1993

Tax Issues Affecting Individuals

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I. OBRA 1993

I. Individual Tax Rates

The new tax law effectively added two tax brackets of 36% and 39.6% to the existing tax brackets of 15%, 28%, and 31%. These new rates are retroactively effective to January 1, 1993. Long-term capital gains remain taxed at a maximum statutory rate of 28%. I.R.C. §1.

A. New Brackets:

The 36% bracket applies to taxable income in excess of the following amounts:

$115,000	Single
$127,500	Head of Household
$140,000	Married Filing Jointly
$70,000	Married Filing Separately
$5,500	Estates and Trusts

A surtax, equal to an additional 10% of the 36% tax bracket is imposed on taxable income over certain amounts. The effect is a 39.6% marginal tax bracket on the following:

$250,000	Single, Head of Household, or Married Filing Jointly
$125,000	Married Filing Separately
$7,500	Estates and Trusts

The 36% bracket and the surtax will be indexed for inflation for years beginning after December 31, 1994.

B. Effect of Phase-out of Personal Exemptions

Taxpayers subject to the surtax will experience a marginal rate of at least 39.6%. The phase-out of personal exemptions increases this top marginal rate. Currently, the exemption amounts ($2,350 for each individual, spouse and dependent) are reduced 2% for each $2,500 of adjusted gross income over designated threshold amounts. The phase-law. I.R.C. §151(d)(3)(E). To the extent the phase-out still applies to incomes above the surtax amount, a taxpayer's marginal tax rate will increase. For instance, the phase-out effectively increases the top tax rate by approximately 2/3 to 3/4 of a percentage point for each exemption claimed.

C. Effect of Scale-back of Itemized Deductions

Taxpayers subject to the surtax will experience a marginal rate of at least 39.6%. The scale-back of itemized deductions increase this top marginal rate. The new law makes permanent the itemized deduction limitation. I.R.C. §68(f). Most itemized deductions are reduced by 3% of adjusted gross income in excess of certain thresholds. This reduction cannot exceed 80% of these itemized deductions. As a result of this scale-back, taxpayers in the 39.6% marginal bracket face an additional 1.2% tax to the extent the scaleback of itemized deductions still applies when taxable income is above the surtax level.

D. Observation

As a result of the phase-out of personal exemptions and the scaleback of itemized deductions, high income taxpayers will face a marginal rate in excess of 39.6% For example, a taxpayer with four exemptions would face a marginal income tax rate of 43.76%.

E. Planning Opportunities

Higher individual income tax rates enhance traditional planning opportunities which encourage taxpayers to defer income, invest for long-term capital gains, and seek out tax-exempt investments. High income individuals may again consider shifting income to children or parents where they are taxable at lower rates. Incorporating incentive stock options (ISO's) within compensation packages to generate capital appreciation should reappear as a planning tool.

F. Three Year Deferral on Increased Tax Resulting From Rate Increase for 1993

Individuals are provided an election to pay in installments that portion of their 1993 taxes resulting from the retroactive rate increases over a three year period. The payment dates are April 15, 1994, 1995, 1996. No interest or penalties will be applied to these payments.

The deferral over the three year period does not apply to AMT taxpayers even for that portion of tax attributable to increased AMT rates. Apparently this is true because the relief provided only applies to increased regular taxes, not to others such as AMT which is considered a penalty. OBRA, §13201(d) (1993).

Should a taxpayer qualify for relief under the three year deferral provision, significant savings could result. Essentially, the taxpayer would have full use of the deferral amount pro-rated over three years.

II. Individual Estimated Tax Payments

A. Current Law

Individuals are subject to penalties for any underpayment of estimated tax. However, there is no penalty if they make timely estimated tax payments equal to: (1) 100% of the tax shown on the prior year's tax return; or (2) 90% of the tax shown on the current year's tax return. The 100% safe-harbor is not available to married taxpayers filing jointly if: (1) current year's AGI is $40,000 more than the prior year's; (2) current year adjusted gross income (AGI) exceeds $75,000; and (3) estimated tax payments were made in one of the three prior years. Payment of 90% of the current year's actual liability or annualized liability is still available as an option.

B. New Law Effective for Tax Years Beginning after 1993

In tax years beginning after 1993, only individuals or married couples with prior-year AGI of $150,000 or less may utilize the 100% of prior year's tax safe-harbor. Individuals or married couples with high income will, however, be permitted to base their estimated tax payments on 110% of their prior year's tax. The change is a significant simplification because the trigger for higher estimated tax payments is based solely on the prior year AGI (AGI in excess of $150,000) and does not rely on the current year's AGI in any way. I.R.C. §6654(d)(1)(C).

C. Observation

Due to the accuracy of projections required to avoid any overpayments and to meet the 90% safe harbor, the "cost" of overpaying should be considered. At prevailing money market rates, the loss of the use of funds to estimated payments is not that material.

III. Individual Alternative Minimum Tax

The new tax law replaces the flat 24% tax rate on individual AMT income in excess of an exemption of up to $40,000 on a joint return ($30,000 for a single individual).

The new law also increases the exemption amounts. These rates and increases are retroactively effective to January 1, 1993.

A. New AMT Rates

The rate is increased to 26% on AMT income up to $175,000 over the exemption amount (or $87,500 if married filing separately).

AMT income in excess of $175,000 over the exemption amount is now subject to a 28% rate. I.R.C. §55(b)(1).

B. New AMT Exemption Amounts I.R.C. §55(d)(1).

The new law increases the AMT exemption amounts to:

$33,750 -	Single or Head of Household
$45,000 -	Married Filing Jointly
$22,500 -	Married Filing Separately/Estates & Trusts

C. Phase-out of Exemption I.R.C. §55(d)(3).
The phase-out of the AMT exemption amount remains in effect. Thus, a greater amount for high income individuals will be subject to the AMT tax.

D. AMT Treatment of Appreciated Charitable Contribution Property

1. The new law eliminates the AMT income add-back for gifts of appreciated property. Effective June 30, 1992, for contributions of tangible personal property and December 31, 1992 for all other property, taxpayers no longer must treat appreciation in their gifts as an AMT preference item. I.R.C. §56(g)(4)(J).

2. Observation

Individuals no longer run the risk of increasing their exposure to the AMT by gifting appreciated property to charitable organizations. Since the new law applies to contributions of appreciated property made after June 30, 1992, taxpayers who made such contributions may want to amend their returns.

IV. Estate and Gift Considerations

A. Tax Rates for Estates and Trusts I.R.C. §1(e).

Effective January 1, 1993, the new law provides new tax rates for estates and trusts.

The following chart summarizes these changes.

Rates	Old Bracket	New Bracket
15%	$0 - $3,750	$0 - $1,500
28%	$3,750 - $11,250	$1,500 - $3,500
31%	over $11,250	$3,500 - $5,500
36%	-	$5,500 - $7,500
39.6%	-	over $7,500

B. Observation

For trusts, distributions of income should be considered where beneficiaries are subject to tax at lower rates.

V. Capital Gains Provisions

A. Provisions Preventing Ordinary Income Characterized as Capital Gains

While the ordinary income tax rates increased effective January 1, 1993, the maximum capital gain tax rate remains at 28%. As a result, it is more advantageous to have capital gain income. Consequently, Congress enacted additional provisions aimed at preventing the conversion of ordinary income to capital gains.

1. General Rule: Effective for transactions entered into after April 30, 1993, capital gain from any "conversion transaction" is recharacterized as ordinary income (but not interest income) to the extent that interest would have been accrued on the taxpayer's net investment in the position at a yield equal to 120% of the applicable federal rate. I.R.C. §1258

2. When is a Transaction Treated as a Conversion Transaction?

   A conversion transaction occurs when a taxpayer holds two or more positions with respect to the same or similar property, and substantially all of the return is attributable to the time value of the net investment in the transaction.

   A transaction will be treated as a conversion transaction if it:

   a. consists of the acquisition of property and there is a substantially contemporaneous agreement to sell the same or substantially identical property in the future;

   b. is a straddle;

c. was marketed or sold to the taxpayer on the basis that it would have the economic characteristics of a loan but the interest-like return would be treated as capital gain; or

d. is described as a conversion transaction in prospective IRS regulations.

3. Certain Transactions Excluded

Certain transactions of options dealers and commodity traders made in the ordinary course of their business are excluded from the definition of a conversion transaction.

4. Treatment of the Conversion Transaction

Once a transaction is deemed to be a conversion transaction, any gain must be bifurcated into its ordinary and capital elements. The resulting ordinary income is not considered interest or investment income and thus may not be offset by investment interest expense.

5. Other Provisions Intended to Prevent the Conversion from Ordinary Income into Capital Gain.

a. The law subjects certain market discount debt instruments purchased after April 30, 1993, to the market discount rules. Generally, these rules recharacterize gain to the extent of the accrued market discount as ordinary income. The new law extends this treatment to tax-exempt bonds and market discount bonds, including those issued prior to July 18, 1984. I.R.C. §1278.

b. Purchasers of stripped preferred stock (preferred stock where the rights to dividends have been separated from the underlying stock) are to be treated the same as purchasers of stripped bonds under the original issue discount rules. Such treatment results in ordinary income (not as a dividend or interest) to the holder rather than capital gain on redemption. Similarly, this provision is effective for purchases after April 30, 1993. I.R.C. §305(e).

c. A partner's "deemed" distribution attributable to substantially appreciated inventory, i.e. the fair market value exceeds 120% of the adjusted basis, will be treated as ordinary income and not capital gain. Prior law did not require this treatment if the substantially appreciated inventory portion of the distribution did not exceed 10% of the value of all partnership property. I.R.C. §751(d)(1).

6. Planning Opportunities

a. Any transaction resulting in capital gain treatment rather than ordinary income is subject to recharacterization. The new law grants the IRS extremely broad authority to recharacterize any reported capital gain to ordinary. For legitimate investments which are subject to market risk, the anti-conversion rules should not be a material concern.

b. An interesting planning opportunity arises in the context of selling a corporation. Prior to the new tax law, the purchaser in such a transaction allocated the purchase price to readily identifiable assets such as covenants not to compete or customer lists, rather than to goodwill. In such a case, while allocating income to a covenant resulted in ordinary income, because of the similarity between tax rates, the seller was often ambiguous as to the treatment.

Under the new tax law, I.R.C. §197 allows for a 15 year write-off for intangibles, both readily identifiable and not. As a result, the buyer will generally be indifferent in regard to allocation of purchase price. The new rate differential between capital and ordinary gain makes it more advantageous to allocate the purchase price to those assets producing capital gain. In arriving at a total purchase price, both parties should consider this potential tax savings.

B. Other Provisions Intended to Discourage Converting Ordinary Income into Capital Gains

1. Effective for tax years beginning after 1992, net capital gain cannot be treated as investment income for purposes of a provision in existing law that limits an individual's investment interest expense to the amount of investment income earned. Taxpayers electing to have net capital gains taxed at ordinary income rates may treat such income as investment income. I.R.C. §163(d)(4)(B).

2. Planning Opportunities

Taxpayer who have excess investment interest expense who incur capital gains may find the election to forego the lower capital gains treatment advantageous. This would enable them to deduct the additional investment interest expense currently. The analysis should be balanced with the ability to carryforward the excess investment interest expense.

VI. Small Business Investment Incentives

A. Targeted Capital gains Exclusion I.R.C. §1202.

The new law provides for a targeted capital gains exclusion for individuals who invest in certain qualified small businesses. Under the new law, individuals who invest in "qualified small businesses" and hold such stock for five years may exclude up to 50% of any gain when the stock is sold.

1. "Qualifying Small Business Stock" Defined

To qualify for the exclusion, stock must meet the following requirements:

a. The stock must be that of a C corporation;

b. The corporation must not have more than $50 million of gross assets during the holding period; and

c. Substantially all of these assets must be used in a trade or business.

In addition, only certain types of businesses qualify for the targeted capital gains exclusion. Generally, only manufacturing, retail, and wholesale businesses will qualify.

2. Other Requirements

Qualifying stock must be original issue, acquired directly or through an underwriter, and must be issued after the date of enactment. Moreover, gain eligible for the exclusion will be limited to the greater of 10 times the investor's stock basis in the stock or $10 million for each qualified small business.

Only investments by individuals, either directly or through certain pass-through entities, will qualify for the exclusion. The stockholder may receive such stock in exchange for cash, property (other than stock), or services. Stock will not qualify if the corporation purchases or redeems any of its stock from the investor during a four year period beginning two years prior to the issuance of such stock. Further, the redemption by the corporation of more than 5% of its stock within one year before or one year after the taxpayer's purchase will cause the stock not to qualify for the exclusion.

3. AMT Ramifications

Taxpayers must include one-half of the 50% exclusion as an AMT preference item. As a consequence, 75% of the gain on qualified small business stock will be included for AMT purposes. I.R.C. §57(a)(7).

B. Rollover of Gain Into Specialized Small Business Investment Companies

The new law permits a C corporation or individual selling publicly traded stock or securities to defer taxation on the capital gains if the proceeds are reinvested within 60 days in a specialized small business investment company (SSBIC). I.R.C. §1044.

1. Specialized Small Business Investment Company Defined

An SSBIC is an investment partnership or corporation which is licensed by the Small Business Administration. They are designed to provide a mix of private and SBA-guaranteed venture capital to minority-owned businesses.

2. Limitations on Amounts of Gain Eligible

An individual availing himself of this provision may only rollover the lower of: (1) $50,000 or (2) $500,000, less any gain previously excluded under this provision. For corporations, the limits are the lower of: (1) $250,000 or (2) $1,000,000 reduced by previous gain nonrecognition.

The tax break is not available to estates, trusts, S corporations and partnerships. Moreover, the provision prevents an investor from benefitting from both the targeted capital gains and rollover provisions in the same transaction.

C. Observation

As the incentives are to generate investment in start-up companies, the inherent uncertainty of the venture must be factored into the investment. For planning purposes, the investment should also be structured to comply with the favorable I.R.C. §1244 requirements for ordinary loss treatment.

VII. Limits on Deductible Executive Compensation

A. General Rule

For purposes of both the regular tax and AMT, a publicly held corporation will not be able to deduct compensation paid to a covered employee to the extent the compensation exceeds $1 million per tax year. New Sect. 162(m), OBRA Act Sect. 13212. This provision is effective for tax years beginning after December 31, 1993.

1. Covered employee.

A covered employee is any employee if:

- as of the close of the tax year, the employee is the CEO of the corporation (or acts in that capacity), or

- the total compensation of the employee for the tax year is required to be reported to shareholders under SEC rules because the employee is among the four highest compensated officers for the that tax year (other than the CEO).

2. Compensation subject to the limitation.

Applicable employee compensation includes any cash and noncash benefits paid for services other than:

- income from specified employee trusts, annuity plans, or pensions;

- any benefit that is reasonably anticipated to be tax free under the Code;

- specified commissions;

  - compensation based on performance goals; and

- income payable under a written binding contract which was in effect on February 17, 1993.

3. Performance Exception

In addition, the rules do not apply to compensation based on the attainment of performance goals if:

- the performance goals are established by a compensation committee of the board of directors which is comprised solely of two or more outside directors;

- the material terms of the compensation, including the performance goals, are disclosed to shareholders and approved by majority in a separate shareholder vote before the compensation is paid; and

- before the compensation is paid, the compensation committee certifies that the performance goals and other material terms were satisfied.

Compensation (other than stock options or other stock appreciation rights) is not treated as paid solely on account of the attainment of one or more performance goals unless the compensation is paid to the particular executive pursuant to a pre-established objective performance formula or standard that precludes discretion. This means that a third-party familiar with the relevant performance results could calculate the amount paid to the executive.

a. Outside director

a director is considered an outside director if he or she:

- is not an employee of the corporation or related entities;

- is not a former employee still receiving compensation for prior services (other than benefits under a tax-qualified pension plan);

- was not an officer of the corporation or related entities at any time; and

- is not currently receiving remuneration from the corporation in any capacity other than as director (for example, as a consultant).

b. Shareholder approval

Shareholder approval occurs if the compensation arrangement is approved by a majority of shareholders in a separate vote after the material terms of the compensation are disclosed.

In the case of performance-based compensation other than stock options, the shareholder approval requirement generally is satisfied if the shareholders approve the specific terms of the compensation plan, as well class of executives to which it applies. In the case of stock options, the shareholders generally must approve the specific terms of the option plan, the class of executives to which it applies, the option price or formula for setting the price, and the maximum number of shares subject to the option that can be awarded under the plan to any executive.

c. Stock options and other rights

Stock options and similar rights generally qualify for exemption, provided the outside director and shareholder approval requirements are met.

Grants of restricted stock do not qualify for the exception, because the employee has received compensation regardless of the relative value of the stock, unless the grant or vesting of the stock is based on a performance-based compensation under this provision.

d. Binding contract exception

These rules do not apply for compensation payable under a written binding contract that was in effect in February 17, 1993, and was not modified thereafter in any material respect before the renumeration is paid.

VIII. Health Insurance Wage Base Cap

A. General Provisions

For the 1993 tax year the cap on wages or self-employment income on the

Medicare portion of the FICA tax remains at $135,000. The rate to be applied against the cap also remains at 1.45% in the case of wages and 2.9% for self-employment income.

Effective in 1994, the new law removes the cap on wages subject to the Medicare tax. As a consequence, all wages will be subject to the 1.45% tax, and all self-employment income will be subject to the 2.9% tax. I.R.C. §3121.

B. Observation

The repeal of the health insurance wage cap, when added to the other provisions affecting high income taxpayers, raises the top marginal rate to over 42% for wage earners or 43.1% for self-employed individuals.

C. Planning Considerations

1. Taxpayers should consider accelerating income into tax year 1993. The overall tax liability should be analyzed in conjunction with this opportunity.

2. In the case of a sole shareholder of an S corporation, the taxpayer should consider paying a reasonable salary and taking distributions which are not subject to FICA rather than all compensation. In so doing, the taxpayer and the corporation would avoid paying FICA tax on the distribution.

D. Effect on Deferred Compensation

Section 3121(v)(2) says deferred compensation is subject to FICA tax at the later of which services are performed or when property is subject to a substantial risk of forfeiture. therefore, deferred compensation is subject to the new rule, presenting a problem in that large deferrals will produce situations where substantial Medicare taxes are due before the employee has received value.

1. What is Deferred Compensation?

The IRS has not defined the term deferred compensation. It is possible that when regulations are released it will be defined in the more classic sense, i.e. fixed cash deferrals (either elective or nonelective). Thus variable plans and SERPs and the like would not be considered deferred comp. This means that the elimination of the medicare surtax cap would require classic deferred comp. plans to be subject to FICA now (when earned) rather than later (when paid).

The other types of plans might possibly be subject to FICA as paid. however, it is highly possible that the IRS will even say that variable plans are subject to the tax up front, even though measurement is difficult.

2. Time-Value Adjusted Plans

Deferred compensation plans frequently defer a fixed amount, which when paid later is adjusted for "interest" that accrued while the employer held the funds. This is not treated as interest under IRS rules but as additional wages. However, it appears that this "interest" will not be subject to FICA on a yearly basis due to an exception in Sec. 3121(v)(2)(B).

3. Bonuses Declared in the Year After When Services are Performed.

It is common for employers to declare bonuses to employees in January based upon the prior year's profitability. It appears that these bonuses, if not decided until that next year, would not be treated as FICA wages for the year that the bonuses apply. Rather, they would be considered wages in the year declared and paid.

(a) a one year planning opportunity may be to accelerate the declaration of bonuses into 1993, thus turning it into deferred compensation and taking advantage of the alw change's 1/1/94 effective date.

IX. Miscellaneous Provisions

A. Club Dues

1. General

The new law prohibits deductions for all club dues. The prohibition applies to amounts that are paid or incurred after 1993. The provision extends to all types of clubs, including business, social, athletic, luncheon, airline, hotel and sporting clubs.

2. Planning Opportunities

Since this provision applies to amounts paid or incurred after 1993, prepaying dues during calendar year 1993 may result in tax savings.

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II. GIFTING COMPENSATORY STOCK OPTIONS

I. General

The fundamental objective of a effective lifetime estate plan is the shifting of potential asset appreciation out of an individual's estate. When designing a gifting program to meet this objective, the ideal assets to use are those that have a low current value but high potential appreciation. Compensatory stock options held by an executive are often the perfect candidate for this mission. Options have the unique attribute of allowing the executive to participate in corporate appreciation without an up-front cash outlay. thus, they generally have a relatively low value as a percentage of appreciation potential - much more so than the underlying stock itself.

A. Use of a Trust

Under this planning technique, potentially appreciating stock options are transferred to an irrevocable trust set up by an executive for the benefit of his or her children or other beneficiaries. Later, when the options are in-the-money, the trustee either exercises the options and sells the stock or distributes the options to the beneficiaries for them to exercise and sell.

1. Benefits

- It removes a potentially appreciating asset from the executive's estate at a relatively low gift tax cost (or at no current cost through the use of annual exclusions or unified credit). Thus, any stock appreciation is shifted to the executive's heirs and will escape the 55 percent federal estate tax levy as well as most state inheritance taxes.

- When the option is later exercised by the trust, the executive will be taxed on the sale as if they had never transferred the stock to trust. While the trust becomes the legal and beneficial owner of the options, the executive continues to bear the tax burden up to the point of exercise. Therefore, the executive's Form W-2 will report compensation in the year that the trust (or the beneficiary) exercises the option. As a consequence of this tax, the stock's basis is stepped up in the hand's of the trust to the exercise date value. See Reg. Sections 1.83-4(b) and 1.83-1(c).

- When the stock is later sold, the trust will only pay tax on the excess of the selling price over the exercise date value. Because the sale will often take place on or near the date of exercise, the holder will pay little or no additional tax. As a result, the executive's estate is further diminished by the taxes he or she pays while the heirs enjoy the benefit of that tax in the form of the increased stock basis that reduces the gain on their stock sale -this can be viewed as an additional gift from the executive that is exempt from gift tax.

2. Example: Bob is granted 50,000 options to acquire his employer's stock at $30. Five years later, he exercise the options, sells the stock at $60 and gifts the proceeds to his children. After paying income and gift taxes, only $81,000 will be available to Bob's heirs, assuming an income tax rate of 40% and an estate tax rate of 55%.

   On the other hand, if Bob transferred the options to an irrevocable trust on day one when the options were deemed to have a value of $10 each, and the trust exercised the options and sold the stock in year five, $631,000 would be available to Bob's heirs using the same income and estate tax rates, an increase of $550,000 over the non-trust approach.

   If it is assumed that the executive would not otherwise have made gifted the proceeds in year five and instead would have retained the proceeds until death 25 years later, the benefits of the trust technique are even more dramatic. Using a trust earnings rate of 10%, nearly $10 million would be in the trust at year 25, while roughly $3 million would be available after tax had the trust not been used.

3. Issues

   a. Option Transferability

      As stated above, this technique requires that the option be transferred to trust. Because most options granted in a compensatory environment do not provide for such transferability, action must be taken to amend the stock options to provide for such a limited transfer, e.g. the options will provide that they may be transferred to an irrevocable trust established by an executive for the benefit of a family member.

   b. SEC Issues

      Option non-transferability is required to avoid the short-swing profit rules under SEC Section 16(b). while SEC rules allow limited transferability, exemption from the short-swing rules is lost. As a result, the executive must avoid trading in the stock for 12 months.

c. Option Valuation

This technique's value is a product of the fact that the initial transfer to trust is a completed gift for gift tax purposes. Thus, any gift tax is imposed on the value of the option on day one rather than the value of the stock or its proceeds upon their transfer in the future. As a result, the value of the option is important to determine the economic effects of this transaction. While their is little precedent to value these options, consideration of their limited marketability and transferability should allow substantial discounts from the underlying stock's value.

III. HOME OFFICE DEDUCTION AFTER *SOLIMAN*

I. Background of *Soliman*

On January 12, 1993, the Supreme Court of the United States ruled on the standard of home office expense deductibility in *Commissioner v. Soliman*, ___ U.S.___, 113 S.Ct. 701, 121 L.Ed. 2d. 634 (1993). In holding against the taxpayer, the Court redefined the standard as to when a home office will qualify as the "principal place of business" under §280A(c)(1).

A. LAW: I.R.C. §280A(c)(1) allows a home office deduction where a portion of the dwelling unit is exclusively used on a regular basis -

(A) [as] the principal place of business for any trade or business of the taxpayer,

(B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or

(C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.

In the case of an employee, the preceding sentence shall apply only if the exclusive use referred to in the preceding sentence is for the convenience of his employer.

B. FACTS: At issue in *Soliman*, was the interpretation of subparagraph (A), "principal place of business". Dr. Soliman was anesthesiologist who worked at three hospitals; however, he maintained an office at home solely to perform normal business recordkeeping and administration. Approximately 30 to 35 hours per week were spent at the hospitals, while 10 to 15 hours represented the time at the home office.

C. ISSUE: Did the home office qualify as the taxpayer's "principal place of business?"

D. HOLDING: The home office was not the "principal place of business" and accordingly, no deduction was available. The standard applied by the Court reversed the current trend of a more lax approach developed by the Circuit Courts of Appeal and finally adopted by the Tax Court in *Soliman*.

E. NEW STANDARD: In determining whether a home office is the "principal place of business", the Court concluded the following:

1. The determination is a comparative analysis of the business involved

at each location. No "bright-line" rule is applicable.

2. Two primary considerations should be analyzed:

   a. The relative importance of the activities performed at each location is respect to the trade or business as a whole.

      1) Relevant factors:
         a) Location where client contact occurred.
         b) Point where goods or services are actually provided.
            -if a unique facility is required, this becomes even more relevant.

      2) Less relevant factors:
         a) The "necessity" of the work performed does not equate to "importance".
         b) The lack of "availability" of office space other than the home office.

   b. The actual time spent at each location.

      1) This consideration will be highly relevant where the relative importance prong is not conclusive; i.e., where various locations generate income.

      2) This new standard may even result in a finding that NO location qualifies as a "principal place of business".

F. ANALYSIS: In holding that the taxpayer's location of most importance was the hospitals, the Court emphasized that the actual treatment was the "essence" of the professional service. Further, the comparative amount of time spent at each location supported the conclusion that the home office was not the "principal place of business".

II. *Post-Soliman* interpretations and considerations.

A. The Internal Revenue responded to *Soliman* by issuing Notice 93-12 which discussed the following:

   1. The Service will not challenge a home office deduction claimed in 1991 and prior which reasonably relied upon the proposed regulations under §280A.

2. A waiver of any estimated tax penalty attributable to the reliance of a home office deduction for 1992 which would have been reasonably available based on the same proposed regulations.

3. Three interpretive examples were presented.
   a. A fact pattern based upon the *Soliman* decision.
   b. An outside salesman who made all sales at the customer's location, while performing all the administrative work at home, did not qualify for the home office deduction.
   c. Under similar facts as b., a home office deduction was allowed where the sales were made via phone or mail.

B. Questions left open under the new standard of *Soliman*.

1. Where the "time spent" prong determination is inconsistent with the "relative importance" analysis, which prong is controlling? The Court appears to consider the time factor as relevant only where the importance determination is inconclusive.

2. The standard fails to provide the certainty which was the apparent intent of Congress when §280A was passed. See *H.R. Rep. No. 658, 94th Cong., 1st Sess.*, 157, 160 (1975).

C. Potential planning opportunities under *Soliman*.

1. The other alternatives under §280A(c)(1) for claiming a home office deduction remain available:
   (B) place to meet or deal with clients in the normal course of business.
   (C) separate structure.

2. A review of existing business functions to determine where income generation occurs, which is apparently the material factor under the "importance" prong, should be conducted.

   a. Controlling the location of income production to occur from the home office seems critical. The nature of a business must be understood and the functions changed, if possible, to tie revenue to the work performed out of the home office. With family enterprises, the work can be properly allocated to secure the home office as the principal place of business for one of the individuals. For example, the wife who works as the bookkeeper out of the home office should qualify based on her location of importance.

b. Additionally, time tracking should also be incorporated into the normal business routine to enhance the position in claiming a home office to be the "principal place of business".

D. CONCLUSION: With the Supreme Court announcing a stricter standard, the claiming of a home office deduction has clearly been limited. Although planning can avoid the harshness of the "importance" prong via income sourcing control, individuals must strike a balance between the effort expended to qualify for the deduction and the actual benefit of a home office deduction which is often not material. A possible consideration involves filing amended returns which are inconsistent with the *Soliman* standard. However, a challenge by the Service on the deduction should not lead to any penalties for reliance on the Tax Court holding is substantial authority.

III. Bibliography

A. *Commissioner v. Soliman*, ___ U.S.____, 113 S.Ct. 701, 121 L.Ed.2d 634 (1993)

B. Fiore, *Determination of "Principal" Place of Business Requires Comparison of Locations; Sup. Ct. Reverses 4th Cir.*, TAX ADVISER, Mar. 1993, at 199.

C. Knight and Knight, *Supreme Court Develops New Test for Home Office Deduction*, TAX ADVISER, July 1993, at 414.

D. Note, *Soliman Leaves Uncertainty in the Area of Home Office Deductions: Suggested Guidelines*, 46 TAX LAWYER No. 4 at 947 (1993).

E. I.R.S. Notice 93-12, 1993-8 I.R.B. 46.

IV. MISCELLANEOUS TAX DEVELOPMENTS

I. Trust expense deductibility standard

In *O'Neill v. Commissioner*, 994 F.2d 302 (6th Cir. 1993), the court reviewed the deductibility standard for investment fees incurred by a trust to determine the applicability of the 2% of adjusted gross income limitation.

A. LAW: Under §67(e), expenses incurred in connection with the administration of an estate or trust which would not have been incurred if the property were not held in estate or trust shall be treated as a deduction in arriving at adjustable gross income.

B. ISSUE: What are the parameters to be considered in determining when a cost would not have been incurred if property was not held in trust? Must the expense be unique to trust administration?

C. CONCLUSION: Under *O'Neill*, investment fees incurred to comply with the state law standard of fiduciary duty were held deductible without the 2% limitation.

D. ANALYSIS: The following factors were relied upon by the court in concluding the need for the expense by the trust, which would not have been necessarily incurred if held by an individual.

1. State law imposed a fiduciary standard on a trustee to act as a "prudent investor". Factually, the trustees established their inability to properly invest the trust funds.

2. Although individuals often incur investing fees for advice, the fiduciary duty on the trustee creates a unique situation. Poor investment performance does not create an actionable cause by an individual against oneself; however, a trustee can be held liable for negligence. This liability justifies the incurring of the investment fees as a type of expense which "would not have been incurred if the property were not held in trust."

3. Although a state statute provided for "pre-approved" forms of investments, the trustee remained under a duty to diversify. By simply investing pursuant to the statutory quidelines, the trustee's performance would not equate to the standard of a "prudent investor".

C. PLANNING CONSIDERATION: This holding provides a potential opportunity to allow deductions otherwise limited by 2% of adjusted gross income:

1. By placing assets into trust, a fiduciary duty is created. Accordingly, a taxpayer can take a position that such fees are allowable without limitation under facts similar to *O'Neill.*

2. The applicable state law should be reviewed. Where a trustee has limited liability, the necessity and, therefore the uniqueness, of the costs is more questionable.

3. In dicta, the court stated that the fiduciary fees paid by a trust would not be subject to the 2% limitation.

4. Taxpayers should consider filing of amended returns in the wake of the *O'Neill* standard for deductions of investment and fiduciary fees without the 2% limitation.

II. Accelerated Life Insurance Benefits

An increasingly important topic relates to life insurance payable prior to death. In general, the need for funds to cover medical costs, etc increase dramatically with someone terminally ill. To provide for this need, insurance companies have initiated life insurance contracts with morbidity benefits, i.e. payable prior to death under certain circumstances. An additional consideration recently addressed by the Service deals with the taxability of such policy payouts.

A. LAW: The Service has issued proposed regulations under §7702, which defines a life insurance contract for tax purposes. The preamble to the proposed regulations, §§1.7702-2 and 1.7702-2A set forth the purpose as follows:

1. To provide insurers with the standards necessary to properly promote policies with both the standard death benefit and the morbidity benefit which do not create taxable events upon the covered event.

2. To generally allow that benefits received within twelve months of the expected death of the recipient to be non-taxable.

3. To provide transition rules for insurance contracts in effect prior to the proposed regulations which prevent adverse federal tax consequences.

B. ISSUE: The determination of the scope and application of the proposed regulations requires development which will occur over time.

C. OBSERVATION: The availability of this source of funds is an economic reality under current life expectancies. With the Service attempting to timely address the related tax implications, the taxability uncertainty will be removed.

III. Insuring Deferred Compensation Promises

A. General

The IRS has clarified its position regarding the purchase of insurance to protect promised benefits under an unfunded nonqualified plan. In the past, the IRS raised concerns that the purchase of insurance guaranteeing the payment of benefits under an unfunded nonqualified plan could cause the plan to be treated as funded for ERISA purposes and subject the employee to immediate taxation. In a recent private letter ruling, however, the IRS states that employees may purchase insurance to protect their benefits under a nonqualified plan without causing the plan to be treated as a funded plan and without causing current taxation to employees.

Under the ruling, employees must purchase the insurance policies, although the employer can reimburse the employees for the cost of the premiums. Because the employee has only the employer's unsecured promise to pay the deferred compensation benefits and the employee independently obtains the insurance policy, there is no transfer of property between the employee and employee that would cause current taxation. If the employer reimburses the employee for the cost of the insurance premiums, the employee would have to include those amounts as compensation.

Observation: This ruling takes on added importance with the new reduced $150,000 compensation limit under Sect. 401(a)(17) as added by the 1993 Budget Act. Because more executives will be running up against the compensation limit, more companies will probably be turning to nonqualified arrangements to supplement their executives' retirement pay. The ability to insure the payment of those benefits in case of the employer's bankruptcy or refusal to pay should help to increase the popularity of nonqualified plans.

Observation: The importance of this ruling ultimately hinges on the availability of insurance products designed to protect nonqualified deferred compensation payments and the cost of such products. With this private letter ruling, more insurance companies may begin offering policies that secure the payment of deferred compensation. However, premiums for such insurance products will probably be fairly high and the period of coverage relatively short. Since insurance companies will in effect be guaranteeing the solvency of the company, the cost of such insurance policies will obviously vary greatly depending on the stability and growth potential of the company.

IV. Stock Options and Section 83(b) Elections

A. General

In Cramer v. Commr., 101 T.C. No. 16 (1993), the Tax Court determined that the petitioners should recognize ordinary income, rather than long term capital gains, on the sale of their stock options despite the fact that they made a Sec. 83(b) election at the grant date. The options were subject to restrictions on transferability and vesting. Additionally, they were not traded on an established securities market. Because the options did not have a readily ascertainable fair market values when they were granted, the proceeds from the options were taxable as ordinary income at the time of disposition. Ancillary issues considered by the Court were whether penalties should be assessed for negligence and for substantial understatement of tax. The Tax Court held that both penalties applied, and that they could be assessed simultaneously.

The case involved a closely held corporation, IMED. In 1978, 1979 and 1981, IMED issued compensatory stock options to the petitioners. The options vested in increments of 20 percent over five years. The options were also subject to restrictions on transferability in that the options could only be transferred with board approval and could not require registration under the Securities Act of 1933.

With respect to the options issued in 1978 and 1979, Section 83 (b) elections were made to include the fair market value of the options income in the years the options were granted. The petitioners determined that the value to be zero.

In 1982, Warner-Lambert purchased all of the outstanding stock of IMED including the vested and non-vested options. The petitioners reported the proceeds from the sale of the options as capital gains. The IRS determined that the sale resulted in ordinary compensation income to the petitioners in 1982.

The Tax Court held that the options did not have a readily ascertainable value as required by Sec. 83 and thus were not "property" under the Code. The Sec. 83(b) elections, therefore, were not proper and the inclusion of the options as compensation income in the year they were granted was not appropriate treatment. The proceeds were taxable as ordinary (compensation) income at the time of disposition.

Observation: An option holder cannot make a Sec. 83(b) election unless the options have a readily ascertainable value at the time they are granted. For closely-held corporations, this will rarely, if ever, be the case, due to the uncertainly of valuing the corporation's underlying stock, the option and the option privilege. In Cramer v. Commr.

V. Bibliography

A. *O'Neill v. Commissioner*, 994 F.2d 302 (1993).

B. Note, *The Standard for Fully Deductible Trust Expenses Under Section 67(e): O'Neill Irrevocable Trust v. Commissioner*, 46 TAX LAWYER No. 2 at 655 (1992).

C. Prop. Treas. Reg. §§1.7702-0 to 1.7702-2A, 57 Fed. Reg. 59319-01 (Dec. 15, 1992).

V. FAMILY TRANSFERS: VALUATION CONSIDERATIONS

I. Potential of 100% Step-up In Jointly Held Spousal Property Upon the Death of a Joint Owner

According to a recently decided Sixth Circuit case, a taxpayer who inherits property held jointly with her spouse may obtain a 100% step-up in basis for the entire property in certain circumstances. *Gallenstein v. U.S.*, 975 F.2d 286 (1992).

A. LAW: TRA '76 amended §2040 to provide for a step-up in basis for 50% of jointly held spousal property upon death. §2040(b)(1). Prior to that the determination of step-up was based upon respective contributions by the joint tenants.

B. FACTS: At issue in *Gallenstein*, was the determination of which standard in §2040 to apply to determine the surviving spouse's basis in jointly held property. The taxpayer and her husband purchased real property in 1955. The entire purchase price of $38,500 derived from her husband's earnings. The property was held in joint tenancy with right of survivorship until death of the husband.

C. ISSUE: Does §2040 and its amendments operate to limit the step-up in basis by 50% to a surviving spouse who becomes the sole owner of jointly held property?

D. HOLDING: Section 2040 does not limit the step-up in basis to a surviving spouse who inherits jointly held property acquired prior to 1977. The court confines its interpretation of §2040 allowing for up to a 100% step-up in basis to a narrow set of circumstances:

1. a surviving spouse inherits property held in a spousal joint tenancy;
2. the joint tenancy must have been created prior to 1977; and
3. the deceased spouse must have died after 1981.

E. RATIONALE: The court held that Congress when amending §2040 did not supersede the standards applicable to property acquired prior to 1977 and that the contribution standard of determining basis still applies to spousal joint tenancy created prior to 1977. In this case, the husband contributed 100% of the cost of the property and therefore 100% of the value was properly included in his estate. Accordingly, the surviving spouse was entitled to a 100% step-up.

F. PLANNING OPPORTUNITIES: Based on *Gallenstein*, taxpayers considering disposing of jointly held property acquired prior to 1977 should do so only after applying *Gallenstein* to their situation.

Taxpayers who subsequently disposed of inherited property and calculated gain without considering *Gallenstein*'s impact may need to amend their returns.

II. Minority Discount Availability For Family Owned Corporations

According to the IRS, a taxpayer who simultaneously transfers all of the stock in a wholly owned corporation pro-ratably to each of his five children may take a minority discount when valuing the transfer. Rev. Rul. 93-12.

A. LAW: Taxpayers who gift or will less than a controlling interest in a corporation where only a single class of stock is outstanding are entitled to take a discount reflecting the lack of a controlling interest when valuing the transfer for gift tax purposes. In the past, the IRS has taken the position that if, via family aggregation, a controlling interest can be established, then no minority discount was allowed. Rev. Rul. 81-253.

B. ISSUE: May a donor, who transfers 100% of the shares of a wholly owned company equally to each of his five children, take a minority discount when valuing the gift.

C. HOLDING: The IRS held that in such a case, where only a single class of stock existed, the minority interests transferred to the five children should be valued without regard to family relationship of the parties. In so holding, the Service revoked the earlier Revenue Ruling requiring the taxpayer to aggregate percentage owned among all family members to determine if a controlling interest existed and therefore, whether a minority interest discount applies.

D. PLANNING OPPORTUNITIES:

1. Will the IRS limit this position to corporate stock?

   In a recent private letter ruling, the IRS addressed the issue based on similar facts in regard to a transfer of real property. PLR 9336002. The IRS held that in the case of a land transfer, the discount available with the dual interest in real property is limited to the cost of partitioning the property and not the full minority discount.

2. Will a minority discount be available to corporations with more than

one class of stock in the above context?

According to the Revenue Ruling, family voting independent of other factors, will not itself be a factor. However, the Ruling confines itself to those corporations having only a single class of stock.

3. In allowing a minority discount for transfers of stock in a family business, the Service has enhanced the value of the "family partnership" as a planning tool. A family partnership is created where a parent either gives or sells an interest in a partnership controlled by the parent. From a transfer tax perspective, the discounted value will limit any gift tax. Once established, the family partnership creates potential income shifting to the recipients of the interest subject to the confines of §704(e).

III. Bibliography

A. *Gallenstein v. U.S.,* 975 F.2d 286 (1992).

B. Bird, Platau, & Segel, *Determining How Much Joint Property Is in a Spouse's Estate,* Est. Planning May - June 1993 at 64.

C. Rev. Rul. 93-12, 1993-7 I.R.B. 13 (1993).

D. Priv. Ltr. Rul. 93-36-002 (Sept. 10, 1993).

E. Henkel, *How Family Limited Partnerships Can Protect Assets*, EST. PLANNING Jan. - Feb. 1993 at 3.

VI. CHARITABLE DEDUCTION PLANNING

I. Charitable Transfers

A. Both income and transfer tax savings

1. Sheltering Income
2. Fully deductible for transfer tax purposes

B. Major planning issues

1. Present uses of income tax deduction versus estate tax savings
2. Charitable contribution deduction carryover for income tax purposes will expire at death
3. Marital deduction/charitable deduction planning should be considered

II. Current Gifts

A. Cash - deductible up to 50% of donor's adjusted gross income (AGI).

B. Long-term capital gain property (securities and real estate) deductible up to 30% of AGI at the full fair market value with no tax on any increase in value since acquisition.

C. Short-term capital gain property - deductible up to 50% of AGI at cost basis.

D. Tangible personal property (art, books, antiques) -

1. Deductible up to 30% of AGI at the full fair market value with no tax on any increase in value since acquisition <u>if</u> use of the property is related to charity's exempt purpose (gift of painting to an art museum). Prior law provided that, for purposes of the AMT, appreciation in excess of adjusted basis in capital gain property (real, personal or intangible) donated to charity was treated as a preference item and was added to AMT income. For contributions of tangible personal property made after December 31, 1990, and before July 1, 1992, however, this add-back to AMT income was not required.

2. Effective June 30, 1992, for contributions of tangible personal property and December 31, 1992, for all other contributed property, the new law eliminates the AMT income add-back for gifts of appreciated property.

Observation: Individuals no longer run the risk of increasing their exposure to the AMT by gifting appreciated property to charitable organizations. Since the new law allows the contribution of tangible personal property for the remainder of 1992 without creating an AMT preference item, individuals who made such contributions can prepare their 1992 tax returns (or file amended returns) and not take any preference into account.

3. If unrelated gift, deductible up to 50% of the AGI at cost basis.

E. Gifts to private foundations

1. Private foundations are Sect. 501(c)(3) organizations that do not qualify as public charities.

2. General rule - appreciated securities, real estate, and tangible personal property held long-term are deductible at cost basis.

3. Pass-through foundations - deduction allowed for full fair market value.

4. Publicly traded securities held long-term qualify for a deduction at full fair market value. This increased deduction is available for gifts made after July 18, 1984 and before 1995. it is not available if more than 10% of the stock of any one corporation is contributed by the donor or members of his or her family.

5. Deductible ceilings

- cash and ordinary income property - 30% AGI
- capital gain property - 20% AGI
- pass-through foundation - 30% - 50% AGI

6. Gift tax charitable deduction - Sec. 2522

7. Estate tax charitable deduction - Sec. 2055.

F. Deferred or Planned Gifts

1. Pooled income fund - A commingled fund that is maintained by a public charity. A donor contributes money or property to the fund and keeps (or gives to someone else) a life income interest in the donor's

share of the fund's future earnings. The remainder interest is irrevocably assigned to the public charity.

a. Donor is allowed a charitable deduction for the present value of the remainder interest. This present value depends on the historical year rate of return of the fund (highest yearly rate in the three tax years preceding the transfer).

b. Income producing property and property that can be readily sold and converted into income producing property is appropriate for this type of transfer.

c. Advantages

- maintained by charity at minimum cost to beneficiaries
- commingling permits larger investment pool and diversity
- pays actual income earned
- additional contributions allowed
- charity can maintain multiple funds with different investment expectations.
- transfer does not cause recognition of gain

d. Disadvantages

- cannot invest in tax-exempts
- limited to one charitable beneficiary
- cannot be for a term of years
- controlled by the charity

2. Charitable Remainder Trusts - These trusts have two interests, an income interest and a remainder interest. The remainder interest is transferred to a charitable organization.

a. Charitable Remainder Annuity Trust (CRAT). The income interest consists of a fixed dollar amount (at least 5% of the initial net fair market value of the transferred property) which is paid annually to the income beneficiary. The donor is entitled to a contribution deduction for the present value of the remainder interest determined using IRS tables. (Pub. 1457).

- Advantages
    - fixed annual payments - valuation required only once.
    - favorable to beneficiary during recession
    - flexibility in selecting and changing charitable remaindermen
    - trustee can be beneficiary or donor
    - investment in tax-exempts allowed
    - transfer does not cause recognition of gain
- Disadvantages
    - no additional contributions allowed
    - high-income property generally required
    - not favorable to beneficiary in inflationary times
    - administrative and start-up fees
    - distribution to beneficiary not taxed as favorably as a gift annuity

b. Charitable Remainder Unitrust (CRUT). The income beneficiary receives annual payments determined by multiplying a fixed percentage (at least 5%) by the net fair market value of the principal determined each year. The donor is entitled to a charitable contribution deduction for the value of the remainder interest determined using IRS tables. (Pub. 145).

- Advantages
    - an income exception is available to distribute only income earned even if less than 5% of the value

of the principal and this allows for retirement type planning when coupled with a make-up provision

- additional contributions are allowed

- favorable to beneficiary in periods of inflation

- Disadvantages

  - must be valued annually

  - not favorable to beneficiary during recession

  - drafting and administration fees required

c. Income taxation of payments - amounts retain the character they had in the trust. Each payment is treated as follows:

- First, as ordinary income to the extent of the trust ordinary income for the year and undistributed ordinary income for prior years.

- Second, as capital gain to the extent of the trust capital gains and undistributed capital gains for prior years.

- Third, as other income (for instance, tax-exempt income) to the extent of such income for the year and amounts undistributed from prior year.

- Fourth, as a tax-free distribution of principal.

d. Charitable remainder trusts are exempt from tax unless unrelated business income is received.

e. Rev. Rul. 92-48 provides that a charitable remainder trust is not an eligible shareholder of an S corporation.

3. Charitable Lead (Income) Trusts - Income payments are made to charity for a term of years or for a life and then the principal returns to the donor or to a third party. The income interest is generally a guaranteed annuity or a fixed percentage of the value of the trust determined annually.

a. Grantor trust - if the donor is treated as the owner of the trust (for instance, if his reversionary interest exceeds 5%) the donor is taxed on the trust's income. A charitable contribution deduction is available for the income paid to the charity.

b. Nongrantor trust - if the donor is not treated as the owner of the trust, the donor is not taxed ont he trust's income and no charitable deduction is available.

- Since the donor is not taxed on the income paid to the charity, the donor's income taxes are reduced while meeting charitable objectives.

- This type of trust is useful when the donor has current income in excess of comfortable living requirements and wishes to pass the property to family members at a reduced transfer tax cost because of available estate and gift tax charitable deductions.

c. Advantages

- provide immediate gift to charity

- reduced transfer tax cost

- trustee can be beneficiary or donor

d. Disadvantages

complicated drafting and administration

no income tax deduction unless the income of the trust is taxable to the donor.

no income during trust term

4. Charitable Gift Annuities - A donor irrevocably transfers money or property to a charity in return for a promise to pay fixed and guaranteed payments for life. The arrangement is part charitable gift and part purchase of an annuity. the charitable contribution for a gift annuity is the difference between the fair market value of the property transferred and the value of the annuity. The amount of the payment (annual, semi-annual, quarterly, or monthly) is fixed and is based on age (the older the annuitant, the larger the payments).

a. Each annuity payment is composed of a tax-free return of investment element, a taxable interest element, and, if issued in exchange for appreciated property, a taxable gain element. After the investment is fully recovered (for annuities beginning after 1986), the full amount of each annuity payment is taxable.

b. Deferred charitable gift annuities - A donor transfers money or property a charitable organization in exchange for a promise to pay an annuity more than one year later. The donor can make a gift now and get an income tax charitable deduction, deferring payment until later years when income may be needed (such as retirement) and when the donor may be in a lower tax bracket. This technique may also be effective for providing funds for college tuition to family members (see PLR 9108021).

c. Advantages

- charity receives gift currently
- constant income for the beneficiary
- deferral option is available
- minimal administration expense - operated by charity
- favorable taxation of annuity payments if favorable for beneficiary during a recession

d. Disadvantages

- unless reinsured by charity, assets of charity put on the line
- state regulations and restrictions
- capital gain ma be realized on purchase with appreciated property.
- low charitable deduction compared to that available with CRAT.

4. Resources and Citations

a. Pooled Income Fund

- Governing instrument - must contain specific provisions. See Internal Revenue Code (IRC) Sect. 642(c)(3), (4), (5); Reg Sect. 1.642(c)-5 and -6; IRC Sect. 508(e); IRC Sect. 4947(a)(2); Rev. Rul. 82-38, 1982-1 CB 96

- Sample documents: Rev. Proc. 88-53, 1988-2 CB 712; Rev. Proc. 88-54, 1988-2 C.B. 715, Rev. Proc. 90-103, 1990-2 CB 159

- Valuation - IRS Pub. 1457

b. Charitable Remainder Trusts

- Governing instruments - must contain specific provisions. See Reg. Sect. 1.64-1 through Sect. 1.664-3; Sect. 508(e), IRC Sect. 4947(a)(2).

- Sample documents

  - CRAT - Rev. Proc. 90-32, 1990-1 CB 546

  - CRUT - Rev. Proc. 90-30, 1990-1 CB 534; Rev. Proc. 90-31, 1990-1 CB 539

- Valuation

  - CRAT - IRS Pub. 1457

  - CRUT - IRS Pub. 1458

c. Charitable Lead Trusts

- Governing instruments - subject to private foundation rules. See IRC Sect. 508; Sect. 4947; Reg. Sect. 1.508-2(b)(1)(vi); Sect. 1.170A-6(c)(1),(2)(i), and (2)(ii)

- Valuation - Reg. Sect. 20.2031-7

d. Charitable Gift Annuities.

- Governing instruments - A contract between the donor and the charity. The contract states that the charity has received the donor's property and promise to pay in return a specified annuity.

- Valuation - IRS Pub. 1457, Committee on Gift Annuities (2401 Cedar Springs, Dallas, TX 75201)

- Other - Sect. 501(m), PLR 9108021 (deferred gift annuity with option to sell for college education)

VII. RECENT RULINGS IMPACTING S CORPORATIONS

I. Second Class of Stock Rulings

In light of the new regulations addressing the single class of stock requirement for S corporations, the Service, to provide interpretive guidance, issued the following rulings:

A. In PLR 9248019, the Service considered whether providing split-dollar life insurance for key employees created a second class of stock.

1. LAW: Under §1.1361-1(1)(2)(i), an employment agreement is not treated as a binding agreement impacting distribution or liquidation rights unless a principal purpose of the arrangement was to circumvent the single class of stock rule.

2. ISSUE: Does the split dollar arrangement fall within the regulatory exclusion as an employment agreement or similar contract?

3. CONCLUSION: As a fact, the Service accepted the life insurance as a fringe benefit, not an attempt to circumvent the single class of stock standard. Accordingly, the arrangement did not disqualify the corporation by creating a second class of stock.

B. Similarly, the Service accepted a split-dollar arrangement where the shareholder was the insured in lieu of the key employees. PLR 9318007.

1. LAW: In Rev. Rul. 79-50, the Service had previously held that the benefit received by the shareholder in excess of the premiums required to be paid under a split dollar arrangement would be a distribution under §301(c). This distribution would impact the determination of equal distribution rights.

2. ISSUE: By paying the corporation the value of the benefit received, did the shareholder effectively avoid a distribution and, therefore, any second class of stock issue?

3. CONCLUSION: The Service ruled that the shareholder's reimbursement to the corporation for the economic benefit prevented a separate distribution from occurring. No second class of stock concern existed.

4. COMMENT: Although not specifically addressed, the Service would likely rule that the economic benefit would be valued similar to the PS-58 cost computation generally used with split-dollar life insurance arrangements.

C. Finally, in PLR 9247013, the Service held that a non-qualified deferred compensation plan for employees, officers, and directors did not create a second class of stock.

1. LAW: The Service analyzed the structure under §1.1361-1(b)(4), which determines what constitutes "outstanding stock". An arrangement falling within the following guidelines is not considered outstanding stock where it:

   a. does not convey the right to vote;
   b. is an unfunded and unsecured promise to pay compensation;
   c. is issued to an employee or independent contractor in connection with the performance of services for the corporation; and
   d. is issued under a plan with respect to which the employee/independent contractor is not taxed currently on income.

2. ISSUE: Does the structure of the non-qualified plan fall within the stated parameters to be excluded from consideration as outstanding stock?

3. CONCLUSION: By initially ruling that the arrangement would not be currently taxable under §451 until paid or made available and accepting the remaining factors to be factually correct based on the taxpayer's representations, the Service again concluded that a second class of stock issue did not exist.

D. OBSERVATION:

1. The trend of these favorable rulings appears to incorporate the liberal approach found in the final second class of stock regulations.

2. As a planning tool, the rulings allows companies to provide compensation packages for both employees and shareholders within S corporations. The greater certainty that the S status will not be terminated, via a finding of a second class of stock, removes some of the risk associated with such planning.

II. Availability of the Installment Sale Method with S Corporation Stock

In general, the sale of publicly-traded stock will not qualify for the installment sale method of accounting. However, the sale of stock in an S corporation holding publicly-traded stock should qualify. See PLR 9306001. Where properly structured, this vehicle could lead to a substantial tax deferral.

A. LAW: §453(k)(2) provides that the installment method under §453(a) is not available for stock traded on an established securities market. The introduction to §453(k) authorizes the Service to promulgate regulations addressing the potential avoidance of this general rule via, among other structures, the use of flowthrough entities. At present, the Service has not issued regulations.

B. ISSUE: What is the implication of the installment method limitations to a sale of S corporation stock?

C. CONCLUSION: In ruling that the sale qualifies for the installment sale treatment, the Service concluded that the failure to issue regulations covering flowthrough activities left the analysis to the general rule. Since the S corporation stock was neither tradable on an established market nor convertible to such a stock, the sale qualified for installment treatment.

D. OBSERVATION: The availability of this opportunity is dependant on the Service's reaction in drafting regulations. Until that point, a taxpayer should consider this alternative for any material sales with substantial gain to maximize the related tax deferral.

III. Bibliography

A. Priv. Ltr. Rul. 92-48-019 (Nov. 27, 1992).

B. Priv. Ltr. Rul. 93-18-007 (May 7, 1993).

C. Priv. Ltr. Rul. 92-47-013 (Nov. 20, 1992).

D. Bailine, *IRS Letter Ruling 9306001: a Window of Opportunity to Sell Publicly Traded Stock and Use of the Installment Method*, TAX ADVISER, June 1993 at 352.

E. Priv. Ltr. Rul. 93-06-001 (Feb. 12, 1993).

VIII. RECENT DEVELOPMENTS WITH PARTNERSHIPS

I. Taxability of the Receipt of a Partnership Interest

An opportune method used by partnerships generally in the start-up phase includes the issuance of partnership interests for services performed. This enables a cash-poor partnership to receive needed expertise. The individual would receive a "piece of the action" with no required out of pocket investment. The troubling issue with an otherwise beneficial arrangement dealt with the taxability of the receipt of the partnership interest.

A. LAW: The taxability of the receipt of a partnership interest is defined as follows:

1. A capital interest is taxable upon receipt under §1.721-1(b)(1). The amount of income is generally the fair market value of the interest.

2. The taxability of a "profits interest" does not have as concise of a standard. Varying caselaw has left great uncertainty in the area.

   a. The receipt of the profits interest was taxable upon receipt under §83. See *Diamond v. Commissioner*, 56 T.C. 530 (1971) aff'd 492 F. 2d 286 (7th Cir. 1974), *St. John v. U.S.*, No. 82-1134 (C.D. Ill. Nov. 16, 1983) and *MARK IV Pictures, Inc. v. Commissioner*, 969 F.2d 669 (8th Cir. 1992).

   b. The receipt is a taxable event, however the profits interest has no determinative value. See *Campell v. Commissioner*, 943 F. 2d 815 (8th Cir. 1991).

   c. In dictum, the court in *Campell* stated that a possible conclusion was that no taxable event even occurred upon the receipt of the profits interest, See *Campell*, 943 F. 2d at 823.

3. The definitions applicable to distinguishing the partnership interests are as follows:

   a. A capital interest is an interest with a right to a proportionate share of partnership assets.

   b. Alternatively, a profits interest is any interest which is not a capital interest.

B. SERVICE'S REACTION: To provide a workable standard in the valuing of profits interest, the Internal Revenue Service issued Rev. Proc. 93-27 with specific taxability guidelines.

1. The general rule provides that the receipt of a profits interest in a partnership does not constitute a taxable event to either partner or partnership.

2. The following are exceptions which would lead to a taxable event:

   a. The interest is in a partnership which has a certain income stream, i.e. an existing profitable leasing arrangement;

   b. The interest is disposed of within two years of receipt; or

   c. The interest is in a PTP (publicly traded partnership).

C. CONCLUSION: Since the area where this strategy is most effective involves high risk ventures, the use of profits interest for services is a viable alternative. The benefit of securing expertise while deferring any type of a taxable event can be obtained by compliance with the two year holding period. Assumptively, any taxable receipt would still be subject to a "value" analysis.

II. Life Insurance Partnerships

The use of a partnership as a means to handle a corporate ownership change, via the holding of the life insurance on the corporate shareholders, offers potential tax savings. The receipt of life insurance proceeds by a corporation to effect a shareholder redemption is considered in computing corporate Alternative Minimum Tax (AMT). As this amount is generally material, adverse tax consequences may follow. Additionally, the cash infusion has already been dedicated to effecting the shareholders redemption and payment of additional tax may be a strain. A potential solution is the use of a partnership among the shareholders to effect a cross-purchase agreement.

A. LAW: In PLR 9012063, the Service held that the transfer of the life insurance policies on the shareholders to an existing, affiliated partnership was valid. The holding reached the following conclusions:

1. The transfer to the partnership was for valid business reasons, including funding the shareholders buy-sell agreement and limiting any potential AMT.

2. The transfer for value rule, which generally limits the amount of life insurance proceeds which are excludable from income to the cost of acquiring the policy, would not apply. As the shareholder-insureds would be the partners, the life insurance proceeds would remain excludable in full.

B. ISSUE: How far can the ruling be expanded? Specifically, does the ruling sanction a situation where an existing partnership does not exist?

C. SERVICE'S REACTION: The Internal Revenue Service has issued PLR 9309021 accepting the formation of a partnership to hold the life insurance policies to effectuate a corporate buy-sell arrangement via a cross purchase agreement . Along with paralleling the conclusions under PLR 9012063, the Service stated the following:

1. The partnership would acquire the insurance policies from the corporation at the "interpolated reserve value", representatively, fair market value.

2. The proceeds would not only be excludable from income upon receipt, but also treated as tax-exempt income. This would allow a step-up in partner basis. Accordingly, the proceeds could be distributed tax-free to the partner to the extent of basis.

3. The Service has issued subsequent rulings in this area which specifically address the availability of grantor trusts to hold the policies. See PLR 9328010-012, 9328017, and 9328019-020.

D. CONCLUSION: The Service's sanctioning of this planning arrangement provides a workable vehicle to complete corporate ownership changes with insurance without the downside due to potential AMT liability. Previously, the perceived position of the Service was that some other business purpose was needed to justify the formation of a partnership by shareholders to effect a cross-purchase arrangement. The concern was that the Service would classify the transaction as a sham and formed only to avoid or evade taxes. In this ruling, the Service has apparently recognized that the formation of a partnership to own the life insurance policies necessary to complete a cross-purchase agreement meets the business purpose test. Existing buy-sell arrangements should be reviewed to timely take advantage of this opportunity.