1998

Pass-Through Entity Update

Richard B. Robinson

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PASS-THROUGH ENTITY UPDATE

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PASS-THROUGH ENTITY UPDATE

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Property Of: ____

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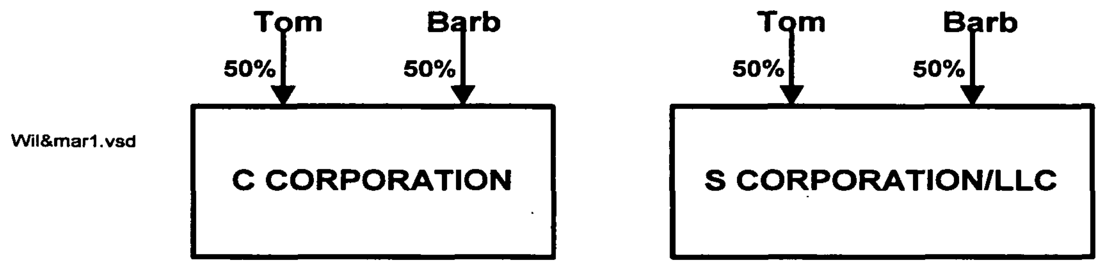
TAX RATES--BUSINESS SALES

I. FACTS.



Tom and Barb will form a manufacturing business on January 1, 1999. Both Tom and Barb are in the 39.6% federal income tax bracket.

II. ISSUES.

Should the business operate as a C corporation or a pas-thru entity? Would it make a difference whether they plan to sell the business in five years, 20 years, or pass it on to their children?

III. DISCUSSION.

A. Tax Rates.

1. Ordinary Income and Capital Gain.

   a. Ordinary income rates range from 15% to 39.6%. IRC § 1.

   b. Capital gains: 20% for capital assets or IRC § 1231 assets held more than 12 months. IRC §§ 1201 and 1202. IRC §§ 341 and 306 can convert gain from the sale of stock from capital gain into ordinary income.

   c. IRC § 1202 generally permits a noncorporate taxpayer who sells qualified small business stock issued after August 10, 1993, which has been held for more than five years, to exclude up to 50% of any gain on the sale or exchange. The federal income tax rate cannot be less than 14%. A qualified small business corporation, among other requirements, must use 80% of its assets in an active business. Real property cannot exceed 10%, by value, of its assets, and portfolio stock cannot exceed 10% of its assets, by value. IRC § 1045 permits proceeds from the sale of qualified small business stock held more than six months to be rolled over, tax free, into stock of another qualified small business corporation. The rollover must be completed within 60 days. There is no five-year holding period for this provision, but the stock must have been issued after August 10, 1993.

The gain can result from a sale, redemption, or liquidation. *See* Rev. Proc. 98-48, IRB 1998-38 for IRS procedure to apply to IRC § 1045.

d. Generally, the sale of a partnership interest produces capital gain. IRC § 741. However, if the partnership owns unrealized receivables or inventory items, the seller's gain will be taxed as ordinary income to the extent of their shares of these hot assets. IRC § 751.

e. Employers and employees each pay social security and medicare taxes:

(1) 6.2%, maximum of $68,400, for 1998.

(2) 1.45%, no maximum.

f. Corporations can participate in tax-free reorganizations. IRC § 368. Partnerships and LLCs cannot participate in tax-free reorganizations under IRC § 368, but may be acquired tax-free by another partnership under § 721.

g. Corporate Tax Rates:

(1) IRC § 11:

$0 - $50,000	-	15%
$50,001 - $75,000	-	25%
$75,001 - $100,000	-	34%
$100,001 - $335,000	-	39%
$335,001- $10,000,000	-	34%
$10,000,000 - $15,000,000	-	35%
$15,000,001 - $18,300,000	-	38%
Over $18,300,000	-	35%

(2) Tax rates for personal service corporations: 35%. IRC § 11.

(3) Built-in gains penalty tax and passive investment income tax: 35%. IRC §§ 1374 and 1375.

(4) Personal holding company tax and accumulated earnings tax: 39.6%. IRC §§ 531 and 541.

2. <u>Gain From the Sale of Property</u>.

a. Gain or loss from the sale or exchange of property is the difference between the amount realized and the adjusted basis of the property. IRC § 1001(a). Amount realized includes the amount of money received, the fair market value of other properties received, and the amount of liabilities which the purchaser assumes or takes subject to. IRC § 1001(b); Reg. § 1.1001-1(e). The tax basis of property is its cost. The buyer's cost includes the amount of money paid, the fair market value of other property transferred as consideration for the purchase, and the amount of liabilities assumed or the amount of liabilities to which the property received is subject, etc. *See* IRC §§ 1011, 1012. Basis may be adjusted by increasing the basis to take into account expenses related to the property and properly capitalized, and by decreasing the basis on account of losses and allowable depreciation. *See* IRC § 1016(a)(1), (2).

b. Gain or loss is usually recognized in the year a sale takes place, unless a specific authority exists for such deferral or nonrecognition. IRC §§ 1001(c), 1001(d), and 1002.

c. Gain or loss upon the sale or exchange of property is treated as ordinary income unless it is the "sale or exchange" of a "capital asset", or an IRC "§ 1231 asset." IRC §§ 1221 and 1231.

(1) A "capital asset" includes all property held by a taxpayer, except for certain types of properties specifically excluded by the statute. IRC § 1221. There are five statutory exceptions: Stock in trade, inventory, and property held for sale to customers in the ordinary course of the taxpayer's business. IRC § 1221(1). Property used in the taxpayer's trade or business that is subject to allowance for depreciation under IRC § 167, or real property used in the taxpayer's trade or business. IRC § 1221(2). Copyrights and similar property held by the creator of the property or by a person who has a carryover basis in such property. IRC § 1221(3). Accounts or notes receivable acquired in the ordinary course of business for services rendered or sales of inventory. IRC § 1221(4). Certain government obligations. IRC § 1221(5).

(2) IRC § 1231 assets include property used in the taxpayer's trade or business that is subject to depreciation, and real property used in a trade or business, provided that such real property is used in a trade or business that provided that such property is held for more than six months and is not either: (1) property which is included in the taxpayer's inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of his business; or (2) a copyright, an artistic composition, or a letter or memorandum composed or created by the taxpayer and held by a taxpayer whose basis in the property is determined with reference to the creator's basis. IRC § 1231(b).

(3) The recapture provisions cause gain from the sale of property to be taxed as ordinary income to the extent of prior depreciation or amortization deductions. *See* IRC §§ 1245 and 1250.

B. Double Tax vs. Single Tax--Asset Sales vs. Entity Sales.

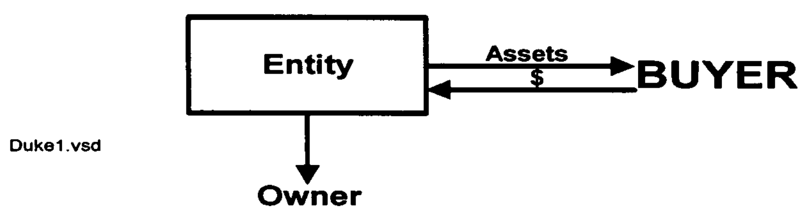
1. C Corporations. C corporations are separate taxable entities. § 11. Any gain from an asset sale is taxed at the corporate level, then another tax is imposed when the proceeds are distributed to the shareholders. A stock sale eliminates the double tax.

2. Pass-Through Entities. Proprietorships, partnerships, LLCs, and S corporations are generally pass-through entities. IRC §§ 701 and 1361. No entity level tax is exacted. S corporations, however, may be subject to a built-in gains or a passive investment income penalty tax. IRC §§ 1374 and 1375. There is generally no difference between an asset sale and a stock sale.

3. Transactional Patterns:

   a. Asset Sale.

   b. Stock Sale.



   c. Tax Cost Comparison for Earnings Produced by Different Entities: 40% ordinary income/20% capital gains/14%. § 1202.

      (1) Current earnings realized through distributions:

Tax, Inc.	50,000.	75,000.	400,000.
Flow through @ 40%	20,000.	30,000.	160,000.
C Corporation	7,500.	13,750.	136,000.
Savings/Cost	12,500.	16,250.	24,000.
Distribution tax @ 40%	17,000.	24,500.	105,600.
Double tax	24,500.	38,250.	241,600.
Savings/Cost	<4,500.>	<8,250.>	<81,600.>

(2) Sale of business--capital gain/zero basis.

Tax, Inc.	$500,000.	$1,000,000.
Flow through @ 20%	100,000.	200,000.
C Corporation	170,000.	340,000.
Distribution tax @ 20%	66,000.	132,000.
Double tax	236,000.	472,000.
Savings/Cost	<136,000.>	<272,000.>

(3) Current earnings realized through liquidation or sale.

	Liquidation	Liquidation	Liquidation
Tax Inc.	50,000.	75,000.	400,000.
Flow Through	20,000.	30,000.	160,000.
C Corp.	7,500.	13,750.	136,000.
Savings/Cost	12,500.	16,250.	24,000.
Distribution Tax	8,500.	12,250.	52,800.
Distribution Tax @ 14%	5,950.	8,575.	36,960.
Double tax	16,000.	26,000.	188,800.
Double tax @ 14%	13,450.	22,325.	172,960.
Flow Through	20,000.	30,000.	160,000.

(4) Sale of business--$500,000/$1,000,000 gain, current earnings and FV savings at 8% realized through liquidation or sale after five years:

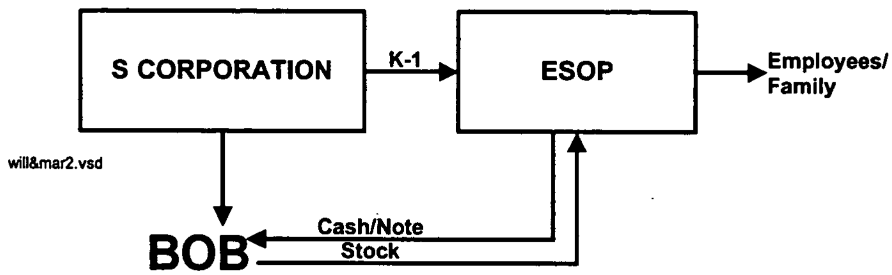
	S Corp.	C Corp.	S Corp.	C Corp.
Gain from sale	$500,000.	$500,000.	$1,000,000.	$1,000,000.
Accum earnings	150,000.	150,000.	1,200,000.	1,200,000.
FV savings		73,333.		140,798.
Flow through @ 20%	<100,000.>		<200,000.>	
C corp. @ 34%	<170,000.>		<340,000.>	
Distribution tax @ 20%	___.	<110,666.>	_____.	<400,159.>
Net to shareholders	$550,000.	$442,667.	$2,000,000.	$1,600,639.
Distribution tax @ 14%	___.	<74,666.>	_____.	280,111.
Net to shareholders	550,000.	478,667.	2,000,000.	1,720,687.

(5) Sale of business, $500,000/$1,000,000 gain, current earnings and FV savings at 8% realized through liquidation or sale after 15 years:

	S Corp.	C Corp.	S Corp.	C Corp
Gain from sale	500,000.	500,000.	1,000,000.	1,000,000
Accum earnings	450,000.	450,000.	3,600,000.	3,600,000
FV savings		339,401.		651,651
Flow through @ 20%	<100,000.>		<200,000.>	
C corp. @ 34%	<170,000.>		<340,000.>	
Distribution tax @ 20%	___.	<223,880.>	____.	<982,330
Net to shareholders	$850,000.	$895,521.	$4,400,000.	$3,929,321
Distribution tax @ 14%	___.	<156,716.>	_____.	<287,631
Net to shareholders	$850,000.	$962,685.	$4,400,000.	$4,224,020

CHAPTER 2
S CORPORATION ESOPS

I. FACTS.



Bob owns 100 shares/100% of Bobco. The corporation has been appraised at $5mm. Bob desires to sell the business to his employees.

II. ISSUES.

Will Bob recognize capital gain if he sells his stock to the issues? What are the tax benefits to the employees from this transaction?

III. DISCUSSION.

A. ESOPs As S Shareholders--An Overview.

1. Effective January 1, 1998, an ESOP is an eligible, tax-exempt S shareholder. Sales of C corporation or S corporation stock to an ESOP can offer several advantages as an exit strategy for disposing of the family business.

2. The sale can qualify for capital gains rates. ***Note***: for S corporation ESOPs, § 341(f) might eliminate any collapsible corporation risk.

3. Sales of C corporate stock can qualify for IRC § 1042 rollover tax deferral of the gain.

4. The payment of both principal and interest can be accomplished with pre-tax rather than after-tax dollars.

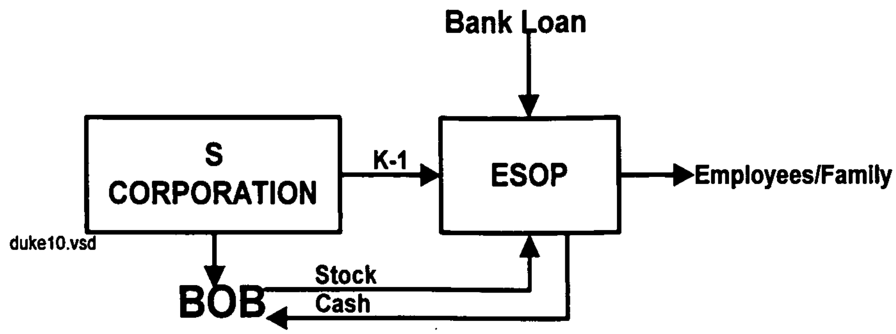
5. S corporation ESOPs permit tax-deferral for the corporation's operating income.

6. Selling shareholder may continue to participate in ESOP, thereby sharing in part sale/earnings of corporation.

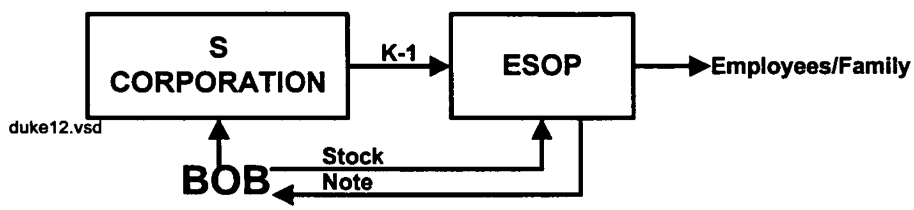
7. Distributions of appreciated employee securities from the ESOP can qualify for capital gain rates. Code § 402(e)(4).

B. ESOP Transactions.

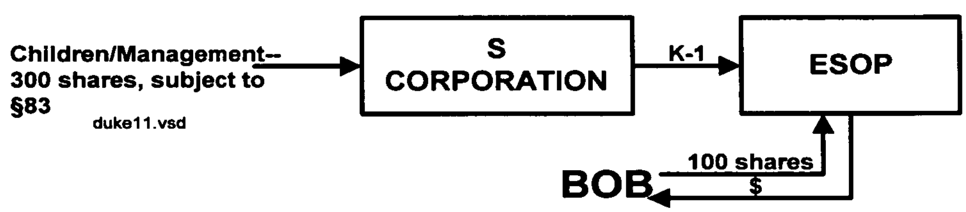
1. Classic ESOP transaction:



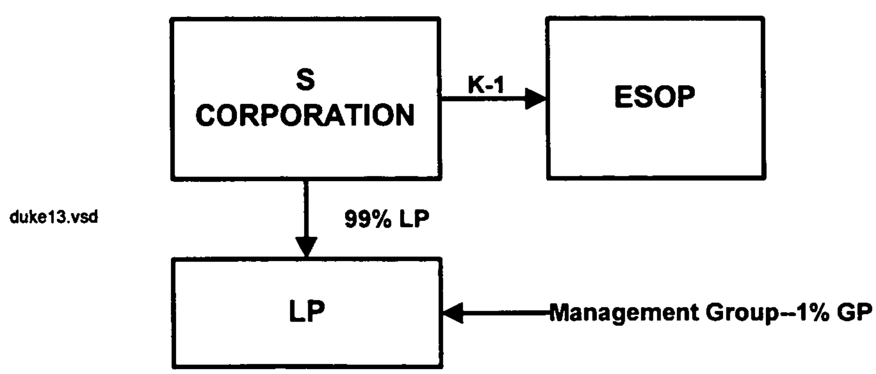
2. Debt financed acquisition without bank:



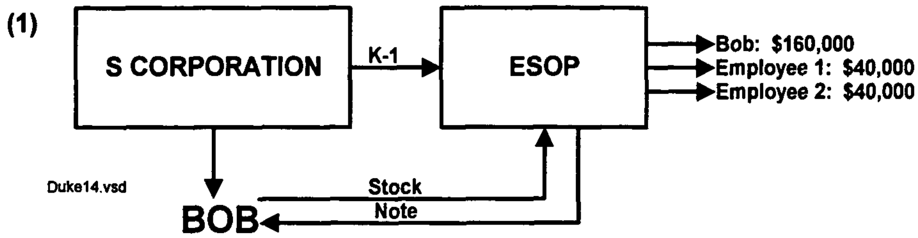
3. Strategy for maintaining control in family or management group:

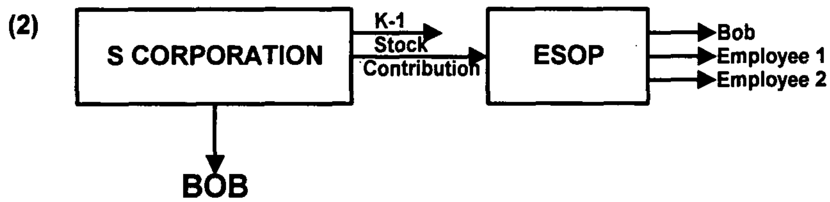


4. Strategy for maintaining control in family or management group:

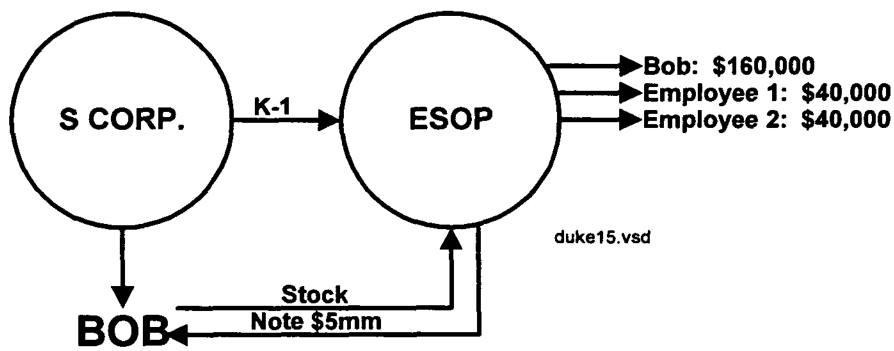


5. Increased Retirement Plan Contributions. Assume Bob has two employees with annual salaries of $40,000 each.

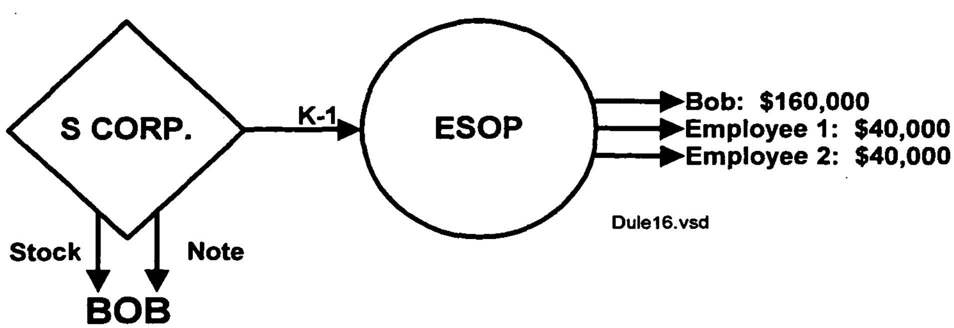




6. Conversion of Ordinary Income Into Capital Gain. Bob is a real estate developer. The value of the corporation represents real estate inventory held for sale to customers.



7. Sale by Redemption:



C. Comparison of ESOP As a Financing Alternative:

Assumptions:

Sales Price $12,800,000.
If stock sold to ESOP or Corporation, Seller carries for ten years at 7% per annum. If stock sold to third party, Seller paid in lump sum.
Ordinary income tax rate 42.62%.
Capital gain tax rate 24%.
Corporate tax rate 38%.
$3,000,000 annual employee payroll.
$3,665,000 annual corporate pre-tax income.

XYZ COMPANIES
COMPARISON OF FINANCING ALTERNATIVES

	ESOP S CORP.[1]	ESOP C CORP.	NON-ESOP DEBT FINANCING	THIRD PARTY STOCK PURCHASE
Results to Seller				
Sales Price	$12,800,000.00	$12,800,000.00	$12,800,000.00	$12,800,000.00
Capital Gain Tax @ 24%	(3,072,000.00)	(3,072,000.00)	(3,072,000.00)	(3,072,000.00)
Net to Seller - Principal	9,728,000.00	9,728,000.00	9,728,000.00	9,728,000.00
Interest Payments to Seller[2]	5,424,320.00	5,424,320.00	5,424,320.00	-0.-
Ordinary Income Tax @42.62%	(2,311,845.00)	(2,311,845.00)	(2,311,845.00)	
Net to Seller - Interest	3,112,475.00	3,112,475.00	3,112,475.00	
Total to Seller Net of Tax[5]	15,366,524.00	15,366,524.00	15,366,524.00	14,385,977.00
§1042 Available?	Yes[3]	Yes	No	No
§453 Installment Sale Available?	Yes[4]	Yes[4]	Yes	Yes

[1] S election effective January 1, 1999. Sale to ESOP would occur on or before December 31, 1998.

[2] Based on 10 year amortized annual installments, 7% per annum interest.

[3] Section 1042 applies only if C corporation at time of sale to ESOP. Applies only to the sales proceeds (excluding interest) reinvested within one year of sale.

[4] Applies only to portion of sales proceeds not applied in Section 1042 tax-free exchange.

[5] Net after-tax proceeds 10 years following sale assuming after-tax proceeds invested at 7% per annum.

[6] Assumes third party incurs no costs of capital.

[7] Deductible contribution to ESOP @ 25% x $3,000,000 payroll + interest on note.

XYZ COMPANIES
COMPARISON OF FINANCING ALTERNATIVES

Results to Purchaser	ESOP S CORP.[1]	ESOP C CORP.	NON-ESOP DEBT FINANCING	THIRD PARTY STOCK PURCHASE
Annual Payment				
Year 1				
Principal	$ 926,432.00	$ 926,432.00	$ 926,432.00	$12,800,000.00
Interest @ 7%	896,000.00	896,000.00	896,000.00	0.[6]
Total Payments	1,822,432.00	1,822,432.00	1,822,432.00	12,800,000.00
Deductible (Non-Taxable) Portion	(1,822,432.00)	(1,646,000.00)[7]	(896,000.00)	0.
Taxable Portion	0.	176,432.00	926,432.00	12,800,000.00
Tax at 38%	0.	67,044.00	352,044.00	4,864,000.00
Total Payments + Tax	1,822,432.00	1,889,476.00	2,174,476.00	17,664,000.00
Year 2				
Principal	$ 991,282.00	$ 991,282.00	$ 991,282.00	0.
Interest @ 7%	832,150.00	831,150.00	831,150.00	0.
Total Payments	1,822,432.00	1,822,432.00	1,822,432.00	0.
Deductible (Non-Taxable) Portion	(1,822,432.00)	(1,581,150.00)	(831,150.00)	
Taxable Portion	0.	241,282.00	991,282.00	0.
Tax at 38%	0.	91,687.00	376,687.00	0.
Total Payments + Tax	1,822,432.00	1,914,119.00	2,199,119.00	0.
Year 1 - Total Payments + Tax	1,822,432.00	1,889,476.00	2,174,476.00	17,664,000.00
Year 2 - Total Payments + Tax	1,822,432.00	1,914,119.00	2,199,119.00	0.
Year 3 - Total Payments + Tax	1,822,432.00	1,940,467.00	2,225,487.00	0.
Year 4 - Total Payments + Tax	1,822,432.00	1,968,701.00	2,253,701.00	0.
Year 5 - Total Payments + Tax	1,822,432.00	1,998,890.00	2,283,890.00	0.
Year 6 - Total Payments + Tax	1,822,432.00	2,031,192.00	2,316,192.00	0.
Year 7 - Total Payments + Tax	1,822,432.00	2,065,756.00	2,350,756.00	0.
Year 8 - Total Payments + Tax	1,822,432.00	2,102,738.00	2,387,738.00	0.
Year 9 - Total Payments + Tax	1,822,432.00	2,142,310.00	2,427,310.00	0.
Year 10 - Total Payments + Tax	1,822,432.00	2,184,651.00	2,469,651.00	0.
Ten Year Cumulative Payments	18,224,320.00	20,238,300.00	23,088,320.00	17,664,000.00
PV @ 7%	12,800,000.00	14,088,395.00	16,090,132.00	17,664,000.00

D. Cash Flow Illustrations.

1. Cash flow to corporation:

   a. 100%ESOP shareholder:

(1)	C corporation taxable income	$1mm.
	Tax	37.5%
	After-tax proceeds	$625,000.
(2)	S corporation taxable income	$1mm.
	Tax	$ 0.
	After-tax proceeds	$1mm.

   b. 50% ESOP Shareholder:

(1)	C corporation taxable income	$1mm.
	Tax	37.5%
	After-tax proceeds	$625,000.
(2)	S corporation taxable income	$1mm.
	Tax: 42.5% @ 50%	$212,500.
	Distributions to pay tax	$425,000.
	After-tax proceeds	$575,000.
	After-tax proceeds if ESOP	$787,500.
	Uses distribution to buy more stock	

2. Cash Flow to Shareholder. How much stock can the shareholder afford to give up? Assume business has a value of $600,000 or $300,000 alternatively, and taxable income after shareholder's salary of $100,000. Shareholder's salary is at least $160,000 and represents 100% or 50% of the total eligible salary of all employees participating in the ESOP. The illustration set forth below compares the after-tax return to the shareholder on the $100,000 of annual income if taxable to the shareholder or deferred through the ESOP. Assumptions: Annual earnings invested for 10 years at 10%. Balance at the end of 10 years distributed to shareholder in equal installments over 20 years. 45% ordinary tax rate, 25% capital gain rate.

	Annual Contribution	Ten-Year Account Balance	Annual After-Tax Distribution	Cumulative After-Tax Distribution
Without ESOP -- $600,000 FMV				
10 Year Earnings	$55,000	$708,153	$60,000	$1,174,118
Stock Sale Proceeds	N/A	450,000	38,000	747,992
Total		1,158,153	98,000	1,922,110
Without ESOP -- $300,000 FMV				
10 Year Earnings	$55,000	$708,153	$60,000	$1,174,118
Stock Sale Proceeds	N/A	225,000	20,000	360,214
Total		933,153	80,000	1,534,332
With ESOP 100% -- $600,000 FMV				
10 Year Earnings -- ESOP	$2,353	$37,501	$2,420	$48,573
ESOP Note	97,647	839,657	70,000	1,409,636
Stock Sale Proceeds -- ESOP	N/A	600,000	38,500	786,487
Total		1,477,158	110,920	2,244,696
With ESOP 100% -- $300,000 FMV				
10 Year Earnings -- ESOP	$51,176	$815,617	$52,250	$1,072,796
ESOP Note	48,824	419,835	35,000	704,837
Stock Sale Proceeds -- ESOP	N/A	300,000	19,250	393,246
Total		1,535,452	106,500	2,170,879
With ESOP 50% -- $600,000 FMV				
10 Year Earnings -- ESOP	$1,177	$18,759	$1,210	$24,326
ESOP Note	97,647	839,657	70,000	1,409,636
Stock Sale Proceeds -- ESOP	N/A	300,000	19,250	393,246
Total		1,158,416	90,460	1,827,208
With ESOP 50% -- $300,000 FMV				
10 Year Earnings -- ESOP	$25,588	$407,809	$26,125	$536,402
ESOP Note	48,824	419,835	35,000	704,837
Stock Sale Proceeds -- ESOP	N/A	150,000	9,625	196,622
Total		977,644	70,750	1,437,861

E. ESOP Operating Rules.

1. Definition. An ESOP is a defined contribution plan (*i.e.*, qualified tax-exempt retirement plan), which is a stock bonus plan, or a stock bonus and a money purchase plan, which is/are designed to invest primarily in qualifying employer securities. The plan must meet the requirements of §§ 409(h), 409(c), and, if applicable, §§ 409(b) and (e). § 4975(e)(7).

2. Deduction of Contributions. ESOP contributions must be paid prior to the due date of the employer's tax return for the taxable year for which the deduction is claimed. ESOPs are also subject to the excise tax on contributions in excess of the deductible amount. I.R.C. § 4972.

   a. General Rules: Contributions are deductible up to 15% of the compensation of plan participants. I.R.C. § 404(a)(3). For C corporations, the deduction is increased to 25% of the compensation of plan participants if the contributions are used primarily to pay principal on an ESOP loan. The 25% deduction limit (rather than the 15% deduction limit) will be available to an S corporation if the ESOP is a combination of a money purchase pension plan and a stock bonus plan.

   b. Principal on ESOP Loans. Contributions used to pay principal on a loan to an ESOP are deductible up to 25% of the compensation of the plan participants. S corporation ESOPs are subject to the 15% limitation unless structured as, or in conjunction, with a money purchase pension plan. I.R.C. § 404(a)(9)(C).

   c. Interest on ESOP Loans. Contributions to pay interest on an ESOP loan are deductible by the employer without regard to the 25% of compensation limit. This provision is not available to S ESOPs.

   d. Dividends Paid to an ESOP. A C corporation can deduct dividends paid to an ESOP, provided the dividends are either used to pay principal or interest on an ESOP loan or are passed through to the participants. I.R.C. § 404(k)(1). This provision is not available to S corporation ESOPs. For unallocated shares in a loan-suspense account, there does not appear to be any restrictions on the trustee's ability to use dividends for loan payments with respect to these shares. Treas. Reg. § 54.4975-7(b)(5)(iii) and Labor § 2550.408(b)-3(3)(3). Dividends paid on allocated shares for C corporations used for loan payments does not violate IRC § 4975(d)(3)'s prohibited transaction rules. *See* IRC § 404(k)(5)(B). Since IRC § 404(k)(1) is not available for S ESOPs, it's not clear whether the IRC § 4975(d)(3) exemption applies for dividends on allocated shares used for acquisition loan payments. *See* IRC § 404(k)(5)(B).

3. Capital Gain Deferral for Sales to ESOPs. If a shareholder of a C corporation sells stock to an ESOP and reinvests the proceeds of the sale in qualified replacement securities, no gain is recognized. *See* IRC § 1042. This provision is not available to S corporation shareholders. An IRC § 1042 rollover for a C

corporation, followed by an S election, may be collapsed if the S election occurs within a short period of time after the sale.

4. Qualifying Employer Securities.

   a. An ESOP must be designed to be invested primarily in "qualifying employer securities." A "qualifying employer security" is either a common stock of the employer or a related company that is publicly traded or non-traded common stock of the employer or a related company having the best combination of voting rights and dividend rights of any class of common stock of the employer.

   b. S corporation shares held by an ESOP must possess as good or better voting rights and the same dividend rights as non-ESOP shares. Nonvoting S common stock cannot be held by an ESOP. IRC § 409(l).

5. Distributions of Employer Securities.

   a. Generally, an ESOP participant must have the right to a distribution of stock upon termination of employment. I.R.C. § 409(h)(1)(A). If the articles of incorporation or the bylaws of the company restrict the ownership of substantially all of the stock of the company to persons who are active employees or to qualified plans, then the ESOP is not required to distribute stock to terminated participants. I.R.C. § 409(h)(2). Be careful of the IRC § 411(d)(6) anti-cutback rule.

   b. IRC § 409(h)(2)(B) permits an S corporation ESOP to distribute cash, instead of employer securities, as long as the cash distribution is based on the stock's fair market value. If securities are distributed, a required resale to the employer can be imposed.

   c. §§ 402(e)(4)(A) and (B) permit a distributee from an ESOP who receives employee securities to exclude the net unrealized appreciation from employer securities. The securities will qualify for long-term capital gains at 20% rate, to extent of pre-distribution appreciation, post-distribution appreciation qualifies for long-term capital gains at 20% rate if held by the distributee for more than 18 months. *See* IRS Notice 98-24.

6. Voting Rights. Participants must be given the voting rights for publicly traded shares allocated to their accounts. I.R.C. §§ 4925(e)(7); 409(e)(2). If the stock is non-publicly traded, the participants must be given the right to vote the stock allocated to their accounts on specified corporate issues (*i.e.*, a sale of substantially all the company's assets, merger with or into another company, reorganizations, recapitalizations, liquidations, or dissolutions). I.R.C. § 409(e). Unallocated stock can be voted by a designated plan fiduciary. Rev. Rul. 97-57, 1995-35 I.R.B. 5.

7. Diversification of Investments. Participants must be given the right to diversify their accounts. I.R.C. § 401(a)(28)(B).

a. Participants Who are Entitled to Diversify. Participants who have attained age 55 and completed 10 years of participation in the ESOP. I.R.C. § 401(a)(28)(B)(iii).

b. Period for Diversification. Diversification may be requested during the six-year period commencing with the plan year during which he first becomes eligible for diversification. I.R.C. § 401(a)(28)(B)(ii).

8. Nondiscrimination Rules. All of the nondiscrimination rules of qualified plans apply to ESOPs. I.R.C. §§ 401(a)(4), 401(a)(5), and 410. Permitted disparity under § 401(l) is not allowed in ESOPs. Reg. § 54-4975-11(a)(7)(ii).

9. Plan Distributions. Distributions from an ESOP are subject to the same requirements as other qualified plans.

a. Lump sum distributions. I.R.C. § 402(d).

b. Rollover and direct transfers. I.R.C. § 402.

c. Required minimum distributions after a participant attains age 70½. I.R.C. §§ 401(a)(9) and 4974. A participant (other than a 5% shareholder of the employer) may elect to defer the distribution to the later of attaining age 70½ or actual retirement from the employer. I.R.C. § 401(a)(9)(C).

d. A 10% penalty tax is imposed on distributions prior to age 59½. I.R.C. § 72(t).

10. § 415 Limits. The $30,000, or 25% of compensation annual addition limitations, apply to ESOPs. Code § 415. However, if no more than one-third of the contributions to an ESOP are allocable to highly compensated employees, amounts contributed by the employer to pay interest on an ESOP loan are not considered to be annual additions for purposes of the limitation. Dividends and S corporation earnings passed through to ESOPs are considered plan earnings and not annual additions. Forfeitures of employer securities purchased with the proceeds of an ESOP loan are also not considered to be annual additions in an ESOP.

11. Top Heavy Rules. The top heavy rules apply to ESOPs. I.R.C. § 416.

12. Unrelated Business Income Tax ("UBTI") Code § 512(e)(3).

a. For taxable years beginning after December 31, 1997, certain tax-exempt organizations, including employee stock ownership plans ("ESOPs") can be a shareholder of an S corporation. § 1361(c)(6).

(1) All income and gain attributable to S stock is unrelated business taxable income for any tax-exempt entity, other than an ESOP. I.R.C. §§ 512(e)(1), (2) and (3). The basis of any stock acquired by purchase is reduced by dividends received with respect to the stock.

(2) S corporation income and gain is not UBTI for an ESOP. I.R.C. § 512(e)(3). The Conference Report states that "The Committee believes that treating S corporation income as UBTI is not appropriate because such amounts would be subject to tax at the ESOP level and, also, again when benefits are distributed to ESOP participants."

13. Prohibited Transactions. Code §§ 4975(d) and 4975(f)(6).

a. Prohibited Transactions. IRC § 4975(c).

(1) A direct or indirect sale, exchange, or leasing of any property between a plan and a disqualified person.

(2) A direct or indirect lending of money or other extension of credit between a plan and a disqualified person.

b. Exemptions: IRC § 4975(d):

(1) Any loan to a leveraged ESOP;

(2) If the loan is primarily for the benefit of the plan participants, and

(3) has a reasonable interest rate and any collateral must be qualifying employer securities. IRC § 4975(d)(3).

(4) Any sale of employer stock to the ESOP. IRC § 4975(d)(13) and ERISA Act §§ 406 and 408(e). This exemption was not available to S shareholders or their family members.

c. Shareholder-Employees.

(1) An S shareholder, a family member of the shareholder, or a corporation in which the shareholder-employee owns at least 50% of the stock is permitted to sell S stock to an ESOP.

(2) The sale can be financed by a bank loan to the ESOP or by a purchase money loan from the seller. § 4975(f)(6).

14. Risk of Ordinary Income Treatment.

a. Generally, the sale of stock results in capital gain treatment, unless § 341 collapsible corporation treatment applies.

b. In 1976, the IRS issued a proposed regulation (later withdrawn), which suggested that an ESOP's leveraged purchase of a shareholder's stock could, under appropriate circumstances, constitute an indirect § 301 property distribution. *See* Prop. Reg. § 1.301-1(l), 41 Fed. Reg. 31833 (July 30, 1976).

c. Notwithstanding the subsequent withdrawal of the regulation, Rev. Proc. 87-22, 1987-1 C.B. 718, states the IRS will not issue advanced rulings that a sale to an ESOP qualifies for capital gains unless three conditions are satisfied:

(1) The seller's interest in the plan doesn't exceed 20%.

(2) There are no stock restrictions except a first right of refusal.

(3) There is no intention for the employer to redeem stock from the plan.

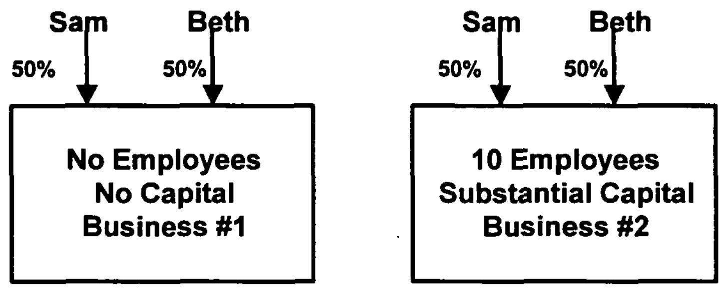
d. In LTR 7802015, a 45% shareholder received a favorable ruling on the sale of his stock to an ESOP, when his interest in the plan was reduced to 5%.

e. Senator Long stated the sale of securities to an ESOP should be considered a dividend only in rare situations where the transaction doesn't result in a substantial change in beneficial ownership of stock acquired by the plan. 122 *Congressional Record* 30717 (Sept. 16, 1976).

CHAPTER 3
SELF-EMPLOYMENT TAXES

I. FACTS.

Wil&Mar3.vsd



Sam and Beth each own 50% of Business #1 and Business #2.

II. ISSUES:

Will the K-1 income allocated to Sam and Beth be subject to self-employment taxes? What if Sam and Beth work full time for the corporation, take no salary, but receive distributions?

III. SELF-EMPLOYMENT TAXES. ACT § 935.

A. **Rate of Tax.**

1. I.R.C. §§ 1401(a) and (b) impose an annual tax on self-employment income of every individual. The self-employment income tax rate is currently 15.3%, which consists of the old age survivors and disability insurance tax (OASDI) of 12.4%, and the hospital insurance tax (HI) of 2.9%. The OASDI tax is currently imposed on the first $68,400 of self-employment income. The HI tax is imposed on all self-employment income.

2. § 935 of the Taxpayer Relief Act of 1997 prohibits the IRS from issuing temporary or final regulations under § 1402(a)(3) before July 1, 1998, but don't offer any legislative solution to the problem.

3. <u>Definition of Net Earnings From Self-Employment</u>.

   a. The term net earnings from self-employment means the income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by the Internal Revenue Code which are attributable to such trade or business, plus his ***distributive share*** (whether or not distributed) of income or loss described in § 702(a)(8), from any *trade or business* carried on by a partnership of which he is a member. *See* I.R.C. § 1402(a) and Reg. § 1.1402(a)-(2)(d). § 1402(a)(13) exempts limited partners from self-employment treatment.

b. The LLC Rulings.

(1) LTR 9432018. Professional partnership converted into an LLC. The partnership was managed by managers rather than members, however, all the members were actively engaged in the LLC's business. The ruling concluded that the LLC was a partnership for tax purposes, and that I.R.C. § 1402(a)(13) did not apply since the members were not limited partners under state law. This conclusion was based upon Reg. § 1.1402(a)-(2)(f) which provides that for self-employment purposes, a partner is considered a partner for classification purposes. The ruling made it clear that members of a LLC who actively engage in its operations, will be subject to self-employment income and can make retirement plan contributions based upon their income.

(2) LTR 9452024. The Service held that a member's distributive share of self-employment income was subject to self-employment tax because the members were engaged in the daily activities of the LLC, and performed substantial services for it. Thus, the Service focused on the nature of the economic relationship between the members and the LLC rather than analyzing whether the members were managers or had limited liability.

c. Partnerships and LLCs. Prop. Reg. § 1.1402-2--delayed per § 935..

(1) Except as otherwise provided in I.R.C. § 1402(a), an individual's net earnings from self-employment include the individual's distributive share (whether or not distributed) of income or loss described in I.R.C. § 702(a)(8) from any trade or business carried on by each partnership of which the individual is a partner. I.R.C. § 1402(a).

(i) An individual's net earnings from self-employment do not include the individual's distributive share of income or loss as a limited partner. I.R.C. § 1402(a)(13); Prop. Reg. § 1.1402-2(g).

(ii) However, guaranteed payments described in I.R.C. § 707(c) made to the individual for services actually rendered to or on behalf of the partnership engaged in a trade or business, are included in the individual's net earnings from self-employment.

(2) An individual is treated as a limited partner unless the individual:

(i) Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership;

(ii) Has personal liability for partnership debts by reason of being a partner; or

(iii) Participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year. Prop. Reg. § 1.1402-2(h)(2).

4. Self-Employment Income for S Corporations.

a. The Service's position is that undistributed S corporation income is not self-employment income. *See Paul B. Ding, et ux v Comm'r*, T.C. Memo. 1997-435. In Rev. Rul. 59-221, 1959-1 C.B. 225, deemed dividends from a former S corporation were not considered earnings from self-employment under I.R.C. § 1402. *See* Reg. § 1.1402(a)-1(b) and IRS Publication 533, *Self-Employment Tax*, which specifically state that S corporation income or loss are not considered to be self-employment income even though included in gross income for income tax purposes. IRS Publication 589, *Tax Information on S Corporations* (1995) at 13, confirms that income that passes through from an S corporation is not self-employment income. *See, also, Gardner v. Hall*, 366 F.2d 132, (10th Cir. 1966); and *Somers v. Gardner*, 254 F. Supp. 35 (E.D. Va. 1966).

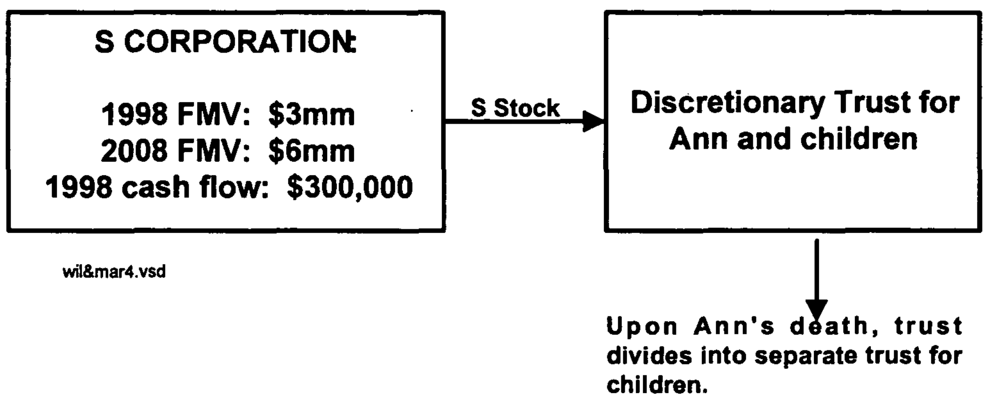
b. If a shareholder causes the S corporation to pay a distribution rather than a salary in order to avoid employment taxes, the Service will treat the distribution as wages, unless the taxpayer determines that such payment exceeds reasonable compensation for services rendered. In Rev. Rul. 74-44, 1974-1 C.B. 287, a distribution in lieu of the amount that shareholders would otherwise have received as reasonable compensation for services performed was treated as wages for FICA, FUTA, and tax withholding purposes. *See*, also, Rev. Rul. 82-83, 1982-1 C.B. 151; and LTR 8239100.

c. *See Radtke, S.C. v. USA*, 90-1 USTC ¶ 113, *aff'g.*, 89-2 USTC ¶ 9466; *C.D. Ulrich, Ltd.*, 89-1 USTC ¶ 9318; *Greenlee*, 87-1 USTC ¶ 9306; *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990); *Fred R. Esser, P.C.*, 750 F. Supp. 421 (D. Ariz. 1990); *Dunn & Clark P.A. v. Comm'r.*, 73 AFTR 2d 94-1860 (D. ID. 1994); and *Davis v. U.S.*, 74 AFTR 2d 94-5618 (D. Colo. 1994).

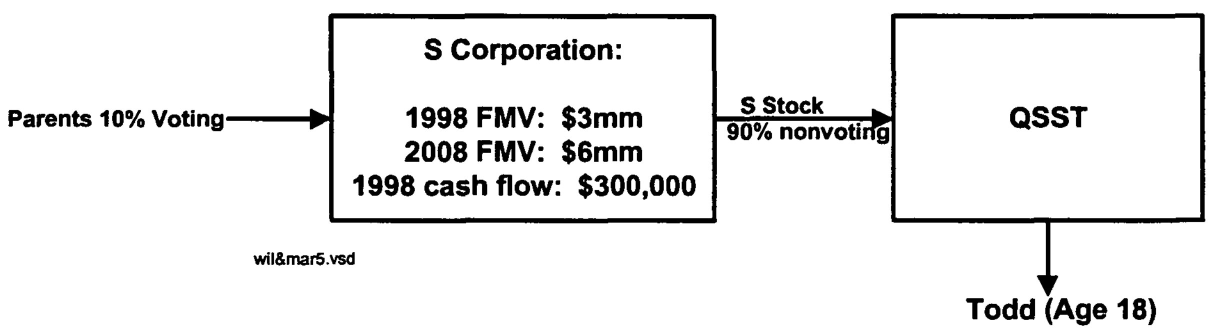
CHAPTER 4
S CORPORATION TRUSTS

I. FACTS.

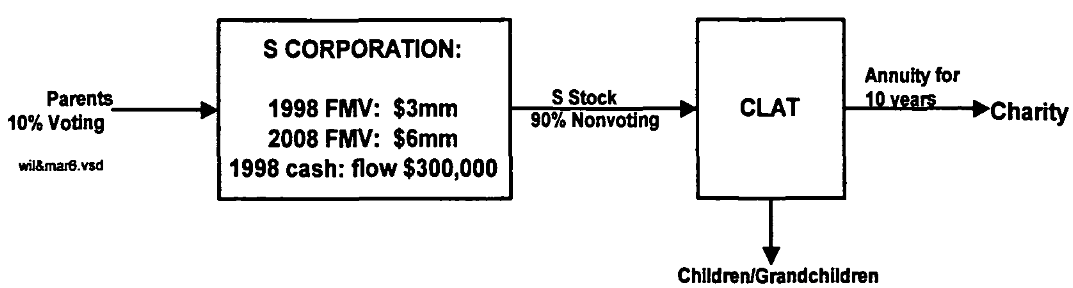
A. Problem 1.



B. Problem 2.



C. Problem 3.



II. ELECTING SMALL BUSINESS TRUSTS.

A. Permitted Shareholders.

1. Permitted Stockholder. Electing Small Business Trusts ("ESBTs"), Qualified Subchapter S Trusts ("QSSTs"), Grantor Trusts, Testamentary Trusts, and Charitable Lead Trusts ("CLTs") are all permitted S shareholders. *See* IRC §§ 1361(c)(2)(A)-(i)-(v) and 1361(d).

2. Definition of ESBT. An ESBT is **any** trust (other than a QSST or a CRT), if

   a. Such trust does not have as a beneficiary any person other than:

      (1) an individual.

      (2) an estate; or

      (3) a charitable organization described in §§ 170(c)(2), (3), (4), or (5), which holds a contingent interest and is not a potential current beneficiary. § 1361(e)(1)(A)(i). Beginning January 1, 1998, those charitable organizations can own S stock and, therefore, will be eligible to hold a current, rather than a contingent, interest in the trust. The organizations described in §§ 170(c)(2), (3), (4), and (5) are as follows:

         (i) Corporations, trusts, community chests, funds, or foundations. § 170(c)(2).

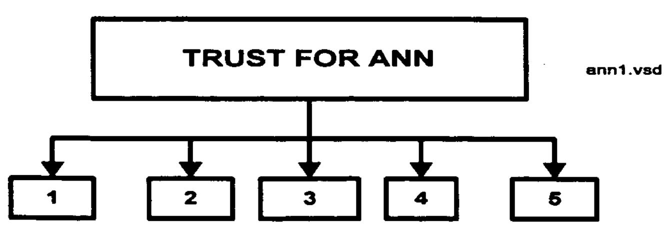
         (ii) Posts or organizations of war veterans. § 170(c)(3).

         (iii) A domestic fraternal society, order, or association. § 170(c)(4).

         (iv) A cemetery company operated exclusively for the benefit of its members. § 170(c)(5).

   b. A trust is not listed as a permissible beneficiary of an ESBT.

      (1) Example (1): GST Exempt Trust is established for Ann for life. Upon Ann's death, the corpus is divided into separate trusts for her five children.



(2) IRS Notice 97-49, 1997-36, I.R.B. 8. ESBT Beneficiaries.

(i) The term "distributee trust" means a trust that is receiving, or may receive, distributions from an intended ESBT, whether the rights to receive the distributions are fixed, contingent, immediate, or deferred.

(ii) § 1361(e) does not provide a specific definition of the term "beneficiary." Solely for purposes of § 1361(e)(1)-(A)(i), the following rules apply in defining the term "beneficiary":

(A) The term "beneficiary" does not include a distributee trust (other than a trust described in paragraphs (2) or (3) of § 170(c)), but does include those persons who have a beneficial interest in the property held by the distributee trust.

(B) For example, an intended ESBT's governing instrument provides for discretionary distributions of income or principal to A for life, and upon A's death, the division of the remainder into separate trusts for the benefit of A's children.

(C) For purposes of § 1361(e)(1)(A)(i), the beneficiaries of the intended ESBT are A and A's children, and not the separate trusts for the benefit of A's children.

(D) Therefore, because all the beneficiaries of the intended ESBT are individuals, the intended ESBT meets the requirements of § 1361(e)(1)(A)(i).

(iii) The term "beneficiary" does not include a person in whose favor a power of appointment could be exercised. Such a person becomes a beneficiary only when the holder of the power of appointment actually exercises the power of appointment in such person's favor.

(iv) The term "beneficiary" does not include a person whose contingent interest is so remote as to be negligible. For example, except in unusual circumstances, the contingent interest a state has under its laws pertaining to escheat would be considered negligible, and the state would not be considered a beneficiary of the intended ESBT.

c. No interest in the trust may be acquired by purchase. § 1361(e)(1)(A)(ii).

(1) For this purpose, "purchase" means any acquisition of property with a cost basis determined under § 1012. § 1361(e)(1)(C).

(2) An interest in the trust must be acquired by reason of gift, bequest, or inheritance.

(3) <u>**Comment**</u>: Joint Committee on Taxation, General Explanation ("Blue Book") , issued December 18, 1996, p. 113, confirms interest in trust can't be acquired by purchase, but interest in S stock may be acquired by purchase.

d. A trust must affirmatively elect to be treated as an electing small business trust. §§ 1361(e)(1)(A)(iii) and 1361(e)(3).

(1) The election must be made by the trustee of the trust. § 1361(e)-(3). IRS Notice 97-12 states that an ESBT election must list all potential current beneficiaries with addresses and taxpayer identification numbers. It must also specify an effective date not more than 2½ months prior to filing.

(2) The election applies to the taxable year of the trust for which made and all subsequent years. It can be revoked only with the consent of the Secretary of the Treasury or his delegate. § 1361(e)(3).

(3) <u>**Note**</u>: Notice 97-12 applies the QSST timing rules in Reg. § 1.1361-1(j)(6)(iii) for the ESBT election, *i.e.*, the later of

(i) 2½ months after date stock transferred to trust; or

(ii) 2½ months after effective date of S election.

(4) A QSST or a CRT cannot elect to become an electing small business trust. §§ 1361(e)(1)(B)(i) and (ii). However, Rev. Proc. 98-23, 1998-10, I.R.B. 30, provides rules for converting from QSST to ESBT.

(i) The trust must meet all the ESBT requirements.

(ii) Both the trustee and the current income beneficiary make the ESBT election.

(iii) The trust hasn't converted from ESBT to QSST within the past 36 months.

e. <u>Grantor Trusts</u>. An ESBT is <u>**any**</u> trust, other than a QSST or a CRT, which meets the definitional requirements of § 1361(e)(1). Nothing in the ESBT rules addresses the question of whether the ESBT election takes precedence over the grantor trust rules of §§ 671-678. An ESBT is a separate taxable entity, while the income of a grantor trust is taxed to the deemed owner. There are at least three possible results when a grantor trust makes an ESBT election:

(1) The ESBT election is not valid for a grantor trust.

(2) The S portion of the trust will be taxed as an ESBT and the balance of the trust will be taxed as a grantor trust.

(3) The ESBT election takes precedence over the grantor trust rules.

3. Each potential current beneficiary of the trust is treated as a shareholder (or if there are no potential current beneficiaries, the trust will be treated as the shareholder). § 1361(c)(2)(B)(v).

a. A potential current beneficiary means any person, with respect to the applicable period, who is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. § 1361(e)(2).

b. Where the trust disposes of all the stock in an S corporation, any person who first became eligible to receive a distribution of income or principal during the 60 days before the disposition is not treated as a potential current beneficiary. § 1361(e)(2).

c. All potential current beneficiaries are counted for purposes of the 75 shareholder limit and other shareholder eligibility rules. Thus, a nonresident alien who is a potential current beneficiary of an ESBT will cause a loss of the S election. However, if such nonresident alien was only a contingent beneficiary, the corporation's S election would not be affected. However, the Blue Book states that a nonresident alien cannot be either a current or contingent beneficiary.

d. Notice 97-12 requires a trustee's consent to S election. Rationale is that only trust is taxed on income. Should trustee get consent to avoid second guessing by beneficiary, or should documents be drafted to permit ESBT election? The issue is higher income tax rates.

e. Example (2): Gamma is a calendar-year S corporation, all of the 10,000 shares of which are owned by Fred. Fred transfers 5,000 shares of his Gamma stock to a trust established for his descendants. The trust agreement grants the trustee the power to distribute income and principal equally or unequally among the four children and his 16 grandchildren. Thus, the trust cannot qualify as a QSST. If the trustee of the trust elects to be an electing small business trust, it will be an eligible S shareholder, even though it is not a QSST, a voting trust, a testamentary trust, or a grantor trust (*i.e.*, a subpart E trust). Each of Fred's four children and 16 grandchildren are potential current beneficiaries will be counted as shareholders for purposes of the 75 shareholder limit.

f. IRS Notice 97-49. ESBT Potential Current Beneficiaries. § 1361(c)(2)-(B)(v) provides that each potential current beneficiary of an ESBT shall be treated as a shareholder for purposes of determining whether a corporation qualifies as a small business corporation, except that the trust is treated as the shareholder for any period in which there is no potential current beneficiary. § 1361(e)(2) provides that, for purposes of § 1361, the term "potential beneficiary" means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. § 7701(a)(2) defines person to include a trust for all purposes of the Code where not otherwise distinctly expressed or manifestly incompatible with the intent of the specific provision. For purposes of § 1361, the following rules apply in defining the term "potential current beneficiary":

(1) If a distributee trust becomes entitled to, or at the discretion of any person may receive, a distribution from principal or income of the intended ESBT, then the S corporation election will terminate unless the distributee trust is a trust. . . described in § 1361(c)(2)(A) (*e.g.*, ESBT, qualified subchapter S trust, etc.). In addition, if the distributee trust is a trust described in § 1361(c)-(2)(A), the persons described in § 1361(c)(2)(B) are treated as shareholders of the corporation for purposes of determining whether the shareholder restrictions under § 1361(b)(1) are met.

(2) In the example (1) above, involving the distributee trusts for A's children, the distributee trusts for A's children will become entitled to receive distributions from the ESBT upon A's death. At such time, the S corporation election will terminate unless

(i) the distributee trusts are trusts described in § 1361(c)(2)-(A); and

(ii) the persons described in § 1361(c)(2)(B), with respect to the distributee trusts, satisfy the shareholder restrictions in § 1361(b)(1).

(iii) If, for example, the distributee trusts are qualified subchapter S trust, and A's children are the current income beneficiaries, A's children are treated as shareholders of the corporation for purposes of satisfying the shareholder restrictions under § 1361(b)(1).

(3) A person who is entitled to receive a distribution only after a specified event (such as the death of the holder of the power of appointment) is not a potential current beneficiary until such time or the occurrence of such event. Whether a person to whom a distribution is or may be made during a period pursuant to a

power of appointment is a potential current beneficiary is currently under study.

III. QUALIFIED SUBCHAPTER S TRUSTS ("QSSTS").

A. QSST Requirements.

1. The terms of the QSST must require that:

    a. During the life of the current income beneficiary, there is only one income beneficiary. § 1361(d)(3)(A).

    b. Any corpus distributed during the life of the current income beneficiary must be distributed only to such beneficiary. § 1361(d)(3)(A)(ii).

    c. The income interest of the current income beneficiary must terminate at the earlier of such beneficiary's death or the termination of the trust. § 1361(d)(3)(A)(iii); and

    d. If the trust terminates during the life of the current income beneficiary, all of the trust assets must be distributed to such beneficiary. § 1361(d)-(3)(A)(iv).

    e. In addition, all the income of a QSST (within the meaning of § 643(b) must be currently distributed (or required to be distributed) to one individual who is a resident or citizen of the United States. For these purposes, the term "income" means trust accounting income and not federal taxable income. § 643(b) and Reg. § 1.643(b)-1. § 1361(d)(1)(B).

2. The trust beneficiary must elect to treat the trust as a QSST. §§ 1361(d)(1) and (2). The beneficiary's election causes the trust to be considered a grantor trust under § 678(a). The beneficiary will be taxed on the trust's K-1 income, without regard to whether there are any S distributions to the trust. Rev. Proc. 94-23, 1994-1 C.B. 609 provides automatic inadvertent termination relief if QSST election is not timely. Automatic relief is provided if the consent is filed within two years of its original due date.

B. Identifying QSST Income and Principal.

1. Under trust accounting rules, trust income and principal are determined as follows:

    a. Income generally includes interest on bonds, notes, and other securities and obligations, ordinary dividends, rentals and the lease of land, farm crops and the like. *See Scott on Trusts*, 4th Ed. §§ 233, 236.1 and 236.2, and Colorado Revised Statutes ("CRS") 1973, § 15-1-401(1).

b. Profits on the sale or exchange of any part of the principal are ordinarily principal. Profits on the sale of shares of stock or other securities are principal. *See Scott, supra*, §§ 233, 236.3, 236.10, and 236.14.

c. Any of the above rules can be altered by a decedent's will or the terms of a trust instrument. *See*, for example, CRS § 15-1-405 and *Scott, supra*, §§ 233 and 236.15.

2. These rules suggest that there are potentially two levels for determining the character of S distributions. First, the corporation itself can control the characterization of a distribution by identifying the source of a distribution as either ordinary course of business operations or as an extraordinary item, such as the proceeds from the sale of a corporation's assets. Second, the trustee, if he has sufficient discretion, can allocate payments received between principal and income.

a. Ordinary S corporation distributions are dividends under state law and, therefore, fiduciary income whether or not they are taxable to the shareholder. *See* § 1368(d) which provides that a distribution of property by an S corporation with respect to its stock to which but for the subsection, § 301(c) applies, is taxed as provided in § 1368. § 301(c) provides that a dividend distribution is taxable as ordinary income to the extent of earnings and profits. *See Scott*, supra, § 236.1 and CRS § 15-1-408(1) which provides that ordinary dividend constitute fiduciary income.

b. Distributions of an S corporation's assets or proceeds from the sale of assets which are designated by the corporation as return of capital, division of corporate property, or a partial liquidating distribution, are allocated to principal. *See Scott*, § 236.14, § 236.15, and CRS § 15-1-408(6).

c. The terms of the will or trust may authorize the trustee to allocate distributions for any corporation, including an S corporation, between income or principal, in the trustee's reasonable discretion. *See Scott*, supra, § 236.15.

3. In LTR 9349009, all of an S corporation's stock was held by three QSSTS. The corporation wanted to make substantial distributions to its shareholders but for estate planning purposes, preferred that the distribution be treated as principal rather than income distributable to the beneficiaries. To achieve this result, the company made distributions to its shareholders as a pro rata redemption of their stock. The IRS held that for income tax purposes, the distribution was treated as a dividend subject to taxable income under § 1368. However, for fiduciary accounting and QSST purposes, it was a principal distribution which did not have to be distributed to the beneficiaries. In reaching this conclusion, the IRS relied on the broad discretionary power given the trustee to allocate trust receipts between principal and income under the trust agreement. In addition, under the applicable state law, redemption proceeds were allocable to principal rather than income. *See*, also, LTR 9710026.

4. Examples:

a. Example (1): XYZ Trust is a Qualified subchapter S Trust (QSST) established for the benefit of Bill, a minor child, by his father. The sole asset of XYZ is all of the stock of Bosco, Inc., a calendar year S corporation. During 1997, Bosco earned $100,000 net taxable income, all of which is shown on XYZ's K-1, but Bosco makes no distributions to the trust. Although the trust's taxable income is $100,000, its trust accounting income is $0. *See* § 643(b). Therefore, no distribution is required to be made to Bill.

b. Example (2): Bilbo, Inc. is a calendar-year S corporation, 100% of the stock of which is owned by a QSST. Ann is the current income beneficiary of the QSST. During 1997, Bilbo sells a portion of its assets and distributes the net sale proceeds to the QSST. The corporation labels the distribution as a "capital distribution". If under the trust current and applicable state law, the distribution is allocable to trust principal rather than income, it can be accumulated rather than distributed to Ann.

c. Example (3): Beta, Inc. is a calendar-year S corporation owned equally by Teri and a QSST which was established for her son, Sam. During 1997, Teri wants to distribute $100,000 which will be divided equally between Teri and the QSST. However, she doesn't want the funds to be distributed from the QSST to Sam. Teri and the QSST each redeem 100 shares of stock for $50,000. Provided the redemption is allocable to capital under state law and/or the trust instrument, the QSST is not required to distribute the income to Sam.

IV. CHARITABLE LEAD TRUSTS ("CLTs").

A. Eligible S Shareholder.

1. A charitable lead trust makes payments to a qualified charitable beneficiary for a specified term with the remainder interest reverting to the grantor, family members, or other noncharitable remaindermen. Code §§ 2522(c)(2), 2055(e)(2), and 170(c); Treas. Regs. §§ 25.2572(c)(3) and 1.170A-6(c). The CLT can be structured as either an annuity trust (CLAT) or a unitrust (CLUT).

2. The CLT can be structured as either a grantor trust or a nongrantor trust for income tax purposes. Transfers of property to a grantor lead trust produce a current charitable contribution deduction for the present value of the lead interest. The grantor is then taxed on the trust income without offsetting deduction for amounts payable to charity. *See* Code §§ 170(f)(2)(A) and (B), and 671. Transfers of property to a nongrantor lead trust produce no current charitable deduction, but the trust receives a deduction annually for the lead trust payments. The trust is subject to income tax. Code §§ 170(f) and 641.

3. If the CLT is structured as a wholly grantor trust, it is an eligible S shareholder under Code § 1361(c)(2)(A)(i). If the CLT is structured as a nongrantor trust, an ESBT election is permissible, provided the charitable beneficiary is described in Code §§ 170(c)(2), (3), (4), or (5). Code § 170(c)(2) describes typical Code § 501(c)(3) organizations. Note: CRTs, but not CLTs, are prohibited from making ESBT elections. *See* § 1361(e). A QSST election should also be theoretically possible, but the qualified charity would have to receive all of the trust income, and would be subject to the unrelated business income tax on its share of the S corporation's income. Code § 1361(c)(6) permits Code § 501(c)(3) organizations to be S shareholders.

B. Strategies for Using S Stock to Fund CLT.

1. A charitable lead trust may be created during life or through a decedent's estate.

2. The gift/estate tax benefit of a CLT is transfer tax reduction. The gift to the noncharitable remaindermen is reduced by the present value of the lead interest. Therefore, if the CLT is funded with S stock which qualifies for minority/marketability valuation discounts, the gift to family members is subject to a double discount. Any growth or income in excess of the lead interest transfers to the family without tax. **Caution**: § 2642(e) prohibits allocating GST exemption to a charity lead annuity trust until the lead interest has terminated. A CLUT permits allocation of GST exemption upon formation of the trust.

3. Example: Ramco is a calendar-year S corporation, all of the stock of which is owned by Sara Ram, a widow. Ramco was recently appraised at $5mm, and has historically paid after-tax dividends of $300,000 per year (a 6% return). Sara has two children. Sara typically makes charitable contributions of $60,000 per year. Sara contributes 20% of Ramco stock to a CLUT (fair market value $1mm) which is required to pay $60,000 to qualified charities each year for 9 years. After 9 years, the trust terminates and the assets are distributed to Sara's grandchildren.

   a. Assuming a 40% minority/marketability discount, the Ramco stock has a $600,000 value, and the $60,000 annual payment results in a 10% lead trust payment.

   b. The value of the remainder interest in the CLUT, for gift tax purposes, is approximately $252,000. Sara allocates $252,000 of GST exemption to the CLUT. Sara's charitable gifts are not subject to the 3% excess itemized deductions limitation.

   c. Assuming the corporation appreciates at the rate of 4% per year but the distribution remains the same, the amount available for the grandchildren after 9 years will be approximately $1,423,312. Total transfer tax/GST value was $252,000.

   d. Without the CLUT, the after tax value transferred to the grandchildren would be $225,000 (50% regular tax, 55% GST tax). The after-tax return would have to exceed 15.5% to provide them with $4mm after 20 years.

4. The CLT is a split interest under Code § 4947(a)(2) and subject to the private foundation rules, *i.e.*, self-dealing (Code § 4941(d)), excess business holdings (Code § 4944), and taxable expenditures (Code § 4945(d)). The excess business holdings and jeopardy investment restrictions do not apply if the CLT lead interest does not exceed 60% of the fair market value of the trust. A nongrantor CLT is subject to the UBTI tax, and Code § 642(c) disallows a charitable deduction, except to the extent payments are actually made to charities from the UBTI. *See* Code § 4947(b)(3)(A).

5. Caution: If a nongrantor trust makes an ESBT election, it's not clear whether the UBTI regime or the ESBT regime controls for tax purposes. The most likely result is that ESBT regime controls, and no charitable deduction would be allowed.

CHAPTER 5
VALUATION DISCOUNTS--BUILT-IN GAINS

I. FACTS.

C Corporation	S Corporation	LLC/Partnership
FMV: $1mm Tax Basis: $100	FMV: $1mm Basis: $100	FMV: $1mm Basis: $100

wil&mar.7

Sara and Ron each own 50% of three business entities. Each business has assets with a fair market value of $1mm and a tax basis of $100.

II. ISSUES.

If Sara transfers a 40% interest in each entity to her children, Sam, Marty, and Sally, will the value of the gift be discounted for the difference between the fair market value and tax basis of the entities' assets?

III. DISCUSSION.

A. The Willing Buyer and Willing Seller Test.

1. The fair market value of any interest of a decedent in a business, whether a partnership, a proprietorship, or a corporation, is the net amount which a willing purchaser, whether an individual or a corporation, would pay for the interest, to a willing seller, neither being under any compulsion to buy or sell, and both having a reasonable knowledge of the relevant facts. Reg. § 20.2031-3 and Reg. § 25.2512-3(a). The focus must not only be on what a willing buyer would pay, but also what a willing seller would sell for in order to consummate the sale. *John R. Moore*, T.C. Memo. 1991-546. *See, also, Est. Of Artemus D. Davis*, 110 T.C. No. 35, (June 30, 1998), and *Eisenberg v. Comm'r.*, 1998-2 USTC ¶ _____ (2d Cir. 1998).

2. Discounts for Controlling Interests. A marketability discount has been permitted even where a decedent owned 100% of a corporation. The Tax Court has specifically rejected the IRS argument that the value of the stock of the stock for a 100% shareholder could not be less than the value of the underlying assets. Typically, this discount is applied when the corporation owns illiquid assets and a purchaser may find some properties less desirable than other properties. The costs and complications of liquidation to realize net asset value must also be taken into account. *See Est. of Charles Russell Bennett*, 65 T.C.M. 1816 (1993), *Est. of Andrews*, 79 T.C. 938 (1982); *Est. of Piper*, 72 T.C. 1062 (1979); *Est. of Albert L. Dougherty*,

T.C. Memo. 1990-274; *Est. of James H. Gay, Sr.*, T.C. Memo. 1993-334, and *Est. of Ray A. Ford*, T.C. Memo. 1993-580.

B. Discount for Potential Taxes Upon Liquidation.

1. Prior to 1998, the courts have been reluctant to permit a discount for potential taxes which would be recognized if the assets were sold, the rationale for this result, *i.e.*, that there was no evidence of a present intent to liquidate and liquidation could have been accomplished without an entity-level tax, may not be as persuasive after TRA 1986's repeal of the "*General Utilities*" rule. *Edwin A. Gallun*, 33 T.C.M. 1316 (1974); *Est. of William T. Piper, Sr.*, 72 T.C. 1062 (1979). TAM 9150001. No discount for potential capital gains tax because the corporation did not contemplate liquidation. *Est. of Alvin Thalheimer*, T.C. Memo. 1974-203, *aff'd and rem'd*, 532 F.2d 741 (4th Cir. 1976). No discount for capital gains tax where there is no evidence of a plan to liquidate. *Jewell E. Gray*, T.C. Memo. 1997-67. No discount for built-in gain because it was too speculative whether corporation would ever recognize the gain.

2. However, the Tax Court and the Second Circuit have now permitted valuation discounts for the built-in gains tax. *See Est. of Artemus D. Davis*, 110 T.C. No. 35 (June 30, 1998). (The Tax Court allowed a discount for built-in gains as part of the marketability discount. All of the experts testified that this tax liability would be taken into account under the willing buyer-willing seller test); and *Est. Of Irene Eisenberg*, 98-2 USTC ¶ _____. (The Second Circuit reversed the Tax Court and permitted a discount for the built-in gains tax, even though there was no present plan to liquidate the corporation).

C. Proving the Discount.

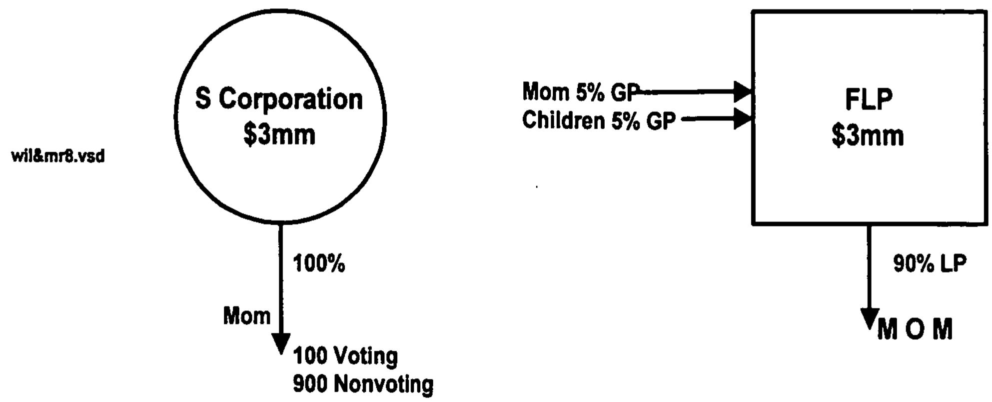
1. *Est. of Berg*, T.C. Memo. 1991-279, *aff'd in part and rev'd in part*, 92-2 USTC ¶ 60,117 (8th Cir. 1992), reliance on the discounts in other valuation cases without analysis of the particular facts of the company at issue was disregarded by the Tax Court. The IRS appraiser's report was found to be "persuasive because he relied on very specific studies of comparable properties and then adjusted the discount for the relevant factors of decedent's interest. Petitioner's appraisals, on the other hand, were exceedingly general and lacking in specific analysis of the subject interest." § 6660 valuation penalties were imposed. *See, also, Mandelbaum*, 69 T.C.M. 2852, where the Tax Court required the appraiser to apply general discount concepts to the specific entity under analysis.

2. Appraiser Qualifications: Experience, qualifications, professional affiliation, past employment by IRS; knowledge of the specific type for property being valued.

3. Appraisal coverage; description of property; thoroughness, specificity and analysis of valuation method used; explanation of assumption made and reliance on the approaches generally accepted by the cases and the profession; a well-reasoned and well-documented analysis of the valuation.

CHAPTER 6
VALUATION DISCOUNTS--THE DARK SIDE

I. FACTS.



The S corporation and the FLP are the principal assets in Mom's estate. They are operating businesses. Mom's will devises the voting interests to the children and the nonvoting/LP interests to the marital trust for Dad. Mom's will is designed to eliminate any tax in her estate and provides for a credit shelter trust and a marital trust.

II. ISSUES.

Will Mom's estate be subject to estate tax? What will be the value of the assets in the marital trust and the credit shelter trust?

III. DISCUSSION.

A. Situations Where IRS Asserts Valuation Discounts.

1. Valuation discounts reduce § 1014 basis increase.

2. Valuation discounts reduce marital and charitable deductions.

B. **Beware:** The sum of the parts don't always equal the whole--the risk of disappearing marital or charitable deductions.

1. Partnerships.

Dad--5% General Partner-------► **Family Limited Partnership** ◄--90% Limited Partner--Dad
Children 5% General Partner-----► **$3MM**

a. Dad dies. Dad's general partner interest goes to children. Dad's 90% limited partnership interests go to QTIP for spouse. Estate tax value of Dad's 95% interest is $2.85mm, based on liquidation value.

b. Superficial analysis: Marital deduction eliminates estate tax in first estate, and allows § 1014 basis since liquidation value applies.

c. More Critical Analysis: Marital trust is funded with limited partnerships and not general partnership. Marital deduction is based on discounted value of limited partnership interests and may result in a taxable estate. The sum of the parts may be less than the whole.

d. *See* TAM 9050004 (valuation of controlling block of stock devised to the credit shelter trust); *Ahmanson Foundation*, 81-2 USTC ¶ 13438 (9th Cir. 1981) (nonvoting stock valued higher when aggregated with voting stock for § 706 purposes, than for charitable deduction when the charity received only nonvoting stock); and *Est. of Chenowith*, 88 T.C. 1577 (1987) (majority block transferred to spouse valued for marital deduction based on stock transferred, plus control premium).

2. S Corporations.

S Corporation
$3mm ---------→ Dad 100%/1,000 shares

a. *See* TAM 9050004 (valuation of controlling block of stock devised to the credit shelter trust); *Ahmanson Foundation*, 81-2 USTC ¶ 13438 (9th Cir. 1981) (nonvoting stock valued higher when aggregated with voting stock for § 706 purposes, than for charitable deduction when the charity received only nonvoting stock); and *Est. of Chenowith*, 88 T.C. 1577 (1987) (majority block transferred to spouse valued for marital deduction based on stock transferred, plus control premium).

(1)

Gross estate	$3,000,000.
Marketability discount	<$ 600,000.>
AGE	$2,400,000.
Value per share	$ 2,400.
§ 2057 deduction	<$ 675,000.>
Applicable exemption	<$ 625,000.>
Marital deduction	<$1,100,000.>
Taxable estate	$ 0.

(2) Marital Gift.

(i) $1,100,000 ÷ 2,400 = 453 control value.
(ii) $1,100,000 ÷ 1,920 = 572 minority value.
(iii) Difference: 119.

(iv) Shares required to increase value of marital shares from minority value to control value is 48. Additional shares result in overvaluation of marital share (501 x 2,400 = 1,202,400).

(3) <u>§ 2057 Deduction and Applicable Exemption Amount</u>.

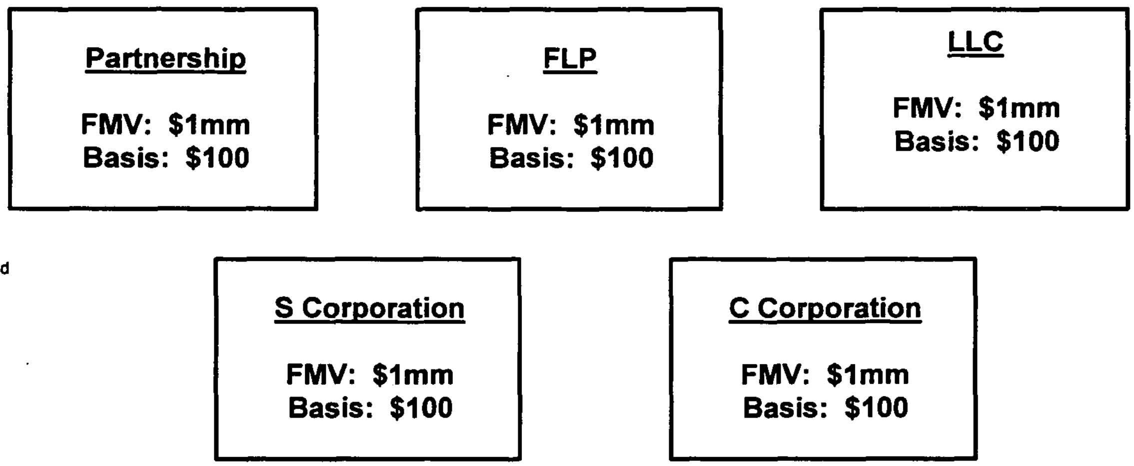
(i) Remaining shares 499 x 1,920 = 958,080, resulting in $341,920 underfunding.

(ii) If 677 shares (1,300,000 ÷ 1,920) fund the exemption and exclusion, shares remaining for marital gift (323) results in marital deduction of $620,160. Taxable estate is $479,840.

CHAPTER 7

STRUCTURING CONSIDERATIONS: MINIMIZING THE TAX BENEFITS OF VALUATION ADJUSTMENTS

I. FACTS.



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Sam owns $1mm of rental real estate and marketable securities. He wants t form a family entity, then gift 90% to his children.

II. ISSUES.

Which entity would provide Sam with the maximum valuation adjustment?

III. DISCUSSION.

A. The Willing Buyer and Willing Seller Test.

1. The fair market value of any interest of a decedent in a business, whether a partnership, a proprietorship, or a corporation, is the net amount which a willing purchaser, whether an individual or a corporation, would pay for the interest, to a willing seller, neither being under any compulsion to buy or sell, and both having a reasonable knowledge of the relevant facts. Reg. § 20.2031-3 and Reg. § 25.2512-3(a). The focus must not only be on what a willing buyer would pay, but also what a willing seller would sell for in order to consummate the sale. *John R. Moore*, T.C. Memo. 1991-546. *See, also, Est. Of Artemus D. Davis*, 110 T.C. No. 35 (June 30, 1998), and *Eisenberg v. Comm'r.*, 1998-2 USTC ¶ 60,263 (2d Cir. 1998).

2. "The discounts are conceptually distinct: (1) the discount for lack of control (minority interest discount) reflects the minority shareholders' inability to compel liquidation and inability to realize a pro rata share of the corporation's net asset value; (2) the lack of marketability discount reflects that there is no ready market for the shares of a closely held corporation." *See Est. of Newhouse v. Comm'r.*, 94 T.C. 193 (1990).

3. The valuation adjustments available for transfers of certain ownership interests in pass-through entities provide leverage for annual exclusion and unified credit transfer tax planning. Valuation adjustments may also be available for any interests in the pass-through entity retained by the transferors, thereby reducing the parent's taxable estate. The leverage arises because of the differences in liquidation value vs. going concern value.

   a. Liquidation value is based on the owner of a pass-through entity having the right to realize a pro rata share of the entity's assets.

   b. Going concern value is based on the owner of a pass-through entity not having any control of the entity and not having any right to realize a pro rata share of the entity's assets.

   c. The difference between these valuation approaches is the difference between a smaller discount and a larger discount, not the difference between no discount and a large discount. *See McCormick*, T.C. Memo 1995-371; *Newhouse*, 94 T.C. 133 (1990); and *Curry Est.*, 83-1 USTC ¶ 13,518.

   d. <u>Example (1)</u>: Parents contribute real estate worth $1mm to a family limited partnership and make unified credit gifts of limited partnership interests to the children, constituting 90% of the total ownership interests. Assuming a 40% minority/marketability discount, liquidation value is $900,000 and going concern value is $540,000.

   e. <u>Example (2)</u>: Parents died owning a 90% limited partnership interest in a family partnership with real estate worth $1mm. Assuming a 40% minority/marketability discount, the limited partnership interests have a $900,000 liquidation value, and a $540,000 going concern value in parents' estate.

4. But *see Schauerhamer*, T.C. Memo. 1997-242. In 1990, decedent was terminally ill and created three FLPs with each of her children as general partners of one FLP. In December, 1990, decedent made 33 assignments using her annual exclusion. She made similar assignments in November, 1991. She died in December, 1991. Decedent used her own checking account as a personal account and as a partnership account. She did not maintain records itemizing the allocations of her funds. Both personal and partnership items were deposited in the accounts. The Tax Court found an "implied agreement" that decedent would retain the benefits of the transferred FLP interests taxable in the decedent's estate under § 2036. The Court was particularly concerned about the decedent's commingling of funds/assets and her continuing management role.

B. A Comparison of Liquidation Rights for Different Partnership and Entities.

1. § 2704(b)--Disregarding Applicable Restrictions.

   a. Transfers Subject to Applicable Restrictions. If an interest in a corporation or partnership (an "entity") is transferred to or for the benefit of a member of the transferor's family, any applicable restriction is disregarded in valuing the transferred interest. This section applies only if the transferor and members of the transferor's family control the entity immediately before the transfer. IRC § 2704(b) and Reg. § 25.2704-2(a).

   b. Applicable Restriction Defined. An applicable restriction is a limitation on the ability to liquidate the entity (in whole or part) that is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction. Apparently this rule applies to both the right to force a liquidation of the entire entity and thereby receive a liquidating distribution and to the right to put one's interest to the entity and demand that it be redeemed. A restriction is an applicable restriction only to the extent that either the restriction by its terms will lapse at any time after the transfer, or the transferor (or the transferor's estate) and any members of the transferor's family can remove the restriction immediately after the transfer. Ability to remove the restriction is determined by reference to the state law that would apply but for a more restrictive rule in the governing instruments of the entity. *See* § 25.2704-1(c)(1)(B) for a discussion of the term "state law."

2. The Impact of the Check the Box Regs. Prop. Reg. §§ 301.7701-2 and -3 would allow any unincorporated entity to elect partnership status. If finalized, these regulations will eliminate any classification risk from entity shopping.

3. General Partnership and Limited Liability Partnerships:

   a. A general partnership is dissolved upon the retirement, withdrawal, or death of any partner, unless the partnership agreement provides otherwise, or unless the other partners elect to continue the partnership without dissolution and reconstitution. C.R.S. §§ 7-60-131(a) and (c).

   b. If a general partner's withdrawal is in contravention of the partnership agreement, he, she, or it is entitled to the "value" of the partnership interest less any damages caused by the dissolution. If the nonbreaching partners elect to continue the business, the value of the wrongfully withdrawing partner's interest in the partnership goodwill is not considered. C.R.S. § 7-60-138.

   c. If a partnership is dissolved and it's not in contravention of the agreement, each partner is entitled to his share of partnership property, less liabilities. C.R.S. § 7-60-138.

d. Upon the death or retirement of a partner, if the business is continued by the remaining partners, the deceased partner's estate is entitled to the value of the partnership interest. C.R.S. § 7-60-142. Courts have generally ruled that the value of a deceased general partner's interest is a pro rata share of the net fair market value of the partnership's assets. *See Chapman v. Dunnegan*, 665 S.W. 2d 643 (Mo. App. 1984); Bromberg and Ribsten, *Bromberg and Ribsten on Partnerships*, § 7.13(b).

4. Limited Partnerships and Limited Liability Limited Partnerships:

a. A general partner may withdraw from a limited partnership at any time upon written notice to the other partners, but he may be liable for damages if the withdrawal is in violation of the agreement. C.R.S. § 7-62-602.

b. A limited partner may only withdraw upon the events specified in the partnership agreement. C.R.S. § 7-62-603. Revised Uniform Limited Partnership Act ("RULPA") § 603 gives a limited partner the right to withdraw on six months' notice, only if the agreement does not specify when a limited partner may withdraw or provide a definitive time for dissolution of the partnership.

c. Upon withdrawal, the withdrawing partner is entitled to receive any distribution to which he is otherwise entitled under the partnership agreement and if not otherwise provided in the agreement, he is entitled to receive, within a reasonable time after withdrawal, the "fair value" of his partnership interest based upon his right to share in distributions from the limited partnership. *See* RULPA § 604 and C.R.S. § 7-62-604.

d. The personal representative of a deceased partner may exercise all of the partner's rights for purposes of settling his estate. RULPA § 705 and C.R.S. § 7-62-705. It is not clear whether the deceased partner's executor has the same right to withdraw as the partner.

e. Fair value probably means the net fair market value of the partnership's assets multiplied by the withdrawing partner's percentage interest.

(1) *See* Hecker, "The Revised Uniform Limited Partnership Act: Provisions Governing Final Affairs," 46 *Missouri L. Rev.*, 577, 617 (1981); Kessler, "The New Uniform Limited Partnership Act: A Critique," 48 *Fordham L. Rev.*, 157, 171, 172 (1979).

(2) *Chapman v. Dunnegan*, 665 S.W.2d 643 (Mo. App. 1984); Bromberg and Ribsten on Partnerships, § 7.13(b).

(3) Fife and Hosta "Minimizing Application of § 2704 in the Estate Tax Valuation of a General Partner's Family Limited Partnership Interests," 20 *Tax Management Estate, Gifts and Trust Journal* 3, 127 (1995).

f. A general partner's withdrawal, dissolution, or death does not cause a dissolution of the partnership, unless the remaining partners elect to dissolve within 90 days of the event of withdrawal for the last remaining general partner.

5. Limited Liability Company:

a. A member may resign from an LLC at any time unless prohibited by the Operating Agreement. The LLC may recover damages for a resignation in violation of the agreement. C.R.S. § 7-80-602.

b. A member who resigns may only receive distribution which such member would have been entitled if the member had not resigned or withdrawn. C.R.S. § 7-80-603.

c. The death, retirement, resignation, expulsion, bankruptcy, or dissolution of a member does not cause the LLC to be dissolved, unless the agreement provides for dissolution. C.R.S. § 7-80-801(g). If there is no election to continue, the net property is distributed in accordance with each member's ownership interests. C.R.S. § 7-86-805(c).

6. Limited Partnership Association.

a. A member may not resign or withdraw. C.R.S. § 7-63-114(4).

b. An association shall have indefinite duration and shall continue until terminated by a vote of the members or upon such other event as specified in the agreement. C.R.S. § 7-63-116.

7. Liquidation Rights Don't Necessarily Eliminate Discounts.

a. *See Est. of Lucille Marie McCormick*, 70 T.C.M. 318 (1995), in which the decedent's general partnership interests qualified for a discount despite the liquidation rights provided under state law.

b. Under North Dakota law, a general partner had the ability to cause a dissolution of the partnership. However, the estate argued that the dissolution procedure merely caused the partnership to go into a "winding up mode" which would not enhance the value of a general partner's minority interest and would not necessarily result in partition of the realty or the immediate receipt of partnership property in kind.

c. The taxpayer argued that dissolution and liquidation would be a lengthy process because of the nature of the business and the underlying assets. As a result, any difference between a partner's and a shareholder's ability to obtain the net value of his interest would have relatively little effect on the minority discount used in the case.

d. The Tax Court agreed with taxpayers on this point because liquidation value, in this case, would not be readily available to the holder of a small percentage of these family partnerships. In this connection, it is less likely that a willing buyer would purchase any of the interests under consideration for the purposes of liquidating the underlying asset. It is more likely that a willing buyer would seek to invest in what appears to be a profit-making and ongoing business. The availability of assets in the event of a dissolution and/or liquidation may indicate less overall risk and support a higher value for the entity.

C. Structuring Considerations: Maximizing the Tax Benefits of Valuation Adjustments.

1. Assumptions: In each of these examples, the family entity has assets consisting of real estate and marketable securities. The net fair market value of the entity's assets is three million dollars, and there are no entity debts. A qualified appraiser has determined that a 40% minority/marketability discount is appropriate. The tax basis of the entity's assets is $500,000. The parents are in a 50% transfer tax bracket.

2. General Partnerships and Limited Liability Partnerships.

Parents--> 50% **GP/LLP** <-----Children 50%

a. Gift tax value of children's 50% should be liquidation value, not going concern value, because general partners and limited liability partners have liquidation rights, unless restricted by the agreement, provided they become substitute partners or members and not mere assignees.

(1) If the agreement restricts a general partner's right to withdraw, it's an applicable restriction, which should be ignored under § 2704(b).

(2) If the donees are not admitted as substitute partners or members, there has been a lapse of liquidation rights which should be taxable under § 2704(a). *Compare Est. of Gordon B. McLenden*, 77 AFTR2d ¶ 96-398 (5th Cir. 1996), an unpublished 5th Circuit decision in which the value of a partnership interest was an "assignee" not a "substitute partner" interest.

b. Estate tax value of parents' 50% should be liquidation value for the same reasons. § 1014 basis should apply to parents' retained interest and § 1015 carryover basis should apply to child's interest. Transfer could result in worst possible consequences:

(1) No valuation discount for transfer tax purposes.

(2) No basis increase for income tax purposes.

3. Parents Retain Majority of Value and Control--LLC, Limited Partnership or S Corporation.

Parent----------------► 80% General Partner/ Voting Stock	**LLC, Family Limited Partnership**	◄---------Children 20% Limited Partner/Nonvoting Stock

a. Gift tax value is \$360,000 vs. liquidation value \$600,000 for children's nonvoting interests. Children don't have liquidation rights.

b. Parents have liquidation rights, and any limitations thereon would be an applicable restriction under § 2704(b). If the deceased partner's/shareholder's executor cannot exercise the same liquidation rights as the parent, it would constitute the lapse of a liquidation right under § 2704(a). The difference in value would be considered a taxable transfer.

c. Total transfer tax values upon parents' death: \$360,000 gift tax value for 20% given to children + \$2,400,000 estate tax value on 80% retained interests = \$2,760,000. Tax savings from valuation adjustment is \$120,000 (\$240,000 x 50%).

d. § 1014 basis for 80% (\$2,400,000) and § 1015 carryover basis for 20%. (\$100,000). Income tax cost from loss of § 1014 basis on 20% is \$165,000 (\$600,000 - \$100,000 x 33%). Tax savings from the valuation discount is \$45,000 less than the income tax cost.

4. Parents Transfer Majority of Value and Retain Control: LLC, Limited Partnership or S Corporation:

Parents------------► 10% General Partners/Voting Stock	**LLC, Limited Partnership or S Corporation**	◄---------Children 90% Limited Partners/Nonvoting Stock

a. Gift tax value for 90% limited partnership is \$1,620,000 going concern is \$2,700,000 liquidation value, because limited partners have no liquidation rights.

b. Estate tax value for 10% general partner is \$300,000, because general partners/voting stock have liquidation rights.

c. § 1014 basis for 10% based on liquidation value is \$300,000 and § 1015 basis for 90% is \$450,000 (\$500,000 x 90%). The transfer tax savings is \$1,080,000 (\$2,700,000 - \$1,620,000) x 50% = \$540,000. The total income tax cost is \$742,500 (\$2,700,000 - \$450,000 x 33%). Net savings/cost: (\$202,500).

5. <u>Parents Retain Majority of Value But No Control: LLC, Limited Partnership or S Corporation</u>:

Parents--------------► 90% Limited Partners/ Nonvoting Stock	**LLC, Limited Partnership or S Corporation**	◄-----------Children 10% General Partners/ Voting Stock

a. Estate tax value of parents' 90% interest is $1,620,000, based on going concern value vs. $2,700,000 liquidation value. Transfer tax savings is $540,000.

b. Gift of children's 10% interest worth $300,000 based on liquidation value.

c. § 1014 basis for 90% based on going concern value, not liquidation value, increases the basis from $450,000 to $1,620,000. Income tax cost for 90% is reduced to $356,000 ($1,080,000 x 33%). Transfer tax savings of $540,000 is greater than income tax cost of $356,000.

6. <u>Parents and Child Split Control and Parents Retain Value</u>:

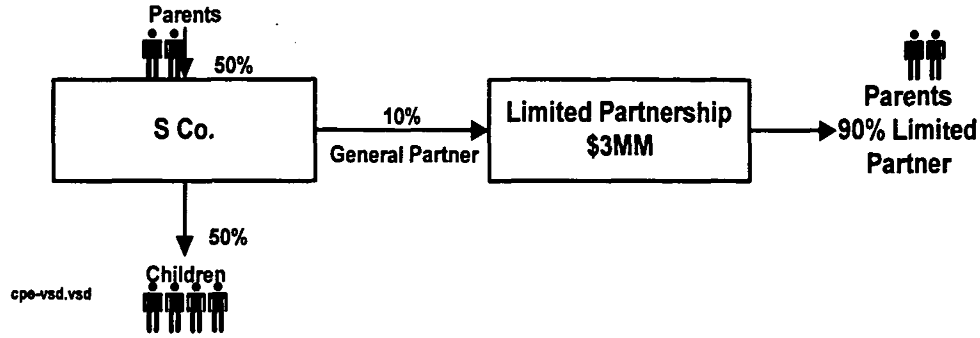
Parents: 5%/5% General Partner--► Children: 10% General Partner----►	**Limited Partnership**	◄---40%/40% Limited Partners Parents

a. Each of the parents own a 5% general partnership interest and a 40% limited partnership interest. Parents don't have control, but they have liquidation rights, since general partner and limited partner interests are combined for valuation purposes. The parents' 90% interests are worth $2.7mm for transfer tax purposes.

b. First estate gets § 1014 basis step up for 45% based on liquidation value ($1,350,000), but marital deduction eliminates any tax liability.

c. If the surviving parent/QTIP transfers general partnership interests to children prior to death, so survivor and QTIP have no liquidation rights, the second estate qualifies for valuation discount and § 1014 basis step up.

7. Parents and Children Split Control Through an Entity and Parents Retain Value:



a. Parents don't have either control or liquidation rights.

b. Both parents' stock and limited partnership interest obtain § 1014 basis and valuation discount.

c. Parents retain 95% of income and value.

8. Surviving Parent Share Control With Children and QTIP Holds Value--Limited Partnership After First Death:

QTIP Trust-------▸ 90% Limited Partnership | **Limited Partnership** | ◂-----Mom 5% General Partner ◂-----Children 5% General Partner

a. Goal is valuation discount for QTIP.

b. Caution: TAM 9550002 aggregates stock held by QTIP with stock held by surviving spouse, and TAM 9608001 aggregates general and limited partnership interests held by the QTIP trust and the surviving spouse for valuation purposes. The Service argued that, based on § 2044 and its legislative history, the assets in the QTIP are treated as held outright by the spouse at death. But, *see Est. Of Louis Bonner, Sr.*, 1996-2 USTC ¶ 60,237, (5th Cir. 1996), where the Fifth Circuit held no aggregation was permitted.

9. Parent Controls in First Estate and Parent Retains Value With Control Split in Second Estate: S Corporation:

Parent/Child-------------▸ 10% Voting Stock | **S Corporation** | ◂------90% Parent QTIP Nonvoting Stock

a. Parent has control, marital deduction eliminates tax and § 1014 basis.

b. Second estate parent has neither control, nor liquidation rights. Estate tax value is $1,600,000 ($2,700,000 x 60%).

c. § 1014 basis is $1,620,000 in second estate, but $3,000,000 in first estate.

D. The Impact of § 2703--Basic Rules.

1. § 2703 was enacted in 1990 to provide more specific rules relating to the effect of buy-sell agreements and other results on the value of property for federal estate and gift tax purposes.

2. § 2703 provides that the value of any property shall be determined without regard to: (a) any option agreement or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or (b) any restriction on the right to sell or use the property. This rule applies for purposes of the estate, gift, and generation-skipping taxes. Reg. § 25.2703-1(a)(1).

3. A right of restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, shareholder agreement, or any other agreement.

   a. A right of restriction may be implicit in the capital structure of the organization. Reg. § 25.2703-1(a).

   b. For these purposes, the term "right of restriction" means any option, agreement, or other right to acquire or use property at less than fair market value (determined without regard to the option agreement or right, or any restriction on the right to sell or use the property). Reg. § 25.2703-1.

4. Example: Tom owns all of the stock of Builders, Inc., a calendar-year S Corporation. Builders, Inc. has a fair market value of $1 million. Bob gifts 10% of the stock to his son, Bob, Jr. Bob and Bob, Jr. enter into a buy-sell agreement which values the stock at $500,000. Bob dies on May 1, 1996. In valuing Bob's stock, the value placed by the buy-sell agreement will be ignored under § 2703 for federal estate tax purposes.

5. § 25.2703-1(d). Example (1): T dies in 1992 owning title to Black Acre. In 1991, T and T's child entered into a lease with respect to Black Acre. At the time the lease was entered into, the terms of the lease were not comparable to leases of comparable property entered into among related parties. The lease is a restriction on the use of property that is disregarded in valuing the property for federal estate tax purposes.

6. § 2703 will not allow the Service to ignore a buy-sell agreement to determine the value of stock, provided each of the three following requirements are satisfied:

   a. The right of restriction is a bona fide arrangement. Reg. § 25.2703-1(b)(1).

b. The right of restriction is not a device to transfer property to the natural objects of the transfer's bounty for less than full and adequate consideration in money or money's worth. Reg. § 25.2701-1(b)(2).

(1) The requirements that the right or restriction must be a bona fide business arrangement and not a testamentary device are based upon the prior regulation under Treas. Reg. § 20.2031-2(h).

(2) The existing case law should be consulted in interpreting these requirements.

(3) The Regulations make it clear, however, that they are separate requirements and that a mere showing that a right or restriction is a bona fide business arrangement is not sufficient evidence to establish that it is not a testamentary device.

c. At the time the restriction is created, the terms of the right or restriction are comparable to similar arrangements entered into by persons in an arm's length transaction. Reg. §§ 25.2703-1(b)(1)(i), (ii), (iii).

7. In order to satisfy the requirement that the terms of the agreement must be comparable arrangements entered into by persons in an arm's length transaction, the taxpayer must prove that the agreement is comparable to similar arrangements entered into by persons in an arm's-length transaction, *i.e.*, that it could have been obtained in a fair bargain among unrelated parties in the same business, dealing with each other at arm's length. § 2703(b)(3) and Reg. § 25.2703-1(b)(4)(i).

a. A right of restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated arrangements in the same business.

b. This determination generally entails consideration of such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted. *See* Reg. § 25.2703-1(b)(4)(i).

8. <u>TAM 9723009.</u> Decedent died on March 9, 1994. Prior to March 7, 1994, the decedent's assets consisted of rental real property and marketable securities. Decedent's son and daughter were her sole heirs. On March 7, 1994, two days before the decedent's death, the decedent's children, acting as trustees of a revocable trust established by the decedent and a marital trust established by the decedent's husband, contributed all of her property to a family limited partnership. The son and daughter were 1% general partners, the marital trust an 82.287% limited partner, and the revocable trust a 15.8129% limited partner. The total value of the property contributed to the partnership was $2,325,241. Immediately after formation of the partnership, the marital trust transferred two 30% limited partnership interests, one to each of the decedent's son and daughter in exchange for $10,000 cash, and a $30,000 note in the face amount of $485,731. On the

decedent's federal estate tax return, the value of the property held by the marital trust was $352,934 (the revocable trust was $252,251). The estate contends that while the revocable trust and the marital trust contributed assets valued at $2,259,143 on March 7, 1994 in exchange for partnership interests, the very same partnership interest, where the notes received on the transfer of the interests to the decedent's children, should be valued, for estate tax purposes, at $1,177,013, as of two days later on March 9, 1994, with a 48% loss of value (of over $1mm) in a two-day period.

9. Relying upon *Est. of Murphy*, T.C. Memo. 1990-472, the IRS held that the partnership should be disregarded as a sham testamentary transfer. Its sole purpose was to depress the value of the partnership assets. The arrangement merely operated to convey the assets to the individuals, the decedent's children, who would have received the assets in any event under the testamentary instrument. The IRS argued that it is well established that transactions having no purpose or effect to the transferor other than to reduce taxes are disregarded for federal tax purposes.

10. The Service's alternative argument was that § 2703(a)(2) allows the IRS to disregard the section. Citing Reg. § 25.2703-1(a)(3), the IRS argued that a right of restriction may be contained in a partnership agreement. A right of restriction may be implicit in the capital structure of an entity. The IRS rejected the taxpayer's argument that § 2703(a)(2) applied to a restriction on the transfer of the partnership interest. The IRS argues that the value of property transferred is determined without regard to any restrictions relating to the "property". The taxpayer argued that there were no restrictions on transferability in the partnership agreement with respect to the partnership interest. The IRS argued that the transfer of the property to the partnership resulted in the placement of a restriction on the taxpayer's use or transferability of the property. The creation and funding of the partnership and the transfer of the partnership interests should be collapsed and viewed as a single integrated transaction. Therefore, the partnership assets are properly viewed as the subject matter of the transfers.

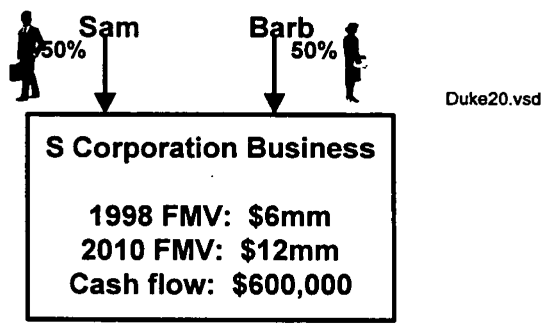
11. The IRS also argued that, even assuming the transactional steps are not collapsed and the partnership interest is recognized as the subject matter of the transfer, § 2703(a)(2) would apply. The IRS argued that Reg. § 25.2703-1(a)(3) provides that the restrictions, which are disregarded under § 2703, are under the terms of the partnership agreement, or may be or implicit in the capital structure of an entity. The IRS held that the partnership agreement and the state law imposed several impediments on the transferor's ability to sell or use the property that would normally be taken into account in determining fair market value. The fact that a transferee would be a mere assignee, rather than a substitute partner, is one example. The prohibition of a limited partner withdrawing from the partnership, reinaction for a partition or otherwise causing a dissolution is another example. The IRS argues "clearly these restrictions constitute restriction of the limited partner's right to use the partnership interest and impede the partner's ability to sell the interest. Accordingly, the failure of the transaction to satisfy the exceptions in § 2703 cause the restrictions to be disregarded in valuing the partnership interest. In the absence of these restrictions, only a discount to reflect the fractional interest of the real estate represented by the partnership interest, if appropriate,

should be available. In the case of marketable securities, any discount is not available." *See, also*, TAM 9719006, 9725002, 9736004, and 9735043. But, *see Est. of White v. Comm'r.*, T.C. Dk. No. 14412-97, in which IRS conceded the § 2703 issue prior to trial.

CHAPTER 8

VALUATION DISCOUNTS--GRATS AND IDGTS

I. FACTS.



II. ISSUES.

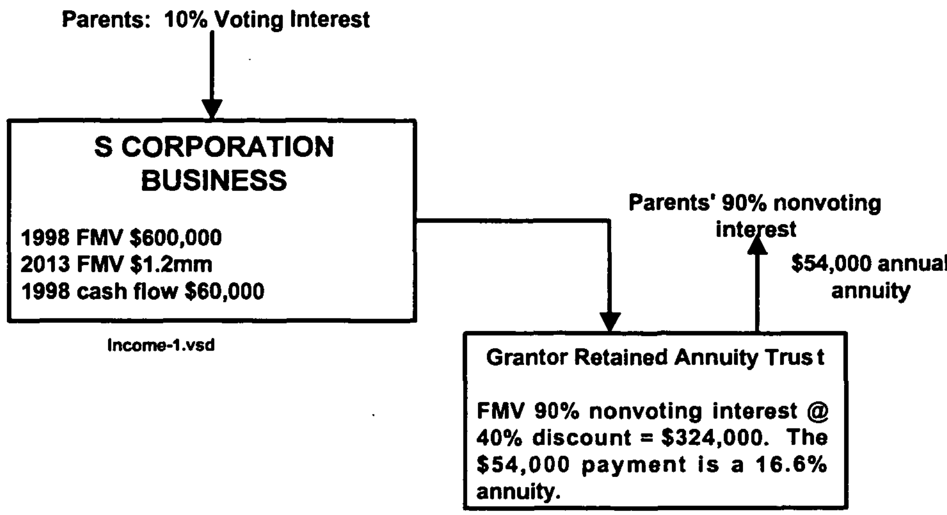
Sam and Barb want to reduce transfer taxes, but retain income for their lives. What planning techniques could be used to accomplish their goals?

III. DISCUSSION.

A. GRATs: Combining Valuation Discounts With GRATs.

1. Background. A GRAT involves the transfer or property to an irrevocable trust in exchange for a series of fixed annual payments over a specified period of time. At the end of the specified term, the remaining trust assets go to the children. The value of the gift to the beneficiaries is the present value of the right to receive the property at the end of the annuity period. If minority/marketability discounts apply, for purposes of valuing the property transferred to the trust, the transfer tax benefits of the technique can be increased significantly. The actual cash flow stream from the property which is available to pay the annuity, becomes a higher percentage annuity payment which, in fact, can be paid. The end result is a decrease in the value of the remainder. A GRAT is particularly advantageous over outright gifts where the parent wants to shift future appreciation to the children and grandchildren, but doesn't want to give up the income stream for a fixed period of time. *See* IRC § 2702; Reg. § 25.2702-1(b), and Reg. § 25.2702-3(b).

GRAT:



a. Parents own an apartment building through a limited partnership, worth $600,000, free and clear of encumbrances, which has net cash flow of $60,000 per year. An outright gift of 90% limited partnership interests of the FIC would result in a $324,000 gift, assuming a 40% discount. More important, however, is the fact that parent must give up 90% of the income or $54,000 per year. Assume building will double in value over 15 years.

b. Parent, age 50, retains an annual annuity of $54,000 (16.66%) from the trust for 15 years. Discount rate for value of annuity in September, 1998 is 6.6%. IRC § 2702 gift = $ 0 or $18,625 under Rev. Rul. 77-454.

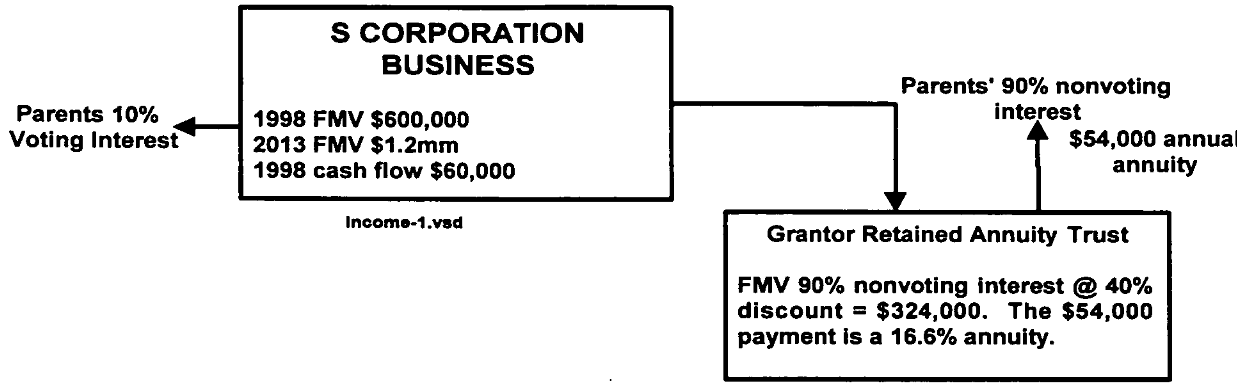
c. Estate and gift tax value - $120,000 for remaining 10% in 2010 + $18,625 gift. Appreciation shifted without tax if property doubles in value = $1.2mm - $120,000 + $18,625 = $1,061,375.

d. Of course, parent has received $54,000/year for 15 years or $1,165,000 (ignoring income taxes) if compounded at 5%, which will be subject to estate tax is not spent, but parent's goal here is to retain cash flow. If no gift, parent's taxable estate would include $1.2mm plus the $1,165,000 income = $2.365,000.

e. Total savings $1,061,375 x 55% = $583,756.

2. Benefits and Disadvantages of GRATS/GRUTS.

a. Benefits: (1) Reduces estate taxes on the gifted property as well as the appreciation; (2) Provides cash flow to the parent; (3) Discounts provide leveraging of unified credits and gift taxes paid; (4) Property transferred outside of probate; and (5) Annual payments may be made in cash or property. Distributions or appreciated property should not be taxable, since it is a grantor trust. *See* Rev. Rul. 85-13, 1985-1 C.B. 184, and *Rothstein*, 84-1 USTC ¶ 9505.



b. Disadvantages: (1) Establishing GRAT is costly and there are ongoing administration costs; (2) The asset may produce insufficient income or have a growth rate less than the § 7520 rate. The Service held that a parent's loan to the GRAT to pay the annuity disqualifies the transfer under § 2702. *See* LTR 9604005. (3) The annual annuity increases the parents' estate unless parent spends money or uses it for annual exclusion gifts to children. (4) If parent dies before the end of the term, the entire trust may be included in their estate. (5) The property doesn't receive a basis step up at death. Consider repurchasing the property prior to the expiration of the trust term, while it's still a grantor trust. *See* Rev. Rul. 85-13, 1985-1 C.B. 184, and LTR 9535026.

3. Caveat: In LTR 9707027, the IRS approved a GRAT funded with limited partnership interests in a nonpublicly traded partnership, but stated that the value of the partnership interests will be determined without any discounts for grantor's lack of control.

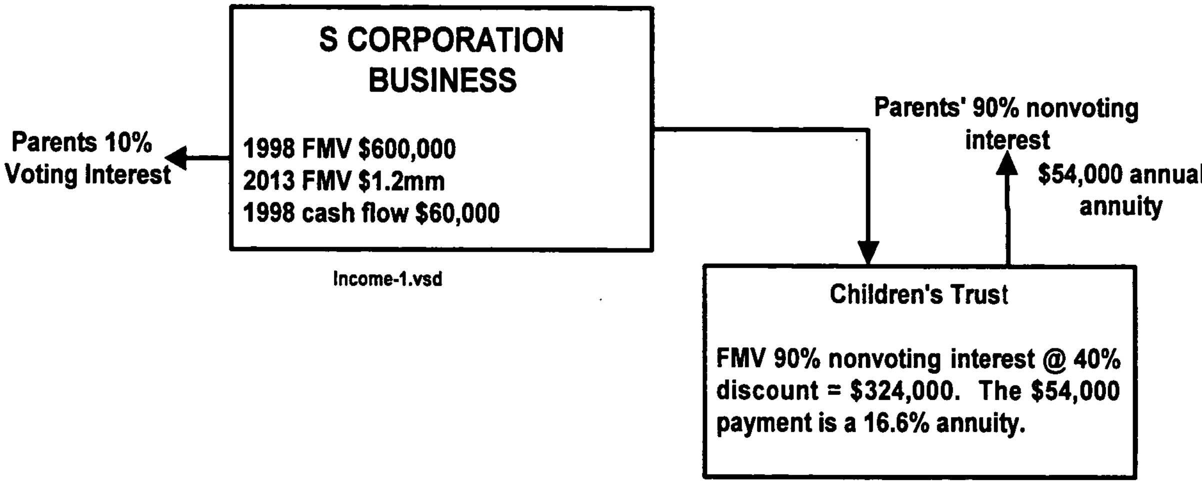
4. LTRs 9444033, 9543049 and 9709001--tax reimbursement provisions are not retained interests pursuant to § 2036.

B. Combining Valuation Discounts With Installment Sales.

1. Background. An installment sale involves sale of property in exchange for an installment note. The property must qualify for installment reporting. If a parent sells child property at its fair market value in exchange for an installment note, no gift occurs. If minority/marketability discounts apply, the sales price is based on the discounted value. The required interest to avoid an imputed gift is found in IRC § 7872. It is a lower rate than the rate used for the GRAT, *i.e.*, 120% of mid-term AFR, or for the freeze partnership in IRC § 2701. The April, 1996 long-term AFR was only 6.51% annually, or 6.33% monthly. The April, 1996 mid-term AFR was 5.88% annually, and 5.73% monthly. The installment note should provide for fixed payments on an annual basis. If the note has a principal amount of less than $2,000,000 then no interest will be imputed annually under IRC § 1274(c), if it is accrued annually at the AFR. *See* § 1274A. From a trans-

fer tax planning perspective, the transaction freezes the value of the property in the parent's estate and shifts future growth in excess of the interest rate to the children/buyers. The transaction should not be 100% financed.

2. <u>Illustration</u>:



a. Parents own an apartment building worth $600,000, through a limited partnership, free and clear of encumbrances, which has a net cash flow of $60,000 per year. An outright gift of 90% of the FIC would result in a $324,000 gift, assuming a 40% discount. A sale of a 90% limited partnership interest in exchange for a $324,000 installment note results in no gift and provides parents with cash flow from the installment payments.

b. **Caution**: Be careful of installment sale qualification. *See* IRC §§ 453(e), (g), (i), and 1239 for rules relating to sales to related parties.

c. All appreciation over $324,000 goes to children. Parents receive interest at 6.5% and amortizes note over 15 years. Payments are $34,458 annually. Future value of payments compounded at 5% is $780,732. <u>Note</u>: For comparison with GRAT payment to zero out, GRAT would be $37,529.

3. <u>Advantages of Installment Sale Technique</u>:

a. No current gift tax.

b. Future appreciation in excess of the interest rate is out of estate.

c. Provides cash flow to parent and liquidity for parent's estate.

d. Sales price may be determined using appropriate valuation discounts. Valuation discount is locked in for the entire property.

e. Sales of nonvoting interests, while retaining voting interests, allows parent to retain control until death.

f. Interest-only notes allow deferral of principal payments keeping growth in the principal out of parents' estate.

4. Disadvantages:

a. Principal payments on note may create gain for income tax purposes.

b. There is no IRC § 1014 basis in parent's estate for the note because it constitutes an item of income in respect of a decedent.

c. Interest must be paid annually or income tax and gift tax consequences will result.

d. A comparison of the income and transfer tax rate may be considered.

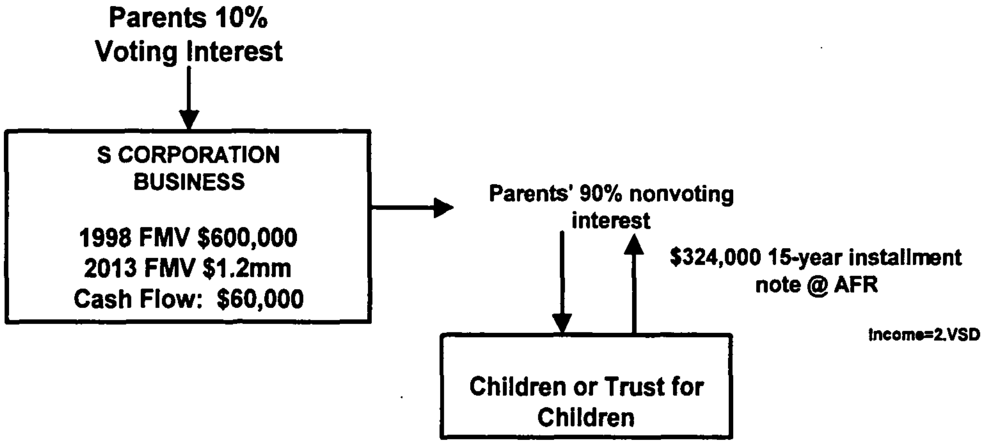
e. A disposition of the note triggers the gain under IRC § 453B. This may result from gifts, forgiveness, or foreclosure of note.

f. IRS may challenge the transaction using debt-equity principles.

5. Use of Grantor Trusts.

a. The disadvantages of the installment sale can be avoided if the trust is established as a grantor defective trust. A grantor defective trust refers to a trust, the income of which under the income tax rules of Code § 671 through 678, is taxed to the grantor rather than the trust or the beneficiary. If the trust is structured in this manner and the seller is the grantor, then all of the interest and principal payments will be taxed to the grantor, and no tax will result, since they will be selling the property to themselves. *See* Rev. Rul. 85-13, 1985-1 C.B. 184, and LTR 9535026.

b. Example:



c. In order to obtain a § 1014 basis in the property, the grantor must repurchase the property from the trust prior to its termination of grantor trust status.

d. The grantor is taxed on all trust income, even though it's in excess of the note payments. The Service has suggested in several letter rulings that this situation could result in an additional gift.

6. Self-Cancelling Installment Notes.

a. A self-cancelling installment note is an installment sale which, by its terms, is automatically cancelled upon the seller's death. If the seller dies before the expiration of the term of the note, the unpaid balance of the note is not subject to estate taxes and there is no gift tax on the transfer.

(1) The estate tax savings are premised on the inclusion of a premium in the selling price to take into account the mortality risk. *Est. of Moss*, 74 T.C. 1239 (1980).

(2) Failure to include the mortality premium causes estate taxation. *Buckwalter v. Comm'r.*, 46 T.C. 805 (1966).

b. The Tax Court has twice held that nothing is includible in the gross estate of a seller who dies before the entire purchase price of a self-cancelling installment note has been paid because the note contains a bargained-for provision under which all obligations to pay automatically cease upon the earlier of the satisfaction of the note or the obligee's death. *See Est. of Moss*, 74 T.C. 1234 (1980), *acq. in result* 1981-1 C.B. 2; *Est. of Kane v. Comm'r.*, 37 T.C. 185 (1961), *acq.*, 1962-2 C.B. 4; *Est. of Buckwalter v. Comm'r.*, 46 T.C. 805 (1986). The Tax Court has also held, however, that the estate has income based upon the cancellation of the note.

C. The Deferred Compensation Estate Planning Gambit for S Corporations.

1. The Retained Income Dilemma. In many family businesses, parents are reluctant to transfer stock to the children if it means giving up income. § 2701 freeze, § 2702 GRAT, or installment sales, all achieve the desired result, but put too much value back into the parent's estate, because in one form or another, the "principal" which produces the income will be estate taxable to the parents.

   a. Consider a deferred compensation plan combined with gifts of qualifying for minority/marketability discounts as a solution to the parent's dilemma.

   b. Example: Sam owns a business worth $2mm. He is age 60, currently drawing a $120,000 salary, and the company has no retirement plan in place for him. He wants to transfer ownership and management of the business to his two children. Even with a 40% minority/marketability discount, a transfer of the entire business would have a $1.2mm gift tax value.

   c. What if Sam enters into a deferred compensation plan with the corporation to provide him with $120,000 a year income until retirement, then $120,000 a year for life as deferred compensation with $120,000 a year continuing to his spouse if she should survive for her life (assume 20 years of payments). Applying a 9% discount rate, the present value of the obligation should be $1,095,425. Arguably, the value of the entity should be reduced by the obligation for transfer tax purposes.

   d. The payments must constitute reasonable compensation to be deductible for federal income tax purposes. §§ 162(a) and 404(a). Reg. § 1.404(a)-1(b); Rev. Rul. 67-341, 1967-2 C.B. 156; *Bianchi*, 77-1 USTC ¶ 9270; *Advisors, Inc.*, 37 T.C.M. 606 (1978); *Texas Instruments, Inc.*, 551 F.2d 599 (1977); Rev. Rul. 64-159, 1964-1 C.B. 163; and TAM 8012005. **Caution**: If deferred compensation is treated as equity, § 2701 may recharacterize the arrangement as an "applicable retained interest," with a zero value for transfer tax purposes.

2. Estate Tax Consequences. The value of a survivor benefit payable by an employer under a nonqualified salary continuation and deferred agreement is includible in the employee's gross estate under § 2039 of the Code. § 2039(a) provides for inclusion if the payment is provided for under any form of contract or agreement and the decedent had a right to receive the payments himself for his life, or for any period not ascertainable without reference to his death, or for any period which does not, in fact, end before his death. Reg. § 20.2039-1(b) provides that the term "contract or agreement" includes any arrangement, understanding, plan, or any combination of arrangements, understandings, or plans arising by reason of the decedent's employment. *See Est. of Barr v. Comm'r.*, 40 T.C. 227 (1963), *acq. in result only*, 1978-1 C.B. 1; *Kneeley v. U.S.*, 613 F.2d 802 (Cl. Ct. 1980); *Edith L. Courtney* v. U.S., 84-2 USTC ¶ 13,580 (N.D. Ohio 1984); and LTR 8005011. A widow's benefit under a typical deferred compensation agreement is includible in the gross estate by reason of § 2039(a). Even if it were not includible

under § 2039(a), it would probably be includible under one of the other estate tax sections of the Code. *See Goodman v. Granger*, 243 F.2d 264.

a. Qualification for Marital Deduction. A terminable interest generally does not qualify for the marital deduction. Certain terminable interests passing to the surviving spouse do qualify for the marital deduction. The terminable interest rule provides that a property interest passing to the surviving spouse will not qualify for the marital deduction if it is only a life estate or other terminable interest, **and** (1) an interest in the property passes or has passed to someone other than the surviving spouse or the surviving spouse's estate; and (2) such other person may possess or enjoy the property after the spouse's interest ends. In this case, no portion of the annuity is payable to any one other than the surviving spouse. *See* § 2056(b)(1)(A) and (B). Reg. §§ 20.2056(b)-1(c) and (d).

b. Deferred Compensation as QTIP Property. A survivor annuity in which only the surviving spouse has a right to receive payments during such spouse's life is treated as a qualifying income interest for life unless otherwise elected on the decedent spouse's estate's tax return. *See* § 2056(7)(c). The value of any QTIP property qualifying for the marital deduction is includible in the surviving spouse's gross estate. *See* § 2044. At the spouse's death, the annuity has no value.

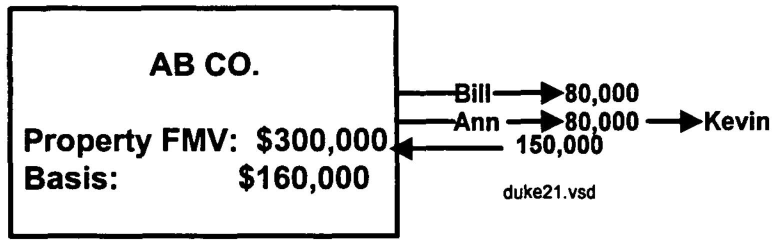
c. Although now repealed § 2036(c) would have possibly covered this arrangement, § 2701 should not apply unless the deferred compensation payment is sufficiently high so it's a disguised equity interest.

3. Income Taxation of Deferred Compensation. Generally unfunded deferred compensation is not taxable for income tax purposes until paid. *See* Rev. Rul. 60-31, 1960-1 C.B. 174; Rev. Rul. 70-435, 1970-2 C.B. 100; *Ray S. Robinson*, 44 T.C. 20 (1965); and *George C. Martin*, 96 T.C. 814 (1991).

4. Employment Taxation of Deferred Compensation. Deferred compensation is taxable for employment tax purposes at the earlier of the time the services are rendered, or the right to deferred compensation becomes nonforfeitable. *See* §§ 3121(v)(2)(A) and (B). TAMs 9051003 and 90050006 suggest it may be the present value of the deferred amount which is considered wages. The discounted amount is then not treated as wages when paid.

CHAPTER 9
PARTNERSHIP TERMINATIONS

I. FACTS.



II. ISSUE:

What are the tax consequences to AB Co. and its partners?

III. DISCUSSION.

A. Transactions Causing Termination.

1. A partnership terminates for tax purposes only if:

   a. Within a 12-month period there are sales or exchanges, including sales or exchanges to the other partners, totaling 50% or more of the total interest in partnership capital and profit; or

   b. No part of the business or financial operation or venture is carried on by any of the partners in a partnership. § 708(b)(1); Reg. § 1.708-1(b)(1)(ii). Nominal activity is required to forestall termination here. *See Baker Commodities*, 415 F.2d 519 (1969), and *Foxman*, 41 T.C. 535. Collection of note prevents termination.

2. Termination is only triggered by sale or exchange. A gift or bequest is not a sale or exchange, nor is reduction of interest by admission of another partner or a contribution of the interest to another partnership or any sale or exchange within the meaning of § 721. *See* Rev. Rul. 84-52 and Rev. Rul. 75-423. However, the contribution of a partnership interest to a corporation under § 351 is a sale or exchange. *See* Rev. Rul. 81-38, and *Jackson*, 42 T.C.M. 1413, for purposes of § 708.

3. A series of sales or exchanges totaling 50% or more, causes termination even if it spans two taxable years as long as they are within a single 12-month period.

4. § 761(e), as amended by TRA 1984, treats "any distribution" not otherwise treated as an exchange, as an exchange for purposes of § 708 and § 743.

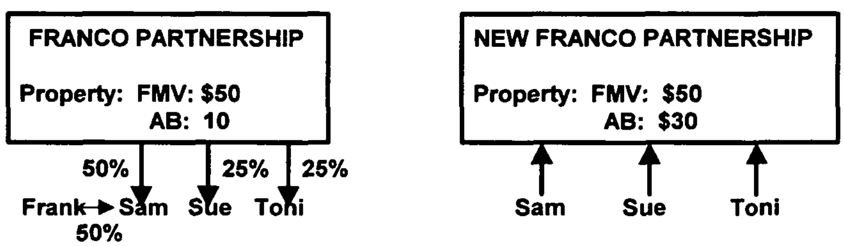
B. Tax Consequences of A Termination--The Old Regulations.

1. Closing of Taxable Year. Termination causes the closing of the taxable year for all partners, not just the one whose interest is sold.

2. Constructive Liquidation. The old partnership is completely ended, and any successor is a new one, as though it was just formed. Upon termination, under § 708(b)(1)(B), the assets are constructively distributed to the partners, who then constructively recontribute them to a successor partnership to carry on the partnership business. Reg. § 1.708-1(b)(1)(iv).

   a. Facts: Franco is a calendar-year partnership owned 50% by Frank, 25% by Sue, and 25% by Toni. Franco's sole assets is five-year depreciable property with a fair market value of $50,000, and an adjusted tax basis of $10,000. The property has one year remaining in its cost recovery period. On January 1, 1997, Frank sold his 50% partnership interest to Sam for $25,000.

   b. Illustration:



(llc1.vsd-vsd)

3. Final Tax Return. A termination requires the partnership to file a tax return and report its income up to the date of termination. Termination may cause a bunching of income.

4. Taxable Year. Termination causes the loss of a favorable taxable year since a new taxable year must be selected.

5. New Election. The new partnership is required to make all new elections. This may be favorable in that it allows the termination of a § 754 election.

6. Depreciation--ACRS. The step into the shoes rule of § 168(i)(7)(A) does not apply to partnership terminations. However, the anti-churning rules of § 168(f)(5) may apply.

7. Gain. The partners may recognize gain under § 731 if cash distributed exceeds their basis for their partnership interest.

8. ITC Recapture. Investment tax credit recapture may occur since, under § 47(b), upon the disposition of recaptured property unless the transaction is considered to be a "mere change in form of doing business". A "mere change in form of doing business" requires the basis of the property in the hands of the distributee to be a carryover basis from the transferor. *See Long*, 81-1 USTC ¶ 9637, *Sexton*, T.C. Memo. 1981-454, *Gorton*, T.C. Memo. 1985-45, and *Sellers Bros. Inc.*, T.C. Docket No. 2948-86.

9. Basis of the Partnership's Assets. Since the partnership is deemed to terminate, a liquidating distribution occurs in which the basis of the distributed assets becomes the basis of the partners' basis for their partnership interests. Upon recontribution to the partnership, § 722 gives the partnership a carryover basis. This may cause an increase or decrease in partnership's basis for its assets. In addition, note that under § 704(c), any difference between fair market value and basis of these assets must be allocated back to the contributing partner. Note that a § 732(d) election may be preferable to § 732(c) allocation for the property on the constructive distribution in that § 732(d) allocates basis in accordance with the adjusted basis of property whereas § 732 (b) and (c) allocates in accordance with the basis of those assets in the hands of the partnership. Recontribution also creates §§ 704(c)(1)(B)/737 problems for all partners.

10. Installment Obligations. If installment obligations, Reg. § 1.453 -9, and § 732, seem to preclude recognition of gain on the distribution of installment receivables.

11. Holding Period of Assets. Under § 735(b) and § 1223, the holding period of the partnership's assets should carryover. However, the Tax Court in *Edwin E. McClausen* concluded other facts, perhaps distinguishable from those of constructive termination, that the purchaser of a partnership interest which precipitates a termination, may not utilize the tacking provisions of § 735. *See* 45 T.C. 588.

12. Retention of § 704(d) Loss Account. The issue is whether or not a constructive termination causes a permanent loss of suspended losses under § 704(d). The answer is that any § 704(d) suspended losses are probably lost, since the partnership is treated as having been terminated for tax purposes.

C. Tax Consequences of a Termination--The New Regulations.

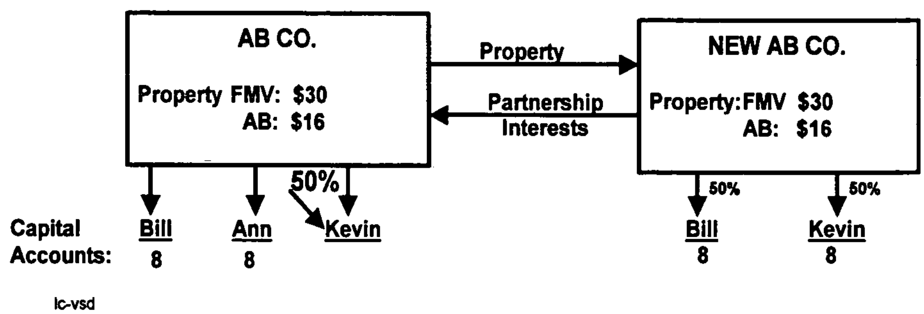
1. Formation of New Partnership. If a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur:

   a. The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up.

b. This rule applies to terminations of partnerships under § 708(b)(1)(B) occurring on or after May 9, 1997. It may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply those rules to the termination in a consistent manner.

c. Example: Ann and Bill each contribute $10,000 cash to form AB Co., a general partnership, as equal partners. AB Co. purchases depreciable Property X for $20,000. Property X increases in value to $30,000, at which time Ann sells her entire 50% interest to Kevin for $15,000 in a transfer that terminates the partnership under § 708(b)(1)(B). At the time of the sale, Property X had an adjusted tax basis of $16,000 and a book value of $16,000 (original $20,000 tax basis and a book value reduced by $4,000 of depreciation). In addition, Ann and Bill each had a capital account balance of $8,000 (original $10,000 capital account reduced by $2,000 of depreciation allocations with respect to Property X).

(1) Illustration:



(2) Following the deemed contribution of assets and liabilities by the terminated AB Co. partnership to a new partnership (new AB Co.) and the liquidation of the terminated AB Co. partnership, the adjusted tax basis of Property X in the hands of new AB Co. is $16,000. *See* § 723.

(3) The book value of Property X in the hands of new partnership AB Co. is also $16,000 (the book value of Property X immediately before the termination) and Bill and Kevin each have a capital account of $8,000 in new AB (the balance of their capital accounts in AB Co. prior to the termination). *See* § 1.704-1(b)(2)(iv)(l) (providing that the deemed contribution and liquidation with regard to the terminated partnership are disregarded in determining the capital accounts of the partners and the books of the new partnership).

(4) Additionally, under § 301.6109-1(d)(2)(iii), new AB Co. retains the taxpayer identification number of the terminated AB Co. Partnership.

(5) Property X was not § 704(c) property in the hands of terminated AB Co. and is, therefore, not treated as § 704(c) property in the hands of new AB Co., even though Property X is deemed contributed to new AB Co. at a time when the fair market value of Property X ($30,000) was different from its adjusted tax basis ($16,000). *See* § 1.704-3(a)(3)(i) (providing that property contributed to a new partnership under § 1.708-1(b)(1)(iv) is treated as § 704(C) property only to the extent that the property was § 704(c) property in the hands of the terminated partnership immediately prior to the termination).

(6) If a partnership is terminated by a sale or exchange of an interest in the partnership, a § 754 election (including a § 754 election made by the terminated partnership on its final return) that is in effect for the taxable year of the terminated partnership in which the sale occurs, applies with respect to the incoming partner. Therefore, the bases of partnership assets are adjusted pursuant to §§ 743 and 755 prior to their deemed contribution to the new partnership.

2. Carryover of Capital Accounts. If the transfer of an interest in a partnership causes a termination of the partnership under § 708(b)(1)(B), the capital account of the transferee partner and the capital accounts of the other partners of the terminated partnership carry over to the new partnership that is formed as a result of the termination of the partnership under § 1.708-1(b)(1)(iv).

a. The deemed contribution of assets and liabilities by the terminated partnership to a new partnership and the deemed liquidation of the terminated partnership that occur under § 1.708-1(b)(1)(iv) are disregarded. *See* the example in § 1.708-1(b)(1)(iv).

b. The rules apply to terminations of partnerships under § 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentences may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentences to the termination in a consistent manner.

c. Example: Immediately preceding the constructive liquidation, the capital accounts of Z and LK equal $11,000 each (LK having inherited Y's $11,000 capital account) and the book value of the G Corp. securities is $22,000 (original purchase price of securities). The deemed contribution of assets and liabilities by the terminated partnership to the new partnership and the deemed liquidation of the terminated partnership that occur under § 1.708-1(b)(1)(iv) in connection with the constructive liquidation of the terminated partnership are disregarded in the maintenance and computation of the partners' capital accounts. As a result, the capital accounts of Z and LK in the new partnership equal $11,000 each (their capital accounts in the terminated partnership immediately prior to the termination), and the book value of the G Corp. securities remains $22,000 (its book value immediately prior to the termination). This Example applies to terminations of partnership under § 708(b)(1)(B) occurring on or after May 9, 1997; however, this Example may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this Example to the termination in a consistent manner.

3. Application of § 704(c) to Constructive Terminations.

   a. A new partnership formed as the result of the termination of a partnership under § 708(b)(1)(B) is not required to use the same method as the terminated partnership with respect to § 704(c) property deemed contributed to the new partnership by the terminated partnership under § 1.708-1(b)(1)(iv).

   b. Property deemed contributed to a new partnership as the result of the termination of a partnership under § 708(b)(1)(B) is treated as § 704(c) property in the hands of the new partnership only to the extent that the property was § 704(c) property in the hands of the terminated partnership immediately prior to the termination.

   c. A termination of the partnership under § 708(b)(1)(B) does not begin a new five-year period for each partner with respect to the built-in gain and built-in loss property that the terminated partnership is deemed to contribute to the new partnership under § 1.708-1(b)(1)(iv).

   d. § 704(c)(1)(B) does not apply to the deemed distribution of interests in a new partnership caused by the termination of a partnership under § 708(b)(1)(B). A subsequent distribution of § 704(c) property by the new partnership to a partner of the new partnership is subject to § 704(c)(1)(B) to the same extent that a distribution by the terminated partnership would have been subject to § 704(c)(1)(B).

4. Application to Tier Partnerships.

   a. If the sale or exchange of an interest in a partnership (upper-tier partnership) that holds an interest in another partnership (lower-tier partnership) results in a termination of the upper-tier partnership, the upper-tier partnership is treated as exchanging its entire interest in the capital and profits of the lower-tier partnership.

   b. If the sale or exchange of an interest in an upper-tier partnership does not terminate the upper-tier partnership, the sale or exchange of an interest in the upper-tier partnership is not treated as a sale or exchange of a proportionate share of the upper-tier partnership's interest in the capital and profits of the lower-tier partnership.

5. Application of § 737.

   a. § 737 does not apply to the deemed distribution of interests in a new partnership caused by the termination of a partnership under § 708(b)(1)(B).

   b. A subsequent distribution of property by the new partnership to a partner of the new partnership that was formerly a partner of the terminated partnership is subject to § 737 to the same extent that a distribution from the terminated partnership would have been subject to § 737.

   c. Any portion of the distributed property that consists of property previously contributed by the distributee partner (previously contributed property) is not taken into account in determining the amount of the excess distribution or the partner's net precontribution gain.

6. Optional Basis Adjustment. A partner with a special basis adjustment in property held by a partnership that terminates under § 708(b)(1)(B) will continue to have the same special basis adjustment with respect to property deemed contributed by the terminated partnership to the new partnership under § 1.708-1(b)(1)(iv), regardless of whether the new partnership makes a § 754 election.

7. Distributions Treated As Exchanges.

   a. For purposes of § 708(b)(1)(B) and § 1.708-1(b)(1)(iv), the deemed distribution of an interest in a new partnership by a partnership that terminates under § 708(b)(1)(B) is not a sale or exchange of an interest in the new partnership.

   b. The deemed distribution of an interest in a new partnership by a partnership that terminates under § 708(b)(1)(B) is treated as an exchange of the interest in the new partnership for purposes of § 743.

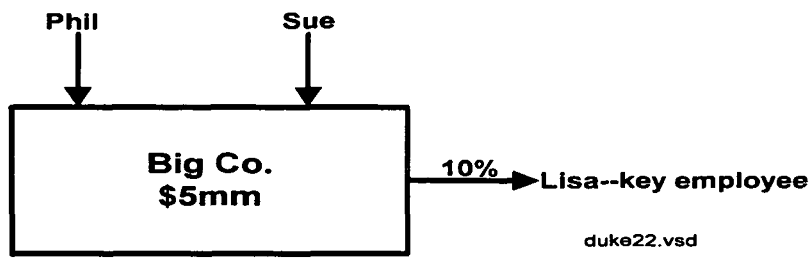
8. Employer Identification Numbers. A new partnership that is formed as a result of the termination of a partnership under § 708(b)(1)(B) will retain the employer identification number of the terminated partnership.

9. Investment Credit Recapture. A § 708(b)(1)(B) termination no longer triggers ITC recapture under the "mere change in form" exception in § 1.47-3(f).

10. § 731(c) Distributions. The deemed distribution of partnership interests does not trigger application of § 731(c).

CHAPTER 10
EQUITY FOR SERVICES

I. FACTS.



Phil and Sue own 100% of Bigco. Lisa is a key employee who wants 10% of the business.

II. ISSUES:

What are the tax consequences to Lisa and Bigco if she received a 10% interest in Bigco? How can it be structured to minimize the tax consequences to Lisa?

III. DISCUSSION.

A. Stock for Services.

1. Under § 83, when property transferred is transferred to an employee or independent contractor in connection with the performance of services the employee or independent contractor must report income when the property becomes substantially vested, *i.e.*, when the transferee's rights become transferable and are not subject to a substantial risk of forfeiture. Reg. § 1.83-1(a) and Reg. § 1.83-3(b). The amount of income recognized is the fair market value of the stock received, determined without regard to any restriction other than a restriction which, by its term, will never lapse, over the amount of money paid for the stock. Reg. § 1.83-1(a). Fair market value is determined by reference to normal valuation rules which would take into account applicable minority/marketability discounts. *See*, for example, Rev. Rul. 93-12, 1993-1 C.B. 202. Until the transferee's rights in the property become substantially vested, all income or loss from the property is taxed to the transferor, and all cash distributions are treated as additional compensation. *See* Reg. § 1.83-1(a). Property is subject to § 83 even if taxpayer paid full value upon receipt, if it's transferred in connection with the performance of services. *See Alves*, 84-2 USTC ¶ 9546, and *MacNaughton*, 89-2 USTC ¶ 9599.

2. If property is not substantially vested, the employee or independent contractor can, nevertheless, elect to include it in income upon receipt at its fair market value by making a § 83(b) election. The advantage of a § 83(b) election is that future appreciation can be capital gain rather than ordinary income. Reg. § 1.83-2(a). However, if property is forfeited, the loss realized is limited to the amount paid for the property, not the amount included in income. Reg. § 1.83-2(a). *See* Reg.

§ 1.83-2(b) for the method of making a proper § 83(b) election. Restricted stock is not considered outstanding for the one class of stock rules unless a § 83(b) election has been made. Reg. § 1.1361-1(b)(3).

3. The employer is entitled to a deduction in an amount equal to the employee's income provided the employer makes the required withholding. § 83(h) and Reg. § 1.83-6(a)(2).

4. Nonqualified options create ordinary income upon exercise based on the difference between exercise price and fair market value for the stock. Reg. § 1.83-7. Qualified options don't create income upon exercise and will result in capital gain upon sale of the stock if the applicable holding periods are satisfied. *See* § 422A.

B. Partnership Interests for Services.

1. Capital Interests. Receipt of a partnership capital interest for services is a taxable event under I.R.C. § 83. *See* Prop. Reg. § 1.721-1(b)(1)(i) and *Hensel Phelps Construction Co.*, 74 T.C. 939 (1980), *aff'd*, 83-1 USTC ¶ 9270. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination is generally made at the time of receipt of the partnership interest. Rev. Proc. 93-27, 1993-2 C.B. 343. A profits interest is a partnership interest other than a capital interest. Rev. Proc. 93-27. Correct valuations become crucial for purposes of determining whether the service partner has received a capital or a profits interest. Profits Interests. Receipt of a profits interest for services to or for the benefit of the partnership in a partner capacity or in anticipation of becoming a partner ***is not a taxable event***, unless the profits interest relates to a substantially certain predicable stream of income from partnership assets, such as income from a high quality debt securities or a high quality net lease; within two years of receipt, the partner disposes of the profits interests; or the profits interest is a limited partnership interest in a publicly traded partnership within the meaning of I.R.C. § 7704(b). *See, also, Wm. Campbell*, 91-2 USTC ¶ 50,420; *St. John v. U.S.*, 84-1 USTC ¶ 9158; and *Kenroy, Inc.*, T.C. Memo. 1984-232.

2. Partnerships/LLCs With S Corporations. In Rev. Rul. 94-43, I.R.B. 1994-27 (July 5, 1994), the IRS revoked Rev. Rul. 77-220, 1977-1 C.B. 263. The ruling held that a partnership of S corporations will not invalidate an S election, even if the principal purpose of the arrangement is to avoid the 35 shareholder limitation. This ruling eliminates the risk that the Service might argue that an S corporation's election was invalid because a principal purpose of the S corporation's participation in a partnership was to avoid one of the eligibility requirements. *See, also, Selig*, 565 F. Supp. 524, aff'd, 740 F.2d 572; *Patterson v. Comm'r.*, 1984-58; Rev. Rul. 71-455, 1971-2 C.B. 318; and LTRs 8819040, 8823023, 8823027 and 8950066 in which S corporations were recognized as partners in partnerships for tax purposes.

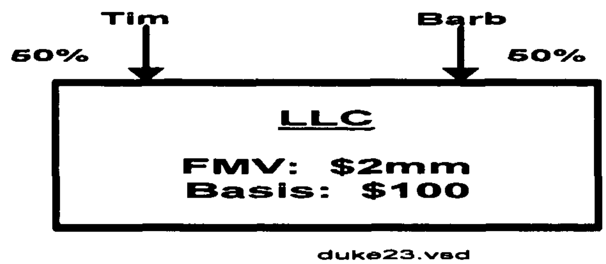
a. Reg. § 1.701-2, Ex. (2) of the anti-abuse rules, specifically approves a partnership with an S corporation even if its principal purpose is to avoid S shareholder requirements.

b. A partnerships/LLC between an S corporation and its employees/shareholders could be a useful planning technique to shift future appreciation to the children performing services for the business without any income tax or transfer tax. It permits S corporation employees to become equity owners under the more favorable tax regime of Rev. Proc. 93-27.

CHAPTER 11

LOCKING IN FAVORABLE CAPITAL GAINS RATES FOR DEVELOPMENT PROPERTY

I. FACTS.



The LLC owns appreciated real estate which is ripe for development. The property has a fair market value of $2,000,000 and an adjusted tax basis of $1,000,000. If the property is subdivided and sold as residential lots, net profit would be $3,000,000.

II. ISSUES.

If the taxpayer develops the property himself, the entire $3,000,000 profit will be taxable as ordinary income, even though $1,000,000 of the profit is attributable to the capital appreciation in the property and would result in capital gains treatment if the property were sold without any development activities. How can the transaction be structured to minimize the ordinary income for Tim and Barb?

III. DISCUSSION.

A. Sale to Controlled Entity.

1. A common solution to this dilemma is a sale to a controlled entity for the undeveloped fair market value of the property. If successful, this approach would lock in the capital gains tax rate for the pre-development appreciation in the property. The related purchaser acquires a cost basis for the property which reduces the gain payable with respect to the development profits.

2. The pitfall often overlooked in this strategy is the proper choice of entity. A pass through entity is usually the most appropriate, because the profits from the development can be distributed to the owners without a double tax.

3. The first choice for a pass-through entity would be an LLC or a partnership, because they are usually more flexible vehicles for holding real estate than S corporations. However, the LLC or the partnership is a poor choice if the seller, directly or indirectly, owns more than 50% of the capital interest or the profits

interest in such entity. § 707(b)(2) treats any gain on the sale or exchange of property, which is not a § 1221 capital asset in the hands of the purchaser as ordinary income, if the sale is between a partnership and a more than 50% partner or between two partnerships in which the same persons own more than 50%. For these purposes, the ownership of capital and profits interests are determined under the constructive ownership rules of § 267(c), excluding the partnership attribution rules which would otherwise be applicable.

4. While S corporations are subject to a similar rule converting capital gains into ordinary income, that rule operates differently. § 1239(a) causes the gain on the sale of depreciable property between related persons to be taxed as ordinary income. The definition of related party is a corporation or a partnership and a more than 50% owner. The S corporation conversion rule only applies to sales of depreciable property. § 1239(a) does not apply to the sale of property which is nondepreciable in the hands of the transferee.

B. Installment Reporting.

1. Pursuing the elusive capital gain tax rate also requires consideration of the installment sale rules because it is unlikely that the related purchaser will pay cash for the property. In this regard, § 453(e)(1) and (2)'s "second disposition rule" requires income to be recognized from the installment sale of property to a related person, when there is a disposition of the property by the related purchaser within two years after the purchase. For these purposes, a related entity is determined under § 318(a) and § 267(b), *i.e.*, a 50% or more test.

2. Consideration should also be given to insuring that the transaction is characterized as a sale for tax purposes rather than a contribution. If the Service were successful in asserting contribution treatment, the related entity would receive a carryover basis rather than a cost basis for the property. The result of such a recharacterization would be that all of the profit would be taxed as ordinary income, including the pre-development appreciation.

C. Debt-Equity Issues.

1. *Bradshaw v. United States*, 683 F.2d 365 (Ct. Cl. 1982), involved the sale of undeveloped land to a newly formed corporation. The purchaser issued its installment notes with maturities ranging from two to six years. The sellers were entitled to capital gains treatment rather than ordinary income. Similarly, in *Bramlett v. Commissioner of Internal Revenue*, 960 F.2d 526 (5th Cir. 1992), *reh'g denied*, 969 F.2d 1046 (1992), a partnership sold property in exchange for installment notes to a corporation owned in the same proportions by the same persons. No payments were made on the installment notes until the property was sold. The seller was nonetheless entitled to capital gain treatment. The corporation was not a mere agent for the partnership, it was not disregarded as a sham, and the partnership held the land for investment. *See, also, Charles B. Curry,* 43 T.C. 667 (1965); *Gyro Engineering Corp.*, 417 F.2d 437 (9th Cir. 1969), and *Rudolph A. Hardman v. United States*, 827 F.2d 1409 (9th Cir. 1987).

2. On the other hand, the Service has been successful in certain situations asserting that the installment note received by the seller represents equity rather than debt for tax purposes. This has occurred when it was extremely unlikely that the note would ever be paid because of the excessive purchase price. *See*, for example, *Burr Oaks Corp.*, 43 T.C. 635 (1965), *aff'd*, 365 F.2d 24 (7th Cir. 1966); *Aqualane Shores, Inc. v. Commissioner of Internal Revenue*, 269 F.2d 116 (5th Cir. 1959); and *Foresun, Inc. v. Commissioner of Internal Revenue*, 348 F.2d 1006 (6th Cir. 1965).

CHAPTER 12
PARTNERSHIP DISTRIBUTIONS

I. FACTS.

Tom is a 25% member in Rivet, LLC. The adjusted basis for his LLC interest is $65,000. Rivet distributes inventory #1, Asset X, and Asset Y to Tom in complete liquidation of his LLC interest. Rivet's November 30, 1998 balance sheet is as follows:

Assets	A.B.	F.M.V.
Inventory #1	$10,000.	$ 20,000.
Inventory #2	$60,000.	$ 60,000.
Asset X	5,000.	$ 40,000.
Asset Y	$10,000.	$ 10,000.
Asset Z	$185,000.	$150,000.
	$260,000.	$280,000.
Capital Assets		
Tom	$ 65,000.	$ 70,000
Liz	130,000.	140,000.
Harry	65,000.	70,000.

II. ISSUE.

What is the basis of the distributed assets?

III. SOLUTION.

A. New § 732(c).

Inventory #1 (basis to LLC)		$10,000.
Asset X		$44,000.
Basis to LLC	$5,000.	
Unrealized appreciation	35,000.	
Excess (40/50 x $50)	4,000.	
Asset Y		$11,000.
Basis to LLC	$10,000.	
Unrealized appreciation	0.	
Excess (10/50 x 50)	1,000.	.
		$65,000.

B. Old § 732(c).

Inventory	$10,000.
Asset X (5/15 x 55)	18,333.
Asset Y (10/15 x 55)	$36,666.
	$65,000.

IV. DISCUSSION--PROP. REG. § 1.732-2.

A. Allocation of Basis Among Properties Distributed to a Partner.

1. General Rule. Unrealized Receivables and Inventory Items. The basis to be allocated to properties distributed to a partner under §§ 732(a)(2) or (b) is allocated first to any unrealized receivables (as defined in § 751(c)) and inventory items (as defined in § 751(d)(2)) in an amount equal to the adjusted basis of each such property to the partnership immediately before the distribution. If the basis to be allocated is less than the sum of the adjusted bases to the partnership of the distributed unrealized receivables and inventory items, the adjusted basis of the distributed property must be decreased. *See* IV.B, below.

2. Other Distributed Property.

   a. Any basis not allocated to unrealized receivables or inventory items is allocated to any other property distributed to the partner in the same transaction by assigning to each distributed property an amount equal to the adjusted basis of the property to the partnership immediately before the distribution.

   b. However, if the sum of the adjusted bases to the partnership of such other distributed property does not equal the basis to be allocated among the distributed property, any increase or decrease required to make the amount equal is allocated among the distributed property.

B. Adjustment To Basis Allocation.

1. Decrease in Basis.

   a. Any decrease to the basis of distributed property is allocated first to distributed property with unrealized depreciation in proportion to each property's respective amount of unrealized depreciation before any decrease (but only to the extent of each property's unrealized depreciation).

   b. If the required decrease exceeds the amount of unrealized depreciation in the distributed property, the excess is allocated to the distributed property in proportion to the adjusted bases of the distributed property.

2. Increase in Basis.

a. Any increase to the basis of distributed property is allocated first to distributed property (other than unrealized receivables and inventory items) with unrealized appreciation in proportion to each property's respective amount of unrealized appreciation before any increase (but only to the extent of each property's unrealized appreciation).

b. If the required increase exceeds the amount of unrealized appreciation in the distributed property, the excess is allocated to the distributed property (other than unrealized receivables or inventory items) in proportion to the fair market value of the distributed property.

3. Unrealized Receivables and Inventory Items. If the basis to be allocated upon a distribution in liquidation of the partner's entire interest in the partnership is greater than the adjusted basis to the partnership of the unrealized receivables and inventory items distributed to the partner, and if there is no other property distributed to which the excess can be allocated, the distributee partner sustains a capital loss under § 731(a)(2) to the extent of the unallocated basis of the partnership interest.

CHAPTER 13

§ 1.751-1--UNREALIZED RECEIVABLES AND INVENTORY ITEMS

I. FACTS.

		ASSETS	
		Adjusted Basis	Market Value
Cash		$3,000.	$3,000.
Loans receivable		10,000.	10,000.
Capital assets		7,000.	5,000.
Unrealized receivables		0.	14,000.
	Total	$20,000.	$32,000.

		LIABILITIES AND CAPITAL	
		Adjusted Per Book	Market Value
Liabilities		$2,000.	$2,000.
Capital:	A	9,000.	15,000.
	B	9,000.	15,000.
	Total	$20,000.	$32,000.

II. ISSUES.

What is the character of the gain realized by B?

III. SOLUTIONS:

A and B are equal partners in personal service partnership PRS. B transfers its interest in PRS to T for $15,000 when PRS's balance sheet (reflecting a cash receipts and disbursement method of accounting) is as follows:

A. The total amount realized by B is $16,000, consisting of the cash received, $15,000, plus $1,000, B's share of the partnership liabilities assumed by T. *See* § 752. B's undivided half-interest in the partnership property includes a half interest in the partnership's unrealized receivable items. B's basis for its partnership interest is $10,000 ($9,000, plus $1,000, B's share of partnership liabilities). If § 751(a) did not apply to the sale, B would recognize $6,000 of capital gain from the sale of the interest in PRS. However, § 751(a) does apply to the sale.

B. If PRS sold all of its § 751 property in a fully taxable transaction immediately prior to the transfer of B's partnership interest to T, B would have been allocated $7,000 of ordinary income from the sale of PRS's unrealized receivables. Therefore, B will recognize $7,000 of ordinary income with respect to the unrealized receivables. The difference between the amount of capital gain or loss that the partner would realize in the absence of § 751

($6,000) and the amount of ordinary income or loss determined is the transferor's capital gain or loss on the sale of its partnership interest. In this case, B will recognize a $1,000 capital loss.

IV. DISCUSSION.

A. Determination of Gain or Loss.

1. The income or loss realized by a partner upon the sale or exchange of its interest in § 751 property is the amount of income or loss from § 751 property (including any remedial allocation under § 1.704-3(d)) that would have been allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction immediately prior to the partner's transfer of the interest in the partnership. The difference between the amount of capital gain or loss that the partner would receive absent § 751, and the amount of ordinary income or loss determined, is the transferor's capital gain or loss on the sale of its partnership interest.

2. Statement Required. A partner selling or exchanging any part of an interest in a partnership that has any § 751 property at the time of sale or exchange must submit with its income tax return for the taxable year in which the sale or exchange occurs a statement setting forth separately the following information:

   a. The date of the sale or exchange;

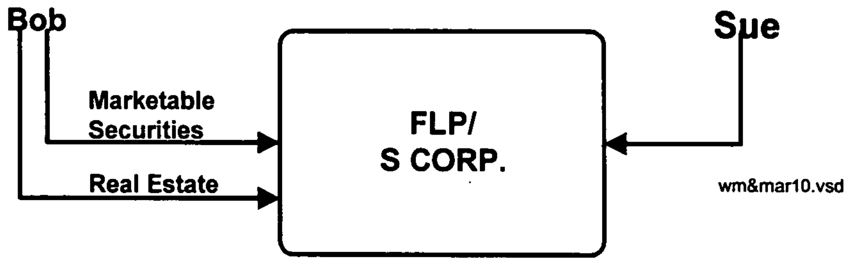
   b. The amount of any gain or loss attributable to the § 751 property; and

   c. The amount of any gain or loss attributable to capital gain or loss on the sale of the partnership interest.

CHAPTER 14

FORMATION OF INVESTMENT COMPANIES

I. FACTS.



Assets	AB	FMV
Real estate	$100,000.	$500,000.
Marketable securities	1,000,000.	2,000,000.
Cash	500,000.	500,000.
	$1,600,000.	$3,000,000.

II. ISSUES:

Will Bob recognize gain on the transaction?

III. DISCUSSION:

§§ 721(b)/351(e); Reg. § 1.351-1(c); Reg. § 368(a)(2)(F)(ii).

1. Transferor is (a) a regulated investment company, (b) a real estate investment trust; or (c) a corporation/partnership ***more than*** 80% of the value of whose assets are marketable securities.

2. A transfer results in diversification if two or more persons transfer nonincidental assets to the corporation.

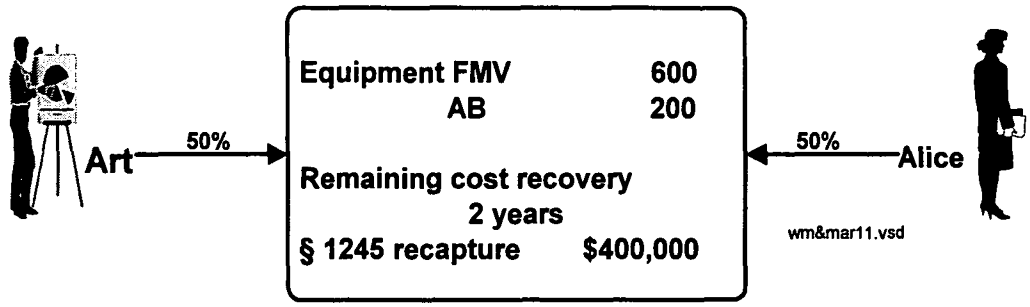
3. Money, futures, contracts, foreign currency, options evidence of indebtedness, and precious metals are treated as stock or securities.

4. No diversification occurs if not more than 25% of the assets are in one issuer and not more than 50% of the assets are in five or fewer issuers.

CHAPTER 15

ADMISSION OF NEW OWNER

I. FACTS:



On January 1, 1999, Dan will become a 50% partner/member/shareholder. Dan will either purchase a 50% interest from Art and Alice for a $300,000 note, payable over five years, or contribute a $600,000 note to the entity payable over five years. The entity has $50,000 net annual income exclusive of depreciation.

II. ISSUES:

What are the tax consequences of each alternative?

III. DISCUSSION:

§ 704; Reg. § 1.704-3.

1. Traditional Method.

	Art/Alice Book	Art/Alice Tax	Dan Book	Dan Tax	Partnership Book	Partnership Tax
	600.	200.	600.	600.	1,200.	800.
MACRS	<150.>	---.	<150.>	<100.>	<300.>	<100.>
Income	25.	25.	25.	25.	50.	50.
Year 1	475.	225.	475.	525.	350.	150.
MACRS	<150.>	---.	<150.>	<100.>	<300.>	<100.>
Income	25.	25.	25.	25.	50.	50.
Year 2	350.	250.	350.	450.	700.	700.

2. Traditional Method With Curative Allocations.

	Art/Alice Book	Art/Alice Tax	Dan Book	Dan Tax	Partnership Book	Partnership Tax
	600.	200.	600.	600.	1,200.	800.
MACRS	<150.>	---.	<150.>	<100.>	<300.>	<100.>
Income	25.	50.	25.	---.	50.	50.
Year 1	475.	250.	475.	500.	350.	150.
MACRS	<150.>	---.	<150.>	<100.>	<300.>	<100.>
Income	25.	50.	25.	---.	50.	50.
Year 2	350.	300.	350.	400.	700.	700.

a. Note: Curative allocations cannot completely eliminate book/tax disparity for Art unless there is sufficient partnership income. The curative allocations cannot create income.

3. Remedial Allocations.

	Art/Alice Book	Art/Alice Tax	Dan Book	Dan Tax	Partnership Book	Partnership Tax
	600.	200.	600.	600.	1,200.	800.
MACRS	<50.>	<50.>	<50.>	<180.>	<100.>	
Remedial	<40.>	<10.>	<40.>	<40.>		
Income	25.	25.	25.	25.	50.	50.
Year 1	535.	215.	535.	535.	470.	150.
MACRS	<50.>		<50.>	<50.>	<180.>	<100.>
Remedial	<40.>	<10.>	<40.>	<40.>		
Income	25.	25.	25.	25.	50.	50.
Year 2	470.	230.	470.	470.	340.	100.
Remedial	<40.>	40.	<40.>	<40.>	<80.>.	
Income	25.	25.	25.	25.	50.	50.
Year 3	455.	295.	455.	455.	310.	150.
Remedial	<40.>	40.	<40.>	<40.>	<80.>	---.
Income	25.	25.	25.	25.	50.	50.
Year 4	440.	360.	440.	440.	280.	200.
Remedial	<40.>	40.	<40.>	<40.>	<80.>	
Income	25.	25.	25.	25.	50.	50.
Year 5	425.	425.	425.	425.	850.	850.

a. Note: $200 \div 2 = 100$ MACRS per year.
$400 \div 5 =$ 80 remedial per year.