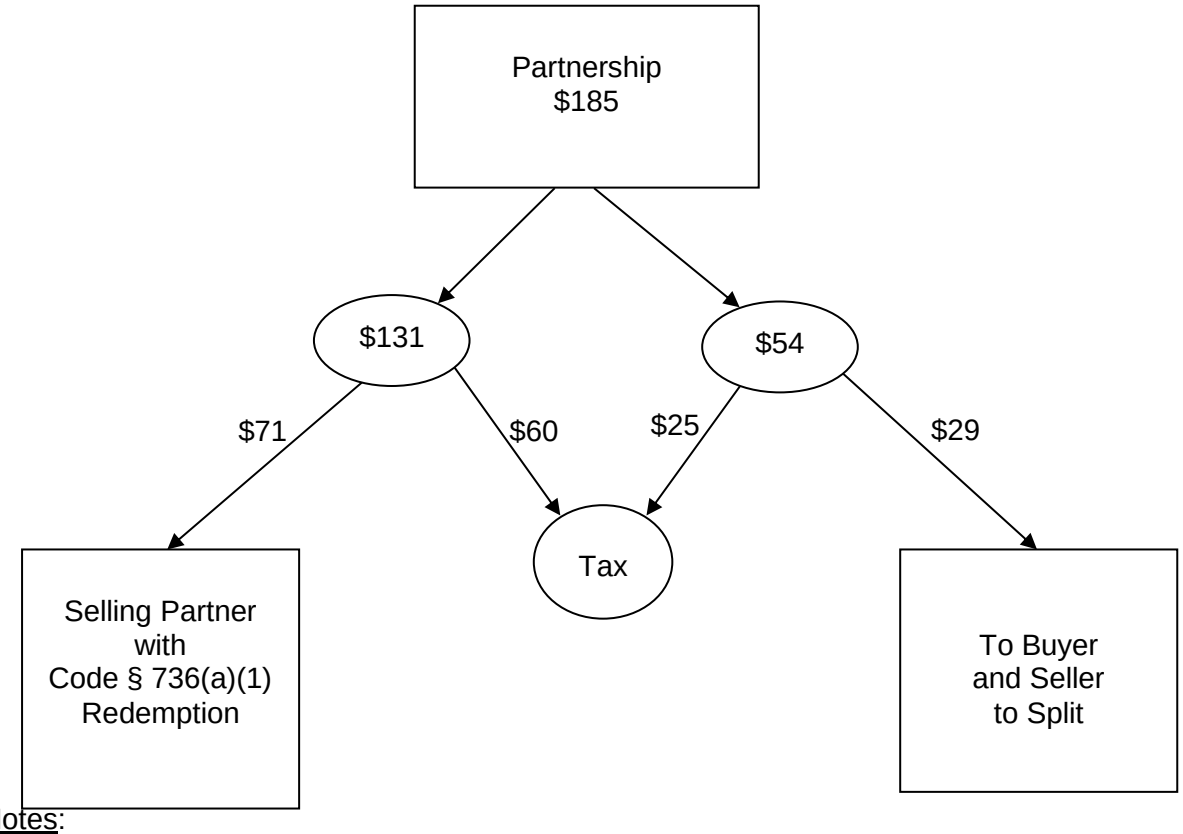

For more details on the tax and nontax benefits of this structure, see part II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill, as well as part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736, which includes allowing income to be taxed to the seller under Code § 736(a).

See part II.Q.8.b.ii.(b) Flexibility in Choosing between Code § 736(a) and (b) Payments (including in fns. 4981-4983 the requirement that, to obtain Code § 736(a) treatment with respect to unrealized receivables and goodwill, a retiring partner must be a general partner and capital cannot be a material income-producing factor).

If the partnership is not a service partnership, one might need to use a preferred profits interest instead of Code § 736(a) payments. However, consider whether such a reallocation of profits might constitute a shifting of goodwill that should be reflected in capital accounts and therefore might constitute a taxable shift of a capital account.[3765]

[3765] See fn. 480 in part II.C.6 Shifting Rights to Future Profits.

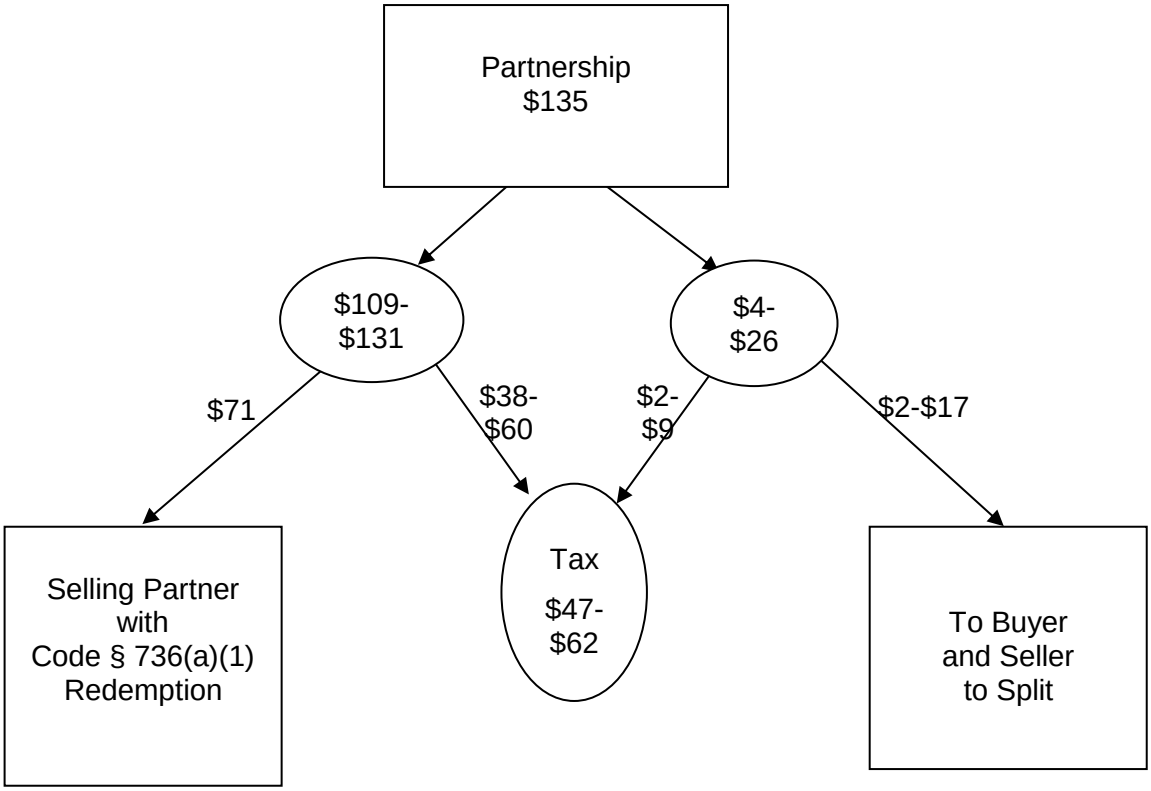
**II.Q.1.a.i.(f). Partnership Use of Same Earnings as S Corporation in Sale of Goodwill**




Notes:

- This scenario uses the income from the scenario II.Q.1.a.i.(d) S Corporation Double Taxation and applies the concepts from part II.Q.1.a.i.(e) Partnership Single Taxation of Goodwill. The left side of the flowchart duplicates the partnership scenario, with $131 of earnings and $71 of tax. The right side of the flowchart takes the $185 from the S corporation double taxation scenario and subtracts from it the $131 from the partnership scenario, resulting in $54 extra earnings in the partnership scenario not needed to generate $71 for the seller. However, these $54 of extra earnings are subject to $25 of income tax, so that only $29 is left, net after-tax.
- The $29 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 29% after-tax dollars that the parties can allocate.
- In either scenario, $185 is subjected to ordinary income tax.

**II.Q.1.a.i.(g). Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill**




Notes:

- This scenario uses the income ($135) from the scenario in in part II.Q.1.a.i.(b) C Corporation Redemption or part II.Q.1.a.i.(c) C Corporation Double Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation and applies the concepts from part II.Q.1.a.i.(e) Partnership Single Taxation of Goodwill. The left side of the flowchart duplicates the partnership scenario, with $109-$131 of earnings and $38-$60 of tax. The right side of the flowchart takes the $135 from the C corporation scenario and subtracts from it the $109-$131 from the partnership scenario, resulting in $4-$26 extra earnings in the partnership scenario not needed to generate $70 for the seller. However, these $4-$26 of extra earnings are subject to $2-$9 of income tax, so that only $2-$17 is left, net after-tax.
- The $2-$17 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 4%-17% after-tax dollars that the parties can allocate.
- In either scenario, $135 is subjected to ordinary income tax.

### II.Q.1.a.ii. California Scenarios

See assumptions in part II.Q.1.a.i Scenario for Moderate State Tax. Consider the portion of the business' equity representing internally generated goodwill, and assume the following top marginal income tax rates, which might or might not be attained:

Sale of Goodwill - Assumptions

| | | |
|---|---|---|
| C corp. income tax rate: | 21.0% | federal |
| | 8.8% | state (really 8.84%) |
| | 29.8% | |
| Individual capital gain rate: | 20.0% | federal |
| | 13.3% | state |
| | 3.8% | net investment income (NII) tax |
| | 37.1% | |
| S corporation income rate: | 29.6%-37% | federal |
| | 13.3% | state individual |
| | 1.5% | state entity |
| | zero-3.8% | NII tax |
| | 44.4%-55.6% | |
| Partnership income rate: | 29.6%-37% | federal |
| | 13.3% | state |
| | zero-3.8% | NII or SE tax |
| | 42.9%-54.1% | |

The capital gain rate for individuals might be overstated when a person sells stock in an S corporation, because the 3.8% tax on net investment income would not apply with respect to the business assets allocable to that stock when a shareholder who is active in the business sells the stock.[3766] The partnership income tax rate might be overstated, either if the partner is a limited partner not subject to self-employment tax[3767] or if the payment is neither self-employment income[3768] nor attributable to business assets allocable to the partnership interest when a partner who is active in the business sells the partnership interest.[3769]

The scenario in the left column below assumes that the buyer uses after-tax dollars to buy the seller's interest in the business. The tax to the buyer in the left column is based on the ordinary income rates, because the buyer is using income generated by operations to fund the payments to the seller. The seller is receiving income at capital gain rates.

[3766] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[3767] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner.
[3768] See part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.
[3769] See parts II.I.8.d Partnership Structuring in Light of the 3.8% Tax on Net Investment Income and II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

| | Capital Gain to Seller | Ordinary Income to Seller |
|---|---|---|
| Profit | $ 175-218 | $ 110-137 |
| Tax to Buyer | - (75-118) | - 0 |
| | $ 100 | $ 110-137 |
| Tax to Seller | - 37 | - (47-74) |
| Net to Seller | $ 63 | $ 63 |

The tax in the right-hand column assumes that the buyer deducts payments to the seller, which is essentially what happens when one pays off a seller by allocating current partnership income to the seller.

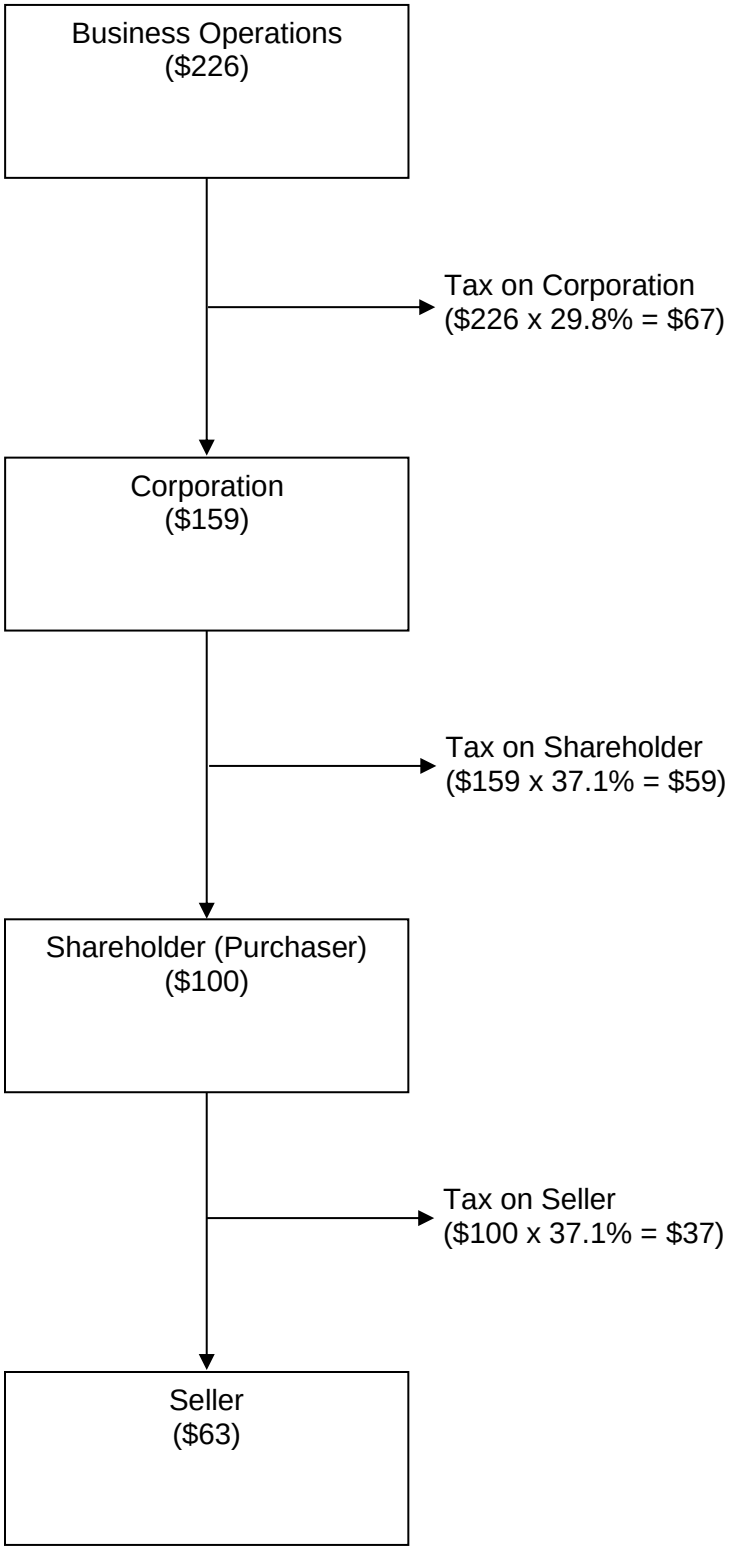
The illustrations ignore the California LLC fee (gross receipts tax) of up to nearly $12K that applies to an LLC taxed as a partnership. If the partnership uses the structure recommended in part II.E.6 Recommended Partnership Structure – Flowchart:

- This fee of up to nearly $12K would be imposed on each LLC subsidiary annually,
- Self-employment tax would not apply, and
- California's 1.5% entity-level tax on S corporations would apply to the general partner's 1% annual income and any profit from its management fee in excess of salaries paid to the owners.

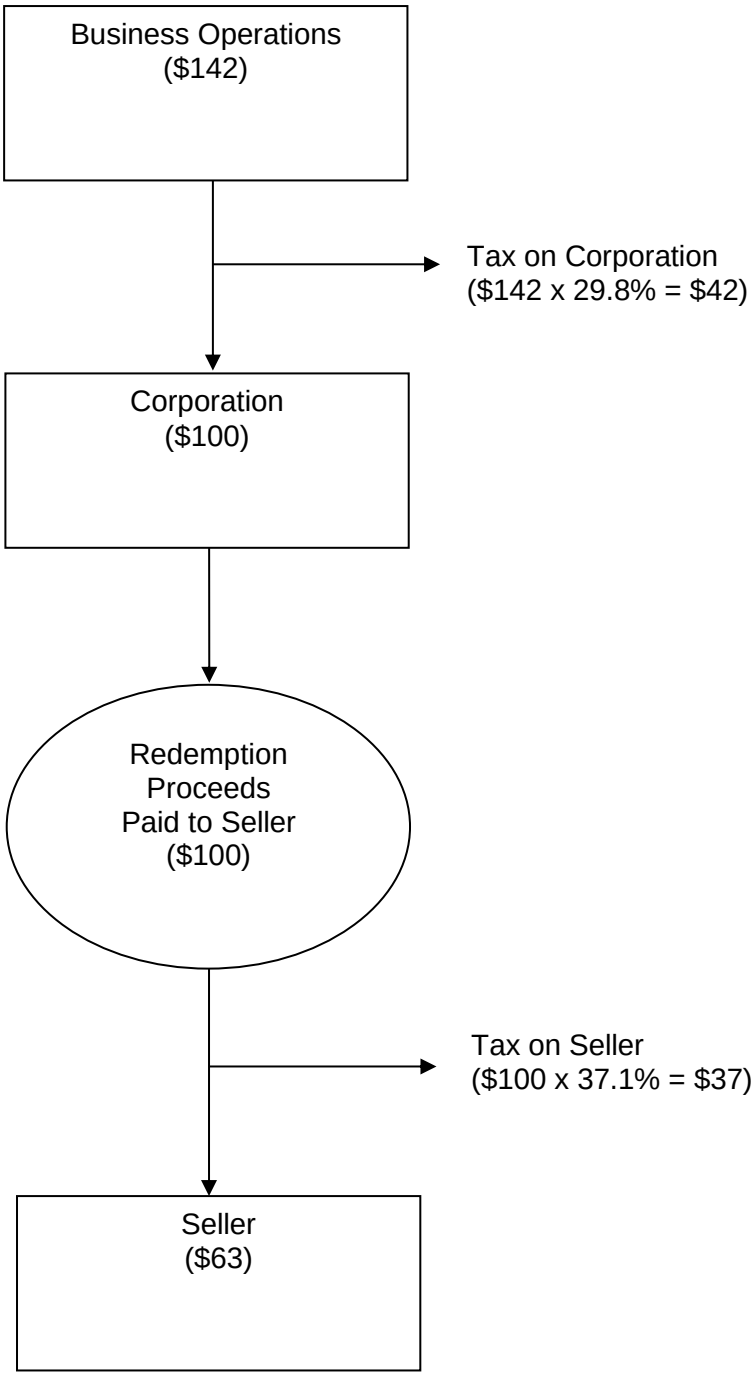
The following pages illustrate this concept, showing that it takes a C corporation $288 in earnings to do a cross-purchase (one owner sells to another)[3770] and $225 to do either a redemption (entity buys from seller)[3771] or a cross-purchase using an exclusion that applies to the sale of certain stock,[3772] an S corporation $218 in earnings,[3773] and a partnership only $147 in earnings[3774] to get $62 to the seller.

[3770] See part II.Q.1.a.ii.(a) C Corporation Triple Taxation (California).
[3771] See part II.Q.1.a.ii.(b) C Corporation Redemption (California). Redeeming the seller entirely might work if buying out one owner and increasing the other owners' interests in proportion to each other. However, if the sole owner is selling, or if the remaining owners are not increased in proportion to each other, then a cross-purchase or a stock issuance is needed to get the remaining owners' interests in the correct proportion, followed by the redemption. For approval of combining a cross-purchase with a redemption, see part II.Q.7.a.ii Hybrid Between Redemption and Cross-Purchase When Selling to New Shareholder or Other Shareholders.
[3772] See part II.Q.1.a.ii.(c) C Corporation Triple Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation (California).
[3773] See part II.Q.1.a.ii.(d) S Corporation Double Taxation (California).
[3774] See part II.Q.1.a.ii.(e) Partnership Single Taxation of Goodwill (California).

**II.Q.1.a.ii.(a). C Corporation Triple Taxation (California)**

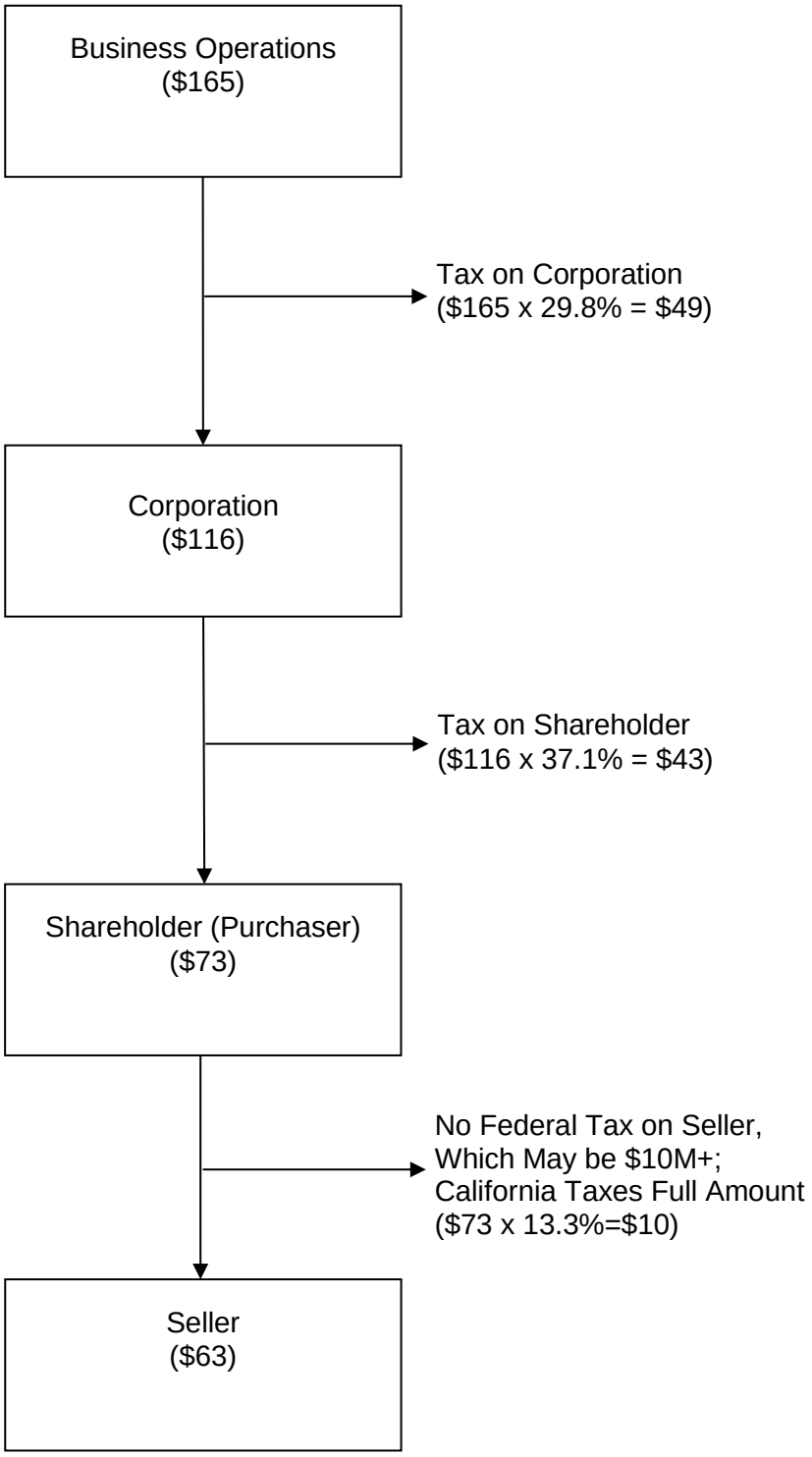


**II.Q.1.a.ii.(b). C Corporation Redemption (California)**

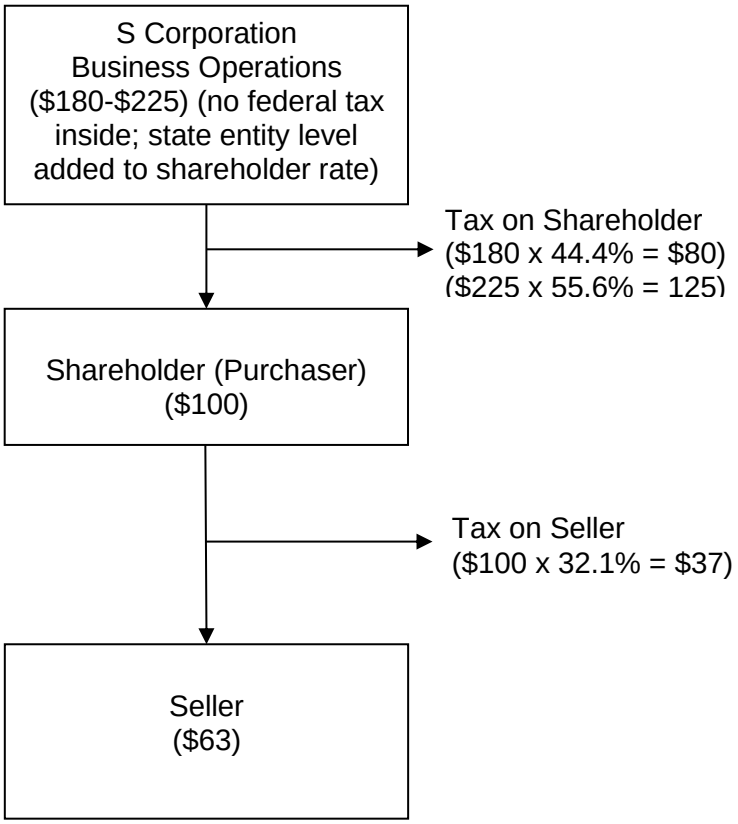



See part II.Q.7.a.ii Hybrid Between Redemption and Cross-Purchase When Selling to New Shareholder or Other Shareholders. The buyer may benefit more from buyer's future sale if buys from corporation more than two years before the seller is redeemed. See part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation.

**II.Q.1.a.ii.(c). C Corporation Triple Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation (California)**



**II.Q.1.a.ii.(d). S Corporation Double Taxation (California)**




Notes:

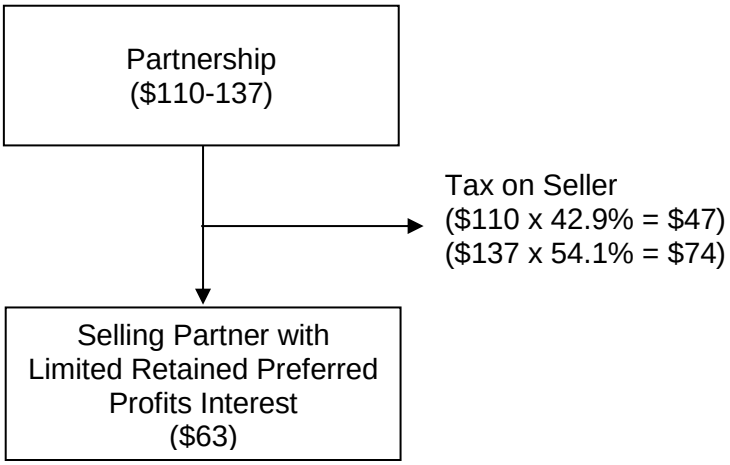
The buyers might very well have lower income tax rates than the seller, resulting in a decreased amount of earnings needed to buy out the seller.

Although an S corporation buyout might be perceived as the same as a Code § 736(b) buyout, it is not. Each year's Code § 736(b) payment creates a new goodwill asset that can amortized over 15 years. This option is not available to S corporations.

This scenario assumes corporate goodwill. Personal goodwill can be dealt with more effectively than corporate goodwill.

If and to the extent sale price is based on accumulated earnings rather than goodwill, sale price is not taxable and exclusion under part II.Q.1.a.ii.(c) is not more favorable.

### II.Q.1.a.ii.(e). Partnership Single Taxation of Goodwill (California)



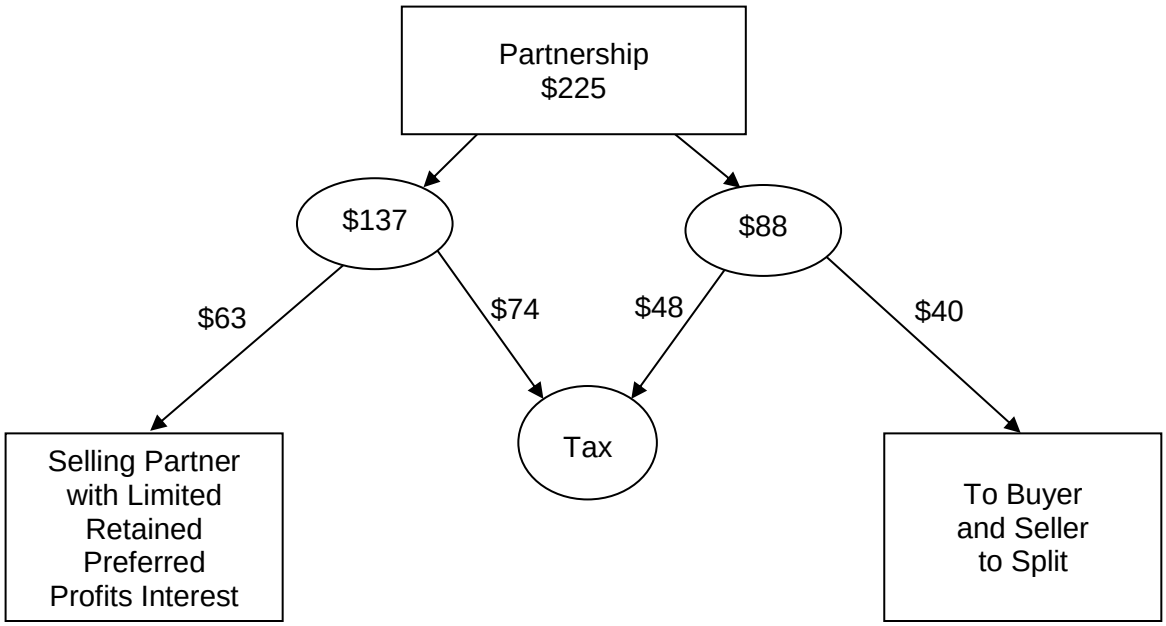

For more details on the tax and nontax benefits of this structure, see part II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill, as well as part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736, which includes allowing income to be taxed to the seller under Code § 736(a).

See part II.Q.8.b.ii.(b) Flexibility in Choosing between Code § 736(a) and (b) Payments (including in fns. 4981-4983 the requirement that, to obtain Code § 736(a) treatment with respect to unrealized receivables and goodwill, a retiring partner must be a general partner and capital cannot be a material income-producing factor).

If the partnership is not a service partnership, one might need to use a preferred profits interest instead of Code § 736(a) payments. However, consider whether such a reallocation of profits might constitute a shifting of goodwill that should be reflected in capital accounts and therefore might constitute a taxable shift of a capital account.[3775]

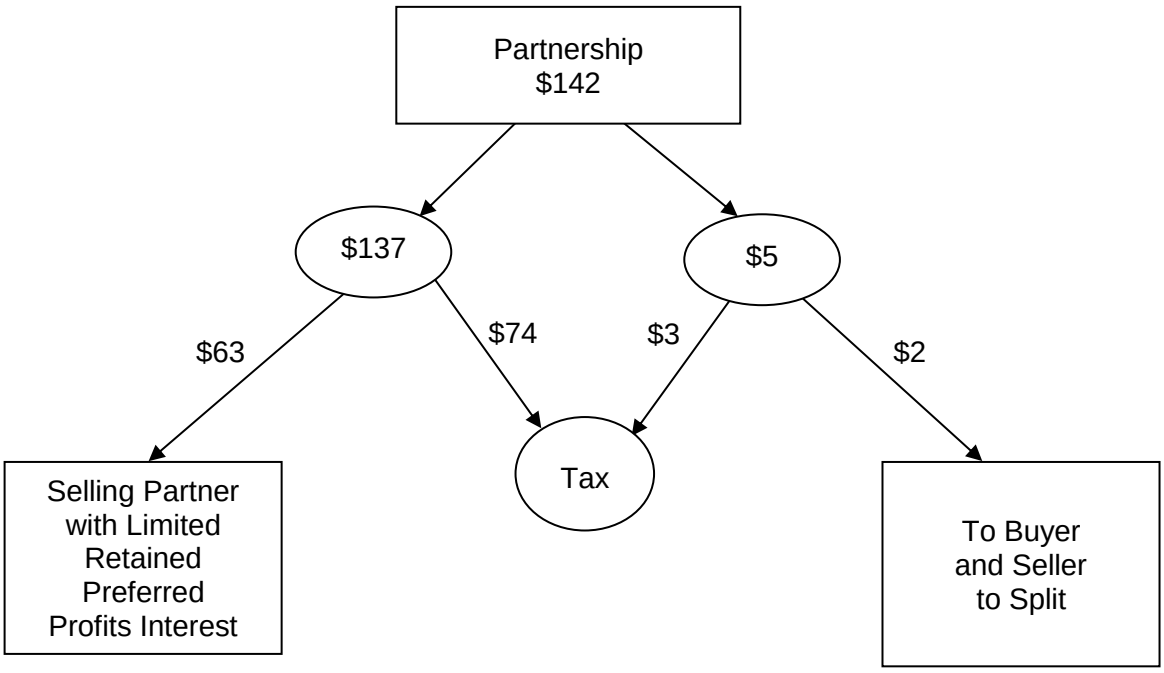
[3775] See fn. 480 in part II.C.6 Shifting Rights to Future Profits.

**II.Q.1.a.ii.(f). Partnership Use of Same Earnings as S Corporation in Sale of Goodwill (California)**




- This scenario uses the income from the scenario in part II.Q.1.a.ii.(d) S Corporation Double Taxation (California) and applies the concepts from part II.Q.1.a.ii.(e) Partnership Single Taxation of Goodwill (California). The left side of the flowchart duplicates the partnership scenario, with $137 of earnings and $74 of tax. The right side of the flowchart takes the $225 from the S corporation double taxation scenario and subtracts from it the $137 from the partnership scenario, resulting in $88 extra earnings in the partnership scenario not needed to generate $63 for the seller. However, these $88 of extra earnings are subject to $48 of income tax, so that only $40 is left, net after-tax.
- The $40 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 40% after-tax dollars that the parties can allocate. The $40 savings consists of $37 capital gain tax and $3 entity level tax (1.5% of $225 S corporation earnings).
- In either scenario, $225 is subjected to ordinary income tax.
- If the buyers are in a lower tax bracket than the seller, then not as much money is required in the S corporation scenario and the $40 net-after-tax amount can be reduced or eliminated.

**II.Q.1.a.ii.(g). Partnership Use of Same Earnings as C Corporation – Redemption (California)**

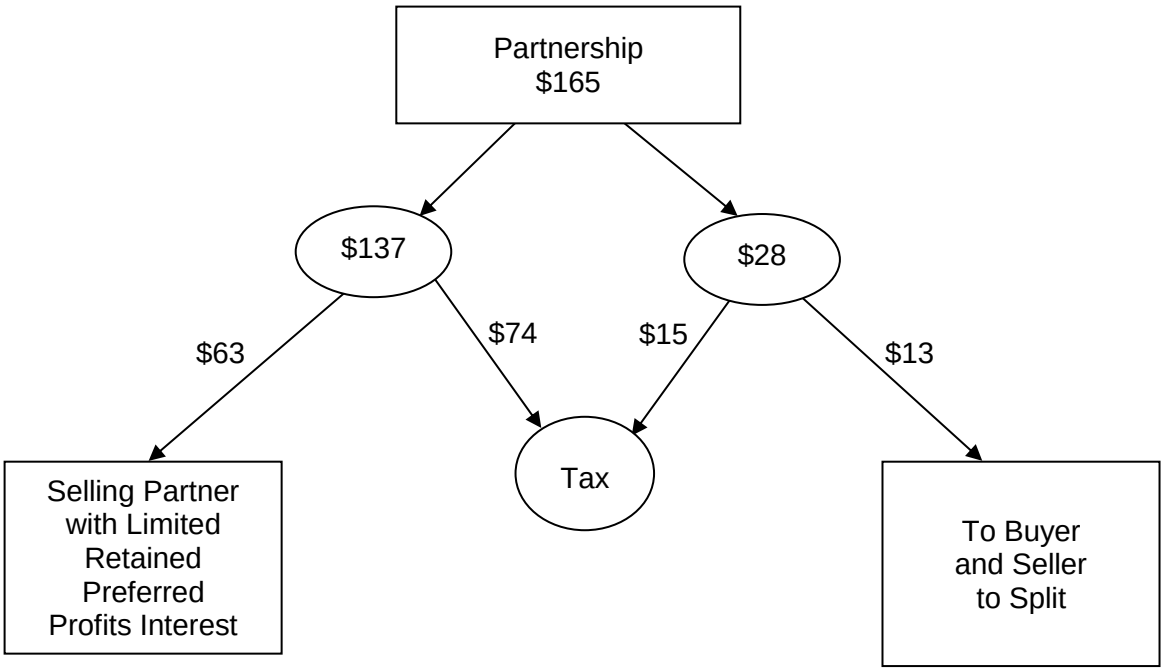



Notes:

- This scenario uses the income from the scenario in part II.Q.1.a.ii.(b) C Corporation Redemption (California) and applies the concepts from part II.Q.1.a.ii.(e) Partnership Single Taxation of Goodwill (California). The left side of the flowchart duplicates the partnership scenario, with $137 of earnings and $74 of tax. The right side of the flowchart takes the $142 from the C corporation double tax scenario and subtracts from it the $137 from the partnership scenario, resulting in $5 extra earnings in the partnership scenario not needed to generate $63 for the seller. However, these $5 of extra earnings are subject to $3 of income tax, so that only $2 is left, net after-tax.
- The $2 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 2% after-tax dollars that the parties can allocate.

In either scenario, $142 is subjected to ordinary income tax.

**II.Q.1.a.ii.(h). Partnership Use of Same Earnings as C Corporation – No Federal Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation in Sale of Goodwill (California)**




Notes:

- This scenario uses the income from the scenario in part II.Q.1.a.ii.(c) C Corporation Triple Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation (California) and applies the concepts from part II.Q.1.a.ii.(e) Partnership Single Taxation of Goodwill (California). The left side of the flowchart duplicates the partnership scenario, with $137 of earnings and $74 of tax. The right side of the flowchart takes the $165 from the C corporation double tax scenario and subtracts from it the $137 from the partnership scenario, resulting in $28 extra earnings in the partnership scenario not needed to generate $63 for the seller. However, these $28 of extra earnings are subject to $15 of income tax, so that only $13 is left, net after-tax.
- The $13 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 13% after-tax dollars that the parties can allocate.

In either scenario, $165 is subjected to ordinary income tax.

**II.Q.1.a.iii. Migrating to a Partnership Structure**

For what might be an ideal partnership structure, see part II.E Recommended Structure for Entities, especially parts II.E.3 Recommended Structure for Start-Ups, II.E.4 Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure, II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons, and II.E.6 Recommended Partnership Structure – Flowchart.

Parts II.E.7 Migrating into Partnership Structure and II.E.9 Real Estate Drop Down into Preferred Limited Partnership explain how to get there.

### II.Q.1.b. Leasing

Some assets used in a business might be held outside of the business and then leased to the business. The buyer continues to lease these assets from the seller. Such lease payments are deductible to the buyer and taxable to the seller, and the seller is not necessarily at risk in that the seller might be able to sell the property to a third party. If a partnership holds the business, the partnership that conducts business operations can save its owners self-employment (SE) tax by leasing real estate instead of owning it;[3776] However, equipment leasing generally would be subject to SE tax.[3777] Also note that Florida and perhaps other states impose a tax on gross rents.

If a long-term lease provides rent above the property's fair rental value, a lease termination payment is deductible as an ordinary business expense, even if the tenant buys the property;[3778] however, be prepared for a fight with the IRS and to go to District Court, because the Tax Court will require the taxpayer to capitalize the lease termination fee outside of the Sixth Circuit.[3779] On the other hand, amounts a lessee receives for the cancellation of a lease are considered as amounts received in exchange for that lease;[3780] although this exchange treatment does not affect whether the lease is a capital asset as to the lessee,[3781] it very well may be.[3782]

---

[3776] Real estate rental income received on a long-term basis is not subject to self-employment tax, Reg. § 1.1402(a)-4(a) (see part II.L.2.a.ii Rental Exception to SE Tax, especially fn. 3096), whereas the rent deduction would reduce self-employment income, if any, of the operating business. In early years of owning the real estate, rent deductions might not produce much saving relative to depreciation, interest expense, insurance and taxes; in later years, however, the saving might be significant. Although rental income generally is subject to the 3.8% tax on net investment income (NII), rental to a business with sufficient common ownership is not NII. See part II.I.8.c Application of 3.8% Tax to Rental Income.

[3777] See part II.L.2.a.ii Rental Exception to SE Tax, fns 3101-3105.

[3778] *ABC Beverage Corporation v. U.S.*, 756 F.3d 438 (6th Cir. 2014) (of $9M purchase price, $6.25M allocated to lease termination expense).

[3779] *Union Carbide Foreign Sales Corp. v. Commissioner*, 115 T.C. 423 (1993) (holding that Code § 167(c)(2) compelled that result). Code § 167(c)(2) provides:

> If any property is acquired subject to a lease-
> (A) no portion of the adjusted basis shall be allocated to the leasehold interest, and
> (B) the entire adjusted basis shall be taken into account in determining the depreciation deduction (if any) with respect to the property subject to the lease.

The Sixth Circuit's opinion in fn. 3778 pointed out that the purchase extinguished the lease; because the lease did not continue after the purchase, the property was not acquired subject to the lease.

[3780] Code § 1241.

[3781] Reg. § 1.1241-1(a).

[3782] In Letter Ruling 200045019, the tenant entered into a commercial lease, then later claimed that the rent that it paid was too high because it used the property primarily for residential purposes. After stating that the local housing authority ruled in the tenant's favor, the Ruling continued:

> City's rent control law gives a tenant the right to continued possession of a property and establishes the maximum rent that may be charged. This right of possession is for an indefinite time period. The landlord may evict such a tenant only under specific circumstances as listed in the Statute.
>
> As a result of the determination that the Premises were subject to the rent control law, the landlord agreed to pay Taxpayer $s in return for Taxpayer surrendering all lease and statutory rights to the Premises. This agreed sum represents $m plus $n to cover estimated taxes. The estimated tax amount was determined under the assumption that Taxpayer's gains from the transaction would be treated as capital gains. Further, the landlord agreed to pay an additional amount, up to $u, plus interest and penalties, if the Internal Revenue Service determines that the

gain is ordinary. Finally, the landlord agreed to pay $v to a law firm to cover Taxpayer's legal fees.

In finding that the lease termination payment was capital gain, the Ruling reasoned:

> We note that section 1231, rather than section 1221, may apply to the instant case because the facts indicate that Taxpayer's leasehold may have been used in part, or for a portion of the lease period, for the conduct of Taxpayer's business. Business use of real property precludes that property from receiving capital asset treatment under section 1221(2). However, we do not need to determine whether the leasehold is excluded under section 1221(2) because it will either be a section 1221 capital asset or a section 1231 asset. In either case, the gain recognized on the exchange of the leasehold will be capital, rather than ordinary.
>
> In Rev. Rul. 72-85, 1972-1 C.B. 234, the Service determined that a leasehold of land used in a trade or business is section 1231 property, even if it is of indefinite duration. This revenue ruling clarified Rev. Rul. 56-531, 1956-2 C.B. 983, which holds, in part, that the Service acquiesces in *McCue Bros. & Drummond, Inc. v. Commissioner*, 19 T.C. 667 (1953), *acq.* 1956-2 C.B. 7, *aff'd*, 210 F.2d 752 (2d Cir. 1954), *cert. denied*, 348 U.S. 829 (1954).
>
> The petitioner in *McCue Bros.* leased a hat shop in New York City. For a portion of his occupancy, the petitioner held the property under a written lease. However, after the lease expired, the petitioner continued to occupy the property under a "statutory tenancy" by virtue of the New York rent control laws that had taken effect shortly before the end of the written lease. In affirming the Tax Court in *McCue Bros.*, the Second Circuit stated that it was immaterial whether the petitioner held the property under a lease or through the rent control laws. The court stated, "we think the right of possession under a lease or otherwise, is a ...substantial property right which does not lose its existence when transferred. If it is sold by the tenant to a third person, the gain derived therefrom is a capital gain." 210 F.2d at 753. The court further stated that the holding period began when the statutory right of possession attached. *Id.* at 754.
>
> In *Stotis v. Commissioner*, T.C. Memo. 1996-431, the Tax Court came to a similar result in the case of a residential leasehold. Mr. Stotis, the petitioner, leased space in an apartment building that he used as a residence. The landlord, desiring to use the real estate for other purposes, entered into a surrender agreement with the petitioner whereby the petitioner exchanged his right in the property for a cash payment. The Tax Court held that the petitioner's leasehold interest in a residence was a capital asset, and that the petitioner's sale of the leasehold interest constituted a sale or exchange, taxable as capital gain.
>
> The facts of this case are not clear as to whether the property in question is properly treated as real property used in the trade or business for purposes of sections 1221 and 1231. If it is not real property used in the trade or business, the leasehold interest is a capital asset under section 1221. If it is real property used in the trade or business, any gain attributable to the sale or exchange of the leasehold interest is treated as long-term capital gain under section 1231. Taxpayer's holding period began with the vesting of the statutory right of occupancy on c. Therefore, Taxpayer held the property for more than one year. Additionally, under Rev. Rul. 72-85, the fact that Taxpayer's leasehold interest under the rent control laws was for an indefinite period does not preclude section 1231 long-term capital gain treatment.
>
> Under section 1241, amounts received by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), are considered as amounts received in exchange for such lease or agreement.
>
> Based on the foregoing, we conclude that the amounts received by Taxpayer are considered amounts received in exchange for Taxpayer's leasehold interest in the Premises. Further, we conclude that Taxpayer realized long-term capital gain on the sale of the leasehold interest. Taxpayer's interest in the Premises is either a capital asset under section 1221 or real property used in the trade or business under section 1231. In either event, gain realized from the sale of the leasehold interest is treated as long-term capital gain. Payments of the legal fees and income taxes are part of the purchase price to the extent that such payments are given in exchange for Taxpayer's leasehold interest and not for Taxpayer abandoning some other legal right or property not related to the transaction in question.

Generally, real property should not be held in the entity that conducts the business. As discussed above, for self-employment tax purposes it should not be owned by a partnership that has business operations. Because appreciated real estate cannot be distributed from a corporation without triggering either premature (in the case of an S corporation) or double (in the case of a C corporation) taxation under Code § 311,[3783] usually real estate should not be held in a corporation (see footnote 358 for some of the issues, including basis step-up issues, involved in whether real estate should be in a corporation).

### II.Q.1.c. Personal Goodwill and Covenants Not to Compete

#### II.Q.1.c.i. Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation

If the business entity does not require its key employees to agree not to compete, the key employees might leave and take their contacts with them. Thus, in such situations the key employees really "own" the business' goodwill. When the business is sold, the buyer would buy goodwill from the person who owns the goodwill, pay key employees not to compete, pay the key employees to work in the business, or a combination of any of these.

When self-created goodwill is sold, generally the seller receives favorable capital gain treatment and the buyer deducts over 15 years the sum of the payments;[3784] furthermore, that capital gain may qualify for an exclusion from the 3.8% tax on net investment income.[3785] (Also goodwill that is not being amortized and is held by a partnership would be eligible for a basis step if a Code § 754 election is in place.[3786]) This capital gain treatment may incentivize taxpayers to

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Note, however, that, gain from the sale of a Code § 1231 asset may be different than gain from the sale of a capital asset. If the taxpayer had Code § 1231 losses in a prior year, those losses may have converted the gain to ordinary income. See part II.G.6.a Code § 1231 Property, especially fns. 1373-1374.

[3783] Code § 311 provides that, when a corporation distributes property, the distribution constitutes a sale or exchange by the corporation. See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders. Together with the rules governing income taxation of shareholders:

- For an S corporation, generally this means that the shareholders are taxed on the exchange (with favorable capital gain rates often available), receive an increased tax basis in their stock equal to the gain reported, reduce the basis of their stock to the extent of the value of the property that was distributed, and adjust to fair market value the basis of the property that was distributed.
- For a C corporation, generally this means that the corporation pays income tax (with favorable capital gain rates not available) and the shareholders are taxed on the distribution as a dividend, thus generating two layers of tax. However, as with an S corporation, the distributed property's basis is adjusted to fair market value.

[3784] *Horton v. Commissioner*, 13 T.C. 143 (1949) (income from the sale of goodwill is capital gain, whereas income from a noncompete agreement is ordinary income); Code § 197(a), (d)(1)(A) (deduction for amortizing goodwill). Although Reg. § 1.197-2(d)(2) disallows amortization deductions for self-created goodwill, it allows amortization when the taxpayer buys the goodwill (including from someone who bought it from the taxpayer). *Fitch v. Commissioner*, T.C. Memo. 2012-358 rebuffed an IRS attack on repurchased goodwill using a very simple contract. But for Code § 197, goodwill is not amortizable. Reg. § 1.167(a)-3(a).

[3785] See text accompanying and preceding fn 2238 in part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

[3786] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 5159. For an

allocate proceeds from sales of intangibles to goodwill, because the sale of some intangibles generates ordinary income instead of capital gain, as described in part II.G.19.b Sale or Exchange of Intellectual Property - Capital Gain vs. Ordinary Income. However, ordinary income treatment applies to the sale to a related party,[3787] which applies whether or not the goodwill was being amortized.[3788] Furthermore, the amortization of goodwill causes it to lose its status as a capital asset, which in some circumstances can cause part or all of the gain on sale to lose capital treatment.[3789] Additional rules are described in the text accompanying fn 1571 in part II.G.19.d Amortization of Code § 179 Intangibles.

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example of the effect of a Code § 754 election on goodwill that is being amortized, see fn. 5332 in part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership.

[3787] See parts II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), which applies to sale of an S corporation's goodwill, and II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

[3788] See text accompanying fn. 4587.

[3789] Letter Ruling 200243002 ruled that the sale of goodwill that has not been amortized is taxed as a capital gain, but goodwill that is being amortized is not a capital asset and therefore was subject to tax at ordinary income rates. However, amortizable goodwill may be eligible for capital gain treatment as described in part II.G.6 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, especially fn. 1367. Because capital gain treatment in that situation arises solely by reason of Code § 1231, any Code § 1231 gain is taxed as ordinary income if and to the extent the taxpayer has unrecaptured Code § 1231 losses. Code § 1231 losses are ordinary losses generated by the sale of Code § 1231 property (property used in a trade or business).

Elaborating on the above, Letter Ruling 200243002 reasoned:

> It is well settled that prior to enactment of § 197, goodwill and going concern value were considered to be intangible and nonamortizable capital assets within the meaning of § 1221, by both the Service and the courts. Rev. Rul. 65-180, 1965-2 C.B. 279; Rev. Rul. 55-79, 1955-1 C.B. 370; *UFE, Inc. v. Commissioner*, 92 T.C. 1314, 1323 (1989) ("going-concern value is an intangible, nonamortizable capital asset that is often considered to be part of goodwill"); *Patterson v. Commissioner*, 810 F.2d 562, 569 (6th Cir. 1987) (stating that "any amount paid for goodwill, since it does not waste, becomes a nonamortizable capital asset," and "amounts received by a seller for the goodwill or going concern value of the business are taxed at the more favorable capital gains rates"); *Better Beverages, Inc. v. United States*, 619 F.2d 424, 425 n. 2 (5th Cir. 1980) ("goodwill is a capital asset"); *Dixie Finance Co. v. United States*, 474 F.2d 501, 506 n. 5 (5th Cir. 1973) (goodwill is a capital asset and amounts received therefor in excess of the seller's basis are treated as capital gains, but represent a nonamortizable capital investment resulting in no corresponding deduction for the purchaser); *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963) ("[i]t is settled that goodwill, as a distinct property right, is a capital asset under the tax laws "); *Michaels v. Commissioner*, 12 T.C. 17 (1949) ("[w]e entertain no doubt that goodwill and such related items as customers' lists are capital assets").
>
> Prior to enactment of § 197, goodwill and going concern value were not considered property used in the trade or business of a character which is subject to the allowance for depreciation provided in § 167, and thus were not excluded from the definition of capital asset by reason of § 1221(a)(2) of the Code. Under § 197, an amortizable section 197 intangible is treated as property of a character which is subject to the allowance for depreciation under § 167. Thus, goodwill and going concern value which are amortizable section 197 intangibles are not capital assets for purposes of § 1221, but if used in a trade or business and held for more than one year, gain or loss upon their disposition generally qualifies as § 1231 gain or loss. Taxpayer has questioned whether enactment of § 197 has changed the treatment of goodwill and going concern value as capital assets for goodwill and going concern value that do not qualify as amortizable section 197 intangibles.
>
> In this case, Taxpayer represents that at the time of each sale of the c, the Goodwill is either self-created Goodwill of the selling entity (or a subsidiary of the selling entity acquired by the selling

Also, the sale and subsequent amortization of goodwill turns it into a "hot" asset, reducing opportunities for deferral on its sale.[3790] Whether or not goodwill is being amortized, a controlled corporation's sale or distribution of goodwill might generate ordinary income,[3791] as would a sale involving a partnership.[3792]

When a covenant not to compete is involved, generally the seller receives ordinary income treatment and the buyer deducts the present value of the payments over 15 years.[3793]

Thus, compensation for current services, which is deductible in full when paid, is much more beneficial to buyers than either of the above alternatives. Taxpayers tend to assign consideration in a sale to whatever produces the fastest deduction – ongoing services, office equipment, etc. Note that assigning a low value to goodwill or a non-compete agreement can have very practical effect – reducing or eliminating damages[3794] – if the agreement is broken, so the buyer is trading deductions for economic risk.

Even if goodwill is taxed to the seller at capital gain rates, deferred compensation[3795] is more tax-efficient than a payment for goodwill; however, the deferred compensation agreement

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entity in a stock transaction) or Goodwill acquired by the selling entity (or a subsidiary of the selling entity acquired by the selling entity in a stock transaction) from third parties prior to August 11, 1993. While it is possible that a selling entity acquired the Goodwill after July 25, 1991, and prior to August 11, 1993, Taxpayer also represents that no retroactive election was made under § 1.197-1T. These representations are material representations. Based solely on Taxpayer's representations with respect to the Goodwill, we conclude that the Goodwill is not an amortizable section 197 intangible, and furthermore is not subject to depreciation under § 167. Thus, the Goodwill is not property that is of a character subject to the allowance for depreciation provided in § 167.

Because we conclude the Goodwill is not an amortizable section 197 intangible and is not property that is of a character subject to the allowance for depreciation provided in § 167, we further conclude that the Goodwill sold by Taxpayer qualifies as a capital asset under § 1221. Although § 197 now provides that goodwill and going concern value that is an amortizable section 197 intangible are not capital assets for purposes of § 1221, it does not address the treatment of goodwill and going concern value that is not an amortizable section 197 intangible, nor does it change prior law treatment of goodwill and going concern value.

[3790] See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests, especially fn. 5129, referring to part II.Q.8.b.i.(f) Code § 751 – Hot Assets.

[3791] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), especially fns. 4584-4588.

[3792] See part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

[3793] Code § 197(a), (d)(1)(E), (f)(3) (buyer's deduction) (see fn 1570 and the rest of part II.G.19.d Amortization of Code § 179 Intangibles); Rev. Rul. 69-643 (seller's income); *Kinney v. Commissioner*, 58 T.C. 1038 (1972); *Coleman v. Commissioner*, T.C. Memo. 2004-126. *Recovery Group Inc. v. Commissioner*, T.C. Memo. 2010-76, held that payments under a one-year covenant not to compete agreed to in connection with the redemption of an employee's stock were deductible over 15 years. The IRS and taxpayer contested the meaning of entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof. The court agreed with the IRS that "thereof" modifies "trade or business," and that "interest" means an ownership interest of any percentage, large or small. The court held alternatively that the employee's 23% stock ownership was substantial.

[3794] A result reported to have happened in *Healthcase v. Orr*, 2016 Cal. App. Unpub. LEXIS 440 (1/20/2016) per *Business Valuation Update*, vol. 22, no. 4 (4/2016).

[3795] Before working in this area, consider reading part II.Q.1.d Nonqualified Deferred Compensation, especially part II.Q.1.d.i IRS Audit Guide for Nonqualified Deferred Compensation..

constitutes a liability on the company's balance sheet that might impair its ability to obtain credit. The benefit of the immediate deduction for compensation for personal services is likely to be of so much benefit to the buyer that the buyer should be willing to pay extra to the seller so that the seller's proceeds after ordinary income tax exceed what the seller would have received for goodwill net of capital gain tax. For example, suppose the seller receives $100 for zero basis goodwill. If the seller's combined federal and state capital gain rate is 20%, the seller receives $80 net of tax. If the buyer pays 40% federal and state tax, the buyer must generate $167 of ordinary income to pay the $100 that it pays the seller. Thus, the buyer needs to earn $167 so that the seller receives $80 net of tax. However, if the buyer and seller both have 40% combined federal and state income taxes, then the seller would need just over $133 in ordinary income to net the same $80 after taxes. Thus, with a compensation payment of $134-$166, both the seller and buyer are better off (ignoring the deduction[3796] the buyer receives for capitalized goodwill in a purchase-of-goodwill scenario). A seller needs "strong proof" that a payment is for goodwill taxable as capital gain rather than a covenant not to compete taxable as ordinary income.[3797]

### II.Q.1.c.ii. Consulting Agreement in Lieu of Covenant Not to Compete

Given that payments to the person selling goodwill are presumed ordinary income[3798] and that they are amortizable over 15 years if for goodwill or covenants not to compete,[3799] consider retaining the seller on a consulting agreement. The buyer might very well need the seller's cooperation to transitions employees, customers, and vendors. If the purchase is amicable, hiring the seller to a lucrative consulting contract can provide not only valuable business benefits but also immediate income tax deductions.

Beware, however, that a consulting contract might very well prevent the seller from having a separation from service that might be needed under Code § 409A. Although that provision is generally viewed as applying to deferred compensation, various payments or noncash benefits triggered by a change in job status might constitute deferred compensation that might require a "separation from service" to avoid imposition of the harsh consequences of Code § 409A.[3800]

Furthermore, when a property right concerns the contractual right to perform a service and receive compensation for the service, a payment made to terminate the contract cannot be considered a capital asset unless the contract confers something more than the right to perform services or receive compensation for services performed.[3801] When an insurance company

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[3796] Although the deduction is valuable, the discounted present value is relatively small, considering that discount rates are high when the sale of a closely-held business is involved. For example, if $100 were capitalized and deducted over 15 years with a 40% tax saving, the extra tax benefit would be $2.67 per year, compared with an immediate tax saving of $20 in not having capital gain on the sale of goodwill. At a 20% discount rate, the present value of these deductions would be $12.48; at a 33% discount rate, the present value would be $7.98.

[3797] *Muskat v. United States*, 554 F.3d 183 (1st Cir. 2009); *Kinney*, fn. 3793. For more on *Muskat*, see fn 5036 in part II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill.

[3798] See fn. 3797.

[3799] See part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.

[3800] See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.Q.1.d Nonqualified Deferred Compensation.

[3801] *Trantina v. U.S.*, 512 F.3d 567 (9th Cir. 2008), held:

retains all rights regarding a policies an agent sold, termination payments made to the agent cannot be considered a sale of rights with respect to those policies.[3802]

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The parties spend considerable time in the briefs discussing cases involving the question of whether a contractual right qualifies as a capital asset. These cases demonstrate that, when the property right asserted concerns the contractual right to perform a service and receive compensation for the service, a payment made to terminate the contract cannot be considered a capital asset unless the contract confers something more than the right to perform services or receive compensation for services performed. See, *e.g.*, *Furrer*, 566 F.2d at 1117; *Vaaler v. United States*, 454 F.2d 1120, 1122 (8th Cir. 1972) ("[T]he courts have quite uniformly held that contracts for the performance of personal services are not capital assets and that the proceeds from their transfer or termination will not be accorded capital gains treatment but will be considered to be ordinary income."); *Md. Coal & Coke Co. v. McGinnes*, 350 F.2d 293, 294 (3d Cir. 1965) (per curiam) (finding a contract giving the taxpayer an exclusive sales agency not to be a capital asset because it did not confer on the taxpayer "some interest or estate in or encumbrance upon some property with which the contract is concerned"); *United States v. Dresser Indus., Inc.*, 324 F.2d 56, 60–61 (5th Cir. 1963) (finding that the exclusive right to practice a patent did constitute a capital asset); *Nelson Weaver Realty Co. v. Comm'r*, 307 F.2d 897, 899–901 (5th Cir. 1962) (finding sale of mortgage servicing contract along with files, ledgers, and records to be a capital asset); *Dorman v. United States*, 296 F.2d 27, 29 (9th Cir. 1961) (finding that an option to become a full partner in a business venture constituted a capital asset); *Brown v. Comm'r*, 28 T.C.M. (CCH) 1330, 1332 (T.C. 1969) ("A payment in discharge of [the right to receive commissions on policies], unlinked to the policies themselves by any proprietary interest, is simply a substitute for ordinary income."). The question in the present case is thus whether the Corporate Agreement conferred on Trantina some right or interest beyond the right to perform the services required by the agreement or to receive compensation for the services performed under the agreement….

We adopt the reasoning of the Seventh Circuit. A precondition to realizing a long-term capital gain is the ownership of a capital asset. Yet under the express terms of Trantina's Corporate Agreement with State Farm, Trantina simply had no property that could be sold or exchanged. The Corporate Agreement contains a provision nearly identical to the one that the *Baker* court found to be controlling. Trantina's Corporate Agreement states:

> Information regarding names, addresses, and ages of policyholders of the Companies; the description and location of insured property; and expiration or renewal dates of State Farm policies acquired or coming into the Agent's possession during the effective period of this Agreement, or any prior agreement, except information and records of policyholders insured by the Companies pursuant to any governmental or insurance industry plan or facility, are trade secrets wholly owned by the Companies. forms and other materials, whether furnished by State Farm or purchased by the Agent, upon which this information is recorded shall be the sole and exclusive property of the Companies.

Given this blanket reservation of all property rights to State Farm, it is unclear exactly what Trantina could have sold or exchanged. Trantina could not sell back to State Farm something that it already owned.

[3802] *Baker v. Commissioner*, 338 F3d 789 (7th Cir. 2003), held:

Fundamentally, in order to have the ability to sell something, one must own it. Because Warren Baker did not own any property related to the policies, he could not sell anything. Section D of the Agreement provides:

> Information regarding names, addresses, and ages of policyholders of the Companies; the description and location of insured property; and expiration or renewal dates of State Farm policies ... *are trade secrets wholly owned by the Companies*. All forms and other materials, whether furnished by State Farm or purchased by you, upon which this information is recorded *shall be the sole and exclusive property of the Companies*.

(emphasis added). Thus, according to the terms of the Agreement, Warren Baker did not own anything related to the policies.

### II.Q.1.c.iii. Does Goodwill Belong to the Business or to Its Owners or Employees?

For purposes of valuing a business:[3803]

> In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.

"Goodwill is often defined as the expectation of continued patronage by existing customers."[3804] (However, in the insurance industry, policy records and policyholder information are the goodwill, and payments to agents tend to be for covenants not to compete.)[3805] Generally, if a

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> As the Tax Court noted, Baker returned everything used in the daily course of business to State Farm. He returned the books, records, and customer lists because the Agreement designated them as the "sole and exclusive property" of State Farm.

*Baker* also dismissed the insurance agent's argument that he sold goodwill; see fn 3805 in part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees? This reasoning was also applied in *Pexa v. U.S.*, 121 AFTR.2d 2018-XXXX (D. CA 5/8/2018).

[3803] Rev. Rul. 59-60, Section 4.02(f).

[3804] *Estate of Adell v. Commissioner*, T.C. Memo. 2014-155, citing *Network Morning Ledger Co. v. United States*, 507 U.S. 546, 572-573 (1993).

[3805] *Baker v. Commissioner*, 338 F3d 789 (7th Cir. 2003) (highlighting added):

> Goodwill is the expectation of continued patronage. *Newark Morning Ledger Co. v. United States*, 507 U.S. 546, 555 (1993). Goodwill enables a purchaser to step into the shoes of the seller. *Decker v. Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988) (quoting *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 681 (5th Cir. 1971)). Courts have recognized that the insurance industry treats policy records and policyholder information as goodwill. *Schelble v. Commissioner*, 130 F.3d 1388, 1394 (10th Cir. 1997); *Marsh & McLennan, Inc. v. Commissioner*, 420 F.2d 667, 669–70 (3d Cir. 1969).
>
> As noted above, Baker did not own any assets related to the business. Goodwill cannot be transferred apart from the business with which it is connected. 38 Am.Jur.2d Goodwill § 10. We find reliance for our position in *Schelble v. Commissioner*, 130 F.3d 1388 (10th Cir. 1997) and *Vaaler v. United States*, 454 F.2d 1120 (8th Cir. 1972). In *Schelble*, the taxpayer argued that "extended earnings" payments made to him after terminating his position as an insurance agent constituted proceeds from the sale of goodwill . The court rejected the taxpayer's argument, finding that no sale of vendible assets occurred. *Schelble*, 130 F.3d at 1394. Citing *Elliott v. United States*, 431 F.2d 1149, 1154 (10th Cir. 1970), the court noted that for tax purposes, a sale of goodwill takes place "only when the business or a part of it, to which the goodwill attaches is sold." *Id.* at 1394. In *Vaaler v. United States*, the Eighth Circuit rejected a similar argument made by the taxpayer. It also cited *Elliott* for the same proposition, adding that as a general agent, the taxpayer built up goodwill for the insurance company, which belonged to the company. *Vaaler*, 454 F.2d at 1123; see also *Webster Investors, Inc. v. Commissioner*, 291 F.2d 192, 195 (2d Cir. 1961).
>
> While Baker built the insurance agency; the tools he used were on loan from State Farm. State Farm's termination payments were not for the sale of a business where a buyer was able to step

business subjects its owners or employees to a covenant not to compete, the business owns the related goodwill; otherwise, generally the owners or employees own the goodwill.[3806] Personal goodwill reflects the owners' relationships with customers; to prove that these relationships had value, the purchasing business should hire the sellers and not just sign a covenant not to compete with them.[3807] Sometimes a variety of factors reduce a company's

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> into the seller's shoes. Baker owned nothing. Thus, he could sell no assets, including goodwill. We agree that goodwill was developed during Baker's tenure; however, it was not his to sell.
>
> Since Baker has failed to establish that the payments were consideration for the sale or exchange of a capital asset, the Commissioner's deficiency determination is upheld. One final point we briefly address: Baker asks if the purpose for the payments are not in consideration for goodwill, what are they? We agree with the Tax Court's conclusion that (a portion of) State Farm's payments were for a covenant not to compete. See, *e.g.*, *Clark v. Commissioner*, 67 T.C.M. 3105 (1994); *Foxe v. Commissioner*, 53 T.C. 21 (1969). The Agreement provides that Baker would not induce any State Farm policyholder to change coverage or solicit coverage through a competitor for one year. The tax consequences of such language are settled: the consideration a buyer pays a seller for a covenant not to compete is taxable as ordinary income. *Patterson v. Commissioner*, 810 F.2d 562, 569 (6th Cir. 1987); *Sonnleitner v. Commissioner*, 598 F.2d 464, 466 (5th Cir. 1979).

*Baker* similarly rejected an insurance agent's assertion that the agent sold other contractual rights for a capital gain; see fn 3802 in part II.Q.1.c.ii Consulting Agreement in Lieu of Covenant Not to Compete.

[3806] Shin, Lightened Taxpayer Burdens in the Sale of Personal Goodwill After *H&M, Inc. v. Commissioner*, *Tax Lawyer*, Vol. 67, No. 2 (Winter 2014), saved as Thompson Coburn LLP doc. no. 6177834; *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998); *Norwalk v. Commissioner*, T.C. Memo. 1998-279; *Bross Trucking, Inc.. v. Commissioner*, T.C. Memo. 2014-107 (lack of non-compete precluded corporate goodwill regarding owner-officer's relationships; owner's sons developed relationships with owner's customers when owner shut down owner's business due to regulatory hassles and sons started new corporation; workforce intangible not deemed transferred when only 50% of the employees of the old corporation worked for the new corporation); *Estate of Adell v. Commissioner*, T.C. Memo. 2014-155 (lack of non-compete precluded corporate goodwill regarding owner-officer's relationships; customers did business with owner's son because they trusted the son personally; son was qualified to run the business). Conversely, goodwill generated while a covenant not to compete is in place is owned by the business entity, even though it was generated by the professional who was the sole owner of a personal service corporation. *Howard v. U.S.*, 106 A.F.T.R.2d 2010-5533 (E.D. Wash. 2010), *aff'd* 108 AFTR.2d 2011-5993 (9th Cir. 2011); *Kennedy v. Commissioner*, T.C. Memo. 2010-206 (payments were consideration for services rather than goodwill; payments varied based on success of seller's efforts to transition customers to buyer; part of payments were for non-compete; taxpayer failed to prove economics of allocation, the court finding that goodwill was a tax-motivated afterthought that occurred late in the negotiations) (distinguished from *Martin Ice Cream*) (self-employment tax imposed; reliance on tax advisor avoided negligence penalty); *H & M, Inc. v. Commissioner*, T.C. Memo. 2012-290 (insurance agent's name and talents were more highly valued than his incorporated insurance agency's name, so compensation payments to agent were not disguised payments to his agency followed by dividends to him; characterization as goodwill or compensation was not raised). See Kliegman and Turkenich, Goodwill Games: Determining the Existence And Ownership of Goodwill In a Closely Held Business, *T.M. Memorandum* (BNA) (9/22/2014).

For more details on sending business as a gift, see fn., part III.B.1.a.v Sending Business.

[3807] *Solomon v. Commissioner*, T.C. Memo. 2008-102, held:

> The *Martin Ice Cream* case is distinguishable from this case. First, the record does not persuade us, nor do we find as a fact, that the value of Solomon Colors in the market was attributable to the quality of service and customer relationships developed by Robert Solomon or Richard Solomon. Rather, the record reflects our finding that Solomon Colors, as a business of processing, manufacturing, and sale, rather than one of personal services, did not depend entirely on the goodwill of its employees for its success. See *Schilbach v. Commissioner*, T.C. Memo. 1991-556; *cf. Longo v. Commissioner*, T.C. Memo. 1968-217. Second, unlike the founder of Haagen-

goodwill, and having the next generation start a new company without so much baggage creates a viable company without making a gift of goodwill.[3808]

If the business is inside an entity taxed as a C or an S corporation, paying for the business' going concern value (of which goodwill tends to be a very significant part) results in short-term double or triple taxation.[3809] If the entity has only one owner, one can set the stage for a more tax-advantaged exit strategy by ***not*** subjecting the owner to a covenant not to compete. For a multiple-owner entity, the business reasons might trump the tax issues, so one might more strongly consider migrating to the ideal business structure[3810] so that one can put these protections in place as soon as possible without complicated issues. The problem with migrating from a corporation to a pass-through entity is that the IRS will argue that goodwill is being distributed from the corporation to the owners and then into the new entity, and a distribution from a corporation to its owners is a taxable event.[3811] If the owners of the new entity are different from but are the natural objects of the bounty of the owners of the original entity, the IRS might also argue that the deemed distribution and transfer constitute a gift.[3812]

A sole proprietorship or partnership does not face these concerns. A sole proprietorship can convert into a partnership tax free by granting the new owner a profits interest in the partnership.[3813] The partnership can then engage in a redemption that obtains the most income tax-efficient result. Thus, a sole proprietorship or partnership is free to enter into covenants not to compete without complicating income tax exit strategies.

### II.Q.1.c.iv. Goodwill (and other intangible) Anti-Churning Rules

Generally, an anti-churning rule provides that goodwill and going concern value are not amortizable if:[3814]

1. The intangible was held or used at any time on or after July 25, 1991, and on or before such date of enactment by the taxpayer or a related person,

2. The intangible was acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before such date of enactment, and, as part of the transaction, the user of such intangible does not change, or

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Dazs in *Martin Ice Cream*, who signed an agreement with Strassberg in his personal capacity, Robert Solomon and Richard Solomon were not named as the sellers of any asset but were included in the sale in their individual capacities solely to guarantee that they would not compete with Prince. Third, the fact that Prince required noncompete agreements, but not employment or consulting agreements, of Robert Solomon and Richard Solomon makes it unlikely that Prince was purchasing the personal goodwill of these individuals.

[3808] See part II.Q.7.h.v Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014).

[3809] See part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis.

[3810] See parts II.E Recommended Structure for Entities, II.Q.7.h Distributing Assets; Drop-Down into Partnership and II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill.

[3811] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

[3812] See part III.B.1.a.v Sending Business. Taxpayers won, but it cost them significant legal fees.

[3813] See part II.M.4.f Issuing a Profits Interest to a Service Provider. The new owner can also contribute capital to the new business, which generally is tax-free (see part II.M.3 Buying into or Forming a Partnership), but be wary of part II.M.3.e Exception: Disguised Sale.

[3814] Code § 197(f)(9)(A).

3. The taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991, and on or before such date of enactment.

For purposes of these rules, a person is "related" to any person only if the related person bears a relationship to such person specified in Code § 267(b)[3815] or 707(b)(1),[3816] or the related person and such person are engaged in trades or businesses under common control.[3817] In applying Code § 267(b) or 707(b)(1) to this test, use 20% instead of 50%.[3818] A person shall be treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.[3819]

However, if the anti-churning rule applies only because the related party's ownership is more than 20% instead of more than 50%, then this rule is subject to an exception.[3820] To qualify for the exception, the person from whom the taxpayer acquired the intangible must elect to recognize gain on the disposition of the intangible and to pay a tax on such gain which, when added to any other income tax on such gain under this title, equals such gain multiplied by the highest income tax rate applicable to such person.[3821] If this exception applies, then the goodwill or concern value is prevented from being amortized only to the extent that the taxpayer's adjusted basis in the intangible exceeds the gain recognized.[3822]

Also, the anti-churning rule does not apply to the acquisition of any property by the taxpayer if the basis of the property in the taxpayer's hands is determined under Code § 1014(a) (basis adjustment by reason of death).[3823]

Code § 197 also does not permit amortization of any intangible acquired in a transaction, one of the principal purposes of which is to avoid the anti-churning rules.[3824]

Reorganizing a tiered structure using nontaxable contributions under Code § 721[3825] and nontaxable distributions under Code § 731[3826] may avoid triggering the anti-churning rules so as to allow the pre-transaction amortization of post-1993 intangibles to continue.[3827]

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[3815] Code § 267(b) is reproduced in part II.G.4.l.iv Code § 267 Disallowance of Related-Party Deductions or Losses.
[3816] For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.
[3817] Code § 197(f)(9)(C)(i). The common control test used is that provided in Code § 41(f)(1)(A) and (B).
[3818] Code § 197(f)(9)(C)(i).
[3819] Code § 197(f)(9)(C)(ii).
[3820] Code § 197(f)(9)(B)(i).
[3821] Code § 197(f)(9)(B)(ii).
[3822] Code § 197(f)(9)(B).
[3823] Code § 197(f)(9)(D).
[3824] Code § 197(f)(9)(E). This provision also prevents amortization of any asset acquired in a transaction that was postponed to avoid the requirement that the intangible be acquired after the date of the enactment of Code § 197.
[3825] See part II.M.3 Buying into or Forming a Partnership, especially part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.
[3826] See part II.Q.8.b.i Distribution of Property by a Partnership, especially part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions.
[3827] Letter Ruling 201709003.

With respect to any increase in the basis of partnership property under Code § 732, 734, or 743, determinations under the anti-churning rules are made at the partner level, and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets.[3828] See part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

Letter Ruling 201906002 sets forth applicable rules and reasoning for partnerships:[3829]

> Section 197(f)(9)(E) provides that with respect to any increase in the basis of partnership property under §§ 732, 734, or 743, determinations under § 197(f)(9) shall be made at the partner level and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets.
>
> Section 1.197-2(g)(3) provides that any increase in the adjusted basis of a § 197 intangible under...§ 743(b) (relating to the optional adjustment to the basis of partnership property after transfer of a partnership interest) is treated as a separate § 197 intangible. For purposes of determining the amortization period under § 197 with respect to the basis increase, the intangible is treated as having been acquired at the time of the transaction that causes the basis increase, except as provided in § 1.743-1(j)(4)(i)(B)(2 ) (dealing with an increase in the basis of the item of the partnership's recovery property under § 743(b) that is attributable to § 704(c) built-in gain when the partnership elects to use the remedial allocation method).
>
> Section 1.197-2(h)(1)(i) provides that this paragraph (h) applies to § 197(f)(9) intangibles. For this purpose, § 197(f)(9) intangibles are goodwill and going concern value that was held or used at any time during the transition period and any other § 197 intangible that was held or used at any time during the transition period and was not depreciable or amortizable under prior law.
>
> Section 1.197-2(h)(1)(ii) provides that the purpose of the anti-churning rules of § 197(f)(9) and § 1.197-2(h) is to prevent the amortization of § 197(f)(9) intangibles unless they are transferred after the applicable effective date in a transaction giving rise to a significant change in ownership or use. Special rules apply for purposes of determining whether transactions involving partnerships give rise to a significant change in ownership or use. See § 1.197-2(h)(12). The anti-churning rules are to be applied in a manner that carries out their purpose.
>
> Section 1.197-2(h)(6)(i) provides, in pertinent part, that a person is related to another person for purposes of § 1.197-2(h) if the person bears a relationship to that person that would be specified (A) in § 267(b) (determined without regard to § 267(e)), and by substitution, § 267(f)(1), if those sections were amended by substituting 20 percent for 50 percent or (B) in § 707(b)(1) if that section were amended by substituting 20 percent for 50 percent.

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[3828] Code § 197(f)(9)(E). For details, see Reg. § 1.197-2(h)(12); see also fn. 3505, found in part II.P.1.a.i Allocations of Income in Partnerships. For an example of the effect of a Code § 754 election on goodwill that is being amortized, see fn. 5332 in part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership.

[3829] See also text accompanying and preceding fn 5151 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

Section 1.197-2(h)(6)(ii) provides that a person is treated as related to another person for purposes of § 1.197-2(h) if the relationship exists, in the case of a single transaction, immediately before or immediately after the transaction in which the intangible is acquired.

Section 1.197-2(h)(12)(i) provides that in determining whether the anti-churning rules apply to any increase in the basis of a § 197(f)(9) intangible under § 743(b), the determinations are made at the partner level and each partner is treated as having owned and used the partner's proportionate share of partnership property. In determining whether the anti-churning rules apply to any transaction under another section of the Internal Revenue Code, the determinations are made at the partnership level, unless under § 1.701-2(e) the Commissioner determines that the partner level is more appropriate.

Section 1.197-2(h)(12)(v)(A) provides, generally, that the anti-churning rules do not apply to an increase in the basis of a § 197 intangible under § 743(b) if the person acquiring the partnership interest is not related to the person transferring the partnership interest. In addition, the anti-churning rules do not apply to an increase in the basis of a § 197 intangible under § 743(b) to the extent that ...

(2) The partnership interest being transferred was acquired after the partnership acquired the § 197(f)(9) intangible, provided -

(i) The § 197(f)(9) intangible was acquired by the partnership after August 10, 1993, and is not amortizable with respect to the partnership;

(ii) The partnership interest being transferred was held after the partnership acquired the § 197 intangible by a person or persons (the post-contribution person or persons) other than the person transferring the partnership interest or persons who were related to the person transferring the partnership interest; and

(iii) The acquisition of such interest by the post-contribution person or persons was not part of a transaction or series of related transactions in which the person transferring the partnership interest or persons related to the person transferring the partnership interest acquired such interest.

Section 1.197-2(h)(12)(v)(B) provides that, solely for purposes of § 1.197-2(h)(12)(v)(A)(1) and (2), a partner who acquires an interest in a partnership in exchange for a contribution of property to the partnership is deemed to acquire a pro rata portion of that interest in the partnership from each person who is a partner in the partnership at the time of contribution based on each such partner's proportionate interest in the partnership.

Rev. Rul. 87-115, 1987-2 C.B. 163, states that when an upper-tier partnership has a § 754 election in effect, the transfer of an interest in the upper-tier partnership is treated as a transfer of an interest in the upper-tier partnership's interest in the lower-tier partnership for purposes of § 743. Such an election shall apply with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year when such election was filed and all subsequent years, unless revoked by the partnership, subject to § 1.754-1(c).

> Section 754 provides that if a partnership files an election in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted ...in the case of a transfer of a partnership interest, in the manner provided in § 743. Such an election shall apply with respect to all distributions by the property by the partnership and to all transfers of interests in the partnership during the taxable year when such election was filed and all subsequent years, unless revoked by the partnership, subject to § 1.754-1(c).
>
> Section 743(b) provides, in part, that in the case of a transfer of an interest in a partnership by sale or exchange, a partnership with respect to which the election provided in § 754 is in effect shall increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property.
>
> Of the requirements for amortization under § 197, only the anti-churning rules are in question in this case. Special rules are provided for partnerships in § 1.197-2(h)(12), and specific rules for § 743(b) basis adjustments are provided in § 1.197-2(h)(12)(v).

Rev. Rul. 87-115 is described in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

Letter Ruling 201906002 reasoned:[3830]

> On Date1 (after August 10, 1993), Partnership3 was formed by Partnership5 and Partnership1 in a transaction that qualified for non-recognition under § 721(a). Partnership5 contributed the Intangible Asset to Partnership3 in exchange for its interest in Partnership3, and Partnership1 contributed cash and other assets in exchange for its interest in Partnership3. Partnership3 has used the Intangible Asset since then in its trade or business. Under § 1.197-2(h)(12)(v)(B), each of the partners of Partnership3 was deemed to acquire their interest in Partnership3 from the other, and each was deemed to acquire a proportional interest in the assets of Partnership3. Since the Intangible Asset was not amortizable in Partnership5's hands, it is also not amortizable in the hands of Partnership3. Section 197(f)(2) and § 1.197-2(g)(2). This will continue to be true after the transactions subject to this ruling occur.
>
> This ruling addresses the § 743(b) adjustments that are allocable to the Intangible Asset that result from the transfer of Partnership2 and Partnership3 interests to NewCo2, a newly formed corporation in a non-taxable transaction. Each § 743(b) adjustment results in a separate intangible asset that is analyzed under § 1.197-2(h)(12)(v) at the partner level. Sections 1.197-2(g)(3) and 1.197-2(h)(12)(i). Partners are treated as directly owning and using their proportionate share of partnership assets. Section 197(f)(9)(E).
>
> In this case, the anti-churning rules do not apply to a § 743(b) adjustment if one of two tests is met, either (i) the transferee is not related to the transferor or (ii) the requirements of § 1.197-2(h)(12)(v)(A)(2) are met. The basis adjustments do not satisfy the first test because the transferor and the transferee of any actual or deemed transfer

[3830] See also text accompanying and preceding fn 5151 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

of Partnership3 interests as a result of the Transaction will be related within the meaning of § 197(f)(9)(C)(i) and § 1.197-2(h)(6) immediately before and after the Transaction. Thus, any transferee entitled to a basis adjustment will be related to the transferor for purposes of the anti-churning rules. Therefore, the basis adjustments will be amortizable under § 197(a) only if the requirements of § 1.197-2(h)(12)(v)(A)(2) are met.

*Principals Transactions*

In the case of the interests in Partnership3 that Partnership1 and Partnership2 acquired in the Principals transactions, the Partnership3 interests that are transferred to NewCo2 were originally owned by Partnership5 and distributed to the exercising Principal through a series of non-recognition transactions. Taxpayer has represented that no Principal exercised their D in connection with, or as part of a plan that included, the formation of Partnership3.

With respect to the interests in Partnership3 acquired by Partnership1 and Partnership2 from the Principals, the requirements of § 1.197-2(h)(12)(v)(A)(2) are met because:

(i) The Principals transactions occurred after Partnership3 acquired the Intangible Asset and, therefore, the interests in Partnership3 that Partnership1 and Partnership2 acquired in the Principals transactions occurred after Partnership3 acquired the Intangible Asset. Also, Partnership3 acquired the Intangible Asset after August 10, 1993, and the Intangible Asset is not amortizable in the hands of Partnership3;

(ii) The Principals' interests in Partnership3 that are being transferred were held after Partnership3 acquired the Intangible Asset by Partnership5, a person other than Partnership1 or Partnership2. Further, Taxpayer has represented that Partnership5 has never been related to Partnership1 or its predecessor, or Partnership2, within the meaning of § 197(f)(9)(C)(i) and § 1.197-2(h)(6); and

(iii) The acquisition of the interests in Partnership3 by Partnership5 was not part of a transaction or series of related transactions in which Partnership1 and Partnership2 acquired its Partnership3 interest from the Principals. That is, the exercise of the D occurred in transactions independent from the formation of Partnership3.

*Public Trading*

With respect to the interests in Partnership3 acquired by Partnership1 upon the formation of Partnership3 on Date1, the requirements of § 1.197-2(h)(12)(v)(A)(2) are met because:

(i) Partnership1 acquired its interest in Partnership3 after Partnership3 acquired the Intangible Asset. Also, Partnership3 acquired the Intangible Asset after August 10, 1993, and the Intangible Asset is not amortizable in the hands of Partnership3; and

(ii) In its letter dated July 31, 2018, Taxpayer represents, subject to confirmation by ongoing diligence, Taxpayer reasonably estimates that as of Date3, through public trading and issuances of limited partnership interests, [Redacted Text] percent or

more of the economic interests in Partnership1 have changed ownership since Partnership1 acquired its interests in Partnership3 in Year1.

As stated in Rev. Rul. 87-115, when an upper-tier partnership has a § 754 election in effect, any § 743(b) adjustment resulting from the deemed transfer is segregated and allocated solely to the transferee of the upper-tier partnership interest.

Further, with respect to any increase in the basis of partnership property under § 743, a partnership is treated as an aggregate of its owners under the anti-churning rules. Section 197(f)(9)(E).

Applying § 1.197-2(h)(12)(i), for purposes of § 1.197-2(h)(12)(v)(A)(2)(iii), the public owners of Partnership1 are treated as acquiring interests in Partnership3 when each public owner purchased an interest in Partnership1, subsequent to the formation of Partnership3 in Year1. Because the public owners of Partnership1 acquired interests in Partnership3 after those interests were held by unrelated owners in transactions independent from the formation of Partnership3, § 1.197-2(h)(12)(v)(A)(2)(ii) and (iii) are satisfied for those acquisitions.

Based on Taxpayer's representation in a letter dated July 31, 2018 that, Taxpayer reasonably estimates that as of Date3, which is one business day before Date 4, through public trading and issuances of limited partnership interests, [Redacted Text] percent or more of the economic interests in Partnership1 have changed ownership since Partnership1 acquired its interests in Partnership3 in Year1, the increases to the tax basis of the Intangible Asset for the benefit of Newco2 or Partnership2 under § 743(b) resulting from Partnership1's transfer of interests in Partnership3 to Newco2 are amortizable under § 197(a) to the extent those interests were treated as previously acquired by public investors since the formation of Partnership3 on Date1.

**CONCLUSIONS**

Based solely on the facts and representations submitted and the law and analysis as set forth above, we rule that the increases to the tax basis of the Intangible Asset, a § 197(f)(9) intangible, under § 743(b) for the benefit of NewCo2 or Partnership2, that result from the Transaction will be amortizable under § 197(a) to the extent those basis adjustments relate to interests that (i) were previously acquired from the Principals or (ii) were treated as previously acquired by public investors subsequent to the formation of Partnership3 on Date1.

Except as expressly set forth above, no opinion is expressed or implied concerning the federal tax consequences of the facts described above under any other provision of the Code or regulations. Specifically, no opinion is expressed or implied concerning the federal income tax treatment of any transactions described in this letter, including the Transaction that Taxpayer represents occurred on Date4.

This letter ruling is conditioned upon Taxpayer demonstrating the extent that the ownership of Partnership1's interests changed between Date1 and Date3.

### II.Q.1.d. Nonqualified Deferred Compensation

For draconian measures that can apply to compensation paid in a year different from the year is which it was earned (as well as detrimental balance sheet effects), see part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

#### II.Q.1.d.i. IRS Audit Guide for Nonqualified Deferred Compensation and Other Noncash Compensation (other than fringe benefits)

In "Nonqualified Deferred Compensation Audit Techniques Guide (June 2015)," the IRS explained its view on deferred compensation and similar tools and described audit techniques.[3831]

#### II.Q.1.d.ii. Using Nonqualified Deferred Compensation to Facilitate a Sale

##### II.Q.1.d.ii.(a). Income Tax Issues when Using Nonqualified Deferred Compensation to Facilitate a Sale

A common tactic had been to pay the seller compensation for past services rendered. The theory was that, during its formative years, the business did not have the financial ability to compensate the owner for all that the owner did to develop the business into the successful operation it is today. When the business would be sold, finally the business would have sufficient resources to express its gratitude for the owner's past services. The business might pay the owner all at once; or, it might pay this bonus over time to provide the owner with a nice stream of retirement income. This compensation could be paid by the buyer or the seller. If the buyer makes the payments, it deducts them as it makes them and reduces the purchase price to take into account the present value of the payments. If the seller makes the payments, the seller would want to deduct the payments against the sale proceeds or against the interest or income equity component of any deferred sale proceeds.[3832]

Under 2017 tax reform, the service recipient may have a lower rate as a C corporation or as a pass-through entity than the service provider. See part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities. This has always been a problem when the compensation paid exceeds ordinary taxable income, but now it may apply regarding most or all of the deferred compensation payments.

Also, under Code § 409A, one is required to have a written plan in place as soon as a legally binding right to nonqualified deferred compensation exists.[3833] Thus, if at the time of sale

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[3831] LB&I-04-0615-005, found at http://www.irs.gov/Businesses/Corporations/Nonqualified-Deferred-Compensation-Audit-Techniques-Guide.

[3832] The seller would not want to liquidate the entity that owned the business until after these payments are made. Otherwise, the payments would constitute an additional capital loss or reduction of capital gain rather than a deduction against ordinary income. *Arrowsmith, Exec. v. Commissioner*, 344 U.S. 6 (1952).

[3833] A plan is any arrangement or agreement providing for a deferral of compensation. Code § 409A(d)(1), (3). If the payment is reasonable because it relates to past services, then it constitutes deferred compensation, and its material terms must be documented in writing to satisfy Code § 409A. Reg. § 1.409A-1(c)(3)(i). The written plan must be in place when the service provider obtains a legally binding right to the compensations. Reg. § 1.409A-1(a)(1). One might argue that compensation was earned in a prior year, but there was no legally binding right to payments based on that service, and now it is necessary and reasonable to pay for those past services to retain the

compensating the owner for past services is reasonable and necessary,[3834] and the entity can show that a legally binding right to compensation for past services did not exist until that time, then the strategy described in the preceding paragraph may be used. Absent a prior written plan, however, convincing a court that the owner was undercompensated might be very difficult.[3835]

A more conservative approach would be to have a plan in place when the business is doing well but is not yet sold, which plan vests over time. That strategy is described later.[3836] Alternatively, consider paying an immediate lump sum if a plan is not already in place and the payor has enough income to absorb the deduction.[3837] An immediate lump sum payment often is very unattractive to the buyer (who has cash flow issues and might not need that much deduction in a single year) or seller (who might rather receive payments over time to avoid accelerating income tax if adequate safeguards are in place to protect the payment).

Deferred compensation in an S corporation will not raise second-class of stock issues unless a principal purpose of the agreement is to circumvent the single class of stock rules.[3838]

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employee. *Aries Communications Inc. v. Commissioner*, T.C. Memo. 2013-97 (comparing actual amounts paid in prior years against what was shown to have been higher reasonable compensation for those years), following the factors in *Elliotts* in fn. 32 as well the independent investor test of *Metro Leasing & Dev. Corp. v. Commissioner*, 376 F.3d 1015, 1019 (9th Cir. 2004), *aff'g* 119 T.C. 8 (2002). Although the author would make such an argument regarding past services on audit, the author would prefer to have more certainty when planning in light of Code § 409A's expansive reach. See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

[3834] See part II.A.1.b.i Compensating Individuals, especially fn. 32.

[3835] *PK Ventures, Inc. v. Commissioner*, T.C. Memo. 2006-36, *aff'd sub nom. Rose v. Commissioner*, 101 A.F.T.R.2d 2008-1888 (11th Cir. 2008), disallowed deductions for such deferred compensation beyond what the IRS conceded. *Thousand Oaks Residential Care Home I, Inc. v. Commissioner*, T.C. Memo. 2013-10, found credible testimony that compensation was intended as catchup compensation – payment of back salaries that were not paid in prior years due to insufficient cash flow. However, the court applied the independent investor test (see fn. 32) to determine that the catch-up compensation was unreasonably high.

[3836] See part III.B.7.c.vi Deferred Compensation.

[3837] A special exception to Code § 409A applies to payments that occur immediately after the payment becomes vested if the taxpayer can prove that the payment was contingent on continuing to provide services from the date the service had been performed until the date that occurred during the current year. Reg. § 1.409A-1(b)(4)(i). The preamble to the final regulations, T.D. 9321, rejected cross-referencing existing rules:

> The final regulations generally adopt the definition of substantial risk of forfeiture set forth in the proposed regulations. Several commentators requested that the definition of substantial risk of forfeiture be the same as the definition of substantial risk of forfeiture in § 1.83-3(c). However, the definition of substantial risk of forfeiture for purposes of compensatory transfers of property under section 83 reflects different policy concerns from those involved in section 409A, and there are also practical differences between transfers of restricted property and promises to pay deferred compensation. This is reflected in the provisions of section 409A(e)(5), directing the Secretary of the Treasury Department to issue regulations disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of section 409A. Accordingly, the final regulations do not adopt this suggestion.

[3838] See part II.A.2.i.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules, especially fns. 265-266.

### II.Q.1.d.ii.(b). Balance Sheet Effects of Deferred Compensation

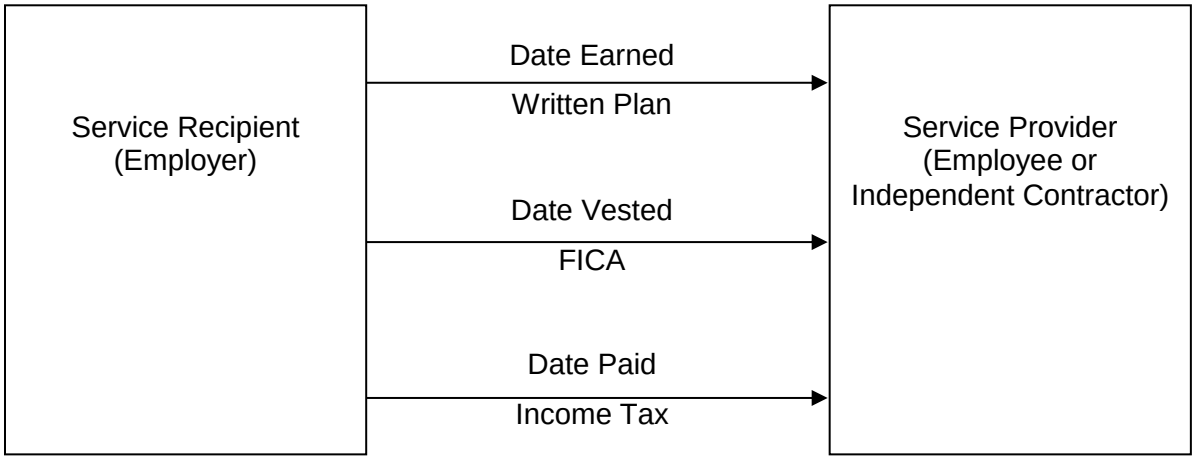
Before establishing a deferred compensation agreement, ask the company's outside CPA to determine what the balance sheet effect is going to be.

Then have the client take that information to the company's lenders to discuss the impact on balance sheet loan covenants. Same with any companies that provide construction bonds, etc., if the company is in such a line of business.

I have seen the balance sheet liability cause deferred compensation agreements to be killed.

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

Here is a timeline for FICA and income taxation of deferred compensation when the service recipient is not a tax-exempt entity:




***Date Earned***. Need to have written plan in place before service provider obtains legally enforceable rights – either required or best practice to be in place before performing service.

***Date Vested***. "Vested" corresponds to no further obligation to perform services. FICA will be due on present value[3839] and will not be due when the benefits are paid.[3840] This vesting is often beneficial when employee's compensation, for the year in vesting occurs, exceeds the taxable wage base ($132,900 in 2019 and $137,700 in 2020) because it is taxed at 2.9% (1.45% x 2) or 3.8% (for compensation in excess of $200,000 for a single person or $250,000 for a married person filing jointly) instead of 15.3% (7.65% x 2).[3841] The employer and employee can

[3839] Reg. § 31.3121(v)(2)-1(c)(2).
[3840] Code § 3121(v)(2)(B). Reg. § 31.3121(v)(2)-1(d)(2) provides how much income on this initially taxed is also excluded from FICA wages when paid.
[3841] FICA tax (for employer and employee combined, or for self-employment tax purposes) is 15.3% on annual income up to the taxable wage base (TWB) and 2.9% on all annual income above the TWB until $200,000 (single) or $250,000 (married), above which it is 3.8%. FICA consists of Old-Age, Survivors, and Disability Insurance benefits (OASDI) and Medicare's Hospital Insurance program (HI). The OASDI tax is 6.2% for employer and 6.2% for employee, for a total of 12.4%, imposed only up to the TWB. The HI tax is 1.45% for employer and 1.45% for employee, imposed on all FICA wages. See http://www.ssa.gov/OACT/COLA/cbb.html for the past and current TWB; see also part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax. Most of the FICA tax on the present value will be at

negotiate whether the employer should pay the employee an additional bonus to cover the additional FICA withholding in the year of vesting. On one hand, the employee might not have the cash flow to pay the FICA, since the employee has not been paid this deferred amount. On the other hand, the employee's share of FICA is properly taxed to the employee, and it is taxed at a lower rate than it would be if the plan had not been in effect, so it's only fair for the employee to pay this additional FICA. Note, however, that the FICA deferred compensation regulations do not provide a discount for the credit risk (that the employer might not be able to pay) that the employee assumes,[3842] and the employee cannot get the FICA back if the employer defaults.[3843]

***Date Paid***. Income tax is due when paid or constructively received, but FICA is not due since that was already paid.[3844] Code § 409A places strict limits on events that accelerate payment and events that delay payment.

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the lower 2.9% or 3.8% rate. When payments are made in future years, they will not be subject to FICA tax. This could save around $15,959 of FICA tax each year ($128,700 TWB for 2018, multiplied by the 12.4% spread between 15.3% and 2.9%; if wages were taxed at 3.8% the savings would be $14,801). The savings is slightly less than indicated, because it does not consider that the employer receives a deduction for the employer's one-half portion of FICA.

[3842] Reg. § 31.3121(v)(2)-1(c)(2)(ii) provides:

> For purposes of this section, the present value must be determined as of the date the amount deferred is required to be taken into account as wages under paragraph (e) of this section using actuarial assumptions and methods that are reasonable as of that date. For this purpose, a discount for the probability that an employee will die before commencement of benefit payments is permitted, but only to the extent that benefits will be forfeited upon death. In addition, the present value cannot be discounted for the probability that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk associated with any deemed or actual investment of amounts deferred under the plan, the risk that the employer, the trustee, or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies. Nor is the present value affected by the possibility that some of the payments due under the plan will be eligible for one of the exclusions from wages in section 3121(a).

[3843] *Balestra v. U.S.*, 803 F.3d 1363 (Ct. Fed. Cl. 2014), holding:

> Sections 3101(b) and 3121(v)(2) required these benefits to be calculated and taxed when he retired, but do not require the use of a risk-adjusted discount rate nor a refund corresponding to the benefits plaintiff never received.

The Federal Circuit, at 803 F.3d 1363 (2015), affirmed the Court of Claims, validating Reg. § 31.3121(v)(2)-(1)(c)(2)(ii):

> Treasury's path to calculating the amount deferred in terms of the compensation's present value without consideration of an employer's financial condition is reasonably discernable. Treasury explained that it sought simple, workable, and flexible rules when valuing future benefits. It devised a regulation that satisfied these goals while comporting with the governing statute. This is neither arbitrary nor capricious. It may seem unfair in a specific instance such as this, but in balancing the desire for simplicity against the ideal of ultimate comprehensiveness, the agency must be allowed a reasonable degree of discretion. We cannot say that this one example of consequent unfairness by the agency results in invalidating the rule-making.

[3844] However, if an amount deferred is required to be taken into account in a particular year, but the employer fails to pay the additional FICA tax resulting from that amount, then the amount deferred and the income attributable to that amount must be included as wages when actually or constructively paid. Reg. § 31.3121(v)(2)-1(d)(1)(ii)(A). An employer that fails to withhold upfront and then causes the employees to pay more FICA when they retire is liable to the employees. *Davidson v. Henkel*

One might also consider whether FICA tax rates might increase in the future as Social Security and Medicare payments for the Baby Boomers increase. Vesting no later than December 31, 2012 should be considered to avoid the additional 0.9% tax on wages in excess of $250,000 (joint return) or $200,000 (single returns) that was added by the 2010 health care act.[3845]

Furthermore, the state in which the service provider worked may not subject the deferred compensation to tax except to the extent paid to the service provider while he or she is a resident of that state.[3846]

Because various tax-exempt entities have no incentive to accelerate income, the present value of the future payments is taxed when vested instead of when paid.[3847] Such an employer includes a State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State, and any other organization (other than a governmental unit) exempt from income tax.[3848] When the employee receives the deferred payments, the payments are exempt from FICA (as described above)[3849] but, to the extent of the interest

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*Corporation*, 115 A.F.T.R.2d ¶ 2015-321 (D. Mich. 2015). AM 2017-001 clamps down to an extent when employers do not follow the rules:

> As noted above, § 31.3121(v)(2)-1(d)(1)(ii) describes the steps to be taken if an employer fails to use the special timing rule as required for part or all of the amounts an employee defers under a NQDC plan. If an employer fails to pay FICA tax on amounts deferred as required under § 3121(v)(2), the employer is required to adjust its employment tax returns for any years for which the period of limitations has not expired to report and pay the additional FICA tax attributable to the amounts deferred and required to be included under the special timing rule. See § 6205 and § 31.6205-1(a) and (b) of the regulations with regard to making interest-free adjustments of underpayments. If the employer does so, the nonduplication rule will apply to the payment of the deferred compensation. However, the general timing rule will apply to any amounts deferred and income attributable to those amounts deferred for closed years that cannot be adjusted.
>
> Upon discovery that they have not correctly applied the special timing rule under § 3121(v) to pay FICA tax when required under the regulations, some employers have requested a closing agreement to permit them to pay FICA tax in a subsequent year that is prior to the year of payment in order to reduce the amount of total FICA taxes that would otherwise be due under the general timing rule if FICA tax was applied at the time of payment of the wages. The employer may also want to avoid application of the allocation rule in § 31.3121(v)(2)-1(d)(1)(ii)(B) that imposes FICA tax on a portion of each payment if the employer took some portion (but not all) of the NQDC into account for FICA tax under the special timing rule.
>
> Because the applicable regulations provide the mechanism for the payment of FICA taxes in the case of NQDC which is not timely taken into account under the special timing rule in § 31.3121(v)(2)-1(a)(2), as a policy matter, a closing agreement should not be entered into if it that has the effect of avoiding application of this regulatory mechanism. The existence of the special transition rule in the regulations for years for which the period of limitations had expired at the time the regulations were finalized reinforces the importance of adhering to the rules contained in § 31.3121(v)(2)-1(d)(1)(ii) for determining the FICA tax due upon payment of amounts that were deferred in prior years and that should have been taken into account under § 3121(v)(2) in such prior years but for which the period of limitations has since expired.

[3845] Code § 3101(b)(2).

[3846] See part II.Q.8.b.ii.(g) Code § 736 Payments as Retirement Income – Possible FICA and State Income Tax Benefits, fns. 5029-5032.

[3847] Code § 457(f)(1)(A), which applies to payments made by an eligible employer.

[3848] Code § 457(e)(1).

[3849] See fn. 3840.

component arising from the present value calculation, would be subject to income tax.[3850] If deferring payments is important to the employer, then the employer should consider paying up-front enough to pay for the employee's up-front taxes and deferring most or all of the rest. Note that the arrangement saves FICA relative to what otherwise might have been the parties' expectations,[3851] so they might want to consider that savings when negotiating the deferred compensation arrangement.

### II.Q.2. Consequences of IRS Audit Exposure for Prior Years' Activities

Consider the impact of part II.G.20 IRS Audits and whether the buyers might want a price adjustment if such audits occur:

- C Corporation. An audit changing a prior year's tax position results in the new shareholders paying the tax.

- S corporation. An audit changing a prior year's tax position results in the former shareholders paying the tax, except to the extent that the change relates to C corporation years,[3852] built-in gain tax,[3853] tax on excess net passive income,[3854] or any other taxes or penalties (for example, payroll taxes) imposed on the entity itself.

- Partnership. Depending on the situation, tax imposed by reason an audit changing a prior year's tax position might be paid by the partnership or by the former partners. Of course, taxes or penalties (for example, payroll taxes) other than income tax might be imposed on the entity itself.

### II.Q.3. Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future

If one expects to sell a business interest for all cash in a few years and would like to defer capital gain on the sale of a business interest, consider selling the business interest in an installment sale to a nongrantor trust. The note might be interest-only for a few years, with principal payments beginning some time after the business interest is expected to be sold. The trust receives basis for the full amount of the promissory note and can sell the business interest tax-free to the extent of that basis.

Similar principles apply to the sale of land or other property that is not depreciable or amortizable.

Potential pitfalls include the following:

- If the trust is a related person (which usually is the case) and it re-sells the business interest within two years, the original seller's deferred gain is accelerated.[3855]

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[3850] Code § 457(f)(1)(B).
[3851] See discussion accompanying fns. 3839-3843.
[3852] Changes to C corporation years might result not only in more tax but also more earnings & profits (E&P); for the latter, see part II.Q.7.b Redemptions or Distributions Involving S Corporations (effect of E&P on taxation of distributions).
[3853] See part II.P.3.b.ii Built-in Gain Tax on Former C Corporations under Code § 1374.
[3854] See part II.P.3.b.iii Excess Passive Investment Income.
[3855] Code § 453(e).

- The original seller's death will not generate a basis step-up in the note.[3856] If the original seller had simply held the business interest until death, part or all of the gain would be eliminated by basis step-up. Consider buying term insurance against the risk of loss of the financial benefit of the basis step-up.

- Be sensitive to possible acceleration of the deferred gain if the original seller later transfers the installment note, including by gift (or transfer to or from a nongrantor trust),[3857] or pledges the note.[3858]

- Beware of the possible need to pay interest on the deferred tax liability if the sale exceeds $5 million.[3859]

- The part of the gain on the sale of a partnership interest attributable to "hot assets" is not eligible for installment sale treatment.[3860]

- The direct or indirect sale of depreciable or amortizable assets to a related party (the nongrantor trust) might trigger ordinary income tax.[3861]

Dealers cannot use the installment method with respect to:[3862]

(A) *Personal property*. Any disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan.

(B) *Real property*. Any disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.

When entities disposed of real properties that were held for sale to customers in the ordinary course of their trades or businesses, they were not permitted to use the installment method to account for their sales of real properties made by contract for deed.[3863]

See also part II.G.27 Real Estate Special Issues.

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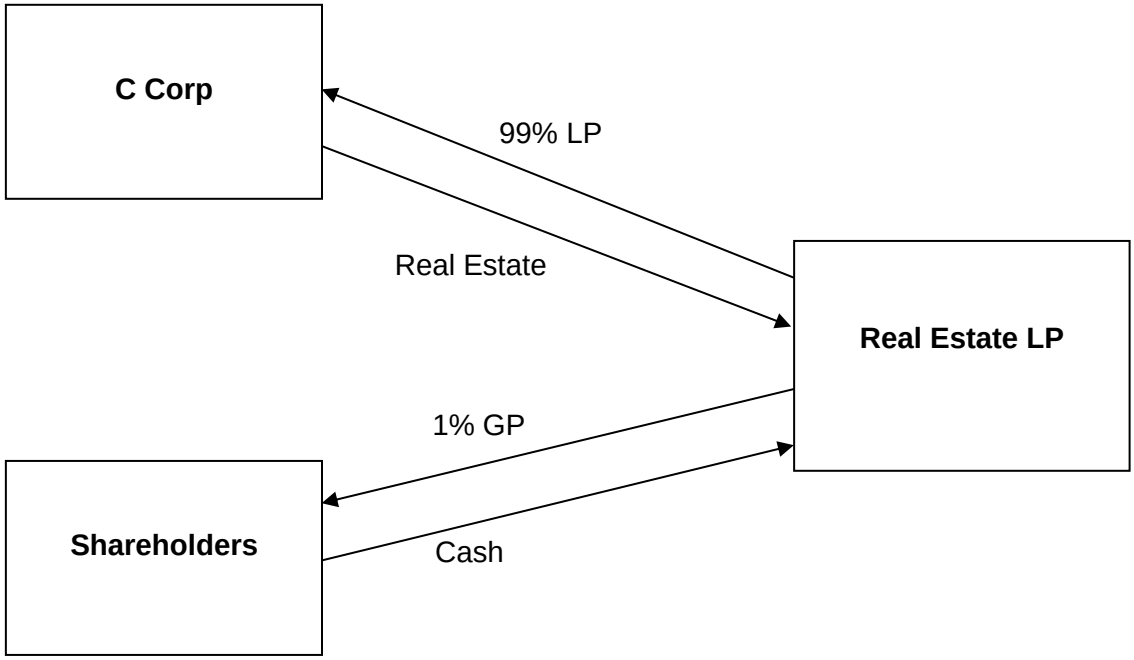
[3856] Code § 1014(c).
[3857] See part II.G.16 Limitations on the Use of Installment Sales for that or other accelerating events.
[3858] Code § 453A(d).
[3859] Code § 453A(c)(4).
[3860] See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests.
[3861] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).
[3862] Code § 453(b)(2)(A). The quoted language is from Code § 453(*l*)(1) and is subject to exceptions in Code § 453(*l*)(2).
[3863] See *SI Boo, LLC v. Commissioner*, T.C. Memo. 2015-19; see fn. 3106 and the accompanying text for this case's facts and analysis.

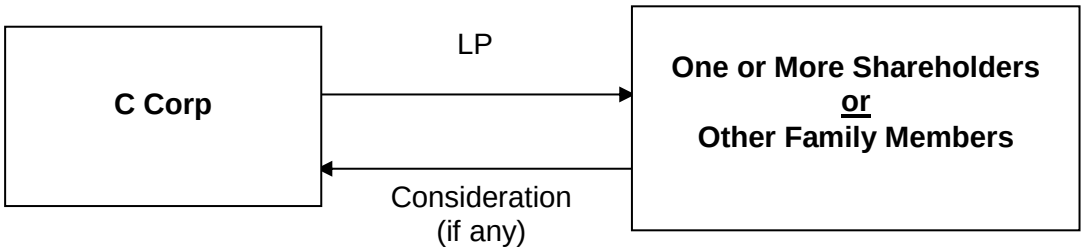
**II.Q.7.h. Distributing Assets; Drop-Down into Partnership**

**II.Q.7.h.i. Structure**

Step 1




Step 2




***Step 1***

General rule under Code § 721 is no gain or loss to contributing partner or receiving partnership when a partnership interest is issued in exchange for cash or other property.

Although real estate is illustrated here, this transaction could involve a line of business or marketable securities. However, if it involves marketable securities and the other partners contribute more than a de minimis amount, then one needs to consider additional issues to avoid gain recognition. Code § 721(b).

***Step 2***

The corporation recognizes gain as if it had sold the property that was distributed. Code § 311. Given that what is transferred is an interest as a limited partner, valuation discounts would reduce the transfer's value and therefore the gain that it triggers.

Shareholders recognize dividend income to the extent of the corporation's earnings and profits (E&P) if it is a distribution (or a state law redemption that does not qualify as an income tax redemption under Code § 302). The balance of the distribution simply reduces the stock's basis and is capital gain after that.

Step 2 could also be done as a taxable sale.

Step 2 might be done in stages to minimize step transaction attacks, including those mentioned in footnote 4607.

### II.Q.7.h.ii. Taxation of Shareholders When Corporation Distributes Cash or Other Property

For taxation of distributions by S corporations, see part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations.

Distributions to shareholders of a C corporation are taxed as dividends to the extent of earnings and profits (E&P), then as return of basis, and then as gain on the sale of stock.[4598] The distributions are applied to each block of share proportionately; if a block of stock has basis lower than other blocks of stock and runs out of basis, then distributions attributable to that block trigger gain, even if the shareholder has plenty of basis available in other blocks of stock that would otherwise have been available to absorb the distribution tax-free.[4599]

Redemptions reduce E&P.[4600]

### II.Q.7.h.iii. Taxation of Corporation When It Distributes Property to Shareholders

The rules below apply to S corporations as well as C corporations.[4601]

#### II.Q.7.h.iii.(a). Taxable Gain to Corporation When It Distributes Property to Shareholders Other Than in Liquidation of the Corporation

Code § 311(b)(1) taxes a corporation when it distributes appreciated assets to its shareholders in a distribution described in Code §§ 301-307 (note that corporate liquidations are described in Code §§ 331-346).[4602] The corporation is deemed to have sold the assets to the distributee.[4603]

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[4598] Code § 301(c).

[4599] *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971), *rev'g* 303 F.Supp. 1 (E.D. Va. 1969).

[4600] Code § 312(n)(7), superseding the limitations of Reg. § 1.312-5. Rev. Rul. 79-376, which had governed, was obsoleted by Rev. Rul. 95-71, presumably in response to this change; see T.M. 767 Redemptions IV.A.2.c. The Senate Report to P.L. 98-369 that enacted the current statutory language provides:

> In the case of a distribution by a corporation in redemption of its own stock, earnings and profits are to be reduced in proportion to the amount of the corporation's outstanding stock that is redeemed. However, the Senate does not intend that earnings and profits be reduced by more than the amount of the redemption.

[4601] Code § 1371(a).

[4602] For the latter, see part II.Q.7.a.vii Corporate Liquidation.

[4603] Although a bargain sale of property to a shareholder is a deemed sale for full fair market value with the bargain element constituting a divided, a corporation is not required to make a profit when it provides services to a shareholder – reimbursing the corporation for the costs it incurred is sufficient to avoid any

If the corporation is a C corporation, then the deemed sale is taxed at ordinary income rates, just like any other corporation gain or loss would be. If the corporation is an S corporation, then it is taxed to the shareholders on their K-1s,[4604] subject of course to any applicable built-in gain tax under Code § 1374.[4605] The entire gain (not just depreciation recapture) from the deemed sale of any depreciable or amortizable property may be taxed as ordinary income (which, in addition to having consequences to S corporation owners, can be an issue to C corporations that have capital losses that could otherwise be offset).[4606]

If the distribution is of all of the corporation's interest in the property, the IRS will attempt to disregard any valuation discounts that would not have applied if the corporation had distributed all of the corporation's interest in the property to one shareholder.[4607] Furthermore, if the IRS determines that a corporation's receipt of a partnership interest does not constitute adequate and full consideration for the property it transferred to the partnership, the IRS will argue that a dividend was made to the other partners and that the corporation recognized gain on the property deemed distributed to the other partners.[4608] However, in what might be the same case, the IRS lost that argument, when the taxpayer convinced the court of the taxpayer's business purpose, in *Cox Enterprises, Inc. & Subsidiaries v. Commissioner*.[4609]

### II.Q.7.h.iii.(b). Nondeductible Loss to Corporation When It Distributes Property to Shareholders

Under Code § 311(a), a corporation cannot deduct a loss when distributing property, the value of which is less than its basis.

CCA 201421015 concluded:[4610]

> Disallowed § 311(a) losses will be treated as non-deductible, non-capital expenses pursuant to § 1367(a)(2)(D). Thus, a § 311(a) loss will reduce shareholders' bases in S corporation stock, and the S corporation must reduce its accumulated adjustments account.

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sale or dividend treatment. *Welle v. Commissioner*, 140 T.C. 420 (2013) (services were incidental; business generally was conducted to make a profit in serving the general public).

[4604] Code § 1366.

[4605] See part II.P.3.b.ii Built-in Gain Tax.

[4606] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

[4607] TAM 200443032; *Pope & Talbot, Inc. v. Commissioner*, 104 T.C. 574 (1995), *aff'd* 162 F.3d 1236 (9th Cir. 1999). See also *Robert E. Smith, III v. Commissioner*, T.C. Memo. 2017-218, in which an S corporation was formed and liquidated in the same year and claimed a loss on the deemed sale of the limited partnership interest it received when it also formed the partnership in the same year; the economic substance doctrine disallowed the loss and imposed penalties (see part II.G.18 Economic Substance Penalty and Doctrines, but the tax year was before Code § 7701(o) was enacted, so penalties applied even without that statute).

[4608] TAM 200239001 (property deemed distributed is based on the value of the property contributed to the partnership rather than the value of the partnership interests received by the partner).

[4609] T.C. Memo. 2009-134.

[4610] This disallowed loss nevertheless reduces the S stock's basis. See fn. 1130.

### II.Q.7.h.iv. Taxpayer Win in *Cox Enterprises* When IRS Asserted That Contributing Property to Partnership Constituted Distribution to Shareholders (2009); *Dynamo Holdings*' Limitation on Using *Cox Enterprises* (2018)

Before discussing *Cox Enterprises*, let's review an important concept when entities owned by related parties conduct business. *Dynamo Holdings Ltd. Partnership v. Commissioner*, T.C. Memo. 2018-61, enunciated the issue of "constructive distribution":

> It is well settled that a transfer of property from one entity to another for less than adequate consideration may constitute a constructive distribution to an individual who has ownership interests in both entities.[4611] A bargain sale, including a bargain sale based on competing property valuations, between related parties, however, does not automatically result in a constructive distribution.[4612]
>
> Courts have outlined a two-prong analysis to determine whether a transfer resulted in a constructive distribution. The first prong, the objective test, asks whether the transfer caused "funds or other property to leave the control of the transferor corporation and …[whether] it allow[ed] the stockholder to exercise control over such funds or property either directly or indirectly through some instrumentality other than the transferor corporation." [4613] The second prong, the subjective test, a "crucial inquiry" in the constructive distribution determination, asks whether the transfer occurred primarily for the common shareholder's personal benefit rather than for a valid business purpose.[4614] Both prongs must be satisfied for a court to find a constructive distribution.[4615]

As to the objective prong, "Because the common shareholder does not directly receive funds or property in a transfer between entities, such a transfer is a distribution if: (1) the transferred funds leave the control of the transferring entity and (2) the owner controls the funds, directly or indirectly, through some means other than the transferor."[4616] As to the subjective prong, *Dynamo Holdings* enunciated:

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[4611] Fn 76 of *Dynamo Holdings* cited here:
*Stinnett's Pontiac Serv., Inc. v. Commissioner*, 730 F.2d at 640; *Cox Enters., Inc., & Subs. v. Commissioner*, T.C. Memo. 2009-134, 97 T.C.M. (CCH) 1767, 1774 (2009).
Fn 42 of *Dynamo Holdings* introduced the citation to *Stinnett's Pontiac Service, Inc. v. Commissioner*, 730 F.2d 634, 638 (11th Cir. 1984), *aff'g* T.C. Memo. 1982-314.

[4612] Fn 77 of *Dynamo Holdings* cited here:
*Davis v. Commissioner*, T.C. Memo. 1995-283, 69 T.C.M. (CCH) 3004, 3007 (1995); *see also Joseph Lupowitz Sons, Inc. v. Commissioner*, 497 F.2d 862, 868 (3d Cir. 1974), *aff'g in part, rev'g in part* T.C. Memo. 1972-238; *Cox Enters., Inc., & Subs. v. Commissioner*, 97 T.C.M. (CCH) at 1775.

[4613] Fn 78 of *Dynamo Holdings* cited here:
*See Stinnett's Pontiac Serv., Inc. v. Commissioner*, 730 F.2d at 641 (quoting *Sammons v. Commissioner*, 472 F.2d 449, 451 (5th Cir. 1972), *aff'g in part, rev'g in part* T.C. Memo. 1971-145.

[4614] Fn 79 of *Dynamo Holdings* cited here:
*Wilkof v. Commissioner*, T.C. Memo. 1978-496, 37 T.C.M. (CCH) 1851-31, 1851-38 (1978), *aff'd*, 636 F.2d 1139 (6th Cir. 1981).

[4615] Fn 80 of *Dynamo Holdings* cited here:
*Sammons v. Commissioner*, 472 F.2d at 451; *Cox Enters., Inc., & Subs. v. Commissioner*, 97 T.C.M. (CCH) at 1774.

[4616] Fn 81 of *Dynamo Holdings* cited here:
*Sammons v. Commissioner*, 472 F.2d at 453; *Davis v. Commissioner*, 69 T.C.M. (CCH) at 3007.

> The subjective prong asks the Court to consider whether the transfer occurred primarily for the benefit of the common shareholder, rather than for a valid business purpose. In applying the subjective prong "the search for this underlying purpose usually involves the objective criterion of actual primary economic benefit to the shareholders as well".[4617] The Court of Appeals for the Eleventh Circuit states the point as follows: "In determining whether the primary purpose test has been met, we must determine not only whether a subjective intent to primarily benefit the shareholders exists, but also whether an actual primary economic benefit exists for the shareholders."[4618]
>
> If the primary purpose is a valid business purpose, then the primary purpose is not for the shareholder benefit.[4619] The benefit to the shareholder must be "direct", a term broadly construed.[4620] For example, courts have found a benefit to the shareholder when the primary purpose of the transfer is to or for the benefit of a member of the shareholder's family.[4621]

The *Cox* court held that a corporation's contribution of a television station to a partnership did not constitute a dividend even though the partnership interest it received was originally worth $60.5 million less than the assets it contributed. The partners in the partnership were the remaindermen of certain trusts. These trusts, indirectly and collectively, owned 98% of the corporation's stock.

The corporation contributed assets worth $300 million, became the managing general partner, and received a majority partnership interest, which entitled it to 55% of partnership distributable

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Based on the *Dynamo Holdings* conclusion below, it's not surprising that the court concluded:

> Considering the control Mrs. Moog exercised over Beekman and Dynamo through 2020072 Ontario, Ltd., we conclude the first prong of the two-prong analysis for a constructive distribution is satisfied. Mrs. Moog had the ability to divert the value of the property to her chosen recipient because of her control.

[4617] Fn 82 of *Dynamo Holdings* cited here:
*Cox Enters., Inc., & Subs. v. Commissioner*, 97 T.C.M. (CCH) at 1774 (quoting *Kuper v. Commissioner*, 533 F.2d 152, 160 (5th Cir. 1976)); *see also Stinnett's Pontiac Serv., Inc. v. Commissioner*, 730 F.2d at 641.

[4618] Fn 83 of *Dynamo Holdings* cited here:
*Stinnett's Pontiac Serv., Inc. v. Commissioner*, 730 F.2d at 641.

[4619] Fn 84 of *Dynamo Holdings* cited here:
*Stinnett's Pontiac Serv., Inc. v. Commissioner*, 730 F.2d at 641; *Sammons v. Commissioner*, 472 F.2d at 452; *Cox Enters., Inc., & Subs. v. Commissioner*, 97 T.C.M. (CCH) at 1774.

[4620] Fn 85 of *Dynamo Holdings* cited here:
*Gilbert v. Commissioner*, 74 T.C. 60, 64 (1980); *Wilkof v. Commissioner*, 37 T.C.M (CCH) at 1851-38; *see also Rushing v. Commissioner*, 52 T.C. 888, 894 (1969) ("[W]hatever personal benefit, if any, Rushing [the sole shareholder of the transferor and transferee corporations] received was derivative in nature. Since no direct benefit was received, we cannot properly hold he received a constructive dividend."), *aff'd*, 441 F.2d 593 (5th Cir. 1971).

[4621] Fn 86 of *Dynamo Holdings* cited here:
*Green v. United States*, 460 F.2d 412, 419-421 (5th Cir. 1972); *Byers v. Commissioner*, 199 F.2d 273, 275 (8th Cir. 1952), *aff'g* a Memorandum Opinion of this Court, *Epstein v. Commissioner*, 53 T.C. 459, 474-475 (1969) (explaining that it is firmly established that when a corporation makes a transfer of property for no or insufficient consideration "to a member of the stockholder's family, whether it be directly or in trust, the stockholder has enjoyed the use of such property no less than if it had been distributed to him directly").

Based on the *Dynamo Holdings* conclusion below, it's not surprising that the court held that the test for constructive distributions was satisfied.

profits and liquidation proceeds up to specified base amounts and 75% of distributable profits and liquidation proceeds in excess of those base amounts. The other partners contributed assets worth $62 million and received the balance of the rights to distributions. Thus, the corporation contributed nearly 83% ($300 million divided by $362 million) of the assets and received the right to profits of 55%-75%.

The IRS argued that the transfer to the partnership should be deemed an indirect distribution to the remaindermen of the trusts and therefore a distribution to the trusts. Judge Halpern rejected the IRS' contention. First, he held that the corporation's transfer to the partnership "was not intended to provide a gratuitous economic benefit to the other partners…." Second, he held that, even if the corporation had made such a gratuitous transfer, the transfer did not benefit the shareholder trusts.

In *Cox*, several factors demonstrated that the corporation's directors did not intend a gratuitous transfer:

1. The partnership's formation had nontax business reasons. As recommended by independent consultants, the corporation tried to sell these operating assets but was unable to do so. The partnership's formation allowed the corporation to retain, for use in other areas, the working capital it had previously needed for the television station.

2. The corporation's board's executive committee adopted a resolution that the other partners be required to make cash contributions to the partnership "in an amount corresponding to the fair market value of the partnership interests acquired by" those other partners. Furthermore, the other partners' acquisition of partnership interests was to "be on terms and conditions no less favorable to" the corporation "than the terms and conditions that would apply in a similar transaction with persons who are not affiliated with" the corporation.

3. The corporation retained an outside accounting firm "to render an opinion of appropriate marketability and minority interest discounts applicable to a minority interest" in the partnership as of the date of formation. The partners made contributions based on the appraised amount. Three years later, the corporation's management discovered errors in computing the other partners' interests in the partnership and obtained a new appraisal. The other partners made additional contributions to bring their contributions up to the appraised value.

4. The court relied on *United States v. Byrum*[4622] to find that the controlling shareholders were subject to fiduciary duties to the minority shareholders. In the *Cox* case, two percent of the stock was owned by people who were not members of the controlling family; these minority shareholders were principally employees of the corporation. Judge Halpern pointed out that the minority shareholders did not own interests in the other partners and "would not be made financially whole for the likely shortfall in income and liquidation (or sale) proceeds" if the corporation's contribution to the partnership constituted a transfer to the other partners.

The court also found that any gratuitous transfer to the other partners would not have benefitted the shareholder trusts. The remaindermen of the trusts held significant interests in the partners, so a transfer to the other partners would have accelerated the remaindermen's interests in violation of the trust agreements. Because the trusts were the controlling shareholders (and the

[4622] 408 U.S. 135, 137-138 (1972).

court assumed for the sake of argument that the trustees also controlled the actions of the other board members), the trustees would have violated their fiduciary duties by accelerating the interests of the remaindermen. Thus, a gratuitous transfer to the other partners would have been detrimental to the shareholder trusts as entities and would have violated the trustees' fiduciary duties.

The court concluded that any gratuitous transfer of an interest from the corporation to the other partners did not constitute a distribution to the shareholder trusts subject to Code § 311.[4623]

Other issues relating to these parties were still before the court when Judge Halpern wrote this opinion, some of which involved the trusts themselves. Subject to any light shed by those cases, one may draw some planning tips from this case:

1. As usual, documenting a transaction very well is always advisable, particularly documentation demonstrating an intent to deal at arms-length.

2. Although the Tax Court seems to place little weight on the *Byrum* case in family limited partnership cases under Code § 2036, having nonfamily member employees hold 2% of the stock might do the trick.

3. Practitioners often wonder whether parties must contribute assets with fair market value to obtain capital accounts proportionate to their interests in profits when all partners are making their initial contributions on formation of the partnership. In this case, the majority partner (the corporation) contributed assets with value significantly in excess of the value of its partnership interest. However, the minority partners contributed assets equal to the value of their interests in the partnership. Thus, the majority partners received capital accounts that were higher relative to their interests in profits compared with the minority partners' capital accounts relative to their respective interests in profits. Judge Halpern did not seem to recognize this issue; if he did, he did not mention it in analyzing the dividend issue.[4624] It will be interesting to see whether the companion cases consider this issue to be of consequence.

However, *Dynamo Holdings Ltd. Partnership v. Commissioner*, T.C. Memo. 2018-61, which was a taxpayer win on other intra-family issues,[4625] contrasted its taxpayer's repeated bargain sales against *Cox Enterprises*' isolated transaction. *Dynamo Holdings* noted and reasoned (footnotes to *Cox Enterprises* omitted):

> Petitioners argue that Beekman's directors held fiduciary duties to the beneficiaries of the Canadian trusts not to deplete the value of Beekman and therefore Beekman could not have underpriced the property. Petitioners rely on *Cox Enters.*, where we held that there was not a constructive distribution. In *Cox Enters.*, one corporation contributed an

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[4623] For information on Code § 311, see part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

[4624] If this case is the same as TAM 200239001, then the IRS must have pressed this issue, because the TAM specifically addressed it. The judge did point out that the IRS argued, in the alternative, that the dividend was of the TV station or of a partnership interest. However, he still did not seem to notice the disproportionality on which the TAM focused.

[4625] See part III.B.1.a.i.(a) Loans Must be Bona Fide, text accompanying fns 5739-5755, excused defects in formalities of loans because, objectively, the parties treated the advances as loans, consistently reported them as such for tax purposes, and were intended to be - and actually were - repaid.

asset to a partnership in exchange for a partnership interest the value of which was lower than the value of the contributed asset, effectively transferring value to the other partners. The other partners were two family partnerships. We found that the primary purpose was not to benefit the other partners, in part because the corporation's majority shareholder and directors would have had to breach their fiduciary duties. This would have resulted in a financial detriment to the minority shareholders who did not own any interest in the partnerships.

Petitioners ask that we follow this line of reasoning because the beneficiaries of the Canadian trusts are not identical to the beneficiaries of the U.S. trusts. Petitioners argue that the directors, officers, and controlling shareholders did not breach any duties to the Canadian trusts by depleting value from Beekman. We disagree. *Cox Enters.* involved a single instance of undervaluing an interest. In these cases, we have found five bargain sales exceeding $200 million. Unlike *Cox Enters.*, we find that the directors, officers, and controlling shareholder acted for the benefit of the U.S. trusts and to the detriment of the Canadian trusts.

We agree with the Commissioner that the primary intent and benefit was for Dynamo and by extension, the dynasty trusts. The bargain sale properties went to Dynamo, enhancing its value. The properties put more equity in Dynamo and freed up its liquid assets. This allowed Dynamo to develop its Florida business and increased Dynamo's borrowing capability. All of this directly benefited the dynasty trusts for the benefit of Christine and Mr. Julien and furthered Mrs. Moog's estate planning. Accordingly, Beekman made deemed distributions.

### II.Q.7.h.v. Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014)

In *Bross Trucking, Inc. v. Commissioner*,[4626] the IRS asserted that the existing corporation (Bross Trucking) distributed appreciated intangible assets to its sole shareholder, who then made a gift of the intangibles to his three sons, who organized their own[4627] corporation (LWK

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[4626] T.C. Memo. 2014-107.

[4627] The sons were not actually the owners – it was their Roth IRAs, as the court explained:

> LWK Trucking was organized on October 1, 2003. Its stock was divided into two classes when it was organized: class A voting stock and class B nonvoting stock. Class A stock represented a 98.2% interest in LWK Trucking and class B stock represented the remaining 1.8%. In December of 2003 each of the three Bross sons established a self-directed Roth IRA. Later that month, each of the Bross sons directed his respective Roth IRA to acquire 2,000 shares of class A shares in LWK Trucking. Together, the 6,000 shares acquired by the three Roth IRAs represented all of the class A shares in LWK Trucking, giving the three sons a combined 98.2% interest in LWK Trucking.[8] The remaining class B shares were acquired by an unrelated third party.

Footnote 8 commented:

> As stated infra note 19, a discussion on the merits of this structure is not relevant to the issues in these cases and the Court does not address the validity of this transaction.

Footnote 19 stated:

> Thus, Mr. Bross could not transfer Bross Trucking assets to his three sons, and it follows that the three Bross sons could not transfer Bross Trucking assets to each of their respective Roth IRAs. Accordingly, IRS Notice 2004-8, 2004-1, C.B. 333, is outside the scope of these cases because

Trucking). The alleged value of the intangible assets would have required both filing a gift tax return and paying gift tax.

The court held:

> there are two regimes of goodwill: (1) personal goodwill developed and owned by shareholders; and (2) corporate goodwill developed and owned by the company. Bross Trucking's goodwill was primarily owned by Mr. Bross personally, and the company could not transfer any corporate goodwill to Mr. Bross in tax year 2004.

Although a lack of non-compete agreements generally facilitates the lack of corporate goodwill, [4628] in this case regulatory action jeopardized Bross Trucking's business and

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> Bross Trucking and LWK Trucking never shared any assets. Further, a discussion on the structure of the Bross sons' ownership of LWK Trucking is outside the scope of this opinion.

My understanding is that the IRS initiated this audit to explore Roth IRA issues, then focused its attack on the corporate issues, trying to get more money from the taxpayers. For more on Roth IRAs owning businesses, see part II.G.23 IRA as Business Owner.

[4628] See part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees? Focusing on the authority cited in fn. 3806, the *Bross Trucking* court held that any goodwill associated with Bross Trucking was personally owned by its shareholder:

> The remaining attributes assigned to Bross Trucking's goodwill all stem from Mr. Bross's personal relationships. Bross Trucking's established revenue stream, its developed customer base, and the transparency of the continuing operations were all spawned from Mr. Bross's work in the road construction industry.
>
> Any established revenue stream, developed customer base, or transparency of continuing operations was a direct result of Mr. Bross's personal efforts and relationships. Like the shareholder in Martin Ice Cream Co., Mr. Bross developed the crucial relationships with the businesses' customers. Bross Trucking's customers chose to patronize the company solely because of the relationships that Mr. Bross personally forged. Mr. Bross had close, personal relationships with the owners of Bross Trucking's primary customers. For example, Mark Twain Redi-Mix, a substantial Bross Trucking customer, was owned by Mr. Bross's wife and two sons. As with the taxpayer in *Norwalk v. Commissioner*, T.C. Memo. 1998-279, it is safe to assume that Bross Trucking's customers sought Mr. Bross' personal ability and reputation when hiring Bross Trucking because he was a successful construction businessman who has been in the road construction industry since the 1960s.
>
> Bross Trucking may have had a developed revenue stream, but only as a result of Mr. Bross' having personal relationships with the customers. It follows that Bross Trucking's developed customer base was also a product of Mr. Bross' relationships. Mr. Bross was the primary impetus behind the Bross Family construction businesses, and the transparency of the continuing operations among the entities was certainly his personal handiwork. [footnote omitted] His experience and relationships with other businesses were valuable assets, but assets that he owned personally.
>
> A company does not have any corporate goodwill when all of the goodwill is attributable solely to the personal ability of an employee. See *MacDonald v. Commissioner*, 3 T.C. 720, 727 (1944); *Norwalk v. Commissioner*, T.C. Memo. 1998-279. Unlike the taxpayer's products in *Solomon v. Commissioner*, T.C. Memo. 2008-102, Bross Trucking's products did not contribute to developing the goodwill. This is demonstrated in part by the services performed by Bross Trucking. Bross Trucking's business model involved hiring independent contractors to haul equipment and supplies around the State. There were very few obstacles to obtaining authority and directly hiring the independent contractors who performed the actual work for Bross Trucking. The State of Missouri's deregulation of the trucking industry allows new entrants to easily begin trucking operations. In other words, it was not Bross Trucking's product which enticed customers to use its services because the services were not unique. *Cf. Schilbach v. Commissioner*, T.C.

necessitated forming a new company.[4629] Therefore, the court held that "the sole attribute of goodwill displayed by Bross Trucking was a workforce in place, and it is therefore the only

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Memo. 1991-556 (holding that a single-shareholder-owned professional corporation possessed all of the goodwill because the corporation's services were unique and was not based on the ability of the shareholder). The expectation of continuing patronage must have been a result of the unique relationships between Mr. Bross and the customers.

….

Mr. Bross did not transfer any goodwill to Bross Trucking through an employment contract or a noncompete agreement. A key employee [footnote omitted] who develops relationships for his or her employer may transfer goodwill to the employer through employment contracts or noncompete agreements. See *Martin Ice Cream Co. v. Commissioner*, 110 T.C. at 207. The transfer is evidenced by the employee's covenant to not use his or her goodwill to compete against the employer. *O'Rear v. Commissioner*, 28 B.T.A. 698, 700 (1933) ([I]t is at least doubtful whether a professional man can sell or dispose of any good will which may attach to his practice except perhaps by contracting to refrain from practicing.), *aff'd*, 80 F.2d 473 (6th Cir. 1935). In other words, an employee transfers the benefit of his or her relationships to an employer when the employee cannot benefit from the relationships without the employer.

An employer has not received personal goodwill from an employee where an employer does not have a right, by contract or otherwise, to the future services of the employee. See *MacDonald v. Commissioner*, 3 T.C. at 727-728. Mr. Bross did not have an employment contract with Bross Trucking and was under no obligation to continue working for Bross Trucking. A contractual duty to continue to use his or her assets for the benefit of the company may show that an employee transferred personal goodwill to an employer for the length of the obligation. Mr. Bross, however, was under no such obligation: he was free to leave the company and take his personal assets with him. Similarly, the lack of an employment contract shows that there was not an initial obligation for Mr. Bross to transfer any of his personal assets to Bross Trucking. Bross Trucking did not take an ownership interest in Mr. Bross' goodwill from the beginning because Mr. Bross never agreed to transfer those rights. Thus, the lack of an employment contract between Mr. Bross and Bross Trucking shows that Bross Trucking did not expect to--and did not--receive personal goodwill from Mr. Bross. Accordingly, Mr. Bross' personal goodwill remained a personal asset separate from Bross Trucking's assets.

An employee may transfer personal goodwill to an employer through a covenant not to compete. See *Martin Ice Cream Co. v. Commissioner*, 110 T.C. at 207-208; *H & M Inc. v. Commissioner*, T.C. Memo. 2012-290. In those cases the Court held an employee did not transfer personal goodwill to the employer because he or she did not sign a noncompete agreement. Similar to those taxpayers, Mr. Bross never transferred any personal goodwill to Bross Trucking by signing a noncompete agreement. Much in the same way that Bross Trucking did not have any contractual expectation of continued services from Mr. Bross while he was an employee, Bross Trucking could also not expect to benefit from Mr. Bross's personal goodwill after he left the business. Mr. Bross' freedom to use his personal goodwill in direct competition with Bross Trucking if he stopped working for the company shows that he did not transfer it to Bross Trucking.

[4629] The *Bross Trucking* court stated:

Bross Trucking might have had elements of corporate goodwill at some point but had lost most of it by the time of the alleged transfer. Specifically, through various regulatory infractions Bross Trucking lost any corporate goodwill because of an impending suspension and the negative attention brought by the Bross Trucking name. During the late 1990s and early 2000s Bross Trucking was investigated extensively by the DOT and the MCRS. As a result of the investigations, Bross Trucking faced a possible suspension of operations and several fines because the authorities gave Bross Trucking unsatisfactory safety ratings. Further, the various regulatory authorities were hounding Bross Trucking to the point that LWK Trucking wanted to immediately remove the Bross name from leased trucks to avoid their being spotted and stopped.

attribute that the corporation could have distributed to Mr. Bross." The court rejected the IRS' assertion that Bross Trucking's intangible workforce assets were transferred to LWK Trucking[4630] or that any other transfers occurred.[4631]

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The impending suspension would cause customers to reevaluate whether to trust Bross Trucking and continue to do business with it. Indeed, Mr. Bross expressed his concern to his attorney that Bross Trucking might not be able to perform necessary functions as a result of the suspension. Mr. Bross's solution was to find or create another business to take over the trucking needs for the Bross family businesses. This is the antithesis of goodwill: Bross Trucking could not expect continued patronage because its customers did not trust it and did not want to continue doing business with it.

Further, the lack of corporate goodwill is demonstrated by the necessity to separate LWK Trucking from Bross Trucking by hiding the Bross name on leased trucks. Trade names and trademarks are the embodiment of goodwill. *Canterbury v. Commissioner*, 99 T.C. 223, 252 (1992). LWK Trucking specifically chose to quickly remove the Bross Trucking name from any leased equipment to avoid confusion between the two companies. This shows that any transferred corporate goodwill was not valuable and may have actually been detrimental to LWK Trucking. In other words, LWK Trucking was trying to hide any relationship with Bross Trucking because association with the targeted company was seen in a negative light. A new company trying to use the transferred goodwill of another company would likely try to associate with the recognized company, not hide the company logo.

Mr. Bross credibly testified that Bross Trucking had relationships with several national suppliers for fuel and parts, but no evidence was submitted showing that LWK Trucking benefited from any transferred supplier relationships. Further, it is unclear whether Mr. Bross or Bross Trucking cultivated the supplier relationships.

….

Bross Trucking's customers had a choice of trucking options and chose to switch from Bross Trucking to LWK Trucking. Respondent's contention that Bross Trucking transferred a developed customer base and an established revenue stream is misleading because it suggests that the transfer was organized between Bross Trucking and LWK Trucking. It appears, however, that Bross Trucking's customers were interested in changing trucking providers because of the impending suspension, showing that the act was not a transfer of intangibles at the service provider level but a business choice made at the customer level. For example, forming LWK Trucking gave Mark Twain Redi-Mix, which shared ownership with LWK Trucking and one of Bross Trucking's primary customers, the option to use a trucking company with an untarnished reputation and clean service record. Thus, the facts support a finding that Bross Trucking did not transfer its customers but that the customers chose to use a new company because of Bross Trucking's troubled past.

[4630] The *Bross Trucking* court stated:

As discussed above, the only aspect of corporate goodwill that Bross Trucking displayed was a workforce in place, but Bross Trucking did not transfer an established workforce in place to Mr. Bross. Respondent repeatedly contends that most of the Bross Trucking employees became LWK Trucking employees. The evidence, however, shows that only about 50% of LWK Trucking's employees formerly worked at Bross Trucking. The Court is unconvinced that most of a workforce in place was transferred when only 50% of the current employees were previously employees by the alleged transferor. Instead it appears that LWK Trucking assembled a workforce independent of Bross Trucking. This is demonstrated by the new key employees and services offered by LWK Trucking. Mr. Bross's sons managed LWK Trucking and also engaged in services different from those performed at Bross Trucking. For instance, in 2004 LWK Trucking started One Star Midwest, which sold GPS services, and LWK Trucking later started performing truck maintenance for third parties. Bross Trucking did not perform these services and could not have provided employees to start the separate service lines . LWK Trucking may have hired former Bross Trucking employees, but there is no evidence that these employees

### II.Q.7.h.vi. IRS' Conservative Roadmap: Letter Ruling 200934013

This ruling approved a corporation's contribution of marketable securities to a partnership in exchange for a partnership interest.[4632] Unlike *Cox Enterprises*, no value was shifted, although future appreciation would be effectively shifted out. This ruling followed the IRS' position that one cannot create discounts by placing assets in a partnership and then distributing all of the corporation's partnership interests to the shareholders. A family-owned S corporation ("Corp") owned 100% of the membership interests in LLC, which was disregarded as an entity separate from Corp for federal tax purposes. LLC's operations consist solely of investing in a diversified portfolio of passive investment assets, including hedge funds, mutual funds, and private equity funds. LLC has no outstanding liabilities. Shareholder A and Corp reached an agreement pursuant to which Shareholder A was admitted as a new member of LLC. Specifically, Shareholder A contributed cash to LLC in exchange for a newly issued, non-voting, preferred interest in LLC. The terms and pricing of the preferred interest were based on an independent appraiser's determination of market rate terms for similar equity investments.

For what have been represented to be valid business purposes, the following steps were proposed: (i) Corp will distribute some of its membership interests in LLC pro-rata to its stockholders (the "Distributed LLC Interests") and (ii) LLC's operating agreement will be amended to provide Corp with a share of LLC's profits disproportionate to capital in exchange for Corp providing future management services to LLC with respect to LLC's ongoing activities. Corp made the following representations with respect to this ruling request:

(a) The principal purpose of the Shareholder A contribution to LLC in exchange for a preferred membership interest was to allow Shareholder A to invest his excess cash directly in a

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were transferred to LWK Trucking rather than hired away on their own merit. It is also unclear whether any of the alleged transferred employees that moved to LWK Trucking were independent contract drivers. These drivers were not obligated to work solely for Bross Trucking and in fact were almost certainly expected to have contracts with companies outside of Bross Trucking. Independent contractors' choosing to accept work from a different business is not a transfer of workers.

[4631] The *Bross Trucking* court stated:

In addition, Bross Trucking did not distribute any cash assets and retained all the necessary licenses and insurance to continue business. Further, Mr. Bross remained associated with Bross Trucking and was not involved in operating or owning LWK Trucking. He was free to compete against LWK Trucking and use every cultivated relationship in order to do so. In other words, the fact that Bross Trucking could have resumed its hauling business supports the view that it retained any corporate intangibles. Accordingly, there was no transfer of intangible assets because Bross Trucking's customers chose to use a different company and Bross Trucking remained a going concern.

LWK Trucking did not benefit from any of Bross Trucking's assets or relationships. LWK Trucking was independently licensed and developed a wholly new trucking company. LWK Trucking did not take a transferred basis in any assets such as property or purchased authority. There is no indication that LWK Trucking used any relationship that Mr. Bross personally forged. The Bross sons were in a similarly close capacity to Bross Trucking's customers to develop relationships apart from Mr. Bross. Cultivating and profiting from independently created relationships are not, however, the same as receiving transferred goodwill. It is true that LWK Trucking's and Bross Trucking's customers were similar, but it does not mean that Bross Trucking transferred goodwill; instead the record shows that LWK Trucking's employees created their own goodwill.

[4632] For more information on preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

diversified portfolio of investment assets managed by a team of experienced professionals, in a manner that allows Shareholder A to enjoy a high rate of preferred return and a priority on distributions. The principal purposes of the Proposed Transaction are to: (1) increase flexibility with respect to the allocation of profits, losses, and cash distributions associated with the LLC asset pool through issuance of various classes of interests in LLC, (2) provide increased liability protection to the LLC asset pool from the ongoing business operations of Corp, (3) facilitate estate planning and charitable objectives of Corp shareholders with respect to their investment in LLC, and (4) facilitate continued co-investment amongst family members outside of Corp.

b) Shareholder A cannot independently cause Corp to distribute its interest in LLC. Additionally, Shareholder A's contribution to LLC was not dependent upon the consummation of the Proposed Transaction and the Corp stockholders had not ratified the Proposed Transaction as of the date of the ruling request.

(c) Following the Proposed Transaction, it is intended that LLC will continue to carry on the operations that were carried on by LLC before the Proposed Transaction.

(d) At the time of the Proposed Transaction, there will be no amounts payable or receivable between LLC and Corp or LLC and Shareholder A.

(e) For purposes of measuring the Code § 311(b) gain to Corp on the Proposed Transaction, if any, the Distributed LLC interests will be valued as a percentage of the value of the assets held by LLC.[4633]

(f) To the best of Corp's knowledge and belief, there is no plan or intention for any transferor to transfer assets to LLC other than cash and/or a diversified portfolio of stocks and securities.[4634]

(g) The assets of LLC immediately prior to the admission of Shareholder A consisted of a diversified portfolio of stocks and securities.[4635]

(h) There is no intention following the Proposed Transaction to dispose of any material assets of LLC (other than dispositions in the ordinary course of business).

(i) To the best of Corp's knowledge and belief, the Corp stockholders have no plan or intention to dispose of any portion of the distributed LLC interests except for the potential transfer to irrevocable trusts which will be taxed as grantor trusts to the respective grantor.

(j) LLC has not, and will not, elect to be classified as a corporation.

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[4633] Citing *Pope & Talbot, Inc. v. Commissioner*, 104 T.C. 574 (1995), aff'd 162 F.3d 1236 (9th Cir. 1999). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

[4634] For this representation, a portfolio of stocks and securities is diversified under Reg. § 1.351-1(c)(6)(i) if it satisfies the 25% and 50% tests of Code § 368(a)(2)(F)(ii), applying the relevant provisions of Code § 368(a)(2)(F)(ii), except that in applying Code § 368(a)(2)(F)(iv), government securities are included in determining total assets unless government securities are acquired to satisfy the requirements of Code § 368(a)(2)(F)(ii).

[4635] As defined under Reg. § 1.351-1(c)(6)(i).

(k) No property, other than cash, has ever been contributed by Corp to LLC, and LLC has never made a distribution of property to Corp.

The IRS ruled:[4636]

- The admission of Shareholder A to LLC caused LLC to convert to a partnership for U.S. federal income tax purposes. Corp, as the sole owner of LLC prior to the admission of Shareholder A, is deemed to contribute the existing assets of LLC to the newly-formed LLC partnership in exchange for a membership interest in LLC.[4637] This deemed transaction is treated as a nontaxable contribution of property to LLC by Corp.[4638] Additionally, because the assets of LLC are represented to be a diversified portfolio of assets, Code § 721(b) does not cause taxation with respect to Shareholder A's contribution of cash and to Corp's deemed contribution of property to LLC.

- Corp's adjusted basis in the Distributed LLC Interests is equal to the product of (A) the amount of Corp's adjusted tax basis in its entire membership interest in LLC and (B) a fraction, the numerator of which is the fair market value of the Distributed LLC Interests on the date of the distribution, and the denominator of which is the fair market value of Corp's entire membership interest in LLC as of that date.

- Corp will recognize gain, if any, on the pro-rata distribution of the Distributed LLC Interests to its stockholders to the extent the fair market value of the Distributed LLC Interests exceeds their adjusted tax basis in the hands of Corp on the date of the distribution.[4639]

### II.Q.7.h.vii. What We Learned

The *Cox* case represented a significant shift in value from the corporation to the shareholders' family members. The corporation's contribution was based on a full pro-rata share of its interest in the partnership, but the family members' contribution was based on the discounted value of its interest in the partnership. The IRS argued that the value shift was a disguised dividend to the shareholders, who wanted to benefit their family members, but the taxpayer convinced the court of the transaction's strong business purpose. The IRS would probably attack similar transactions, so tax advisors should go to extra lengths to document a strong business purpose and warn clients of the risks.

The Letter Ruling shows what the IRS is willing to approve. The IRS continues to want to treat a distribution of a recently formed partnership to its shareholders as if the corporation owned and was distributing the partnership's underlying property. Corporations might want to consider waiting for a while after forming the partnership, then they might consider selling the partnership interests to shareholders at various times in separate minority blocks of the partnership, but again they should be prepared for an IRS attack.

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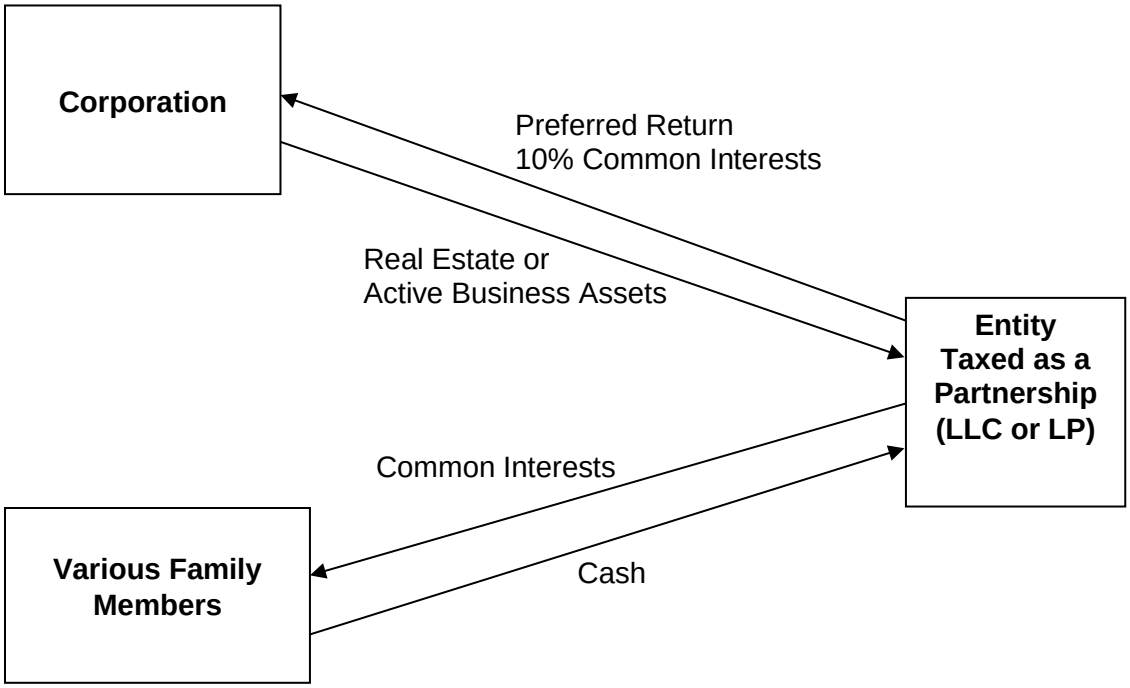
[4636] The IRS also ruled regarding Code § 2701 – that a preferred payment right, the rate at which changes over time, was not a qualified payment right except to the extent that a qualified payment right election is made. Reg. § 25.2701-2(b)(6).
[4637] Rev. Rul. 99-5.
[4638] Code § 721(a).
[4639] Code § 311(b). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

### II.Q.7.h.viii. Value Freeze as Conservative Alternative

Consider the following structure:




The corporation contributes the real estate or other business assets to a partnership,[4640] taking in return a large preferred partnership interest and an interest in the residue of the profits (a "common interest") equal in value to at least 10% of the contributed equity, with the other partners receiving a common interest in the partnership for the balance. Thus, a large majority of the total return (appreciation plus cash flow) that exceeds the preferred interest will be outside of the corporation. Moving to this structure is discussed in part II.E.7.a Overview of How to Migrate into Desired Structure and diagrammed in part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure, culminating in the above structure, which is shown at part II.E.7.c.ii Moving New LLC into Preferred Structure.

The preferred return is to be satisfied out of the partnership's net cash flow and payable at the AFR or another appropriate fixed rate; we typically ask a qualified appraiser to tell us what the rate should be. The preferred return should be cumulative and payable on a periodic basis (at least annually) to constitute a qualified payment under Code § 2701.[4641] For more information

[4640] If the owners perceive difficulty in transferring all of its assets, the owners can form an identical corporation, contribute all of the stock in the old corporation to the new corporation, then merge or convert the old corporation into an LLC owned solely by the new corporation. This first step should constitute a nontaxable F reorganization; see part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. The LLC can be the main organization in which the owners are separately admitted as members, but in most cases the corporation would just contribute its interest as the LLC's sole member to a limited partnership. See part II.E Recommended Structure for Entities.

[4641] Reg. § 25.2701-2(b)(6)(i)(B).

on preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

If the corporation is receiving a return whose present value is equal to the value of the contributed goodwill (if any), it should not be treated as having distributed such goodwill to its shareholders. Using a preferred partnership adds safety, in that a corporation can easily escape the disguised sale rules. If the preferred profits distribution is payable at no more than 150% of the AFR or is limited to the extent of operating cash flow, each of two regulations[4642] separately creates a presumption that a sale has not occurred.[4643]

Investing at least 10% of equity in a common interest is our way of trying to provide the preferred partner with more economic risk than that undertaken by a lender, which is important under cases that held that complying with the disguised sale rules was not enough because the regulations create only a presumption.[4644] This 10%-of-equity-in-common approach is not a hard and fast rule but rather an exercise of judgment; much less than 10% may very well work.

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[4642] Reg. §§ 1.707-4(a)(2) and 1.707-4(b), discussed further in part II.M.3.e Exception: Disguised Sale.

[4643] As discussed in part II.M.3.e Exception: Disguised Sale, it is unlikely that the partnership anti-abuse rules would come into play. The transaction is consistent with the intent of the partnership income tax rules:

- The partnership must be bona fide, and each transaction must have a substantial business purpose. The proposed transaction splits income for generally around 5 years, and it provides the old owner with a way to take control over the business more quickly if the transaction does not work out than in a traditional sale. The new owner benefits by minimizing his risk, in that he is not personally liable. These are substantial, practical business issues.
- The form of each transaction must be respected under substance over form principles. No games are being played here: the parties have every incentive to ensure that the new entity's cash flow is distributed as promised in the transaction.
- Clear reflection of income. All distributions the old owner receives are being taxed. The new owner is not being taxed on income the new owner does not receive.

For more information on possible attacks, see fn. 3242.

[4644] *Chemtech Royalty Associates, L.P. v. U.S.*, 114 A.F.T.R.2d 2014-5940 (5th Cir 2014) (1% partnership interest by provider of capital was not sufficient to make provider a partner where partner's preferred return was virtually certain to be paid and 99% partner indemnified provider for any losses; partnership lacked economic substance). Dow provided the partnership with a stable revenue stream and indemnified the banks that provided the capital against any liabilities the partnership incurred:

> First, the transactions were structured to ensure that Dow paid the foreign banks a fixed annual return on their investment regardless of the success of the [Chemtech] venture, just as in the transaction in *Castle Harbour II*….
>
> Second, Dow agreed to bear all of the non-insignificant risks arising out of the Chemtech transactions, which further shows that the parties did not intend to share any possible losses….
>
> Third, just as in *Castle Harbour II*, the foreign banks did not meaningfully share in any potential upside.

The court pointed out:

> As a practical matter, payment of less than the full priority return was highly unlikely because (i) the minimum royalty payments from Dow sufficiently funded the priority return, and (ii) Chemtech could not incur more than $1 million in annual expenses without the banks' approval.

Also, regarding penalties, the court held that:

> the district court erred in foreclosing the applicability of both the substantial-valuation and gross-valuation misstatement penalties. We remand for the court to determine whether to impose either or both of those penalties. We express no opinion on whether the court erred in imposing the

Although one might be inclined to use an LLC, a limited partnership is better if the partnership engages in a trade or business, to help avoid self-employment tax.[4645] When using a limited partnership, consider using an entity taxed as an S corporation for the general partner and conducting business through various single-member LLCs that the limited partnership owns.[4646] For more description showing how to move in such a structure, see part II.E.7 Migrating into Partnership Structure, especially part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure.

Be careful about possible changes in accounting method. For example, if a cash method C corporation contributes its business to a partnership, the partnership might not be able to continue using the cash method;[4647] for example, if the corporation were a personal service corporation[4648] before the transaction and all of its personal service activities were moved to the partnership, the corporation might no longer qualify and therefore the partnership might not qualify as well. The corporation can avoid this limitation by making an S election[4649] but needs to plan around the built-in gain tax.[4650]

If the corporation has subsidiaries, the subsidiaries could convert to single-member disregarded LLCs, then do a tax-free liquidation;[4651] if the parent and subsidiaries file a consolidated return, be sure that the subsidiaries do not have any excess loss accounts[4652] or deferred intercompany transactions.[4653] Before the liquidation, the parent might consider contributing to the subsidiary any obligations of the subsidiary that the parent holds or cancelling them outright,[4654] particularly as needed to cause them to have a positive net worth on liquidation.[4655] If the corporation has

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negligence and substantial-understatement penalties. On remand, the court should consider the extent to which imposing those penalties remains consistent with this opinion.

Although the court held that the partnership lacked economic substance, no consideration appears to have been given to the penalty described in part II.G.18 Economic Substance.

Also note that the *Castle Harbour* trial court refused to uphold negligence penalties on the taxpayer's actions, *TIFD III-E, Inc. v. U.S.*, 113 A.F.T.R.2d 2014-1557 (D.C. Conn.), which is analyzed by Lipton, *Castle Harbour* V—The Government Loses (Again) in the District Court, *Journal of Taxation* (Oct. 2014).

[4645] See part II.L Self-Employment Tax (FICA).

[4646] See part II.E Recommended Structure for Entities.

[4647] Code § 448(a)(2).

[4648] See part II.G.11 Personal Service Corporations.

[4649] See generally part II.P.3.b Conversion from C Corporation to S Corporation.

[4650] See part II.P.3.b.ii Built-in Gain Tax.

[4651] Code §§ 332, 337. See 784 T.M. *Corporation Liquidations*; Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders* (WG&L), Chapter 10: Complete Liquidations and Other Taxable Dispositions of Corporate Stock and Assets in Bulk, part B. Subsidiary Liquidations.

[4652] Reg. § 1.1502-19. See Hennessey, Yates, Banks & Pellervo, The Consolidated Tax Return (WG&L), ¶13.04. Excess-Loss Accounts.

[4653] Reg. § 1.1502-13 (intercompany transactions). I am not an expert in Code § 332 and consolidated returns; one of my partners told me to watch for excess loss accounts or deferred intercompany transactions. The concept is that certain transactions not recognized in a consolidated environment are recognized when a corporation leaves the consolidated group – in this case, by liquidating a subsidiary.

[4654] See Reg. § 1.332-7 if the parent does not do this. In a consolidated return environment, the parent can take a bad debt deduction based on the partial or complete worthlessness of the debt. Reg. § 1.1502-13(g)(7), Example 3(iii). For more details, see 784 T.M. *Corporate Liquidations*, part IV Tax Treatment of Intercorporate Debt in a Liquidation of a Subsidiary.

[4655] See 784 T.M. Corporate Liquidations, III. Subsidiary Liquidations Not Qualifying Under §332, C. Insolvent Subsidiary. Reg. § 1.332-2(b) provides:

affiliated corporations, they might combine in a tax-free reorganization[4656] before forming the new entity, so that only one corporation remains as the general partner; each corporation that does not survive the merger as a corporation could survive as an LLC (disregarded for tax purposes) wholly owned by the surviving corporation and then contributed to the limited partnership intact as an LLC that is then wholly owned by the partnership. Generally, among other requirements, reorganizations require a continuity of business to be tax-free; this continuity can be satisfied when the acquired business is continued through the new partnership.[4657] Consider the effect of mergers on accounting methods, in that affiliated corporations using different accounting methods might need to change in some manner when combined into a single taxpayer.

If any owners are members of the same family or if any owner might split up his ownership in the corporate general partner from his interest as a limited partner when making transfers to family members, see parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

Transferring the common interest in a preferred partnership is less tax-efficient than selling (to an irrevocable grantor trust)[4658] an interest in a partnership that just has one class of owners, because (appraisers tell us that) the return required on an equity interest in a partnership generally is significantly higher than the AFR. However, a traditional sale to an irrevocable grantor trust is not practical here, as the corporation would have to form the irrevocable grantor trust for its benefit,[4659] which would undermine the whole concept of getting the property out of corporate solution.

### II.Q.7.h.ix. Value Freeze as Alternative to Code § 355 Division

Consider separately applying part II.Q.7.h.viii Value Freeze as Conservative Alternative to different lines of business or groups of assets to split up future growth in each line or group.

The common (non-preferred) interests might be owned by those who have the most interest in particular lines or groups.

Alternatively, each subsidiary depicted at the bottom of part II.E.6 Recommended Partnership Structure – Flowchart can remain wholly owned but might have a separate incentive plan, such as the partnership equivalent of a stock appreciation right.[4660]

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Section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock which it owns in the liquidating corporation. If section 332 is not applicable, see section 165(g) relative to allowance of losses on worthless securities.

[4656] Code § 368.

[4657] Reg. § 1.368-1(d)(4)(iii)(A).

[4658] As described in part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

[4659] If a corporation makes a gratuitous transfer to a trust that is not for a business purpose of the corporation but is for the personal purposes of one or more of the shareholders, the gratuitous transfer will be treated as a constructive distribution to such shareholders under federal tax principles and the shareholders will be treated as the grantors of the trust. Reg. § 1.671-2(e)(4). See part II.D.2 Business Entity as Grantor of Trust.

[4660] See part II.M.4.g Options to Acquire Equity, especially the text accompanying fn. 3423. See also part III.B.7.c Code § 2701 Interaction with Income Tax Planning.

None of these alternatives provides the clean break, disentangling shareholders from each other, provided by part II.Q.7.f Corporate Division into More Than One Corporation.

### II.Q.7.i. Distribution or Sale to Shareholder to Defer Gain on the Sale of Corporate Assets and Perhaps Avoid Double Taxation on Part

Consider forming a partnership, using one of the techniques described in part II.Q.7.h Distributing Assets; Drop-Down into Partnership, more than two years before selling property.

The corporation then might sell the partnership interest using an installment note to defer tax.[4661] If the corporation is an S corporation, be sure not to convert capital gain into ordinary income by using depreciable or amortizable assets.[4662]

The partnership's tax return for the year of the sale of the partnership interest (or before) would elect to step-up the basis of its underlying assets.[4663]

If and to the extent that the corporation is a C corporation that can sell the partnership interest at a discount relative to the partnership's underlying assets, that discount reduces income subject to C corporation income tax.

Be careful if the corporation is an S corporation that was a C corporation within the past 5 years.[4664]

### II.Q.7.j. Prohibition Against Using Partnership to Circumvent Tax on Gain in Property Used to Redeem Stock

Promulgated under Code § 732(f), Reg. § 1.337(d)-3(b) provides that a corporate partner is required to recognize gain when a transaction has the effect of the corporate partner acquiring or increasing an interest in its own stock in exchange for appreciated property when a partnership, either directly or indirectly, owns, acquires, or distributes stock of the corporate partner. Furthermore, Code § 732(f) provides that, if (1) a corporate partner receives a distribution from a partnership of stock in another corporation (distributed corporation); (2) the corporate partner has control of the distributed corporation immediately after the distribution or at any time thereafter; and (3) the partnership's basis in the stock immediately before the distribution exceeded the corporate partner's basis in the stock immediately after the distribution, then the basis of the distributed corporation's property must be reduced by this excess.[4665]

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[4661] See parts II.Q.3 Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future and II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner.

[4662] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

[4663] See part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

[4664] See part II.P.3.b.ii Built-in Gain Tax.

[4665] T.D. 9833 (6/8/2018), promulgating Reg. § 1.732-3. T.D. 9833 further provides:

> The amount of this reduction is limited to the amount by which the sum of the aggregate adjusted basis of property and the amount of money of the distributed corporation exceeds the corporate partner's adjusted basis in the stock of the distributed corporation.

### II.Q.7.k. Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation

Code § 1202 excludes part or all of the gain[4666] on the sale of stock in a qualified small business corporation originally issued to the seller (with some exceptions)[4667] and held for at least five years;[4668] be sure also to check for state income tax recognition of the exclusion.[4669] Many types of businesses are ineligible.[4670] Also, the corporation needs to have no more than $50 million at all times before and immediately after stock issuance[4671] and needs to have conducted sufficient business activities at all times.[4672] These business activities need to be either directly or through C corporation subsidiaries and require at least 80% of the assets being used for those activities (with additional restrictions on real estate ownership); they do not appear to be able to be done be through partnership subsidiaries.[4673] The corporation must have been a C corporation during substantially all of the taxpayer's holding period for such stock.[4674] Thus, stock in a former S corporation would not qualify, but an S corporation may form a C corporation subsidiary that would qualify;[4675] but beware of the mechanics.[4676]

The exclusion for most taxpayers is the greater of $10 million or 10 times the qualified small business stock's adjusted basis of the issued by the corporation and disposed of by the taxpayer during the taxable year.[4677] Adjusted basis used in the 10-times calculation includes the fair market value of property contributed to the corporation, but any built-in gain in contributed assets is not eligible for the exclusion, so running a business as a partnership and then converting to a C corporation has advantages and disadvantages for Code § 1202

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[4666] See text accompanying fns 4689-4694 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[4667] See text accompanying fns 4709-4733 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[4668] See text accompanying fn 4697 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[4669] See Exhibit 3 of Jenson & Kohn, "Maximize Qualified Small Business Stock Exclusion," *Estate Planning Journal* (WG&L), October 2018.
[4670] See text accompanying fns 4744-4749 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[4671] See text accompanying fns 4739-4743 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[4672] See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.
[4673] See fns 4755-4758 and 4768-4770 in part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.
[4674] See fn 4734 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[4675] See text accompanying fns 4713-4719 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[4676] See text accompanying fns 4736-4738 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[4677] See text accompanying fns 4689-4694 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

purposes,[4678] as well as other tax considerations (beware of contributing too much debt; also consider forming a separate corporation for each business).[4679]

In contrast to the Code § 1202 exclusion, which requires a five-year holding period, under Code § 1045 a taxpayer may roll over the gain on the sale of qualified small business stock (QSBS) held for only six months by investing in other QSBS. See part II.Q.7.k.iv Code § 1045 Rollover of Gain from Qualified Small Business Stock (QSBS) to Another QSBS.

Note, however, that purchasers of businesses want to get a new basis in the business' assets rather than just buying stock. If they buy stock instead of assets, they tend to require the sellers to make a special election to treat the stock sale as an asset sale followed by a liquidation; for example, see part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold in part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations. Furthermore, a seller-financed sale of a partnership may be able to avoid capital gain tax on the sale of goodwill, making it more tax-efficient than a tax-free sale of stock. For how the Code § 1202 exclusion compares to other sales of business, see part II.Q.1.a Contrasting Ordinary Income and Capital Gain Scenarios on Value in Excess of Basis. You will notice that a redemption (purchase by the C corporation) is less taxing than a cross-purchase (purchase by other shareholders). In a cross-purchase, the purchased stock will not be eligible for the Code § 1202 exclusion when the buyer later sells it, because it was not originally issued to the buyer.[4680] Similarly, if stock is issued too close to a redemption (within two years), the transactions may be stepped together and the new stock treated as if it had been sold to the buyer instead of issued to the buyer.[4681]

Here is an example, taken from an ABA Section of Taxation meeting:[4682]

- Tom Investor and Tammy Techy organize We Are Tech, LLC on 1/1/2016.
- Each provides capital contributions of $2 million in exchange for 50% interest in the LLC, which is taxed as a partnership.
- During 2016, the LLC purchases a building for $2 million cash and no debt, creates IP assets worth $2 million, and sustains a $1 million loss.
- Thus, each member's capital account and outside basis is $1.5 million at the end of 2016.

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[4678] See text accompanying fns 4800-4801 in part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership?
[4679] See text accompanying fns 4801-4802 in part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership?
[4680] See text accompanying fns 4709-4712 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[4681] See text accompanying fns 4721-4733 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[4682] May 2018 meeting of the Sales, Exchanges and Basis Committee II.Q.7.k.ie of the American Bar Association's Section of Taxation, program name "The Tax Exemption for Small Business Stock is Big Business," slides named "Section 1202 Qualified Small Business Stock," presented by Kohn, Friedman, Rappaport, and Kristall (the latter probably did not author, because the IRS does not author presentation materials at such meetings).

- On January 1, 2017, the LLC incorporates as We Are Tech, Inc., a C corporation that would qualify as a qualified small business stock, in an assets-over transaction:
  - The LLC contributes all assets to the C corporation in exchange for stock, then distributes stock to each member in liquidation.
  - The transaction qualifies under Code § 351.[4683] See also Rev. Rul. 84-111.[4684]
  - The fair market value of the LLC's assets was $5 million at the time of transaction.
- Each shareholder receives a $1.5 million carry-over basis for general tax purposes[4685] and a $2.5 million basis (50% of fair market value) in applying Code § 1202.[4686]
- On January 1, 2018, Tom sells his stock in We Are Tech, Inc. for $10 million. Tom has realized an $8.5 million long-term capital gain ($10 million proceeds minus $1.5 million adjusted basis).
- Within 60 days, Tom reinvests in Tech Savvy, Inc., a qualified small business, for $8 million and elects rollover treatment under Code § 1045.[4687] Consequences:
  - Total recognition of $3 million long-term capital gain (LTCG), consisting of:
    - Immediate recognition of $1 million LTCG, which is the built-in gain deferred upon incorporation.[4688]
    - Immediate recognition of $2 million LTCG, which under Code § 1045(a) is the $10 million gross sales price minus the $8 million gross purchase price of replacement qualified small business stock
  - Adjusted basis under Code § 1045(b)(3) is $2.5 million.
- On January 2, 2021, Tom sells all of his stock in Tech Savvy, Inc. for $25 million without rolling over to another qualified small business:
  - Tom has realized an $22.5 million long-term capital gain ($25 million proceeds minus $2.5 million adjusted basis).

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[4683] See part II.M.2 Buying into or Forming a Corporation.
[4684] See fn 3650 in part II.P.3.c.ii Transfer of Partnership Assets and Liabilities to a Newly Formed Corporation in Exchange for All of its Stock.
[4685] Code § 358(a).
[4686] See fns 4692-4699 (overall limitation on amount of gain excluded and determination of gain subject to exclusion) of part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[4687] See part II.Q.7.k.iv Code § 1045 Rollover of Gain from Qualified Small Business Stock (QSBS) to Another QSBS.
[4688] See fns 4692-4699 (overall limitation on amount of gain excluded and determination of gain subject to exclusion) of part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

- The Code § 1202 exclusion limit is $25 million, which is ten times the $2.5 million basis under Code § 1202.
- The $22.5 million long-term capital gain is less than the Code § 1202 exclusion limit of $25 million, so all of the gain is excluded.

- Contrast with Tom selling all We Are Tech, Inc. stock to purchase Tech Savvy, Inc. in a non-Code § 1045 rollover:
  - $1 million total long-term capital gain recognition.
  - No need to recognize the other $2 million under Code § 1045(a).
  - However, Tom would need to wait until January 2, 2023 to sell in order to meet his holding period requirement.

Other ideas when selling C corporation stock are covered in parts:

- II.G.7 Deferral or Partial Exclusion of Capital Gains (Even from Investment Assets) Invested in Opportunity Zones
- II.G.8 Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy
- II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244
- II.Q.7.m Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company.

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

This part II.Q.7.k applies to stock issued on or after August 11, 1993. The amount of gain that is subject to partial or complete exclusion from income cannot exceed the greater of:[4689]

(A) $10 million ($5 million for married filing separately)[4690] reduced by the aggregate amount of eligible gain taken into account under this rule for prior taxable years and attributable to dispositions of stock issued by such corporation, or

(B) 10 times the aggregate adjusted bases[4691] of qualified small business stock issued by the corporation and disposed of by the taxpayer during the taxable year. The greater of basis or the fair market value of property contributed for Code § 1202 stock counts towards this basis limitation.[4692] The adjusted basis of any stock is determined without regard to any addition

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[4689] Code § 1202(b)(1).
[4690] Code § 1202(b)(3).
[4691] Only the basis on the date of issuance counts for purposes of this test. See the flush language at the end of Code § 1202(b)(1).
[4692] Code § 1202(i)(1) provides that, for purposes of Code § 1202:
*Stock exchanged for property*. In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation -

> to basis after the date on which such stock was originally issued;[4693] therefore, to maximize the benefit of capital contributions, they should be made only in exchange for new stock when the company has assets with a basis (subject to unusual rules defining basis) of no more than $50 million.[4694]

The taxpayer must not be a corporation.[4695] However, an S corporation that holds qualified small business stock may be looked through to its owners who are taxed on the gain.[4696]

Gain is eligible only if from the sale or exchange of qualified small business stock held for more than 5 years.[4697] Also:[4698]

> If property (other than money or stock) is transferred to a corporation in exchange for its stock, the basis of the stock received is treated as not less than the fair market value of the property exchanged. Thus, only gains that accrue after the transfer are eligible for the exclusion.

Thus, contributing appreciated property in exchange for stock is a double-edged sword. On one hand, it provides an even greater amount of future gain that can be excluded. On the other hand, the built-in gain at the time of contribution is not eligible for the exclusion, whereas it would have been eligible if the property had been contributed earlier so that the appreciation occurred after contribution. Thus, if a partnership is considering converting to a C corporation, its owners should consider how long before they intend to sell (so that the 5-year holding period

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(A) such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and
(B) the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.

The legislative history quoted in the text accompanying fn 4698 makes me wonder whether this increase in the overall amount excluded was intended, but the statute's literal language appears to provide this result.

[4693] Code § 1202(b)(1) (flush language).

[4694] See fns 4739-4743.

[4695] Code § 1202(a)(1).

[4696] Code § 1202(g), discussed in the text accompanying fns 4713-4719 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[4697] Code § 1202(b)(2).

[4698] H. Rept. No. 103-111 (P.L. 103-66), p. 603. Code § 1202(i) provides that, for purposes of Code § 1202:

(1) *Stock exchanged for property*. In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation-
  (A) such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and
  (B) the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.
(2) *Treatment of contributions to capital.* If the adjusted basis of any qualified small business stock is adjusted by reason of any contribution to capital after the date on which such stock was originally issued, in determining the amount of the adjustment by reason of such contribution, the basis of the contributed property shall in no event be treated as less than its fair market value on the date of the contribution.

is satisfied) and whether appreciation while a partnership is good (to increase the 10-times-basis exclusion) or bad (pre-conversion appreciation ineligible for the exclusion).[4699]

A taxpayer who wishes to try to exceed these limitations might transfer stock to family members or others by gift before the stock appreciates, and presumably each donee would separately apply the limitation.[4700] If the taxpayer has insufficient lifetime gift tax exemption, consider transferring part of the stock to one or more incomplete gift nongrantor (ING) trusts;[4701] however, beware part II.J.9.c Multiple Trusts Created for Tax Avoidance. Another way to get more than $10 million limitation would be to have a separate C corporation for each qualified business.

For "qualified small business stock" issued after September 27, 2010 and held for more than five years, Code § 1202 excludes from income all of the gain from its sale or exchange, within the limits set forth above.[4702]

For "qualified small business stock" issued before September 28, 2010 and held for more than five years, Code § 1202 excludes from income a portion of the gain from its sale or exchange (within the limits set forth above)[4703]:

- If the above and other requirements are satisfied, then the portion excluded from income is 50% for stock (60% for gain attributable to an empowerment zone business) acquired before February 18, 2009 and 75% for stock acquired on or before September 27, 2010.[4704]

- Any gain that is not excluded is subject to 28% tax instead of the usual, lower capital gain rates.[4705]

- Note also that taxable gain from the sale of C corporation stock is subject to the 3.8% tax on net investment income,[4706] whereas gain on the sale of a partnership or S corporation stock engaged in a trade or business is largely excluded from that tax.[4707]

For stock acquired after September 27, 2010, alternative minimum taxable income no longer applies to the amount excluded from regular taxable income.[4708]

An example combining Code §§ 1202 and 1045 is in the text following fn 4682 in part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation.

"Qualified small business stock" means any stock in a C corporation which the taxpayer acquires on original issue by a qualified small business either in exchange for money or other

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[4699] See fn 4801 in part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership?
[4700] See Code § 1202(h), discussed at fns. 4773-4774.
[4701] See text accompanying fns 2305-2307 in part II.J.3.e.i Strategic State & Local Tax Issues re: Residence, briefly mentioning the idea of an incomplete gift nongrantor (ING) trust.
[4702] See text accompanying fn 4689.
[4703] See text accompanying fn 4689.
[4704] Code § 1202(a).
[4705] Compare Code § 1(h)(4) (tax on Code § 1202 gain) to Code § 1(h)(1) (tax on capital gains generally).
[4706] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[4707] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[4708] Code § 1202(a)(4)(C), eliminating the application of Code § 57(a)(7).

property (not including stock)[4709] or as compensation for services provided to such corporation (other than services performed as an underwriter of such stock).[4710] An option to acquire stock does not count as stock until the stock is actually issued to the taxpayer.[4711] The House Report for the 1993 Revenue Reconciliation Act, P.L. 103-66, included:

> *Options, nonvested stock, and convertible instruments.*
>
> Stock acquired by the taxpayer through the exercise of options or warrants, or through the conversion of convertible debt, is treated as acquired at original issue. The determination whether the gross assets test is met is made at the time of exercise or conversion, and the holding period of such stock is treated as beginning at that time.

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[4709] But, if a corporate reorganization is involved, see fn 4777 of part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.

[4710] Code § 1202(c)(1).

[4711] *Natkunanathan v. Commissioner*, T.C. Memo. 2010-15, *aff'd* 479 Fed. Appx. 775 (9th Cir. 2012), held that, where the taxpayer had been issued options to buy stock in his employer and did not exercise those options, except to acquire shares in a corporation (Intel) that acquired his employer, the taxpayer could not apply Code § 1202:

> Section 1202 itself does not define the term "stock" or otherwise specify what securities constitute stock for purposes of the qualified small business stock exclusion. By comparison, some provisions of the Code explicitly specify that the term "stock" includes options to acquire stock. See, *e.g.*, sec. 305(d)(1) ("For purposes of this section, the term `stock' includes rights to acquire such stock."); sec. 1091(a) (same). We are unaware of any authority that has interpreted the term "stock" for purposes of section 1202. However, we have previously declined to extend the term "stock" beyond its plain meaning in a statutory provision and construe it expansively to include options to acquire stock. See *Gantner v. Commissioner*, 91 T.C. 713 (1988) (options to purchase stock are not "shares" of "stock or securities" under the plain language of section 1091, which was subsequently amended to explicitly provide otherwise), *affd*. 905 F.2d 241 (8th Cir. 1990). Moreover, the legislative history of section 1202 suggests that Congress did not intend section 1202 to cover options to acquire stock.
>
> Section 1202 was added to the Code by the Omnibus Budget Reconciliation Act of 1993, Pub.L. 103-66, sec. 13113(a), 107 Stat. 422. The accompanying conference report included the following statement: "Stock acquired by the taxpayer through the exercise of options * * * is treated as acquired at original issue. The determination whether the gross assets test is met is made *at the time of exercise* * * * and the holding period of such stock is treated as beginning at that time." H. Conf. Rept. 103-213, at 526 (1993), 1993-3 C.B. 393, 404 (emphasis added). The second sentence of the excerpt from the conference report quoted above, in the absence of any countervailing argument by petitioner, suggests to us that the original issuance contemplated by section 1202 in petitioner's case would be the issuance of Intel stock to petitioner upon exercise of his options. This conclusion seems appropriate since both the application of the gross assets test and the commencement of the holding period would occur at the time of such exercise.
>
> Reading the term "stock" as used in section 1202 to exclude petitioner's options to acquire stock, we hold that petitioner could not possibly have satisfied the 5-year holding period requirement of section 1202(a)(1). Petitioner concedes that he sold the Intel stock received upon exercise of his options on the same day that he had exercised the options. Therefore, the period during which petitioner could have held qualified small business stock would, at most, have lasted 1 day. Moreover, for the stock underlying petitioner's options to constitute qualified small business stock under section 1202(d)(1), the aggregate gross assets of Intel on the date of exercise would have to have been less than or equal to $50 million. Petitioner makes no such claims with respect to Intel's aggregate gross assets.

> In the case of convertible preferred stock, the gross assets determination is made at the time the convertible stock is issued, and the holding period of the convertible stock is added to that of the common stock acquired upon conversion.
>
> Stock received in connection with the performance of services is treated as issued by the corporation and acquired by the taxpayer when included in the taxpayer's gross income in accordance with the rules of section 83.
>
> *Offsetting short positions.*
>
> A taxpayer cannot exclude gain from the sale of qualified small business stock if the taxpayer (or a related person) held an offsetting short position with respect to that stock anytime before the 5-year holding period is satisfied. If the taxpayer (or a related person) acquires an offsetting short position with respect to qualified small business stock after the 5-year holding period is satisfied, the taxpayer must elect to treat the acquisition of the offsetting short position as a sale of the qualified small business stock in order to exclude any gain from that stock.
>
> An offsetting short position is defined to be (1) a short sale of property substantially identical to the qualified small business stock (including writing a call option that the holder is more likely than not to exercise or selling the stock for future delivery) or (2) an option to sell substantially identical property at a fixed price.

If any stock in a corporation is acquired solely through the conversion of other stock in such corporation which is qualified small business stock in the hands of the taxpayer, the stock so acquired is treated as qualified small business stock in the hands of the taxpayer and is treated as having been held during the period during which the converted stock was held.[4712]

Special rules apply to C corporation stock owned by certain pass-through entities.[4713] A pass-through entity is any partnership, any S corporation,[4714] any regulated investment company (RIC),[4715] or any common trust fund.[4716] If any amount included in gross income by reason of holding an interest in a pass-through entity meets the requirements of the following sentence, the amount shall be treated as Code § 1202(a) gain and, for purposes of applying Code § 1202(b), that amount is treated as gain from a disposition of stock in the corporation issuing the stock disposed of by the pass-through entity and the taxpayer's proportionate share

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[4712] Code § 1202(f).

[4713] Code § 1202(g).

[4714] Code § 1202(g)(4)(B).

[4715] Code § 1202(g)(4)(C). Notice 97-64, § 8, contemplates that temporary regulations will provide guidance on how RICs may designate dividends as "section 1202 gain distributions," which guidance is:

> expected to provide that: (1) section 1202 gain distributions will be designated separately for different issuers of qualified small business stock; (2) the exclusion from income permitted by section 1202 will be determined at the shareholder level not the RIC level; and (3) the maximum distributable section 1202 gain for each issuer will be calculated separately from limitations on all other classes of capital gain dividends but in the aggregate will not exceed the RIC's net capital gain.

Notice 2015-41, § 5, provides that Notice 97-64, § 8, continues to apply. Notice 2015-41, § 3, requires that RICs must account for "section 1202 gain" in distributions. Code § 1202(g) applies to such distributions.

[4716] Code § 1202(g)(4).

of the adjusted basis of the pass-through entity in such stock is taken into account.[4717] The amount must be attributable to gain on the sale or exchange by the pass-through entity of stock which is qualified small business stock in the hands of such entity (determined by treating such entity as an individual) and which was held by such entity for more than 5 years, and such amount must be includible in the gross income of the taxpayer by reason of the holding of an interest in such entity which was held by the taxpayer on the date on which such pass-through entity acquired such stock and at all times thereafter before the disposition of such stock by such pass-through entity.[4718] This gain exclusion does not apply to any amount to the extent such amount exceeds the amount to this rule would have applied if the amount were determined by reference to the interest the taxpayer held in the pass-through entity on the date the qualified small business stock was acquired.[4719]

The original issuance requirement means that stock bought from another shareholder would not qualify. May one avoid this prohibition by redeeming the seller and issuing stock to the buyer? Code § 1202(c)(3) imposes a waiting period related to redemption activity (including certain cross-purchases between related persons).[4720] Stock is disqualified if, at any time within 2 years before or after the issuance of such stock, the corporation issuing such stock purchased (directly or indirectly) any of its stock from the taxpayer or from a person related[4721] to the taxpayer.[4722] In applying the preceding sentence, one can ignore stock acquired from the taxpayer or a related person if the aggregate amount paid for the stock does not exceed $10,000 and no more than 2% of the stock held by the taxpayer and related persons is acquired.[4723] Also, stock is disqualified if, within the year before or after the issuance of such stock, the corporation made one or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5% of the aggregate value of all of its stock as

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[4717] Code § 1202(g)(1).

[4718] Code § 1202(g)(2).

[4719] Code § 1202(g)(3).

[4720] Code § 1202(c)(3)(C) refers to Code § 304(a), "Acquisition by related corporation (other than subsidiary)," which provides:

> For purposes of sections 302 and 303, if -
>
> (A) one or more persons are in control of each of two corporations, and
>
> (B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,
>
> then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. To the extent that such distribution is treated as a distribution to which section 301applies, the transferor and the acquiring corporation shall be treated in the same manner as if the transferor had transferred the stock so acquired to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in such transaction.

[4721] Within the meaning of Code § 267(b) or 707(b). For a description of Code § 267(b), see part II.G.4.l.iv Code § 267 Disallowance of Related-Party Deductions or Losses. For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

[4722] Code § 1202(c)(3)(A).

[4723] Reg. § 1.1202-2(a)(2), which further provides:

> The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

of the beginning of that 2-year period.[4724] The preceding sentence has a similar de minimis rule.[4725] These rules are strict and do not exclude redemptions that are not tied to issuances. For example, two founders don't get along, and the departing founder could sell his stock to either the corporation or to the remaining founder. If the departing founder were the buyer, the corporation may need to issue a dividend to that buyer, causing the buyer to pay a dividend tax.[4726] If the corporation were the buyer, this dividend tax could be avoided,[4727] but under the above anti-abuse rule the redemption may taint any issuance to a related party, whether the continuing founder or a new investor.

Although generally a shareholder who transfers stock to an employee or independent contractor (or to a beneficiary of an employee or independent contractor) is treated has transferring the stock to the corporation and the corporation then transferring the stock to the employee or independent contractor,[4728] any such deemed transfer to the corporation is not treated as such for purposes of the anti-redemption rules.[4729] The anti-redemption rules also are not triggered by any of the following:

- The stock was acquired by the seller in connection with the performance of services as an employee or director and the stock is purchased from the seller incident to the seller's retirement or other bona fide termination of such services.[4730]

- Before a decedent's death, the stock (or an option to acquire the stock) was held by the decedent or the decedent's spouse (or by both), by the decedent and joint tenant, or by a trust revocable by the decedent or the decedent's spouse (or by both), and the stock is purchased from the decedent's estate, beneficiary (whether by bequest or lifetime gift), heir, surviving joint tenant, or surviving spouse, or from a trust established by the decedent or decedent's spouse; and the stock is purchased within 3 years and 9 months from the date of the decedent's death.[4731]

- The stock is purchased incident to the disability or mental incompetency of the selling shareholder.[4732]

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[4724] Code § 1202(c)(3)(B).

[4725] Reg. § 1.1202-2(b)(2) provides that, for purposes of this exception:

> … stock exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of all outstanding stock is purchased. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

[4726] See part II.Q.1.a.i.(c) C Corporation Double Taxation Under Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation, which is a variation of part II.Q.1.a.i.(a) C Corporation Triple Taxation.

[4727] Contrast part II.Q.1.a.i.(b) C Corporation Redemption with part II.Q.1.a.i.(a) C Corporation Triple Taxation.

[4728] Reg. § 1.83-6(d)(1).

[4729] Reg § 1.1202-2(c).

[4730] Reg. § 1.1202-2(d)(1)(i).

[4731] Reg. § 1.1202-2(d)(2).

[4732] Reg. § 1.1202-2(d)(3).

- The stock is purchased incident to the divorce (within the meaning of Code § 1041(c)) of the selling shareholder.[4733]

During substantially all of the taxpayer's holding period for such stock, the corporation must be a C corporation and use at least 80% (by value) of its assets in the active conduct of one or more qualified trades or businesses.[4734] See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold. Therefore, the C corporation cannot have been an S corporation. However, an S corporation can contribute its assets to a C corporation, and the C corporation could then qualify for the exclusion.[4735] To simplify this process, the owners of the S corporation form a parent S corporation, which new parent assumes all of the original S corporation's tax attributes;[4736] this makes the original corporation a disregarded entity;[4737] then the original corporation elects C corporation treatment. Although technically this reorganization works, it appears that the subsidiary would have the same tax ID as the parent S corporation,[4738] making the C corporation appear on the IRS' records as a former S corporation, even though technically it is considered a new C corporation.

The corporation's aggregate gross assets cannot have a basis exceeding $50 million:[4739]

(A) the aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993, and before the issuance did not exceed $50,000,000,

(B) the aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) does not exceed $50,000,000, and

(C) such corporation agrees to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section.[4740]

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[4733] Reg. § 1.1202-2(d)(4).

[4734] Code § 1202(c)(2)(A), (e). The taxpayer must affirmatively prove what the business assets are and that they met this 80% test. *Holmes v. Commissioner*, T.C. Memo. 2012-251, held:

> The record is again devoid of documentary evidence showing the amount of corporate assets owned during the years in which he held the stock and the amount of those assets used in its business of providing on demand physician practice management software. In fact, the only evidence in the record concerning LeonardoMD's business is a stipulated paragraph describing its business as providing on demand physician practice management software delivered over the Web, and petitioner's above-cited testimony. We cannot, on the basis of uncorroborated testimony and a stipulation that does not rule out inactive business assets and income, reasonably conclude that petitioner met his burden of proving that, during substantially all of his holding period for LeonardoMD stock, the corporation used at least 80% of its assets in the active conduct of one or more qualified trades or businesses.

[4735] See fn 4714.

[4736] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization, especially fn 3731.

[4737] See part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

[4738] See Reg. § 301.6109-1(i)(3) in the text accompanying fn 191 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

[4739] Code § 1202(d). This applies to gross assets at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993 and before the issuance, as well as immediately after the issuance (determined by taking into account amounts received in the issuance).

Although regulations have not been issued regarding reporting requirements, taxpayers will lose the deduction if they do not have records to substantiate that the stock met this requirement.[4741]

As used above, "aggregate gross assets" means the amount of cash and the aggregate adjusted bases of other property held by the corporation.[4742] As used in (A) above:[4743]

> The adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution.

The following businesses are not eligible for this treatment:[4744]

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[4740] [Footnote is mine and not in the statute:] Federal Tax Coordinator Analysis (RIA) ¶ S-4455 Reports With Respect to Exclusion of Gain From Qualified Small Business Stock (QSBS) reports:

> IRS has yet to issue either any reporting requirements described in Code Sec. 1202(d)(1)(C) … or any guidance as to the manner in which, as mandated by Code Sec. 1202(d)(1)(C), a corporation is to agree to meet these requirements. RIA understands that, until IRS provides guidance as to the manner in which a corporation is to agree, a corporation can issue QSBS without the necessity for the corporation to file any sort of agreement that it will comply with any reporting requirements, if and when issued. Presumably, if IRS ever does require reporting, it will prescribe procedures at that time for making the agreement called for in the Code.

[4741] *Natkunanathan v. Commissioner*, T.C. Memo. 2010-15, *aff'd* 479 Fed. Appx. 775 (9th Cir. 2012), held:

> There are no balance sheets or other financial statements of Cognet in the record that establish the amounts of total assets, total liabilities, or owner's equity of Cognet at any time, and petitioner made no attempt to introduce any such evidence at trial.[5] In the absence of any such evidence, we cannot determine the value of Cognet's gross assets at the time that it issued options to petitioner and, therefore, cannot conclude that Cognet constituted a qualified small business within the meaning of section 1202(d)(1) at that time.
>
> [5] After the trial petitioner attached to his reply brief a document purporting to be a statement by the chief executive officer of Cognet at the time of its acquisition by and merger with Intel declaring that "*To the best of my recollection*, the company's assets, including physical assets and total value of outstanding shares did not exceed $50,000,000 before the acquisition." [Emphasis added.] Subsequently, after the record had closed upon the filing of reply briefs, petitioner filed a motion for leave to reopen the record in order to introduce a notarized version of this and other documents. A notarized written statement from Cognet's chief executive officer, even if it were introduced at trial, could have been subject to a hearsay objection and, absent concessions or stipulation by respondent, would probably not have been admitted into evidence. But here, where the purported statement constitutes an affidavit attached to a brief, Rule 143(b) explicitly bars us from considering it as evidence. We have previously issued an order denying petitioner's motion to reopen the record as inappropriate because petitioner has not shown good cause for his failure to introduce such evidence at trial.

Issuing stock options does not necessarily qualify as issuing stock; however, the taxpayer did not hold actual stock for the five-year holding period, so that's why the court looked at when the stock options were issued. See fn 4711 for more about these issues.

[4742] Code § 1202(d)(2)(A).

[4743] Code § 1202(d)(2)(B).

[4744] Code § 1202(e)(3). Code § 1202(e)(3)(A) is discussed in part II.E.1.c.iv Specified Service Trade or Business (SSTB) If Taxable Income Exceeds Certain Thresholds. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202.

- any trade or business involving the performance of services in the fields of health,[4745] law, engineering, architecture, accounting, actuarial science, performing arts, [4746]

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[4745] Letter Ruling 201436001 held that the health service and related exclusion did not apply to the taxpayer:

> Section 1202(e)(3) excludes various service industries and specified non-service industries from the term qualified trade or business. Thus, a qualified trade or business cannot be primarily within service industries, such as restaurants or hotels or the providing of legal or medical services. In addition, § 1202(e)(3) excludes businesses where the principal asset of the business is the reputation or skill of one or more of its employees. This works to exclude, for example, consulting firms, law firms, and financial asset management firms. Thus, the thrust of § 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services, whether those services are the providing of hotel rooms, for example, or in the form of individual expertise (law firm partners).
>
> Company is not in the business of offering service in the form of individual expertise. Instead, Company's activities involve the deployment of specific manufacturing assets and intellectual property assets to create value for customers. Essentially, Company is a pharmaceutical industry analogue of a parts manufacturer in the automobile industry. Thus, although Company works primarily in the pharmaceutical industry, which is certainly a component of the health industry, Company does not perform services in the health industry within the meaning of § 1202(e)(3). Neither are Company's business activities within any of the prohibited categories set forth in § 1202(e)(3).

Letter Ruling 201717010 held that the health service and related exclusion did not apply to a lab:

> Company provides laboratory reports to health care professionals. However, Company's laboratory reports do not discuss diagnosis or treatment. Company neither discusses with, nor is informed by, healthcare providers about the diagnosis or treatment of a healthcare provider's patients. Company's sole function is to provide healthcare providers with a copy of its laboratory report.
>
> Company neither takes orders from nor explains laboratory tests to patients. Company's direct contact with patients is billing patients whose insurer does not pay all of the costs of a laboratory test.
>
> In addition, you represent that the skills employees bring to Company are not useful in performing X tests and that skills they develop at Company are not useful to other employers.
>
> Further, none of Company's revenue is earned in connection with patients' medical care. Other than the laboratory director [who federal law required to have certain qualifications], Company's laboratory technicians are not subject to state licensing requirements or classified as healthcare professionals by any applicable state or federal law or regulatory authority.
>
> Although Company's laboratory reports provide valuable information to healthcare providers, Company does not provide health care professionals with diagnosis or treatment recommendations for treating a healthcare professional's patients nor is Company aware of the health care provider's diagnosis or treatment of the healthcare provider's patients. In addition, the skills that Company's employees have are unique to the work they perform for Company and are not useful to other employers.
>
> Thus, based on the facts and representations submitted, we conclude that for purposes of § 1202(e)(3), Company is not in a trade or business (i) involving the performance of services in the field of health or (ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees.

For additional context, when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See part II.E.1.c.iv.(b) Health. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202.

[4746] For additional context regarding performing arts, when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See part II.E.1.c.iv.(f) Performing Arts. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202.

consulting,[4747] athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees,[4748]

- any banking, insurance, financing, leasing, investing, or similar business,
- any farming business (including the business of raising or harvesting trees),
- any business involving the production or extraction of products, such as oil, gas and mines, eligible for certain depletion deductions, or
- any business of operating a hotel, motel, restaurant, or similar business.

However, engaging in the above activities is not fatal, if it comprises a sufficiently small part of the business.[4749]

The corporation must be a domestic corporation other than a DISC or former DISC, corporation with respect to which an election under Code § 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect, regulated investment company, real estate investment trust, REMIC, or cooperative.[4750]

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[4747] For additional context regarding consulting, when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See part II.E.1.c.iv.(g) Consulting. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202.

[4748] However, a commission sales business might not be disqualified under this provision. In *Owen v. Commissioner*, T.C. Memo. 2012-21, a company that sold prepaid legal service policies, including estate planning services, which were like insurance in that purchasers would get a reduced fee in legal cost by joining this prepaid legal membership, was a qualified small business. The court seemed to accept the taxpayer's testimony that, in the industry, independent contractors generally sold the products and services offered by the company. The taxpayer performed services as an executive and as a sales representative and his compensation was reported on Form W-2 (as an executive) and Form 1099-MISC (as an independent consultant who furnished services through his personal corporation that received commissions and in turn paid him using Form 1099-MISC. The court held:

> Although respondent argues that FFAEP is not qualified because one of the principal assets is the skill of Mr. Owen, the Court disagrees. While we have no doubt that the success of the Family First Companies is properly attributable to Mr. Owen and Mr. Michaels, the principal asset of the companies was the training and organizational structure; after all, it was the independent contractors, including Mr. Owen and Mr. Michaels in their commission sales hats, who sold the policies that earned the premiums, not Mr. Owen in his personal capacity.

However, ultimately this holding was moot (which did not stop the court from opining on it), because the taxpayer was trying to do a Code § 1045 rollover of gain on sale from one company to another. Although the new company qualified as described above, the company being sold did not (fn. 4761), resulting in the taxpayer losing the case. So, keep in mind the IRS' lack of incentive to appeal this holding when viewing it as instructive.

[4749] See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold, especially fns 4752-4754.

[4750] Code § 1202(e)(4).

### II.Q.7.k.ii. Limitation on Assets a Qualified Small Business May Hold

During substantially all of the taxpayer's holding period for the qualified small business stock,[4751] the corporation must use at least 80% (by value) of its assets in the active conduct of one or more qualified trades or businesses and be an eligible corporation.[4752] Assets used for certain start-up or research activities count as qualified.[4753] A specialized small business investment company automatically meets the active business requirement.[4754]

In applying the requirement that the corporation hold active business assets, stock and debt in any subsidiary corporation are disregarded and the parent corporation is deemed to own its ratable share of the subsidiary's assets and to conduct its ratable share of the subsidiary's activities;[4755] no special rule applies to a subsidiary partnership.[4756] The parent owns more than 50% of the combined voting power of all classes of stock entitled to vote, or more than 50% in value of all outstanding stock, of a corporation for the parent to be able to treat the corporation as a subsidiary.[4757] If the holding falls below this threshold, then watch out – the parent fails the active business asset test for any period during which more than 10% of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations which are not subsidiaries of such corporation (other than assets described under the "working capital" exception).[4758]

Under the "working capital" exception, active business assets include assets held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or held for investment and are reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business or increases in working

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[4751] Code § 1202(c)(2).

[4752] Code § 1202(e)(1).

[4753] Code § 1202(e)(2), "Special rule for certain activities," provides:

> For purposes of paragraph (1), if, in connection with any future qualified trade or business, a corporation is engaged in—
> (A) start-up activities described in section 195(c)(1)(A),
> (B) activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under section 174, or
> (C) activities with respect to in-house research expenses described in section 41(b)(4),
> assets used in such activities shall be treated as used in the active conduct of a qualified trade or business. Any determination under this paragraph shall be made without regard to whether a corporation has any gross income from such activities at the time of the determination.

[4754] Code § 1202(c)(2)(B), referring to an eligible corporation licensed to operate under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993). As to "specialized small business investment company," see part II.Q.7.m Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company.

[4755] Code § 1202(e)(5)(A). Code § 1202(d)(3)(A) provides that all corporations which are members of the same parent-subsidiary controlled group shall be treated as one corporation for purposes of the assets test. In determining what is a "parent-subsidiary controlled group," Code § 1202(d)(3)(B) refers to Code § 1563(a)(1), except that:

> (i) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a)(1), and
> (ii) section 1563(a)(4) shall not apply.

[4756] See fns 4768-4770 in part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.

[4757] Code § 1202(e)(5)(C).

[4758] Code § 1202(e)(5)(B).

capital needs of a qualified trade or business.[4759] However, for periods after the corporation has been in existence for at least two years, no more than 50% of the assets of the corporation may qualify as used in the active conduct of a qualified trade or business by reason of this rule.[4760] Be careful not to start the C corporation just accumulating cash for possible business operations, which will disqualify the corporation.[4761] To avoid this issue and for other reasons as well, consider instead starting as an LLC taxable as a partnership then later converting to a corporation.[4762]

A corporation also fails the active business assets test for any period during which more than 10% of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business.[4763] In applying the preceding sentence, the ownership of, dealing in, or renting of real property is not treated as the active conduct of a qualified trade or business;[4764] renting the property to the business may be better anyway.[4765]

In applying the active business asset test, rights to computer software which produces active business computer software royalties[4766] are treated as an asset used in the active conduct of a trade or business.[4767]

Although Code § 1202 authorizes qualified small business stock to be held by a partnership[4768] and corporate subsidiaries,[4769] it does not discuss the corporation conducting its business through one or more partnerships. Accordingly, from a planning perspective, I would not recommend having a corporation seeking qualified small business status invest its assets in a partnership. However, if one is asked to advice an owner of a corporation that is already

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[4759] Code § 1202(e)(6).

[4760] Code § 1202(e)(6).

[4761] *Owen v. Commissioner*, T.C. Memo. 2012-21. The court addressed the qualifications of two companies, one of which did not qualify (this footnote) and one of which did qualify (fn. 4748). In discussing why the company was not a qualified small business under Code § 1202 and therefore not eligible for a capital gain deferral under Code § 1045 (which rollover is not necessary for newer companies), the court imposed a 20% accuracy-related penalty:

> We also find that the Owens did not act with good faith with respect to the section 1045 transaction. Mr. Owen explained that it was his vision to build up J&L Gems as he had the Family First Companies; yet even as late as 2 years after the money had been deposited in the company, J&L Gems had only 16 pieces of jewelry. Mr. Owen should not in good faith have believed that deferring income tax under section 1045, by operating a business, merely involved depositing a large amount of cash in an account. Nor could he reasonably believe that using less than 8 percent of that cash to purchase inventory and selling only a part of what little inventory he did buy to his friends and coworkers was sufficient to defer the tax. Even under Mr. Owen's understanding of section 1045, that he had to operate the business in good faith and reasonably, he failed to meet that requirement.

[4762] See part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? (especially the text accompanying fns. 4796-4804).

[4763] Code § 1202(e)(7).

[4764] Code § 1202(e)(7).

[4765] See parts II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation; Possible Way to Attain Basis Step-Up (which is even more of a concern for C corporations) and II.Q.1.b Leasing.

[4766] Within the meaning of Code § 543(d)(1).

[4767] Code § 1202(e)(7).

[4768] See part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation, especially fns. 4713-4719.

[4769] See fns. 4755-4758 in part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold.

invested in a partnership, I would look to the active business rules for corporate split-ups, which describe when an interest in a partnership constitutes an active business asset.[4770]

Special rules apply to certain tax-free transfers.[4771] If a transfer is by gift,[4772] at death, or from a partnership,[4773] the transferee is treated as having acquired such stock in the same manner as the transferor and having held such stock during any continuous period immediately preceding the transfer during which it was held (or treated as held under these rules) by the transferor:[4774]

- Presumably a taxpayer whose stock's value exceeds the cap of the exclusion of gain[4775] by giving the stock to family members, each of whom could sell the stock separately.

- If the transfer is from a partnership, it must be to a partner of stock with respect to which requirements similar to the pass-through rules described above are met at the time of the transfer (without regard to the 5-year holding period requirement).[4776]

In a Code § 351 formation of a corporation or a Code § 368 reorganization, if qualified small business stock is exchanged for other stock which would not qualify as qualified small business stock but for this rule, that other stock shall be treated as qualified small business stock acquired on the date on which the exchanged stock was acquired.[4777] Unless the stock treated

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[4770] See part II.Q.7.f.iii Active Business Requirement for Code § 355.
[4771] Code § 1202(h).
[4772] See text accompanying fn 4701 regarding gifts to trusts.
[4773] Code § 1202(h)(2).
[4774] Code § 1202(h)(1).
[4775] See fn. 4689.
[4776] Code § 1202(h)(2)(C).
[4777] Code § 1202(h)(4)(A). Letter Ruling 9810010 applied Code § 1202(h)(4) to a corporate split-up that was partly tax-free under Code §§ 355(a)(1) and 368(a)(1)(D). Letter Ruling 9810010 said that Code § 1202(h)(4)(A) necessarily means:

> Thus, stock received in a section 368 reorganization may be treated as QSBS despite the prohibition in section 1202(c)(1)(B)(i) against stock received in exchange for other stock.

Letter Ruling 9810010 continued:

> In the instant case, the taxpayers have represented that the portion of the Distributing stock given up by A through N in exchange for Controlled stock was qualified small business stock (QSBS) and that Controlled was a qualified small business at the time of the reorganization. As part of the section 368 reorganization, A through N received Controlled stock in exchange for a portion of their Distributing stock and thereafter sold their remaining Distributing stock to FX. Unless the specific shares of Distributing stock exchanged for Controlled stock can be adequately identified by each of the exchanging shareholders, it is assumed pursuant to section 1.1012-1(c)(1) that the Distributing stock exchanged will be charged against the earliest of such lots acquired in order to determine cost or other basis and holding period. This rule also applies in determining whether the Distributing QSBS held by each of the exchanging shareholders at the time of the exchange was among the Distributing stock exchanged for Controlled stock.
>
> Based on the assumption that the portion of the Distributing stock given up by A through N was QSBS in the hands of such shareholders as determined by applying the rules of section 1.1012-1, a portion of the Controlled stock received by such shareholders in exchange therefor will be treated as QSBS acquired on the date the exchanged Distributing QSBS was acquired (section 1202(h)(4)(A)). If the stock exchanged by a Distributing shareholder consists of both QSBS and non-QSBS, then only a proportionate amount of the Controlled stock received in exchange will be treated as QSBS.

Ruling 12 of Letter Ruling 9810010 held:

as qualified small business stock by reason of the preceding sentence is issued by a corporation that (as of the time of that transfer) is a qualified small business, Code § 1202 applies to gain from the sale or exchange of stock treated as qualified small business stock by reason of the preceding sentence only to the extent of the gain which would have been recognized at the time of the transfer described in the preceding sentence if Code § 351 or 368 had not applied at that time.[4778]

To the extent provided in regulations, stock in a corporation, the basis of which (in the hands of a taxpayer) is determined in whole or in part by reference to the basis in his hands of stock in such corporation which meets certain requirements or which is received in a reorganization that is a mere change in form in exchange for stock which meets such requirements (and interests in an LLC that elected C corporation taxation qualify as stock),[4779] shall be treated as meeting such requirements.[4780]

If the taxpayer has an offsetting short position with respect to any qualified small business stock, Code § 1202(a) shall not apply to any gain from the sale or exchange of such stock unless the stock was held by the taxpayer for more than 5 years as of the first day on which there was such a short position, and the taxpayer elects to recognize gain as if such stock were sold on such first day for its fair market value.[4781] For purposes of the preceding sentence, the taxpayer shall be treated as having an offsetting short position with respect to any qualified small business stock if the taxpayer has made a short sale of substantially identical property, the taxpayer has acquired an option to sell substantially identical property at a fixed price, or to the

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Based solely on the taxpayer's representations that a portion of the Distributing stock owned by A through N was classified as qualified small business stock under section 1202 (Distributing QSBS), a proportionate amount of Controlled stock received by each of A through N in exchange for such individual's Distributing QSBS will be treated as qualified small business stock (section 1202(h)(4)(A)). The holding period for the Controlled stock treated as qualified small business stock under section 1202(h)(4)(A) includes the holding period for which each of A through N held the Distributing QSBS. Further, based on the representation that Controlled was a qualified small business at the time of the reorganization, the limitation in section 1202(h)(4)(B) will not apply.

Ruling (12) only applies to the Controlled stock that was received in exchange for Distributing stock that was QSBS in the hands of the individual shareholders at the time of the exchange. We have not been asked, and we do not address, whether any stock issued by Distributing was qualified small business stock at any time or whether Controlled is a qualified small business within the meaning of section 1202(d).

[4778] Code § 1202(h)(4)(B). Letter Ruling 9810010 noted:

Section 1202(h)(4)(B) limits the amount of gain that can be excluded under section 1202(a) if the stock constitutes qualified small business stock by virtue of section 1202(h)(4)(A). However, the limitation does not apply if the stock is issued by a corporation that is itself a qualified small business as of the time of the reorganization.

Code § 1202(h)(4)(C) provides:

*Successive application*. For purposes of this paragraph, stock treated as qualified small business stock under subparagraph (A) shall be so treated for subsequent transactions or reorganizations, except that the limitation of subparagraph (B) shall be applied as of the time of the first transfer to which such limitation applied (determined after the application of the second sentence of subparagraph (B)).

[4779] See part II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. Converting a corporation into an LLC taxed as a corporation was such a change. Letter Rulings 201603010-201603014.

[4780] Code § 1202(h)(3), incorporating by reference Code § 1244(d)(2).

[4781] Code § 1202(j)(1).

extent provided in regulations, the taxpayer has entered into any other transaction which substantially reduces the risk of loss from holding such qualified small business stock; in applying this rule, any reference to the taxpayer is treated as including a reference to any person who is related (within the meaning of Code § 267(b)[4782] or 707(b)[4783]) to the taxpayer.[4784]

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

Does the exclusion for the sale of certain stock make being a C corporation more attractive than an S corporation or a partnership? First, we will explore when the sale of such stock has advantages, when the sale does not have advantages, and operational income tax issues.

If and to the extent that the gain on the sale of a business relates to the sale of self-created goodwill, the basis of the ownership interest does not reflect that basis, no matter what kind of entity owns the business. To that extent, the sale of such stock is more favorable than the sale of stock in an S corporation[4785] and the sale for cash of a partnership interest.[4786] However, the seller-financed sale of a partnership interest still produces better results than the sale of such stock.[4787]

In some situations, the exclusion for the sale of certain C corporation stock does not provide any particular advantage, if and to the extent that the owner of a pass-through interest would not have gain on sale. If and to the extent that the sale of the business interest arises from reinvested earnings, the basis of a partnership interest[4788] or stock in an S corporation is increased.[4789] Furthermore, if a pass-through entity redeems only part of one's ownership, the

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[4782] Code § 267(b) is reproduced in part II.G.4.l.iv Code § 267 Disallowance of Related-Party Deductions or Losses.

[4783] For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

[4784] Code § 1202(j)(2).

[4785] Compare part II.Q.1.a.i.(c) with part II.Q.1.a.i.(d) (moderate tax states) and part II.Q.1.a.ii.(c) with part II.Q.1.a.ii.(d) (California).

[4786] The sale of a partnership interest for cash generally would have similar dynamics regarding goodwill as the sale of S corporation stock. The sale of a partnership interest would have a slight advantage, in that the goodwill could obtain a basis step-up (part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations and fn. 5152, unless the anti-churning rules apply per part II.Q.1.c.iv Goodwill (and other intangible) Anti-Churning Rules, especially fn. 3824), but amortization would be over a 15-year period under Code § 197 (fn. 5040). Also, amortizing goodwill turns it into a hot asset, reducing opportunities for deferral on its sale; for more information on the sale of goodwill, including disadvantages of goodwill being amortized, see part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.

[4787] See parts II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill and 0

Partnership Use of Same Earnings as C Corporation – Redemption (California).

[4788] Code § 705. However, as described in part II.Q.8.e.ii.(a) Unitary Basis, a partner does not have the flexibility of a shareholder to pick and choose which shares to sell.

[4789] Code § 1367.

reinvested earnings might offset part or all of the gain on the sale – perhaps even that attributable to self-created goodwill.[4790]

Furthermore, the exclusion is available only for qualified stock that is issued, gifted, or bequeathed to the taxpayer,[4791] making it unavailable to subsequent purchasers of the stock.

Many business sales are asset sales, much of which would be capital gain subjected to lower tax rates to the owners of pass-throughs and subjected to higher rates when sold by a C corporation.[4792] This is especially important when an entity sells only a business line,[4793] rather than the entire business. When the entity sells all of its assets, it might as well liquidate to take full advantage of the exclusion on the gain on sale of the stock and let the shareholders move the sale proceeds outside of a potentially risky business environment.[4794]

A stock sale tends to have a lower sale price than an asset sale, due to buyer's concerns about assuming undisclosed or unseen liabilities and perhaps not receiving a basis step-up in the corporation's assets.[4795]

For the effect of structure on operations, see:

- Part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations (concluding that they don't)

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[4790] For S corporations, see part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally, especially fns. 4396-4398. Of course, the basis resulting reduction basis reduces the ability to take distributions and increases future gains on the sale of the stock, the latter which might not be of concern if and to the extent the stock receives a new basis on the shareholder's death. See part II.H.9 Basis Step-Up In S Corporations That Had Been C Corporations.
For partnerships, see part II.Q.8.b Partnership Redemption or Other Distribution.

[4791] See various requirements described in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[4792] See part II.A.1.a C Corporations Generally, especially fns. 5-7.

[4793] One cannot easily divide a business tax-free, sell a business line, and liquidate the corporation owning just that business lines. See part II.Q.7.f.ii Code § 355 Requirements.

[4794] See part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale. Levun's article, cited at fn. 4807, comments:

> Note that the receipt of liquidation proceeds after a corporate asset sale also qualifies for the QSBC exclusion. However, because of the corporate-level tax exacerbated by the lack of a corporate capital gains rate, the scales would still tip in favor of flow-through taxation, notwithstanding no tax due on liquidation. In other words, assume all an entity owns is zero-basis self-created goodwill having a value of $1 million. In the case of an asset sale as an LLC, there would be federal tax due of $200,000 (assuming a 20-percent maximum capital gains rate). In the case of the same asset sale by a QSBC, while there would be no shareholder tax on the liquidation of the corporation, the corporate entity-level federal tax burden would be $340,000 (or tax at a 35-percent rate, to the extent the corporation has taxable income in excess of $10 million).

The reference to a 35% tax rate was before 2017 tax reform lowered the corporate tax rate.

[4795] Regarding the latter, see part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations, noting that the inside basis step-up may apply under part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold, the latter which is considered most attractive for S corporation holders but also may be attractive when using the Code § 1202 exclusion.

- Part II.E Recommended Structure for Entities (explaining why a partnership structure is better than a corporate structure).

Furthermore, if one decides that a C corporation structure is ultimately desirable, one might consider instead starting as an LLC taxable as a partnership or sole proprietorship, which enables start-up losses to be deducted more easily anyway;[4796] then, if one determines that a C corporation is the ideal structure, convert[4797] to a qualified small business corporation[4798] the earlier of five years before a sale is anticipated or shortly before the $50 million gross asset limitation is exceeded.[4799] Factors when considering this strategy include:

- The delay in forming the corporation can help avoid being disqualified for not deploying start-up capital quickly enough.[4800]

- During this initial operating period, the owners could build value in the business, and the greater of value or basis of the partnership's assets when it converts to a C corporation is used in computing the exclusion of ten times the investment.[4801] This is a double-edged sword in that any value in excess of basis at the time of the conversion is not eligible for the exclusion.[4802]

- The ability to deduct start-up losses may be good or bad, depending on whether the owner is in a high or low tax bracket. See part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. If the taxpayer is in a high tax bracket, then consider taking bonus

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[4796] See part II.G.4 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner, especially part II.G.4.f Comparing C Corporation Loss Limitations to Those for Partnership and S Corporation Losses.

[4797] See part II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations. One might simply file Form 8832 to elect corporate taxation, assign the LLC to a corporation, or convert or merge the LLC into a corporation. As to the former, Letter Ruling 201636003 held:

> While ownership of a corporation is normally tied to stock ownership, and under state law LLC owners hold a member interest and not formal stock, the term "stock" for federal tax purposes is not restricted to cases where formal stock certificates have been issued. Rather, it has been consistent Service position that for federal tax purposes stock ownership is a matter of economic substance, *i.e.*, the right to which the owner has in management, profits, and ultimate assets of a corporation. The presence or absence of pieces of paper called "stock" representing that ownership is immaterial. See Rev. Rul. 69-591, 1969-2 C.B. 172.
>
> Therefore, based on the facts and representations submitted, we rule that the Corporation stock meets the definition of qualified small business stock under §§§ 1202(c), 1202(f) and 1202(h).

[4798] See part II.P.3.c Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations.

[4799] See fn. 4739.

[4800] See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold, especially the text accompanying fns. 4759-4761.

[4801] See part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation, especially fns. 4691-4699.

[4802] See paragraph of text accompanying fn. 4699 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

depreciation[4803] and generating a high-tax-rate deduction now, then paying tax at a lower rate when the assets are sold after conversion to C corporation taxation.

- If the entity accumulates debt in excess of basis, forming the corporation might be a taxable event.[4804]

- Before converting to ***a*** qualified small business corporation, consider whether the LLC might divide into separate entities, each of which conducts a separate business,[4805] and then each separate business would become its own qualified small business corporation with a separate limitation on the amount of gain that is excluded. That may also help stay under the $50 million gross asset limitation for each corporation.

For a case study on converting a partnership to a C corporation to accommodate a venture capital firm's desire for this exclusion, whether converting to a C corporation is a good idea, the Code § 1045 rollover, and issues facing recipients of profits interests on conversion,[4806] see Levun, "Using Partnerships to Leverage "Zero-Tax" Code Sec. 1202 Stock."[4807]

### II.Q.7.k.iv. Code § 1045 Rollover of Gain from Qualified Small Business Stock (QSBS) to Another QSBS

Code § 1045 allows a taxpayer to roll over the gain into new qualified small business stock.[4808]

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[4803] See part II.G.6 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation, especially part II.G.5.b Bonus Depreciation.

[4804] See parts II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities and II.M.2.c Contribution of Partnership Interest to Corporation.

[4805] See part II.Q.8.d Partnership Division.

[4806] See part II.M.4.f Issuing a Profits Interest to a Service Provider. Levun, fn. 4807, points out:

> As a final observation, and somewhat of a frolic and detour, let's assume that the LLC being discussed in this column had a service provider that had been previously admitted as a partner (either by reason of (1) having received a fully vested LLC interest, (2) having received a profits interest subject to a substantial risk of forfeiture but for which the requirements of Rev. Proc. 2001-43, 2001-2 CB 191, had been satisfied or (3) having received a capital interest subject to a substantial risk of forfeiture for which a timely Code Sec. 83(b) election had been made. Also assume that, as part of the incorporation transaction contemplated above (to obtain QSBC stock), the service provider was required to agree to a substantial risk of forfeiture with respect to the C corporation stock he was now obtaining in the LLC to C corporation conversion transaction. Rev. Rul. 2007-49, 2007-2 CB 237, would require that a Code Sec. 83(b) election be made in order for the service partner to be treated as a shareholder in the corporation. This revenue ruling provides that the transfer of vested stock in exchange for nonvested stock in a tax-free corporate reorganization requires a Code Sec. 83(b) election in order for the service provider to be considered the tax owner of the shares received in the reorganization. While the revenue ruling addresses a tax-free reorganization under Code Sec. 368(a), there is no reason to believe that the result would be any different in a Code Sec. 351 transaction. Note that making a Code Sec. 83(b) election does not result in any tax to the service provider, as under the principles contained in Rev. Rul. 2007-49, the service provider would be considered to have paid an amount for the QSBC stock equal to its fair market value.

[4807] *Partnership Tax Watch Newsletter* (Current), No. 349, PARTNERSHIP TAX PLANNING and PRACTICE 11/22/2016, saved as Thompson Coburn LLP document no. 6486765.

[4808] Rev. Proc. 98-48 explains how to elect Code § 1045 deferral, the deadline for which may be extended using Reg. § 301.9100-3 relief (*see*, *e.g.*, Letter Ruling 201650010). Reg. § 1.1045-1 provides rules for partnerships and supersedes Rev. Proc. 98-48 to that extent (see T.D. 9353 8/14/2007).

In the case of any sale of qualified small business stock held for more than 6 months[4809] by a taxpayer other than a corporation and with respect to which the taxpayer elects to apply Code § 1045, gain from the sale is recognized only to the extent that the amount realized on such sale exceeds the cost of any qualified small business stock (QSBS) purchased by the taxpayer during the 60-day period beginning on the date of such sale, reduced by any portion of that cost previously taken into account under Code § 1045.[4810]

Code § 1045 does not apply to any gain which the Code treats as ordinary income.[4811]

QSBS has the meaning given such term by Code § 1202(c). See various explanations under other subparts of this part II.Q.7.k Code § 1202 Exclusion or Deferral of Gain on the Sale of Certain Stock in a C Corporation. However, only the first 6 months of the taxpayer's holding period for the stock referred to in Code § 1045(a)(1) are taken into account for purposes of applying Code § 1202(c)(2).[4812]

A taxpayer is treated as having purchased any property if, but for Code § 1045(b)(3), the unadjusted basis of such property in the hands of the taxpayer would be its cost (within the meaning of Code § 1012).[4813] Code § 1045(b)(3) uses the deferred gain to reduce the basis of any QSBS the taxpayer buys during the 60-day rollover period.

### II.Q.7.l. Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244

An individual[4814] may deduct the first $50,000 of loss[4815] on the sale of "section 1244 stock" as an ordinary loss, rather than a capital loss.[4816]

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[4809] Code § 1045(b)(4)(A) provides, "the taxpayer's holding period for such stock and the stock referred to in subsection (a)(1) shall be determined without regard to section 1223."

[4810] Code § 1045(a).

[4811] Code § 1045(a).

[4812] Code § 1045(b)(4)(B). Code § 1202(c)(2), "Active business requirement; etc.," provides:

(A) *In general*. Stock in a corporation shall not be treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for such stock, such corporation meets the active business requirements of subsection (e) and such corporation is a C corporation.

(B) *Special rule for certain small business investment companies*.

(i) *Waiver of active business requirement*. Notwithstanding any provision of subsection (e), a corporation shall be treated as meeting the active business requirements of such subsection for any period during which such corporation qualifies as a specialized small business investment company.

(ii) *Specialized small business investment company*. For purposes of clause (i), the term "specialized small business investment company" means any eligible corporation (as defined in subsection (e)(4)) which is licensed to operate under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993).

As to "specialized small business investment company," see part II.Q.7.m Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company.

[4813] Code § 1045(b)(2).

[4814] Trust, estates, and corporations are not eligible for this treatment. Code § 1244(d)(4); see Part II.J.11.b Code § 1244 Treatment Not Available for Trusts. Individuals may deduct losses flowing through partnerships if the partnerships were the original owners, and corporations may not claim this benefit. Reg. § 1.1244(a)-1(b)(2).

"Section 1244 stock" is stock of a domestic corporation if:[4817]

- at the time such stock is issued, such corporation was a small business corporation,
- such stock was issued by such corporation for money or other property (other than stock and securities), and
- such corporation, during the period of its five most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50% of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.

The corporation cannot be capitalized with more than $1 million adjusted basis of assets.[4818]

Although it applies to the sale of stock in an S corporation, it might not provide much of a benefit, as often such a loss arises from loss due to operations and therefore was already deducted as a loss on the K-1 issued to the shareholder each year. Similarly, this provision might not provide much of a benefit when choosing whether to be taxed as a corporation instead of a partnership, as often such a loss arises from loss due to operations and therefore was already deducted as a loss on the K-1 issued to the partners each year. Furthermore, S corporation shareholders and partners in a partnership would likely obtain a current deduction for such losses, rather than having to wait until their ownership is disposed of, and they would not be required to jump through any statutory hoops similar to Code § 1244 to obtain the ordinary loss deduction. For more information on the concepts described in this paragraph, see part II.G.4 Limitations on Losses.

### II.Q.7.m. Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company

Generally, an individual may defer $50,000 or a corporation may defer $250,000 of gain on the sale of any publicly traded securities by reinvesting in a specialized small business investment company (SSBIC).[4819]

An SSBIC is any partnership or corporation licensed by the Small Business Administration under section 301(d) of the Small Business Investment Act of 1958 as in effect on May 13, 1993.[4820] That provision authorizes the licensing of small business investment companies organized to invest in small business concerns in such a way as to facilitate ownership by persons whose participation in the free enterprise system has been hampered by social or economic disadvantages.[4821]

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[4815] $100,000 if married filing jointly. Code § 1244(b).
[4816] Code § 1244(a).
[4817] Code § 1244(c).
[4818] Code § 1244(c)(3).
[4819] Code § 1044.
[4820] Code § 1044(c)(3).
[4821] Federal Tax Coord. 2d ¶ I-3794.

### II.Q.8.e.iii.(f). Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold

When an asset sale is desirable for tax purposes but a stock sale is necessary for nontax purposes, Code § 338(g) permits a corporation that buys another corporation from the target's parent in a qualified purchase to elect to treat the stock purchase as an asset purchase. This may help if the gain on sale can be offset by net operating losses[5281] – especially the target's[5282] – or perhaps if the corporation expects to be taxed at a lower rate now and a higher rate later.

Similarly, the owners of an S corporation should consider making a Code § 338(h)(10) election when selling their S corporation stock to a corporation.[5283]

The election causes the stock sale to be treated as if the S corporation sold all its assets while owned by the sellers and while still an S corporation. Gain is therefore recognized by the S corporation and taxed to the selling shareholders, which creates additional basis in their S corporation stock. The actual sale of the stock is ignored for tax purposes and the shareholders are treated as receiving the sale proceeds in liquidation of the S corporation.

Thus, the selling shareholders will be taxed on a deemed asset sale and liquidation, rather than on a stock sale. Unless they bought a portion of their stock at a premium over the value of the corporation's assets, a Code § 338(h)(10) election will generally not significantly affect the amount of gain on which they would be taxed. However, it will cause a portion of their gain to be ordinary income, rather than capital gain, to the extent that a sale of the S corporation's assets would generate ordinary income, and state income tax surprises might occur; for a discussion of the some of the issues mentioned in the sentence, see similar issues raised in part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation. But, the whole point was to replicate an asset sale for tax purposes, so the Code § 338(h)(10) election merely allows a different form to be used for the deemed asset sale. Note, however, that ordinary income tax to the seller may be more expensive than the deduction allowed the buyer, if the buyer is a C corporation taxed at a lower rate, so in an environment of very low C corporation rates relative to individual rates may tend to drive the parties further apart with respect to the value of a Code § 338(h)(10) election.

If the purchaser is not a corporation, a Code § 336(e) election might allow the buyer to replicate the results of a Code § 338(h)(10) election.[5284] The selling corporation or S corporation shareholder(s) must dispose of stock of another corporation (target) in a qualified stock disposition.[5285] "Qualified stock disposition" means any transaction or series of transactions in which stock meeting the requirements of Code § 1504(a)(2) of a domestic corporation is either sold, exchanged, or distributed, or any combination thereof, by another domestic corporation or

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[5281] See part II.G.4.l.iii Code § 172 Net Operating Loss Deduction.

[5282] Code § 382 limits the amount of the taxable income of any new loss corporation for any post-change year which may be offset by pre-change losses. However, Code § 382(h)(1)(C) provides that this limitation does not apply to any gains recognized by reason of an election under Code § 338.

[5283] Reg. § 1.338(h)(10)-1(c)(1) authorizes a Code § 338(h)(1) election when a corporation buys all of the stock of the target corporation.

[5284] Reg. § 1.336-1(a) provides that the effects of Code § 338(h)(10) and the regulations thereunder generally apply to Code § 336(e) elections.

[5285] Reg. § 1.336-2(a), referring to Reg. § 1.336-1(b)(6) in defining a qualified stock disposition.

by the S corporation shareholders in a disposition,[5286] during the 12-month disposition period.[5287] "Disposition" means any sale, exchange, or distribution of stock, but only if:[5288]

(A) The basis of the stock in the hands of the purchaser is not determined in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom the stock is acquired or under Code § 1014(a) (property acquired from a decedent);

(B) Subject to an exception for certain Code § 355(d)(2) and (e)(2) transactions,[5289] the stock is not sold, exchanged, or distributed in a transaction to which Code § 351, 354, 355, or 356 applies and is not sold, exchanged, or distributed in any transaction described in regulations in which the transferor does not recognize the entire amount of the gain or loss realized in the transaction; and

(C) The stock is not sold, exchanged, or distributed to a related person.

Both the rules governing Code § 338(h)(10) elections and Code § 336(e) elections[5290] provide that stock acquired by a purchasing corporation from a related corporation is generally not considered acquired by purchase.[5291] The seller cannot be a person the ownership of whose stock would, under Code § 318(a) (other than Code § 318(a)(4)), be attributed to the buyer.[5292] (Also, in reviewing anything in this part II.Q.8.b.i.(d), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.)

A Code § 336(e) election for an S corporation target is made by completing the following requirements:[5293]

- All of the S corporation shareholders, including those who do not dispose of any stock in the qualified stock disposition, and the S corporation target must enter into a written, binding agreement, on or before the due date (including extensions) of the Federal income tax return of the S corporation target for the taxable year that includes the disposition date, to make a Code § 336(e) election;

- The S corporation target must retain a copy of the written agreement; and

- The S corporation target must attach the Code § 336(e) election statement, to its timely filed (including extensions) Federal income tax return for the taxable year that includes the

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[5286] Within the meaning of Reg. § 1.336-1(b)(5).
[5287] Reg. § 1.336-1(b)(6).
[5288] Reg. § 1.336-1(b)(5).
[5289] Reg. § 1.336-1(b)(5)(ii) provides that:
a distribution of stock to a person who is not a related person in a transaction in which the full amount of stock gain would be recognized pursuant to section 355(d)(2) or (e)(2) shall be considered a disposition.
[5290] Reg. § 1.336-1(b)(5)(iii) provides:
*Transactions with related persons*. In determining whether stock is sold, exchanged, or distributed to a related person, the principles of section 338(h)(3)(C) and § 1.338-3(b)(3) shall apply.
[5291] Reg. § 1.338-3(b)(3).
[5292] Code § 338(h)(3)(A)(iii). For Code § 318(a), see part II.Q.7.a.viii Code § 318 Family Attribution under Subchapter C.
[5293] Reg. § 1.336-2(h)(3).

disposition date. A Reg. § 301.9100-3 extension of time to file the election may be available.[5294]

Instead of the seller(s) being treated as selling stock, the target is treated as selling its assets to an unrelated person in a single transaction at the close of the disposition date (but before the deemed liquidation described below)[5295] in exchange for the aggregate deemed asset disposition price.[5296] The target realizes the deemed disposition tax consequences from the deemed asset disposition before the close of the disposition date while the target is owned by seller or the S corporation shareholders.[5297] If the target is an S corporation, its S election continues in effect through the close of the disposition date (including the time of the deemed asset disposition and the deemed liquidation) notwithstanding the usual rules for S corporation terminations.[5298] Also, if the target is an S corporation (but not a qualified subchapter S subsidiary (QSub)[5299]), any direct or indirect subsidiaries of the target that the target has elected to treat as QSubs remain qualified QSubs through the close of the disposition date.[5300] If the target is an S corporation, its shareholders (whether or not they sell or exchange their stock) take their pro rata share of the deemed disposition tax consequences into account under Code § 1366 and increase or decrease their basis in target stock under Code § 1367.[5301]

Immediately after the deemed asset disposition described above, the target is treated as acquiring all of its assets from an unrelated person in a single, separate transaction at the close of the disposition date in exchange for an amount equal to the adjusted grossed-up basis.[5302]

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[5294] Letter Rulings 201652014 and 201711007, the latter holding:

> WITHIN 45 DAYS OF THE DATE ON THIS LETTER, S Corporation Target and the S Corporation Shareholder must enter into a written, binding agreement to make a section 336(e) election and S Corporation Target must file the section 336(e) election statement in accordance with § 1.336-2(h). The section 336(e) election statement must be attached to S Corporation Target's tax return for B Year. In addition, a copy of this letter must be attached to S Corporation Target's return. Alternatively, if S Corporation Target files its return electronically, it may satisfy the requirement of attaching a copy of this letter to the return by attaching a statement to its return that provides the date and control number (PLR-131803-16) of this letter ruling.
>
> WITHIN 120 DAYS OF THE DATE ON THIS LETTER, all relevant parties must file or amend, as applicable, all returns and amended returns (if any) necessary to report the transaction consistently with the making of a section 336(e) election for the taxable year in which the transaction was consummated (and for any other affected taxable year).
>
> The above extension of time is conditioned on the taxpayers' (*i.e.*, Purchaser's, S Corporation Target's, and S Corporation Shareholder's) tax liability (if any) being not lower, in the aggregate, for all years to which the section 336(e) election applies than it would have been if the Election had been timely filed (taking into account the time value of money). No opinion is expressed as to the taxpayers' tax liability for the years involved. A determination thereof will be made by the applicable Director's office upon audit of the federal income tax returns involved.

[5295] Reg. § 1.336-2(b)(1)(iii).
[5296] Reg. § 1.336-2(b)(1)(i)(A).
[5297] Reg. § 1.336-2(b)(1)(i)(A).
[5298] Reg. § 1.336-2(b)(1)(i)(A).
[5299] See part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[5300] Reg. § 1.336-2(b)(1)(i)(A).
[5301] Reg. § 1.336-2(b)(1)(iii)(A).
[5302] Reg. § 1.336-2(b)(1)(ii).

The target remains liable for the tax liabilities it had before this deemed sale and purchase (including the tax liability for the deemed disposition tax consequences).[5303]

The target and seller (or S corporation shareholders) are treated as if, before the close of the disposition date, after the deemed asset disposition described above, and while target is owned by seller or S corporation shareholders, the target transferred all of the consideration deemed received in the deemed asset disposition to seller or S corporation shareholders, any S corporation election for the original target terminated, and the original target ceased to exist.[5304] This transfer to the seller or S corporation shareholders is characterized for Federal income tax purposes in the same manner as if the parties had actually engaged in the transactions deemed to occur above and taking into account other transactions that actually occurred or are deemed to occur.[5305]

Thus, the following transactions are deemed to have occurred:

1. The target sells its assets to a hypothetical buyer.

2. The target is treated as having bought its assets from a hypothetical seller.

3. The target liquidates, while the old shareholders are deemed to continue owning the stock.

The time for taking into account liabilities in the hypothetical asset transaction and the amount of the liabilities taken into account is determined as if the consideration included the discharge of the liabilities by the unrelated person.[5306] For example, if no amount of a liability is properly taken into account in amount realized as of the beginning of the day after the disposition date, the liability is not initially taken into account in determining the purchase price, but it may be taken into account at some later date.[5307] At the January 2017 American Bar Association Section of Taxation meeting, a discussion of Code § 336(e) gave this example:[5308]

- Deemed asset purchase price equals cash paid plus “liabilities” assumed.

- Liabilities do not include amounts which are not currently deductible or amounts not borrowed from a third party.

- Assume that the assets are worth 100 and are associated with 20 of liabilities, and that the purchaser pays 80 for the target’s stock.

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[5303] Reg. § 1.336-2(b)(1)(ii).
[5304] Reg. § 1.336-2(b)(1)(iii)(A).
[5305] Reg. § 1.336-2(b)(1)(iii)(A), which continues:
For example, the transfer may be treated as a distribution in pursuance of a plan of reorganization, a distribution in complete cancellation or redemption of all of its stock, one of a series of distributions in complete cancellation or redemption of all of its stock in accordance with a plan of liquidation, or part of a circular flow of cash. In most cases, the transfer will be treated as a distribution in complete liquidation to which sections 331 or 332 and sections 336 or 337 apply.
[5306] Reg. § 1.336-3(d)(2).
[5307] Reg. § 1.336-3(d)(2).
[5308] Slides discussed by Bakal, Bakke, Mottahedeh, and Weiss are saved as Thompson Coburn LLP document no. 6563470.

- On the target's deemed liquidation after filing a conversion election, assets distributed are worth 100, but basis is limited to 80, which potentially triggers 20 of gain.

The meeting gave the following examples of liabilities that may trigger this gain:

- Environmental and other contingent liabilities
- Deferred compensation (Code § 404(a)(5))
- Obligations to perform future services (*Pierce*)
- Economic performance (Code § 461(h))

However, it was suggested that such a mismatch may occur in a straight asset sale as well.

A minority shareholder who retains its target stock does not recognize gain or loss with respect to its shares of target stock; thus, the minority shareholder's basis (except as noted below) and holding period for that target stock are not affected by Code § 336(e) election.[5309] Notwithstanding this treatment of the minority shareholder, if a Code § 336(e) election is made, target will still be treated as disposing of all of its assets in the deemed asset disposition.[5310] If the target is an S corporation, any K-1 items the minority shareholder reports by reason of the deemed sale will affect the shareholder's basis.[5311]

A handy list comparing Code § 338(h)(10) elections and Code § 336(e) elections is found at Harper & Andersen, "Section 336(e)-Another Tool in the Toolbox," *BNA Daily Tax Report* (5/28/2014).[5312]

At the May 2017 American Bar Association Section of Taxation meeting, a discussion of Code §§ 336(e), 338(h)(10), 453(h), and 453B(h), included:[5313]

- Helpful flowcharts showing the transactions deemed to occur in Code § 336(e) or 338(h)(10) elections.
- Potential surprises, how to avoid them using a one-day note for 100% of the transaction, and disadvantages of doing so.[5314]
- State approaches.

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[5309] Reg. § 1.336-3(d)(3).

[5310] Reg. § 1.336-3(d)(3).

[5311] Note the parenthetical in this quote from Reg. § 1.336-2(b)(1)(iii)(A):

> If old target is an S corporation, S corporation shareholders (whether or not they sell or exchange their stock) take their pro rata share of the deemed disposition tax consequences into account under section 1366 and increase or decrease their basis in target stock under section 1367.

[5312] A copy of which is saved as Thompson Coburn LLP document no. 6344607.

[5313] "Converting Stock Sales to Assets Sales (and Back Again)," slides discussed by Dolan, Harper, and Waters, is saved as Thompson Coburn LLP document no. 6617969.

[5314] If the buyer was willing to pay cash and the seller wanted the one-day note, the buyer's willingness to pay cash does not prevent the seller from using the installment method – only the actual deal counts. Rev. Rul. 73-396.

One way to avoid the complexity of these elections and disparate state law treatment may be to create a new parent corporation, convey or merge the old corporation into a new single-member, tax-disregarded LLC, and then sell the LLC to the buyers. The first two steps constitute a tax-free Code § 368(a)(1)(F) transaction.[5315] Selling the LLC to the buyers means that the buyer is not concerned with the old corporation's status as an S corporation.[5316]

[5315] See parts II.E.7.c.i.(b) Use F Reorganization to Form LLC and II.P.3.h Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

[5316] For example, the S corporation may have had an ineligible shareholder. See parts II.A.2.f Shareholders Eligible to Hold S Corporation Stock and III.A.3.a.ii How a Trust Can Fall Short of Being Wholly Owned by One Person, the latter explaining how one might think that a trust is a wholly-owned grantor trust but may be incorrect.

### III.B.1.a.i.(a). Loans Must be Bona Fide

*Dynamo Holdings Ltd. Partnership v. Commissioner*, T.C. Memo. 2018-61, held that advances between family-owned entities were not gifts. The court summarized relevant principles:

> The question of whether a taxpayer has entered into a bona fide creditor-debtor relationship pervades Federal tax litigation.[5739] The parties must have actually intended to establish a debtor-creditor relationship for a transaction to be a bona fide loan.[5740] To find a bona fide creditor-debtor relationship, we must determine that at the time the advances were made there was "an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment."[5741]
>
> We apply special scrutiny to intrafamily transfers and transactions between entities in the same corporate family or with shared ownership.[5742] Transfers between family members are presumed to be gifts.[5743] This presumption can be rebutted by "an affirmative showing that there existed a real expectation of repayment and intent to enforce the collection of the indebtedness."[5744] When analyzing transfers between related parties, it is useful to compare the transactions at issue to arm's-length transactions and normal business practices.[5745] However, we must also be mindful of the business realities of related parties.[5746] For example, we have held that security and other creditor protections are less important in a related-party context.[5747]

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[5739] Fn 18 of *Dynamo Holdings* cited here:
*See, e.g., Ellinger v. United States*, 470 F.3d 1325, 1333-1334 (11th Cir. 2006); *Calloway v. Commissioner*, 135 T.C. 26, 36-37 (2010), *aff'd*, 691 F.3d 1315 (11th Cir. 2012).

[5740] Fn 19 of *Dynamo Holdings* cited here:
*Calloway v. Commissioner*, 135 T.C. at 37; see also *Ellinger*, 470 F.3d. at 1333.

[5741] Fn 20 of *Dynamo Holdings* cited here:
*Haag v. Commissioner*, 88 T.C. 604, 616 (1987), *aff'd without published opinion*, 855 F.2d 855 (8th Cir. 1988).

[5742] Fn 21 of *Dynamo Holdings* cited here:
*Kean v. Commissioner*, 91 T.C. 575 (1988); *Malone & Hyde, Inc. v. Commissioner*, 49 T.C. 575, 578 (1968); *Vinikoor v. Commissioner*, T.C. Memo. 1998-152, 75 T.C.M. (CCH) 2185 (1998).

[5743] Fn 22 of *Dynamo Holdings* cited here:
*Perry v. Commissioner*, 92 T.C. 470, 481 (1989), *aff'd without published opinion*, 912 F.2d 1466 (5th Cir. 1990); *Barr v. Commissioner*, T.C. Memo. 1999-40, 77 T.C.M. (CCH) 1370, 1372 (1999); *Vinikoor v. Commissioner*, 75 T.C.M. (CCH) at 2187.

[5744] Fn 23 of *Dynamo Holdings* cited here:
*Vinikoor v. Commissioner*, 75 T.C.M. at 2187.

[5745] Fn 24 of *Dynamo Holdings* cited here:
*Estate of Mixon v. United States*, 464 F.2d 394, 403 (5th Cir. 1972); *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 494 (1980).

[5746] Fn 25 of *Dynamo Holdings* cited here:
*Litton Bus. Sys., Inc. v. Commissioner*, 61 T.C. 367, 377-378 (1973); *NA Gen. P'ship & Subs. v. Commissioner*, T.C. Memo. 2012-172, 103 T.C.M. (CCH) 1916, 1920 (2012); *see also Malone & Hyde, Inc. v. Commissioner*, 49 T.C. at 578.

[5747] Fn 26 of *Dynamo Holdings* cited here:
*NA Gen. P'ship & Subs. v. Commissioner*, 103 T.C.M. (CCH) at 1920-1921.

*Dynamo Holdings* viewed debt-vs.-equity cases as helpful but not directly on point.[5748] Instead, the court to looked to a case that the Eleventh Circuit affirmed without a published opinion:

> In *Jones v. Commissioner*, we used a long-standing nine-factor facts and circumstances test to determine whether two parties entered into a valid debtor-creditor relationship.[5749] We evaluated all the pertinent facts and circumstances of the case, including whether:
>
> > (1) There was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was security or collateral, (4) there was a fixed maturity date, (5) a demand for repayment was made, (6) any actual repayment was made, (7) the transferee had the ability to repay, (8) any records maintained by the transferor and/or the transferee reflected the transaction as a loan, and (9) the manner in which the transaction was reported for Federal tax is consistent with a loan.

Describing its approach that was different than what the parties urged,[5750] the court stated:[5751]

> We apply a special scrutiny to transactions between companies with shared ownership and intrafamily transfers, and we presume that transfers between family members are

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[5748] The court noted that the case would be appealed to the Eleventh Circuit and listed that Circuit's "13-factor debt-versus-equity test," which "asks the Court to look to the totality of all the facts and circumstances and specifically directs the Court to consider" various factors, citing *Ellinger v. United States*, 470 F.3d 1325], 1333-1334 (11th Cir. 2006). The Tax Court then noted:

> But this is not a debt-versus-equity case. The Commissioner argues that the transfers were gifts, not equity. As a result, our inquiry is not focused on weighing debt versus equity, but rather on considering whether there is a bona fide debt. While the debt-versus-equity test adopted by the Court of Appeals offers some guidance, it is not directly on point.

[5749] Fn 29 of *Dynamo Holdings* cited here:

> *Jones v. Commissioner*, T.C. Memo. 1997-400, 74 T.C.M. (CCH) 473, 482 (1997), *aff'd without published opinion*, 177 F.3d 983 (11th Cir. 1999).

[5750] The court noted:

> Petitioners allege that Dynamo and Beekman had the intent to repay and be repaid as demonstrated by their subjective declarations of their intent. Conversely, the Commissioner argues that we should draw an adverse inference from Mrs. Moog's failure to testify at trial and infer that Dynamo and Beekman did not intend to repay and be repaid. We disagree with both parties.

[5751] The court explained:

> Beekman and Dynamo had shared ownership and control. Both Dynamo and Beekman were owned in part by trusts for which Christine, Mr. Julien and their families were beneficiaries. Transfers between the two structures were transfers between companies with shared ownership.
>
> Transfers between Beekman and Dynamo were ultimately intrafamily transfers. When Beekman made transfers to Dynamo, value was being transferred from one family of companies, the majority of which were held by trusts for which Delia Moog is a beneficiary, Delia Moog Family Trust and Delia Moog Family Trust #2, to another family of companies, the majority of which were held by trusts for which her daughter and nephew and their families were beneficiaries. While Christine and Mr. Julien were also beneficiaries of some of the trusts which owned Beekman, the transfers from Beekman to Dynamo reduced Delia Moog's beneficial interest in the underlying properties in favor of her daughter, her nephew, and their families.
>
> Given the nature of these transfers, we treat them with special scrutiny and determine whether the advances are gifts or loans for Federal tax purposes on the basis of the totality of the circumstances.[33] On that basis we find that the advances were loans.
>
> [33] *See Estate of Mixon*, 464 F.2d at 402.

gifts.[5752] Here, transfers between Beekman and Dynamo were transfers between companies with both shared ownership and intrafamily transfers.

Reviewing issues relating to formal indicia of debt, the court noted:

> Dynamo and Beekman satisfied some but not all of the formal indicia of debt. We agree with the Commissioner that at the time the advances were made there was no contemporaneous promissory note identifying all the terms of the agreement, there was no collateral set aside to ensure repayment, there was no invoice or demand made by Beekman, and there was no fixed maturity date or intent to force Dynamo into bankruptcy if required to ensure repayment. However, there are many meaningful indicia of debt. Dynamo and Beekman maintained records that reflected advances as debt in their general ledgers, and they executed promissory notes.

Regarding issues relating to formal indicia of debt, the court concluded:

> We are not troubled by any shortcomings in Dynamo's and Beekman's formal indicia of debt. They must be taken into account in the context of the business realities of the transaction. We would be surprised if Mr. Julien wrote himself an invoice, demanded repayment, or required a credit check or audited financial statements before making an advance. The management of these companies was the same, and they had full knowledge of and access to all financial information. Moreover, we have consistently held that these formal indicia of debt are little more than declarations of intent without accompanying objective economic indicia of debt.[5753]

*Dynamo Holdings* then reviewed the "economic indicia of debt":

> In ascertaining the economic realities of the transaction, it is helpful to measure the transfer against the economic realities of the marketplace to determine whether a third party lender would have extended the loan.[5754] Dynamo and Beekman satisfy all the objective economic indicia of debt. Beekman charged and Dynamo accrued interest on the advances in 2006 and 2007. Beekman reported and paid tax on that interest income. Dynamo reported and deducted that interest expense. Dynamo repaid some of the advances before any examination began. At all times, Dynamo had the ability to repay the loans. Importantly, Dynamo could have received loans on substantially similar terms. And Dynamo did receive sizable loans from third parties.

*Dynamo Holdings* concluded on this issue:

> After analyzing the facts, we hold that Dynamo and Beekman entered into a bona fide creditor-debtor relationship. At the time the advances were made, Dynamo had an

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[5752] Fn 32 of *Dynamo Holdings* cited here:
*Perry v. Commissioner*, 92 T.C. at 481; *Kean v. Commissioner*, 91 T.C. at 595; *Vinikoor v. Commissioner*, 75 T.C.M. (CCH) at 2187.

[5753] Fn 45 of *Dynamo Holdings* cited here:
*Alterman Foods, Inc. v. United States*, 505 F.2d 873, 879 (5th Cir. 1974); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968); *Sensenig v. Commissioner*, T.C. Memo. 2017-1, at *24-*26, *aff'd*, __ F. App'x __, 2018 WL 508567 (3d Cir. Jan. 23, 2018).

[5754] Fn 46 of *Dynamo Holdings* cited here:
*Sensenig v. Commissioner*, at *26-*27.

> unconditional obligation to repay the loans, and Beekman had an unconditional intent to be repaid. A bona fide loan precludes a constructive distribution.[5755] Because we found that the advances were bona fide debt, the advances are not constructive distributions. Likewise, Dynamo is entitled to deduct the interest expenses.

Although the *Dynamo Holdings* taxpayers prevailed, they had to overcome their documentation weaknesses. One might consider documenting the expectation of repayment and the loan itself using the principles of Reg. § 1.385-2; I am not at all suggesting that such documentation is necessary but merely that a tax planner who is extraordinarily cautious might find some comfort there.[5756] This is part of part II.G.21 Debt vs. Equity; see also parts II.G.4.a.ii Bad Debt Loss – Must be Bona Fide Debt, II.G.4.d.ii Using Debt to Deduct S Corporation Losses (discussing deducting S corporation losses against loans from shareholders to the corporation and the consequences of doing so), and II.Q.7 Exiting from or Dividing a Corporation, text accompanying fns 4325-4327 (payments to employee-shareholder characterized as distributions or compensation instead of loans).

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[5755] Fn 58 of *Dynamo Holdings* cited here:

*Schnallinger v. Commissioner*, T.C. Memo. 1987-9 (1987).

[5756] As part II.G.21 Debt vs. Equity discusses, generally Reg. § 1.385-2 targets C corporations engaged in international financial transactions and would not apply to intra-family loans for estate planning. However, if one can satisfy Reg. § 1.385-2, which was geared toward perceived abuses, presumably one would go a long way toward showing a loan's bona fides.