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## Federal Tax Update: Structuring Deals in 2012 and Beyond (Slides)

Stephen L. Owen

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EVERYTHING MATTERS

# Federal Tax Update: Structuring Deals In 2012 and Beyond

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*Stephen L. Owen, Esq.*

*DLA Piper LLP (US)*

*Washington, D.C./Baltimore, Maryland*

*(202)799-4192/(410)580-4230*

*stephen.owen@dlapiper.com*

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**STEPHEN L. OWEN** practices in the Washington, D.C., and Baltimore, Maryland offices of DLA Piper LLP (US). He practices primarily in the areas of mergers and acquisitions, joint ventures, business transactions, corporate and partnership tax planning, real estate tax planning, and business and estate planning for closely-held enterprises and their owners. Mr. Owen represents a variety of publicly-traded corporations and REITs, as well as many successful privately-owned businesses and entrepreneurs. Mr. Owen has written on a variety of tax and business topics, including extensive works on corporate, partnership and real estate taxation, and estate planning in various professional journals. He is a member of the editorial boards of *The Journal of Real Estate Taxation* and *The Journal of Pass-Through Entities*. He is a frequent speaker on tax and business topics at nationally recognized programs including The N.Y.U. Institute on Federal Taxation, The Southern Federal Tax Institute, N.Y.U. Real Estate Tax Institute, The Federal Real Estate Tax Conference, The New Jersey Tax Institute, The North Carolina Tax Institute, The Tennessee Tax Institute, The Kentucky Tax Institute, The National Association of Real Estate Companies Tax Conference, The William & Mary Tax Conference, The AICPA Federal Real Estate Tax Conference, The AICPA National Real Estate Tax Conference, PLI Tax Planning for Domestic and Foreign Partnerships, and The Texas Tax Institute. Mr. Owen is a past Chair of the Partnerships and LLCs Committee of the ABA Section of Taxation and is a past Chair of the Section of Taxation of the Maryland State Bar Association. He also served as Chair of the DLA Piper Tax Practice Group from 1998 to 2008. Mr. Owen is listed in *The Best Lawyers In America* in the categories of tax law, trusts and estates law and corporate law, and *Chambers USA: America's Leading Lawyers for Business*. Mr. Owen was recognized by the *Washington Business Journal* as one of the "2009 Top Washington Lawyers." He is also a Fellow of The American College of Tax Counsel and is an active member of Real Estate Roundtable and NAREIT. Mr. Owen was recently appointed to the William & Mary Tax Conference Advisory Council.

# THE STAKES



- Current Rate on Long Term Capital Gain (“LTCG”) = 15% (plus state)
- Current Rate on Ordinary Income = 35% (plus state)
- Special 25% rate (plus state) on Section 1250 Gain
- Special 28% rate (plus state) on art and collectibles
- AMT Trap = 28% rate; LTCG still 15%
- Capital Losses – Netting Process
- Ordinary Losses
- Note: State and local tax laws may not offer any preference for LTCG. Note Florida, Texas and Nevada residents (among others) have no state or local tax but other states may tax these nonresidents.

# POSSIBLE AND ACTUAL LEGISLATIVE CHANGES



- Current Rates due to increase to 20% (LTCG) and 39.6% (ordinary income) in 2013.
- Itemized deductions “phase down” to return in 2013, making effective rates even higher.
- Will special 25% rate for 1250 Gain be increased? No proposal .... Yet.
- Note: Installment sales prior to 2013. Could “elect out” (453(d)). For older deals, could take action to accelerate deferred gains under 453B.
- \$5 million (\$5.12 million in 2012) estate and gift (and GST) exemption through 2012. Estate and gift tax changes not expected to include repeal (in whole or in part) of stepped up basis at death. Annual exclusion (per donee, per year) increases from \$13,000 to \$14,000 in 2013.
- Codification of “Economic Substance.” A transaction must have both “objective economic substance” and a business purpose. A 40% penalty would be imposed; 20% if adequate disclosure.
- Health Care Act – Effective 2013, Medicare Tax increases from 2.9% to 3.8% for wages over \$200,000 and this increased .9% is not deductible by self employed. In addition, “Unearned Income Medicare Contribution Tax” on “investment income” – 3.8% of lesser of net investment income or excess of AGI over \$250,000 (for married individuals). Investment income includes rents and gains from sales unless attributable to ordinary course of trade or business – Income from a passive activity trade or business is not counted as a trade or business.



# Possible Taxation of Large Pass Thru Entities



- Pressure on Government to reduce corporate tax rates.
- Obama Administration has “floated” taxation of large pass-thru entities as corporations
- More than \$50 million in revenue
- Should be DOA but disturbing that such a proposal could even be in a trial balloon!
- What else is lurking under the guise of “tax reform”?

# HOLDING PERIOD



- LTCG requires one year holding period. Need to watch bifurcation traps.
  - Holding period of Purchase Contract or Option does not tack with holding period of the real estate. Purchase Contract or Option could be a capital asset itself.
  - Newly constructed property could have LTCG for the land but short term for the improvements. See, e.g. Rev. Rul. 75-524, 1975-2 C.B. 342.
  - Partnership (LLC) interests could have bifurcated holding period under Treas. Reg. §1.1223-1(b) for capital contributions within 12 months of sale of interests.
- Holding period for interests in a partnership or LLC could be different than holding period of real estate owned by that entity.

# SPECIAL RULE: SECTION 1231



- Real estate used in a trade or business (not dealer property)
- Net 1231 gains are LTCG if held for one year
- Net 1231 losses are ordinary
- Note Recapture for net 1231 gains as ordinary to the extent of net 1231 losses in prior five years
- Assume Smith recognized net 1231 losses in 2007. Smith is a partner in XYZ Partnership that owns 1231 real property. If XYZ sells real property at a gain in 2009, Smith's share will be ordinary income under the 1231 recapture rule to the extent of prior net 1231 losses. However, what if Smith sells his partnership interest? No authority that the partnership interest is 1231 property

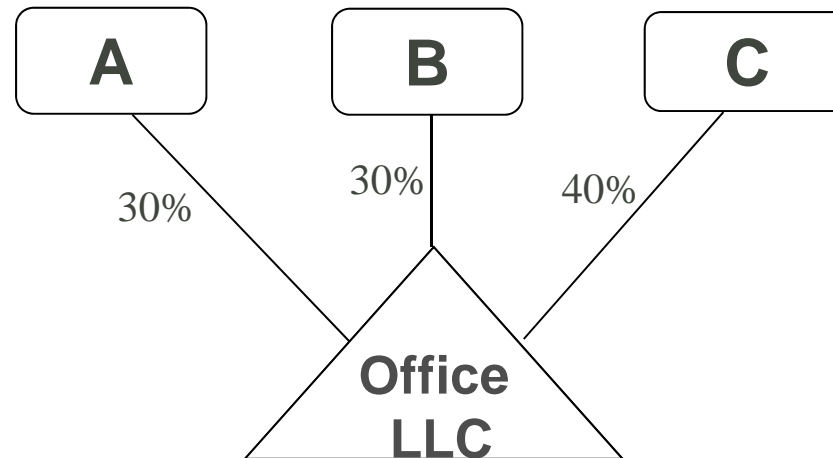


# PARTNERSHIPS AND LLCs



- General rule is that partnership interest is capital asset
- Section 751 “hot asset” rules
  - Inventory (including “dealer” property)
  - Unrealized receivables including recapture
  - Trade or business assets held less than one year
- Look through for 1250 Gain (25% rate), but note special rule for “redemptions” of interests (Treas. Reg. §1.1(h)-1).
- Look through for Collectibles Gain (28%)
- Seems to be no look through for 1231 or 1239 [But see H.R. 1935, Sec. 3]. Also see Rev. Rul. 60-352, 1960-2 C.B. 208 (disposition of interest in partnership holding installment notes is acceleration event).
- Compare S corps - No look through for 1250 Gain
  - Look through for Collectible Gain
  - Note repeal of 341 – Collapsible Corp rules (until 2013)
- Note special rules (Rev. Rul. 99-5; Rev. Rul. 99-6) for going in and out of disregarded entity status.

# PARTNERSHIP “LOOK THROUGH”



- Office LLC purchased an office building for \$2 million. Office LLC's current basis in the building is \$1.2 million. The market value of the building is currently \$3.5 million.
  1. If C sells his interest for \$1.4 million, what are the tax consequences to C?
    - The total gain at the Office LLC level is \$2.3 million.
    - The total amount subject to recapture is \$2 million (original cost) less the adjusted basis of \$1.2 million. The difference (\$800,000) represents depreciation subject to recapture at the rate set forth in Section 1(h) (generally 25%). C's share of Section 1250 gain is \$320,000 (40% x \$800,000), calculated by determining the amount of the partnership Section 1250 gain that would be allocated to C had the LLC sold the property for its fair market value. The remaining share of C's gain (\$600,000) is taxed at the 15% capital gains rate. See Treas. Reg. § 1.1(h)-1(a).

# PARTNERSHIP “LOOK THROUGH” (CONT'D)



2. If C had recognized Section 1231 losses during the 5-year period preceding the sale of his interest, would there be Section 1231 recapture?
  - C is not subject to Section 1231 loss recapture on the sale of his LLC interest. However, C would be subject to recapture had Office LLC sold the property. Section 1231(c).
3. What would be the result if Office LLC were instead an S Corp.?
  - Treas. Reg. § 1.1(h)-1(a) provides that when stock of an S corporation held for more than a year is sold or exchanged, the transferor may recognize ordinary income, collectibles gain and residual long-term capital gain or loss but does not mention Section 1250 gain (as the same regulation does in the context of a sale of a partnership interest). Thus, C would not be subject to recapture had he sold an interest in an S corporation.
4. If C's interest were “redeemed” by Office LLC, C would not be subject to 25% recapture. Treas. Reg. §1.1(h)-1 provides that there is no “look through” in a transaction treated as a redemption of a partnership interest.

# THE POWER OF 1(H)



- James, Richard and Solomon are equal 1/3 members in Apollo Enterprises, LLC.
- The LLC built a building on leased land for \$6 million.
- The building has been depreciated down to \$0.
- The fair market value of the building is \$6 million (i.e. no appreciation).
- Richard wants to sell his 1/3 interest in the LLC to James and Solomon for \$2 million.
- If Richard sells his LLC interest to the other two members, he will realize a gain of \$2 million ( $\$2 \text{ million} - 0 = \$2 \text{ million}$ ).
- Under Section 1(h)(1), the federal tax rate would be 25% (the “unrecaptured Section 1250 gain” rate) -- \$500,000.

Under Treas. Regs. § 1.1(h) – 1(b)(3)(ii), the recapture rate does not apply to a “redemption” of a partnership interest.



- Richard sells his LLC interest back to the LLC for \$2 million (i.e., it is a “redemption” instead of a “cross purchase”).
- Tax rate is 15% instead of 25%.
- Tax = \$300,000.
- Tax savings = \$200,000.
- Query: Does a partial redemption also qualify for this special treatment?

- James and Solomon contribute \$2 million to the LLC as a capital contribution.
- The LLC distributes the \$2 million to Richard.
- This contribution/distribution would be treated as a sale by Richard to James and Solomon, not a redemption.

# HOW TO STRUCTURE THE REDEMPTION – SCENARIO A



- James and Solomon lend \$2 million to the LLC.
- The LLC uses the loan proceeds to redeem out Richard.

## HOW TO STRUCTURE THE REDEMPTION – SCENARIO B



- LLC borrows \$2 million, guaranteed by James and Solomon.
- LLC uses loan proceeds to redeem out Richard.

## WILL THE REMAINING MEMBERS INCUR ADDITIONAL TAX IN THE FUTURE WHEN THE ASSET IS SOLD?



- Experts disagree on this point.
- Upon the redemption, the LLC should get a step-up in basis of \$2 million (assuming a 754 election – Section 734).
- Thus upon a sale of the building, there would be a gain of \$4 million. It would be subject to recapture at 25% rate.
- However, the recapture on the other \$2 million should have “disappeared”. Is this too good to be true?



# RESCISSION TRANSACTIONS



- If a transaction can be fully rescinded for tax purposes, it is treated as if the transaction never occurred --- no tax consequences on the initial transaction and no tax consequences on the rescission. If a rescission is not respected for tax purposes, both the initial transaction and the attempted rescission are independent taxable events.
- Ltr Rul 200952036 (9-23-09). A limited partnership converted into corporation to facilitate acquisitions and to potentially go public. After the conversion to a corporation, the corporation was not able to go public. Entity then converted from corporation to LLC [note that Texas franchise tax did not apply to LPs but law changed and LLC was viewed as more favorable entity than LP – thus rescinded into LLC]. Rescission respected by IRS. Note:
  - Initial transaction and rescission occurred in same taxable year. The tax return for this year will ignore the conversion to corporation.

# RESCISSION TRANSACTIONS (CONT'D)



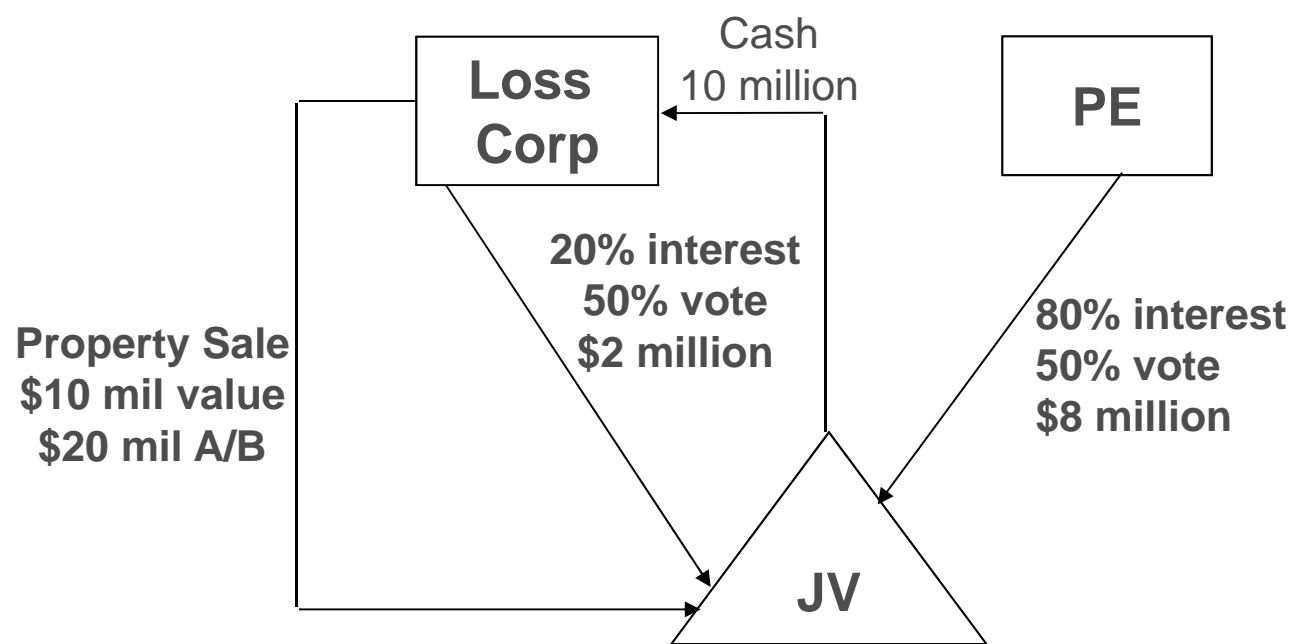
- In intervening period, no actions taken that would have been inconsistent with partnership existence [Corp did not make distributions that would have been made by LP – upon rescission there were make up distributions].
- The LLC operating agreement is “substantially similar in all material respects” to the limited partnership agreement.
- The effect of the rescission was to cause the legal and financial arrangements among the equity holders and the entity to be identical in all material respects as if the conversion to corporation had not occurred.
- No equity holder is taking an inconsistent position.

# RESCISSION TRANSACTIONS (CONT'D)



- Ltr Rul 201211009 (3-16-12). Two stockholders of an S corporation sold their stock to two buyers. The intention was that the transaction would qualify for Section 338(h)(10) election. The two buyers subsequently formed holding company and contributed the purchased stock to the holding company. They then discovered that the purchase was not a qualified purchase under Section 338. The Service permitted the parties to rescind the transaction and to “start over” where the rescission was in the same taxable year and the parties were put in the same position as if they had never done the first transaction.
- See also Rev. Rul. 80-58, 1980-1 C.B. 181 (restoration of *status quo ante* must occur in same taxable year) Ltr Rul 200843001 (7-2-08); Ltr Rul 200908016 (11-13-08); Ltr Rul 201016048 (12-22-09); Ltr Rul 201008033 (11-20-09). Compare Hutcheson, 71 TC Mem 2425 (1996) (attempt at rescission of sale of Walmart stock not respected).
- Rescission doctrine is now on the Treasury’s 2012 Business Plan for further guidance.

# HARVESTING TAX LOSSES



- Loss Corp retains option to purchase less than 50% of the assets (does not have option to purchase LLC interests)
- Loss Corp retains management rights and receives fees
- Loss Corp has right of first refusal over certain assets
- Loss Corp receives disproportionate distributions if certain benchmarks are exceeded.

# HARVESTING TAX LOSSES (CONT'D)



- Is it a “sale” for tax purposes?
  - Is it a capital contribution and a distribution? If a capital contribution, Loss Corp would have a basis of \$22 million and a cash distribution of \$10 million so no loss recognition.
  - Do the “benefit and burdens” of ownership pass to the JV? What are the terms of the option? No requirement or economic compulsion.
- If a “sale” then the ordinary tax loss would be carried back by Loss Corp to get a refund. Generally two years. Recent legislation permits NOLs in 2008 or 2009 to be carried back up to five years (with 50% of taxable income limit for fifth year unless “small business”).
- Does not work if Section 267 or Section 707(b)(1) apply. OK if Loss Corp owns less than 50% of capital and profits of JV, subject to attribution rules.
- Even if it is a “sale”, could the government argue that no loss is recognized to the extent Loss Corp has “preformation expenditures” under the disguised sale rules?



# HARVESTING TAX LOSSES (CONT'D)



- Treas. Reg. §1.707-4(d)- transfer of money by a partnership to a partner is not treated as part of a sale of property to the extent the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that:
  - i. are incurred within 2 years of the transfer and
  - ii. are incurred by the partner with respect to the property “contributed” to the partnership by the partner.
- Treas. Reg. §1.704-4(d)- only provides reimbursement treatment to the extent capital expenditures do not exceed 20% of the FMV of property. However, this limitation does not apply if FMV of property does not exceed 120% of the partner’s adjusted basis in the contributed property

# HARVESTING TAX LOSSES (CONT'D)



- Form is important. Separate Purchase and Sale Agreement
- In Lennar/Morgan Stanley deal, Purchase and Sale Agreement provides:

“9.6 Intended Tax Treatment. The Parties agree that the purchases of the Properties...shall be treated as taxable purchases for U.S. federal and state tax purposes to the maximum permissible extent and that no portion of the cash paid by the Purchaser is intended to or shall constitute reimbursement of pre-formation capital expenditures within the meaning of Treas. Reg. §1.707-4(d).”

# “DEALER” STATUS



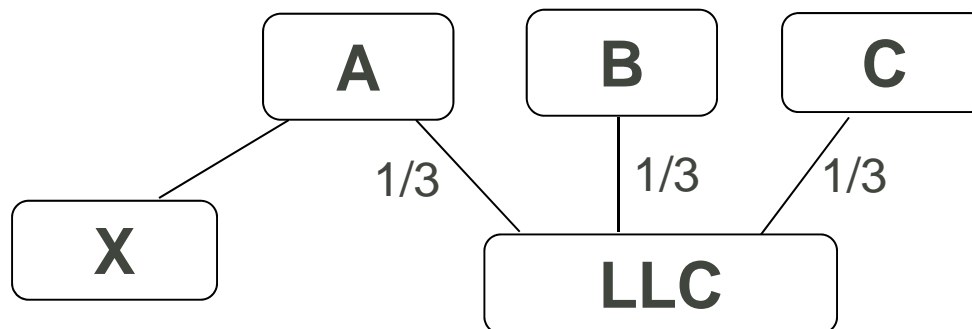
- Whether property is “dealer” property (i.e., held primarily for sale to customers in ordinary course of business) is a question of fact looking at the nature of the property involved, as well as the prior and current activities of the owners of the property.
- An individual could be a dealer with respect to certain property and an “investor” with respect to other property. Separate entities could help. Note: For property sold at a loss, taxpayer will argue he was a dealer.
- Factors to consider:
  - Marketing, pre-sale activities
  - Status of entitlements, record plats, etc.
  - Duration and history of holdings of property
  - Number of sales [sale to one buyer in one transaction]
  - Frequency of sales [“liquidation of investment” theory]
  - Intent/purpose at time of purchase of property; change in circumstances
  - Improvements made in context of sales [breaking ground/infrastructure]

## “DEALER” STATUS (CON’T)



- Patricia and Donald Flood, T.C. Mem 2012-243 (August 27, 2012). The Floods lived in Florida where Mr. Flood was a “day trader in the stock market.” The Floods also engaged in various real estate transactions between 2001 and 2008 when they purchased at least 250 lots. During 2004 they sold 2 lots and during 2005 they sold 40 lots and gave 11 lots to their church. The government argued that the Floods were “dealers”. The Tax Court agreed.
  - Floods argued they were investors. Court was influenced by a variety of factors- Frequency of transactions, amount of profit on real estate versus day trading (??), extent the Floods were actively involved in research, marketing, etc.
  - Mr. Flood engaged and supervised real estate agent, title company, etc. He marketed properties on his website and placed ads in grocery stores.

# SALE OF POTENTIAL DEALER PROPERTY TO AN LLC



- Assume A has held property X for more than one year. Property X consists of undeveloped land that A holds for investment. X is worth \$250,000 undeveloped and A's adjusted basis in X is \$10,000. X is worth \$600,000 when subdivided into several lots.
- Assume that A, B and C are equal members of LLC and have owned their interests for 10 years.
  1. If A subdivides the land and sells the lots to third parties, what is the result?
  2. If A sells the undeveloped land to LLC, what is the result?

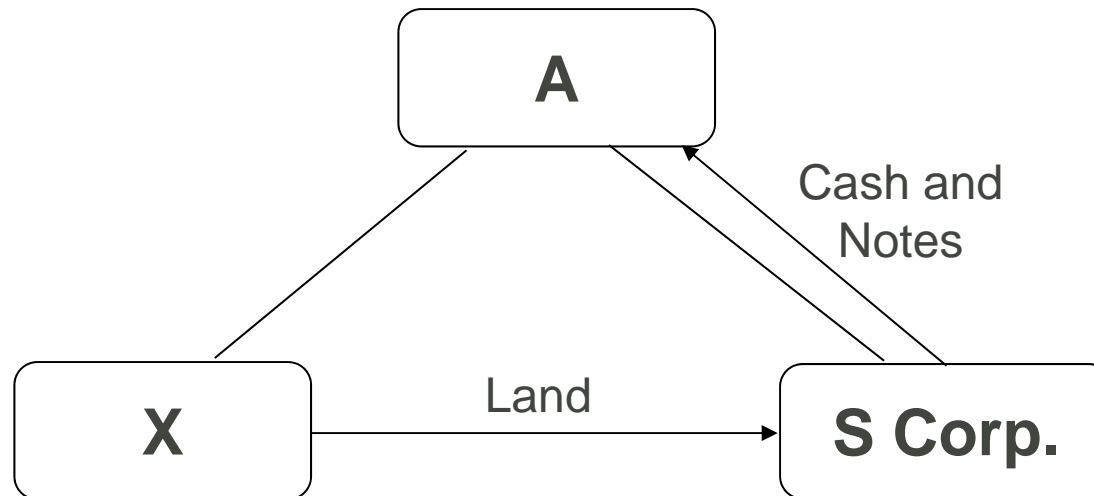


# SALE OF POTENTIAL DEALER PROPERTY TO AN LLC (CONT'D)



- If A subdivides the land and sells the lots to third parties, what is the result?
  - The subdivided land will be dealer property, A will recognize ordinary income in the amount of \$590,000. Sec. 1221(a)(1).
- If A sells the undeveloped land to LLC, what is the result?
  - A can avoid ordinary income on the first \$240,000 of the gain by selling the undeveloped land to LLC if LLC pays \$250,000 (its FMV) for property X. It is important to ensure that the sale of X to LLC is treated as a sale rather than as a capital contribution. The Service will be more likely to treat the sale as a capital contribution if LLC pays for X with an installment note rather than cash or if the LLC pays an inflated price. If the sale is respected and A does not own (directly or indirectly) more than 50% of the capital interest or profits interest in LLC, A should recognize \$240,000 of capital gain, and LLC will take a basis of \$250,000 in X.

# SALE OF POTENTIAL DEALER PROPERTY TO A RELATED S CORPORATION



- A sells the undeveloped land to a related S Corporation for \$250,000 in notes.
- What are the tax consequences?
- What steps can be taken to bolster the taxpayer's position?
- What if X sells interests in an LLC?

## SALE OF POTENTIAL DEALER PROPERTY TO A RELATED S CORPORATION (CONT'D)



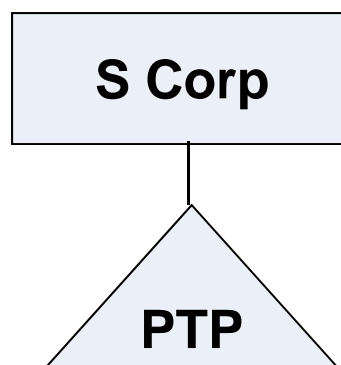
- A's gain is capital gain as long as the form of the transaction is respected. The determination will turn on whether the corporation pays FMV for X rather than an inflated price. If the purchase price is paid by issuing an installment note, the determination hinges on the FMV of the property and whether the corporation has sufficient capital to pay the obligation. See, e.g., Aqualane Shores Inc. v. Commissioner, 269 F.2d 116 (5th Cir. 1959); Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982); Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992).
- The tendency in this situation is to inflate the purchase price to maximize capital gain and minimize ordinary income after the property is developed. If this occurs, the transfer by a controlling shareholder may be treated as a contribution of capital to the corporation rather than a sale. See Burr Oaks Corp. v. Commissioner, 365 F.2d 24 (7th Cir. 1966), *cert. denied*, 385 U.S. 1007 (1967).
- What steps can be taken to bolster the taxpayer's position?
  - Have unrelated stockholders. But see T.J. Phelan, 88 TCM 223 (2004)
  - Have some equity contribution.
  - Make sure S Corp. is held out to the public as the developing entity and not merely serving as A's agent.

# RESTRUCTURING THE TRANSACTION



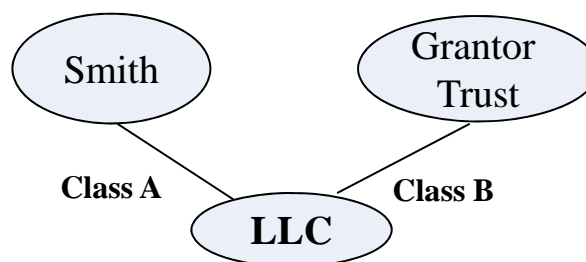
- What happens if, after the sale, the economic environment changes? There are no homebuilders who want to buy lots.
- Can the S corporation request a purchase price adjustment? Can the terms of the promissory note be changed?
  - Section 108(e)(5) – can treat debt reduction where seller is the creditor and purchaser is debtor as a purchase price adjustment and not as COD. Note this is not available when purchaser is insolvent. This should mean “to the extent” purchaser is insolvent. See Ltr. Rul. 9037033.
  - Section 453B(f) – if an installment obligation “is canceled or otherwise becomes unenforceable” the installment note is treated as if it were “disposed of in a transaction other than a sale or exchange”. Where sale was between related parties (as defined in 453(f)) face amount of canceled debt is amount realized. Unclear how this applies when there is a partial cancellation of installment debt. See Ltr. Rul. 8739045 which ignored this provision and treated as a non-acceleration purchase price adjustment.
- Can the S corporation sell the property to a non-related party and trigger an ordinary loss? Will the S stockholders have basis to take the loss? What about two year rule and Section 453?

# UNIFIED BASIS IN PARTNERSHIP INTEREST?



- S Corp has been an S corporation for more than 10 years. S Corp has held 100 common units in PTP for more than 10 years.
- Five years ago, S Corp acquired Target, a C corporation. Target subsequently liquidated under Section 332 and its assets thereupon became built in gain assets under Section 1374. S Corp contributed these assets to PTP in exchange for 300 additional common units in PTP.
- S Corp tracks the basis and holding period for each “lot” of common units. S Corp wants to sell the units that are not subject to Section 1374.
- Rev. Rul. 84-53, 1984-1 CB 159, provides that a partner has a single basis in a partnership interest, even if the partner is both a general and limited, for example.
- PLR 200909001 (11-18-08) permits separate tracking of basis. See Reg. §1.1223-3(c)(2)(i) permits separate tracking of holding periods for separately acquired units in a publicly traded partnership.

# Split Eligible Entity Interests



- Smith formed LLC as a disregarded entity. LLC has two Classes of Interests: Class A and Class B. Smith subsequently transfers, by “sale” or gift, the Class B Interests to Grantor Trust. LLC remains a disregarded entity.
- The LLC operating agreement provides that losses are allocated solely to the Class A and certain tiers of income are allocated solely to the Class B. Purpose is to boost basis in Class B interests.
- In recent IRS Advice (AM 2012-001 released 2/17/12), the Service advised that interests in a disregarded entity cannot be split into separate classes and taxpayers may not make disproportionate allocations between classes. A disregarded entity does not have “membership interests” for tax purposes.
- Quere: What if Class A is a “preferred” or “frozen” interest and Class B is a “common” interest for estate and gift tax purposes? See Pierre, 133 T.C. No. 2 (Aug. 24, 2009) (“Pierre I”); Pierre T.C. Mem. 2010-106 (“Pierre II”).



# ALLOCATING RECOURSE LIABILITIES



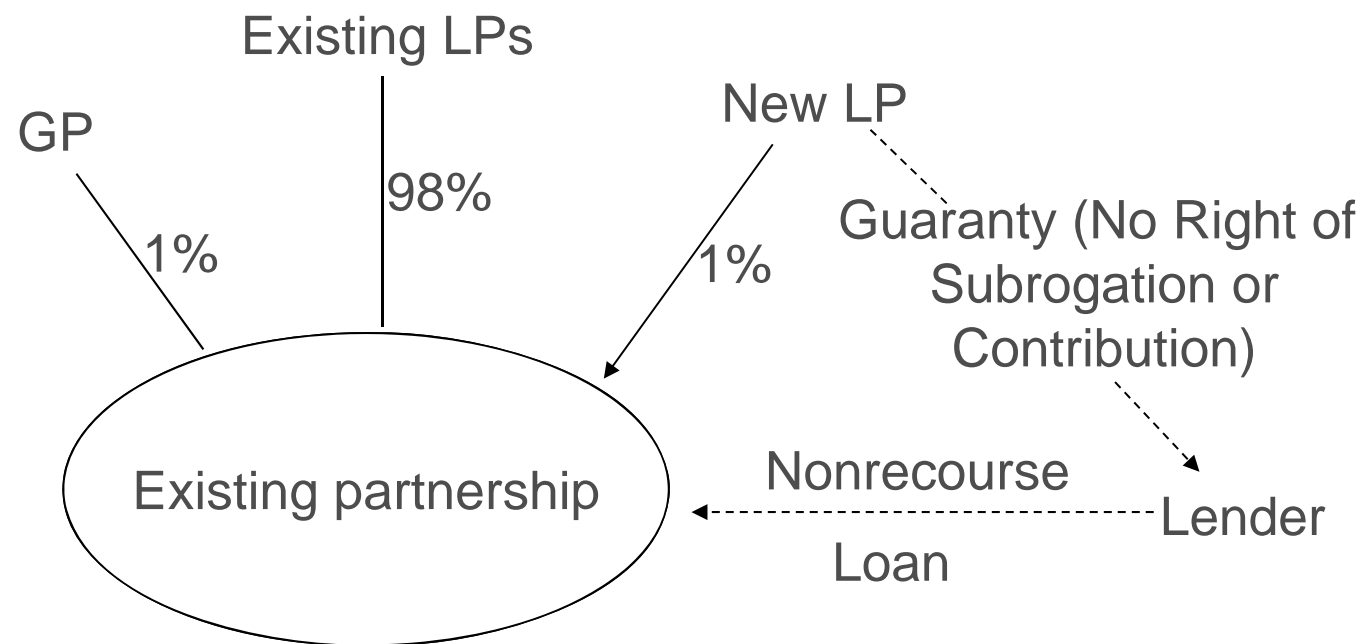
- A recourse liability is allocated to the partner who bears the economic risk of loss for that liability. Can be part recourse and part nonrecourse.
- A partner bears the economic risk of loss to the extent he has a payment obligation (without any right of reimbursement), assuming:
  - Partnership liabilities become payable in full
  - All partnership assets (including cash) have a value of zero and are disposed of in a fully taxable transaction for no consideration (except relief of nonrecourse liabilities)
  - All items of income, gain, loss, or deduction are allocated to the partners
  - The partnership liquidates

# RECOURSE LIABILITIES



- Treas. Reg. § 1.752-2(b)(6) - All partners (or related persons) assumed to pay their obligations regardless of actual net worth unless facts indicate plan to circumvent or avoid the obligation (“Presumption of solvency”)
  - But see Treas. Reg. § 1.752-2(k) - DREs as partners
- Partner bears economic risk of loss for nonrecourse loans made or guaranteed by partner or related person
  - 10% exception - Treas. Reg. § 1.752-2(d)
- “Leveraged partnership” structure instead of outright sale. Chicago Cubs deal.

# BOTTOM DOLLAR GUARANTY OF NONRECOURSE DEBT

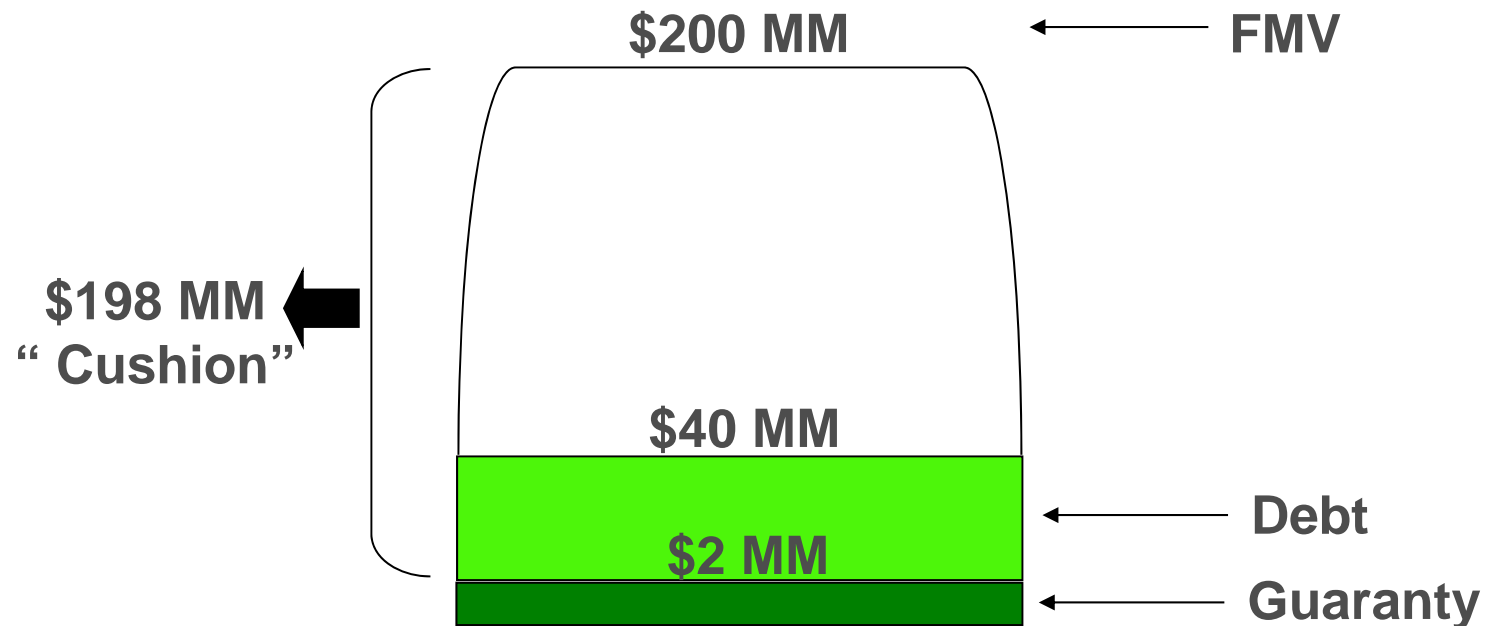


- Assume all assets are worthless
- New LP guarantees Lender that Lender will collect at least \$2 million. New LP will only be liable if and to the extent that Lender fails to recover at least \$2 million.
- Risk of Loss is remote. Would codifying economic substance change the analysis?

# BOTTOM DOLLAR GUARANTY OF NONRECOURSE DEBT (CONT'D)



FMV of Assets	=	\$200 MM
Nonrecourse Debt	=	\$40 MM
Guaranty	=	Bottom \$2 MM



Guarantor liable only to extent assets lose  
more than \$198 MM of value

# CODIFICATION OF ECONOMIC SUBSTANCE



- Health Care and Education Reconciliation Act signed March 30, 2010 codifies the economic substance doctrine (new Section 7701(o)). Effective for transactions after March 30, 2010.
- In the case of any “transaction” to which the economic substance doctrine is “relevant,” the transaction will have economic substance only if:
  - the transaction changes in a “meaningful way” (apart from Federal income tax effects) the taxpayer’s economic position, AND
  - the taxpayer has a “substantial purpose” (apart from Federal income tax effects) for entering into such transaction.
- If a transaction fails this conjunctive test, there is a penalty equal to 20% of the underpayment if there is disclosure. If there is no disclosure, the penalty is 40%.
- Does a “bottom guaranty” have “economic substance”? What about “back-to-back” stockholder loans in S Corp context?

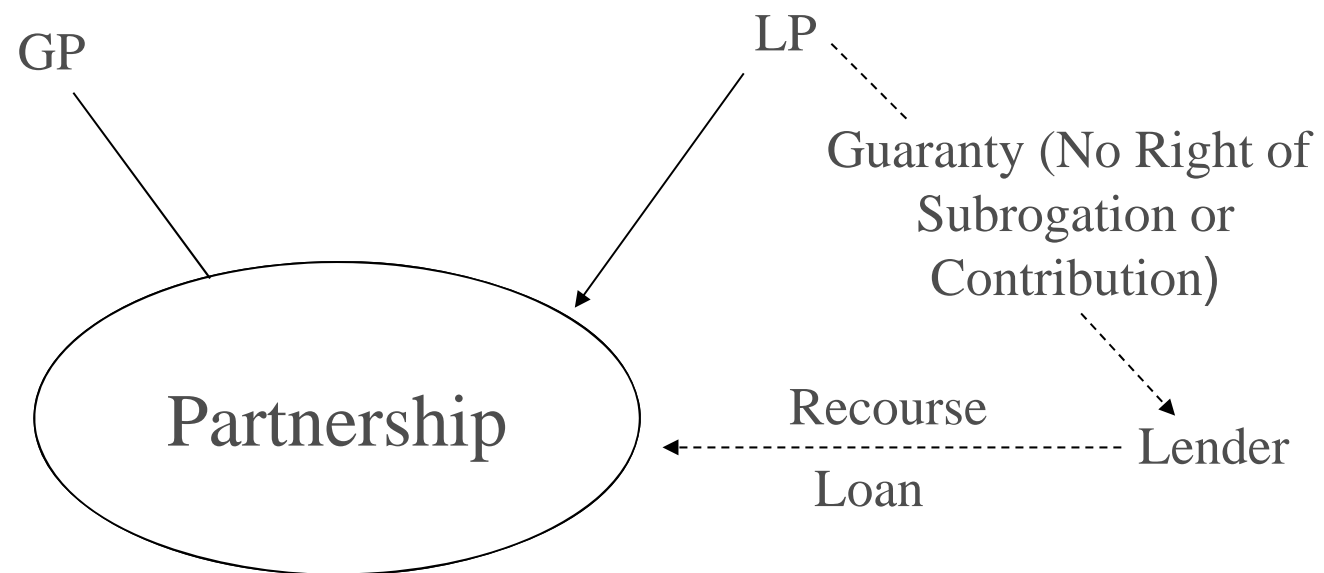
# COMPARE S CORP BASIS RULES



- S Corp stockholder gets basis for his capital contributions, his loans to S Corp and his share of undistributed income.
- Stockholder's basis is not increased by S Corp debt. This is potential tax trap.
- Stockholder guaranty of S Corp debt does not increase basis.
- To boost basis, S Corp stockholder must borrow personally "outside" and lend/contribute funds to S Corp.

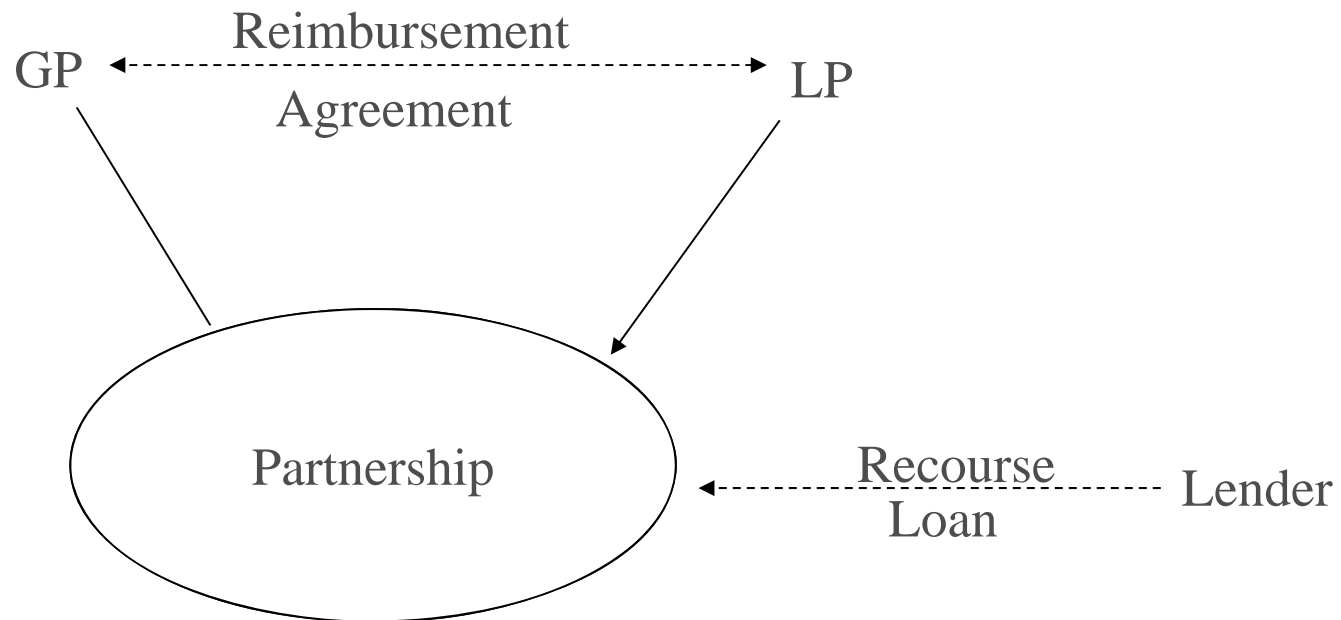


# Guaranty of Recourse Debt



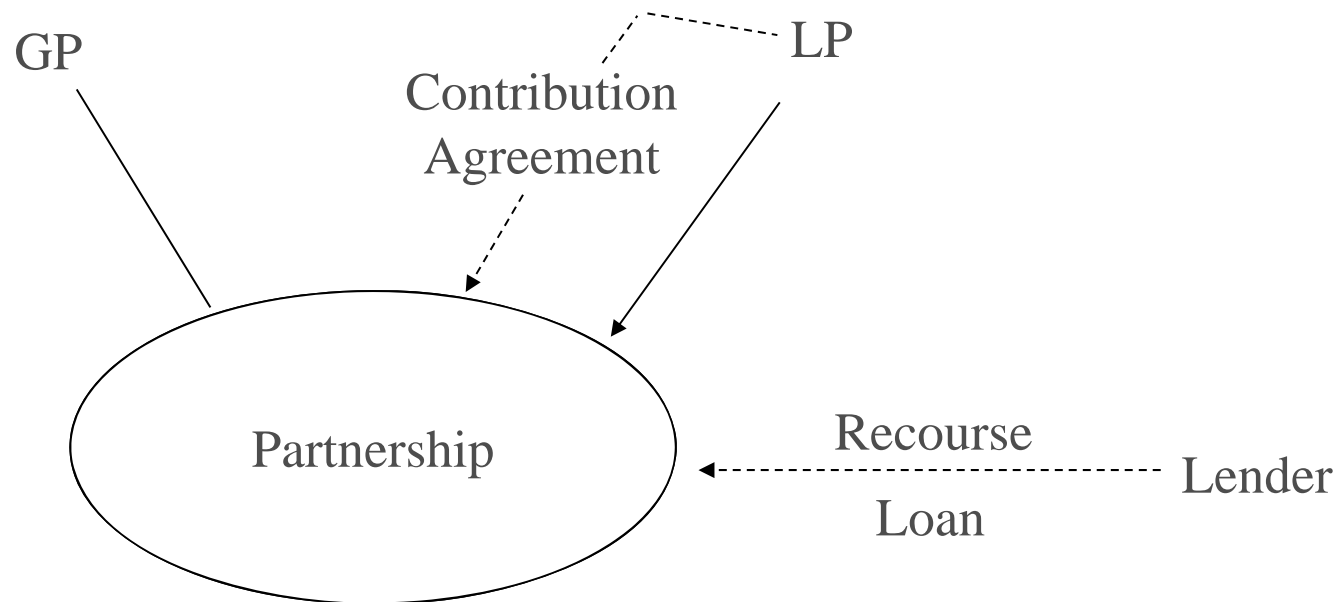
**If Lender seeks payment from GP, will LP bear any risk of loss? See Treas. Reg. §1.752-2(f), Ex. 3.**

# Reimbursement or Indemnity Agreement



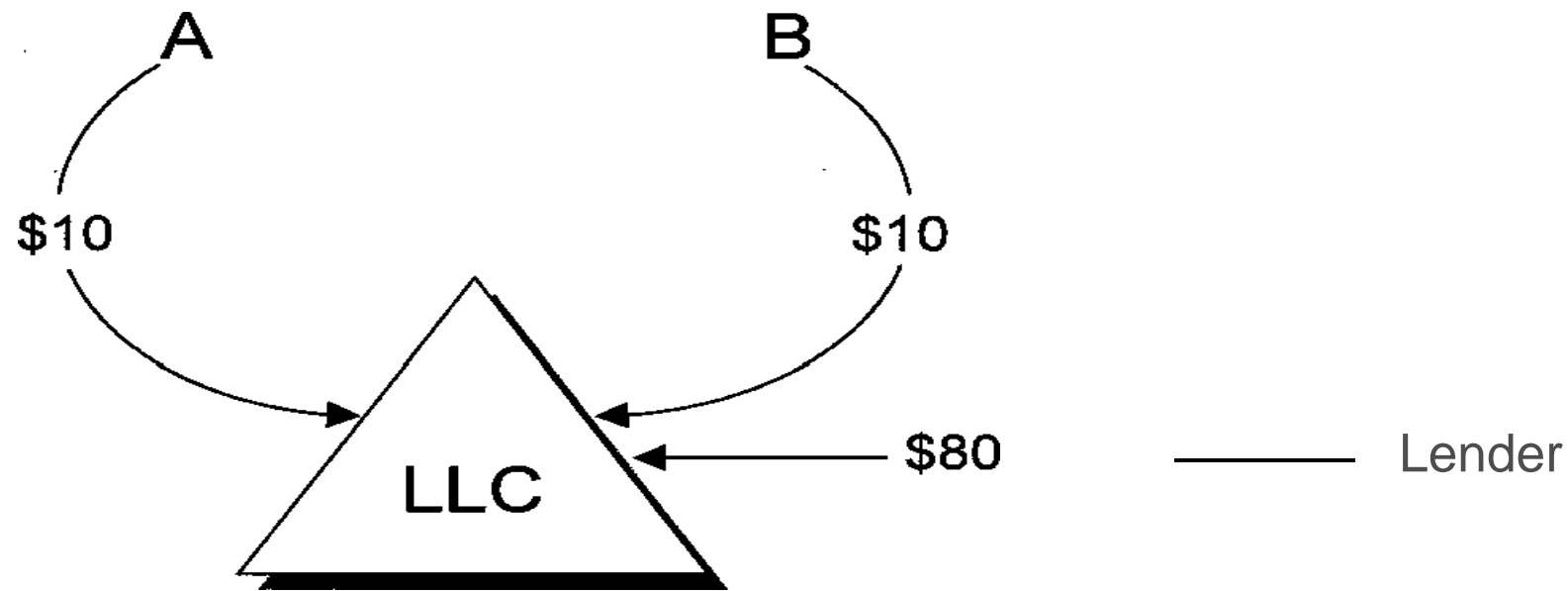
- GP pay Lender
- LP reimburses or indemnifies GP
- Query contractual agreement regarding termination of Guaranty

# Contribution Agreement or DRO



- Essentially allocating recourse debt to LP to cover allocation of deductions attributable to recourse debt
- DRO can be limited to specified dollar amount. “Economic Risk of Loss”.
- What about “elective” guarantys and DROs and economic substance?

# Recourse Loans to an LLC



- LLC purchases Property 1 for \$50 and Property 2 for \$50
- \$80 loan is recourse to LLC but not to A or B. Query effect of DRO by A?

- In 2005, Tax Court held that a DRO did not increase the at risk amount of a member of an equipment leasing LLC under Section 465 (Hubert Enterprises v. Com'r, 125 T.C. 6 (2005)).
- In 2007, the 6<sup>th</sup> Circuit vacated the Tax Court's decision holding that the proper standard was "payor of last resort" using a "worst case scenario". On remand, the Tax Court must determine whether the taxpayer subject to the DRO was the payor of last resort.
- In February, 2008, Tax Court (95 T.C. Mem. 1194) concluded that the DRO did not increase the taxpayer's at risk amount under Section 465. Unfortunately, this decision does not provide a clear articulation of the payor of last resort standard and why the Section 465 analysis is different from economic risk of loss under Section 752.

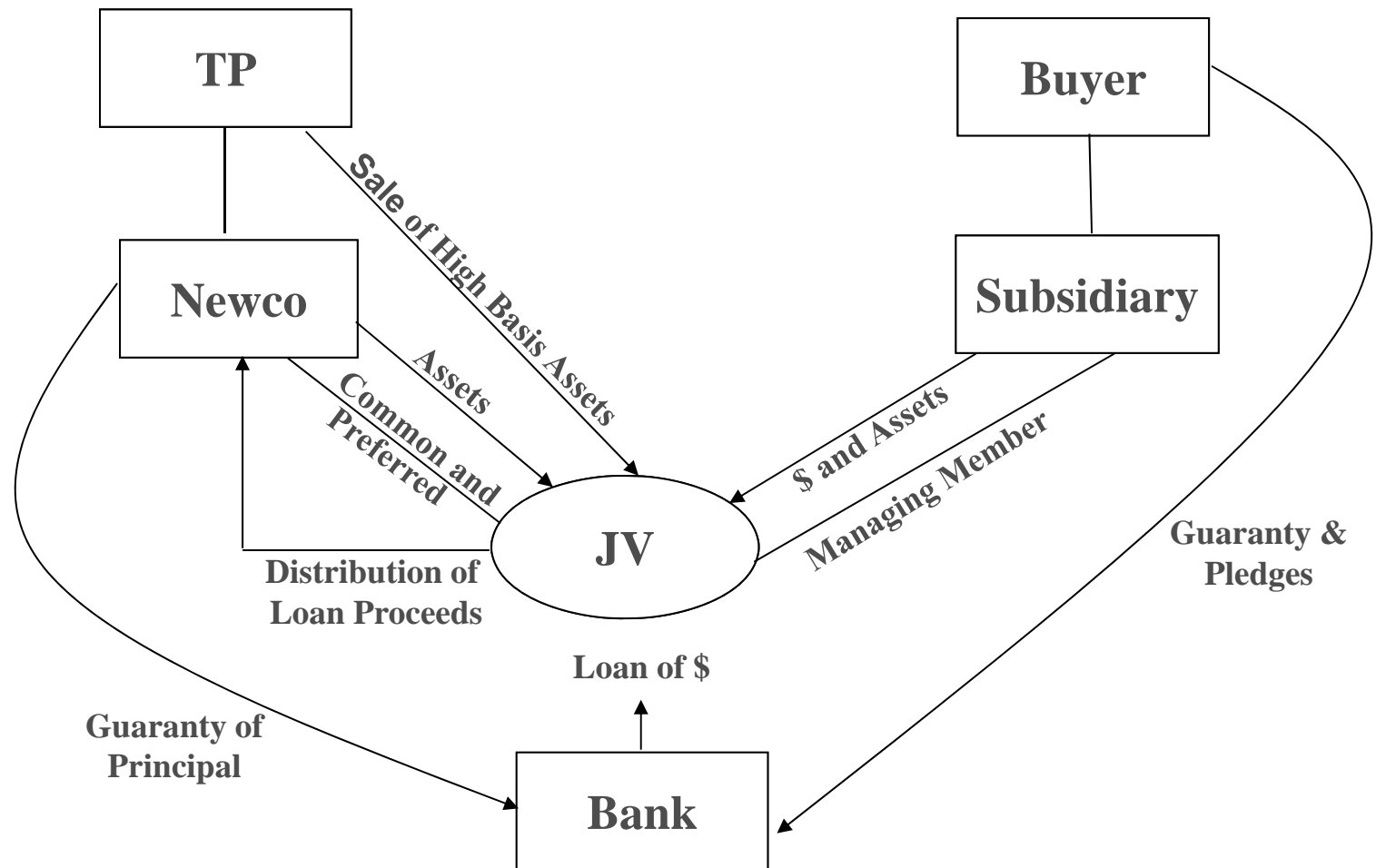
## DROs and At Risk: Hubert Enterprises (Cont.)



- In Hubert, a Wyoming LLC was formed by two related entities to engage in equipment leasing. Equipment was purchased using debt financing, some of which was recourse to the LLC but neither member was personally liable as a guarantor or otherwise. The LLC generated losses.
- In March of 2001, LLC operating agreement was amended to provide DRO – if a member has a negative capital account on liquidation of its interest, then member must restore it by end of taxable year or, if later, within 90 days after date of liquidation. The amount paid would satisfy creditors or be distributed to members with positive capital accounts. The addition of the DRO was intended to be effective as of 1/1/00.
- Tax Court determined:
  - Amendment adding DRO was not retroactively effective
  - Recourse lender to LLC could not recover from members nor could creditor force a liquidation
  - DRO only operative if taxpayer had negative capital account at time of liquidation -- contingent obligation



# ILM 200246014 - Plan to Circumvent Treas. Reg. §1.752-2(j)



## FACTS

- TP announced plan to spin-off or sell assets
- TP received bids to purchase and announced agreement to dispose of assets to Buyer
- TP sold some assets to Buyer and its affiliates and contributed balance to new JV between TP and Buyer
- TP transferred assets to SMLLC and in turn contributed interest in SMLLC to Newco (§ 351)

## **FACTS (cont.)**

- TP contributed assets to JV, Newco contributed its interest in SMLLC to JV and TP contributed its interest in JV to Newco; subsidiary of Buyer contributed cash to JV
- JV borrowed funds from Bank and distributed most of funds to Newco; Newco guaranteed the Bank Loan
- Newco distributed such cash to TP

## FACTS (cont.)

- JV also distributed the subsidiary cash to Newco as reimbursement of capital expenditures - some of subsidiary cash treated as purchase price paid to Newco for other assets
- Guaranty by Newco for principal only - such guaranty was unsecured - guaranty to lapse on date certain or when Newco ceases to be a member of JV

## **FACTS** (cont.)

- TP recognized loss on the taxable sale component
- Amount of the special distribution based on financial results of TP
- Newco had put option
- Subsidiary had call option
- Tax sharing (indemnity) agreement

## 1. Newco guaranty should be disregarded

- Treas. Reg. § 1.752-2(b)(6) presumes partners will perform irrespective of net worth
- Treas. Reg. § 1.752-2(j) - IRS can disregard if principal purpose is to create appearance of economic risk of loss or plan to circumvent
- Newco "severely undercapitalized"
- Pledges by Subsidiary and Buyer
- Debt treated as nonrecourse



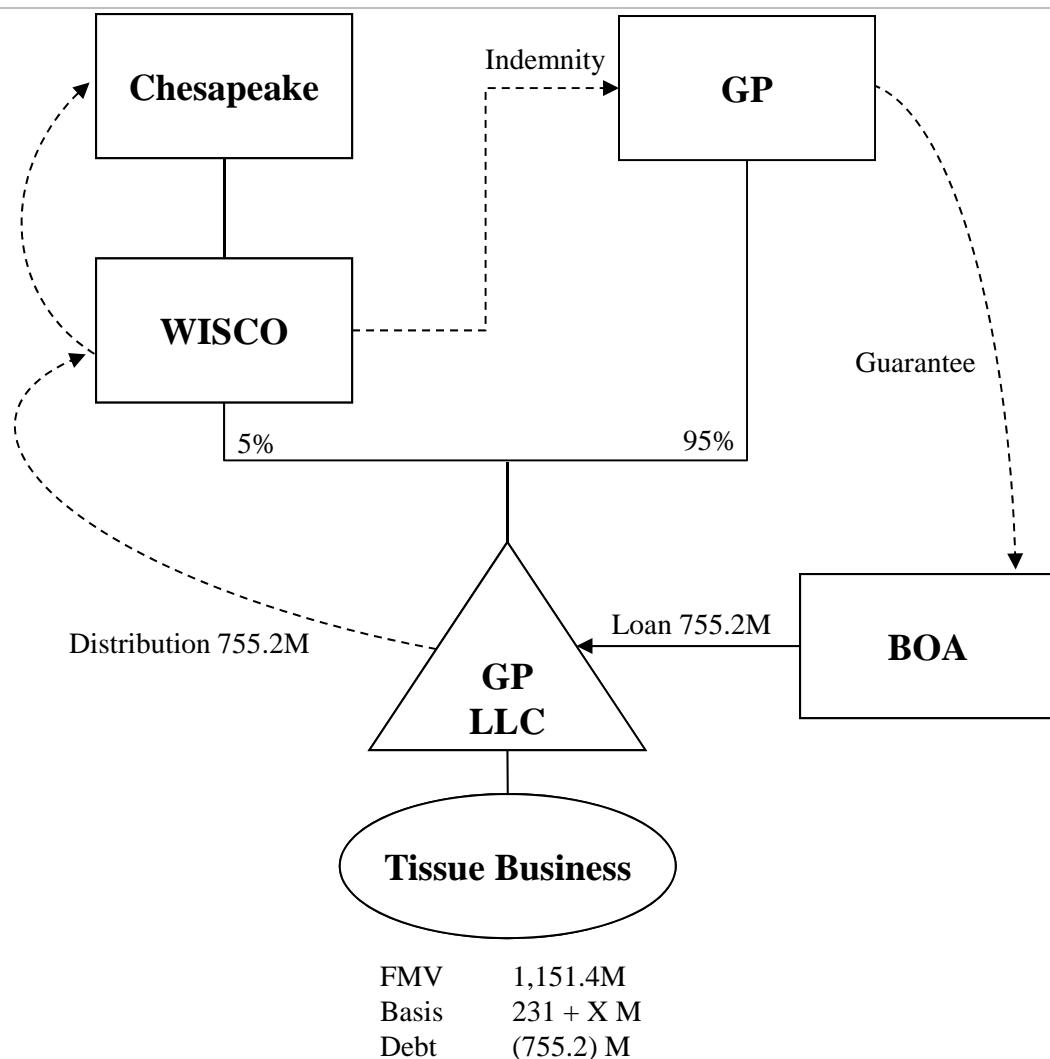
2. Transaction is a disguised sale
3. Anti-abuse rule of Treas. Reg. § 1.701-2
  - TP monetized its equity
  - Direct sale of high basis assets = principal purpose to reduce tax liability
4. Substance over form
  - TP parted with benefit and burdens and received cash

### 5. Shamming the partnership

- JV not really a partnership; Newco not really a partner
- No business purpose for JV
- Newco's interest is nominal due to \$ pulled out
- Newco does not participate in management and control
- Tax avoidance motive = no bona fide intent to be a partner

- Newco does not provide services
- Partners did not really join together as partners
- Even though JV is operating a legitimate business enterprise - that fact has no bearing

# Canal v. Commissioner, 135 T.C. 199 (2010)

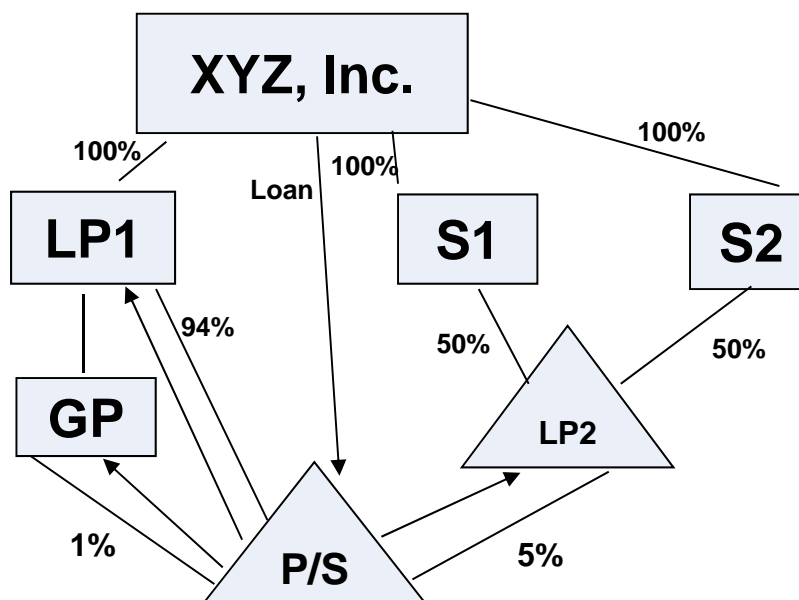


- WISCO and GP formed joint venture, GP LLC
- GP LLC borrowed \$755.2M from Bank of America (BOA) and transferred the loan proceeds to WISCO as a special distribution
- GP guaranteed the debt and WISCO indemnified GP for any principal payments it made under the guarantee
- WISCO used the proceeds from the special distribution to repay amounts due to Chesapeake, make a dividend payment to Chesapeake and make a loan of \$151M to Chesapeake. As a result, WISCO's remaining assets included a corporate jet worth \$6M and an intercompany note worth \$151M (representing an amount equal to approximately 21% of outstanding debt)
- Shortly after formation, the loan from BOA was refinanced with a loan from a subsidiary of GP (with an identical guarantee and indemnity)
- Good business purpose?
- Is it a 707 disguised sale?
- Debt financed distribution exception
- Result hinges on debt being recourse allocated to WISCO (Economic Risk of Loss)

## *Canal v. Commissioner* – Holding



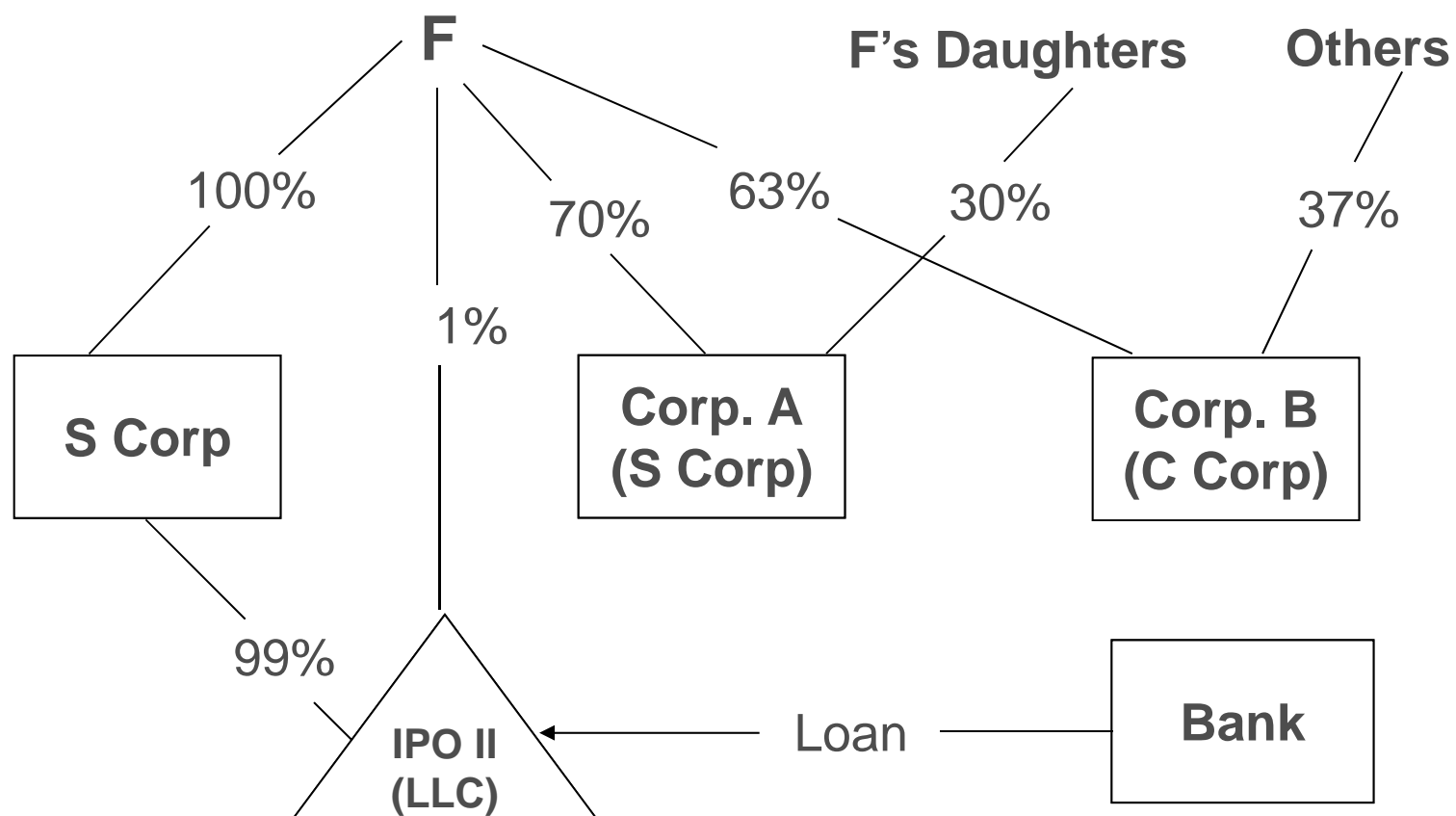
- Anti-abuse rule under Treas. Reg. § 1.752-2(j) applied with result that none of the BOA debt was properly allocable to WISCO
- No part of the 755.2M distribution qualified as a debt financed distribution and, instead, was part of a sale



- XYZ makes recourse loan to P/S.
- P/S distributes proceeds to all three partners.
- Taxpayer took the position that the LPs as well as the GP obtained increased outside basis for the loan. One argument was that State law might require LPs to repay the distribution because the loan exceeded FMV of assets. Alternatively, Taxpayer argued that Reg. §§1.752(j)&(b)(6) permit Taxpayer to treat the loan as nonrecourse.
- IRS disagreed. Loan was recourse only to GP and presumption of solvency applies. Risk of LPs having to repay was too contingent.



# RELATED PARTY RULE - *IPO II v. COMM'R*, 122 TC 295 (2004)



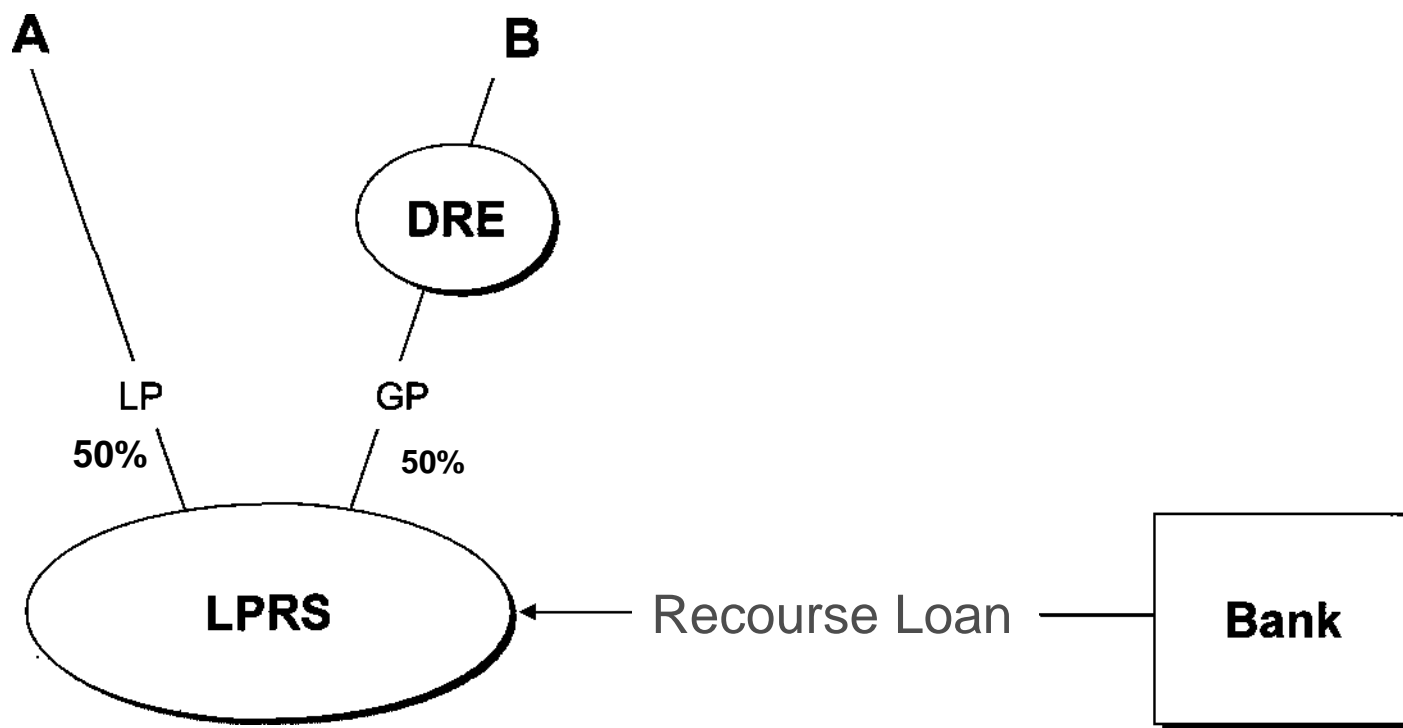
- F, Corp. A and Corp. B guaranteed loan to purchase aircraft
- Held: 100% of bank loan allocable to F - S Corp not “related” to F, Corp. A or Corp. B by virtue of Treas. Reg. § 1.752-4(b)(2)(iii)
- Persons owning interests directly or indirectly in same partnership not treated as “related” for this purpose

# IRS GUIDANCE IS EXPECTED



- See New York State Bar Association Tax Section, Report on Allocations of Recourse Liabilities Among Related Parties (April 23, 2012).
- IRS has initiated a guidance project intended to clarify the rules.
- Recourse liabilities are allocated according to how partners (or “related persons”) share the economic risk of loss (“EROL”).
- Under 752 regulations, a partner is “related” to a person bearing EROL for a partnership liability if their relationship is specified in Section 267(b) or 707(b)(1) substituting “80% or more” for “more than 50%.” If a person is related to more than one partner, the person is “related” only to the one partner with whom such person shares the greatest percentage of ownership (if two or more partners have the same percentage to the related person, the sharing is equal even if they have different percentages in the partnership). Note that this could create odd results.
- Under an exception to the above rules, persons owning interests directly or indirectly in the same partnership are not treated as related persons for purposes of determining EROL borne by each of them. The purpose of this rule is to prevent allocation of partnership liabilities to a partner who does not bear EROL directly merely because that partner is related to a direct or indirect partner who does bear EROL.

# TREATMENT OF DISREGARDED ENTITIES UNDER §752 - TREAS. REG. §1.752-2(K)



- Loan allocable to B as recourse liability only to extent of value of DRE (exclusive of value of interest in LPRS)
- Contrast treatment if DRE elects to be classified as a corporation
- Contrast if DRE is owned 99% by B and 1% by B-1 (B's spouse)

# RECOURSE LIABILITIES AND DISREGARDED ENTITIES



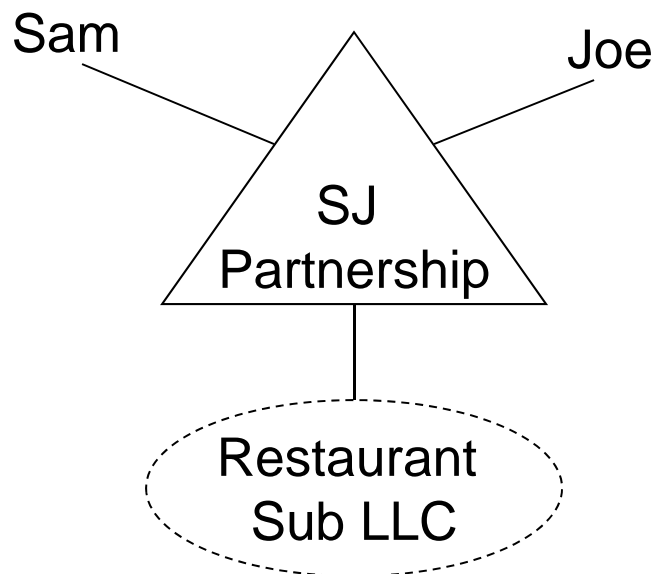
- Treas. Reg. § 1.752-2(k) effective October 11, 2006
- Obligation of a DRE is taken into account *only to the extent* of the net FMV of the entity on the date the § 752 determination is made, *i.e.*, end of year
- Net FMV equals gross FMV of DRE's assets (excluding PRS interest) less liabilities of equal or greater seniority
- Net FMV is not redetermined absent a non de minimis change in liabilities of equal or greater seniority, contributions and/or distributions
- Future questions
  - Should other events be treated as revaluation events?
  - Should a partner be able to elect to revalue a DRE annually?
  - Should the rules be extended to regarded entities?

# RECOURSE LIABILITIES AND DISREGARDED ENTITIES – RANDOM THOUGHTS



- Query loans v. contributions/distributions to avoid revaluation
- Query effect if DRE owns rental real estate and modifies lease
- What is FMV of PRS interests owned by DRE - Discounts
- Revalue some v. all assets of DRE
- How will PRS determine DRE's FMV - Query annual certification
- Query guaranty of loans by individual owner of DRE -Use of DRE as tort shield only

# DISREGARDED ENTITIES AND §108



- Restaurant Sub LLC is a disregarded entity all of the interests in which are owned by SJ Partnership. SJ Partnership owns real estate that is leased to Restaurant Sub LLC which operates a restaurant.
- Restaurant Sub LLC borrows \$1 million from Bank. SJ Partnership is not liable on the debt, nor is Sam or Joe.

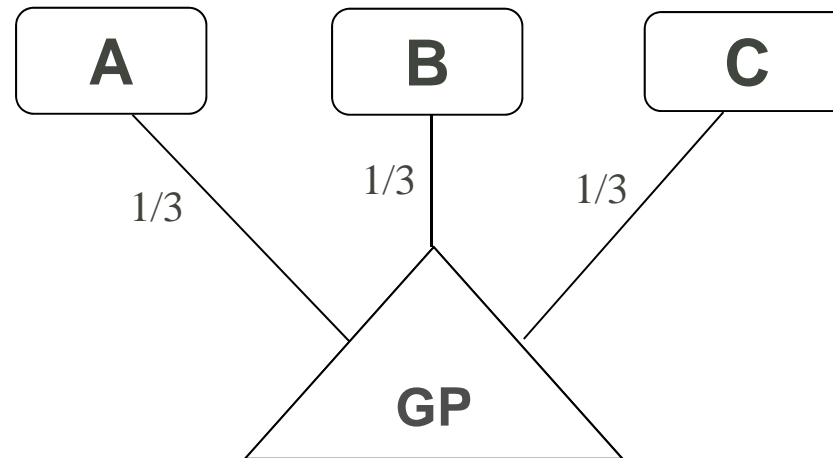


# DISREGARDED ENTITIES AND §108 (cont'd)



- Restaurant Sub LLC files for bankruptcy. Can Sam and Joe avoid COD if the debt is discharged in bankruptcy? Section 108(a)(1)(A) excludes from COD income if the discharge “occurs in a title 11 case.” The “taxpayer” must be under the jurisdiction of the bankruptcy court. Is Restaurant Sub LLC the “taxpayer”? Prop Reg §1.108-9(a) says the owner of the disregarded entity must be subject to the jurisdiction of the bankruptcy court.
- Prop Reg §1.108-9(b) provides special rules for partnerships. The bankruptcy exception to COD is applied at the partner level. Thus for Sam and Joe to benefit from the bankruptcy exception, SJ Partnership and Sam and Joe need to be subject to the jurisdiction of the bankruptcy court. See also Section 108(d)(6).
- What if Restaurant Sub LLC does not file for bankruptcy but it is insolvent. Bank is willing to reduce the debt to \$400,000. At the time, Restaurant Sub LLC is insolvent by \$700,000. Thus, after the debt reduction, it is still insolvent by \$100,000. Section 108(a)(1)(B) provides an exception to COD income to the extent the taxpayer is not rendered solvent by the debt discharge.
- Prop Reg §1.108-9(a) provides that the insolvency exception applies at the level of the owner of the disregarded entity. Further, in the case of a partnership, the test is at the partner level.

# ABANDONMENT OF PARTNERSHIP INTEREST



- C has a basis in his GP interest of \$180,000 which includes his share of \$120,000 GP liabilities. GP owns rental real property valued at \$100,000.
- C “abandons” his interest in GP. C has amount realized of \$40,000 (his share of deemed distributions under 731/752), and a basis of \$180,000 for a \$140,000 loss.
- Does the “abandonment” trigger a tax loss? How does C evidence the abandonment?
- Is the loss ordinary or capital? Because C receives a deemed distribution attributable to the debt, there is a “sale or exchange” of the GP interest that produces a capital loss. Rev. Rul. 93-80, 1993-2 C.B. 239, Situation 1. What if the debt is recourse and C remains liable on the debt?

# ABANDONMENT OF PARTNERSHIP INTEREST (CONT'D)



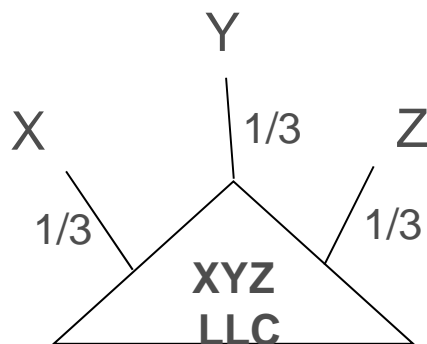
- Suppose that GP is a limited partnership. A and B are the general partners and C is a limited partner. A and B are liable on the GP debt but C is not. Thus, C does not share in any of the GP debt. C's abandonment produces an ordinary loss because there is no "sale or exchange." Rev. Rul. 93-80, Situation 2.
- Could Section 1234A require capital loss treatment even where there was no deemed distribution? Better view is no.
- What about a gift of a partnership interest to charity? Part sale/part gift will apply if donor has share of partnership liabilities. If does not have share of partnership liabilities, a gift will generate a charitable deduction but no taxable loss.
- What about a gift to Nancy Pelosi?

# BASIS CALCULATION IN PARTNERSHIP INTEREST ABANDONMENT



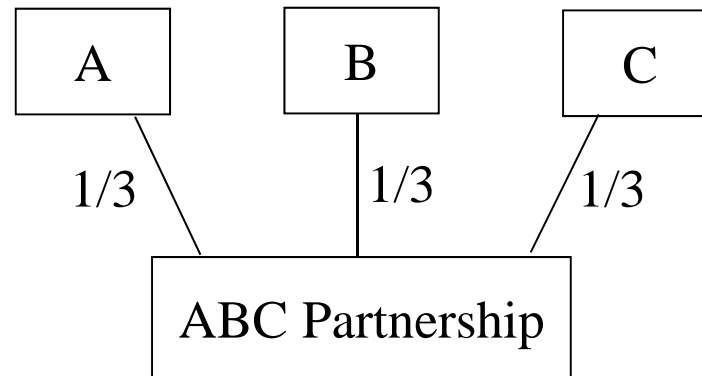
- LeBlanc, Jr., v. U.S., 104 AFTR 2<sup>nd</sup> 2009-7611 (12-04-09), Court of Federal Claims. (Note petition for cert. filed May, 2011).
- Taxpayers claimed ordinary loss deduction (§165) on abandonment of partnership interest. Court determined that taxpayers had no basis in partnership interest, thus zero deduction.
- Example: Partner contributes \$1,000 to Partnership as initial capital contribution. Year 1, Partner is allocated \$3,000 loss. Partner does not share in Partnership debt so Partner deducts \$1,000 of loss and remaining \$2,000 is suspended. Partner's basis stops at zero (no "negative basis"). Year 2, Partner is allocated \$1,000 of income. Partner abandons interest at end of Year 2. Partner argues his basis is \$1,000. Government argues basis is zero.
- Court determines basis is zero, thus no abandonment loss.

# "VANILLA" PARTNERSHIP DISTRIBUTIONS OF PROPERTY



- X, Y and Z formed XYZ, LLC years ago. Each made capital contributions of \$100.
- XYZ, LLC owns 3 parcels of real estate. Each parcel was acquired years ago for \$100. Each parcel is now worth \$500.
- X will withdraw from XYZ and receives one of the parcels from XYZ.
- XYZ is not taxed on the distribution of property to X (§731(b))
- X is not taxed on the receipt of property (§731(a))
- X has a basis in the property received equal to his \$100 basis in his LLC interest (§732)

# REV. RUL. 2007-40: PARTNERSHIP GUARANTEED PAYMENT WITH PROPERTY



ABC Partnership owns various real estate properties

- A receives a guaranteed payment of \$800 each year. In 2007 A and ABC agree to satisfy the guaranteed payment obligation by having ABC distribute property worth \$800 and having a basis of \$500 to A.
- General Rule: §731 partnership distributions of property are not taxable

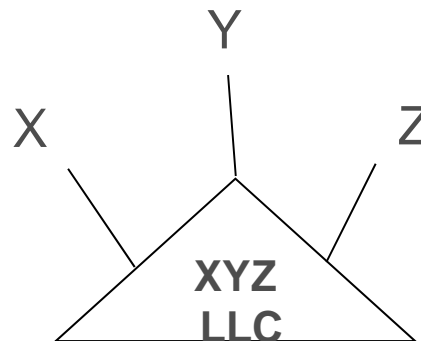


## REV. RUL. 2007-40: PARTNERSHIP GUARANTEED PAYMENT WITH PROPERTY (CONT'D)



- Rev. Rul. 2007-40, 2007-25 IRB 1: Distribution of appreciated property to satisfy partnership guaranteed payment obligation is a deemed sale by partnership
  - ABC has \$300 gain
  - ABC has \$800 deduction
  - A has \$800 income
  - A has property with \$800 basis

# "ROCKY ROAD" PARTNERSHIP DISTRIBUTION OF PROPERTY RECHARACTERIZED: CCA 200650014 (SEPT 7, 2006)



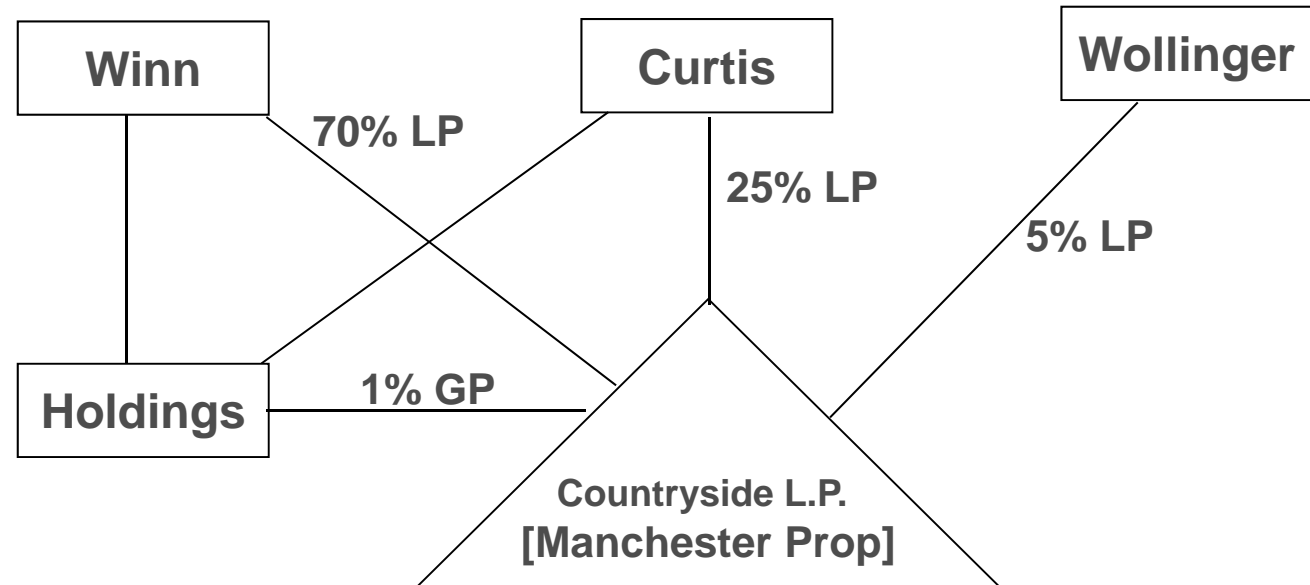
- Same facts except X is in a dispute with Y and Z. The dispute is resolved by the parties entering into a settlement agreement.
- Settlement agreement provides that X will be redeemed. X does not want cash (taxable) nor does he want one of the existing properties. X wants XYZ to acquire and distribute to him Property A (worth \$750,000). XYZ has \$500,000 in available cash.

# "ROCKY ROAD" PARTNERSHIP DISTRIBUTION OF PROPERTY RECHARACTERIZED: CCA 200650014 (SEPT 7, 2006) (CONT'D)



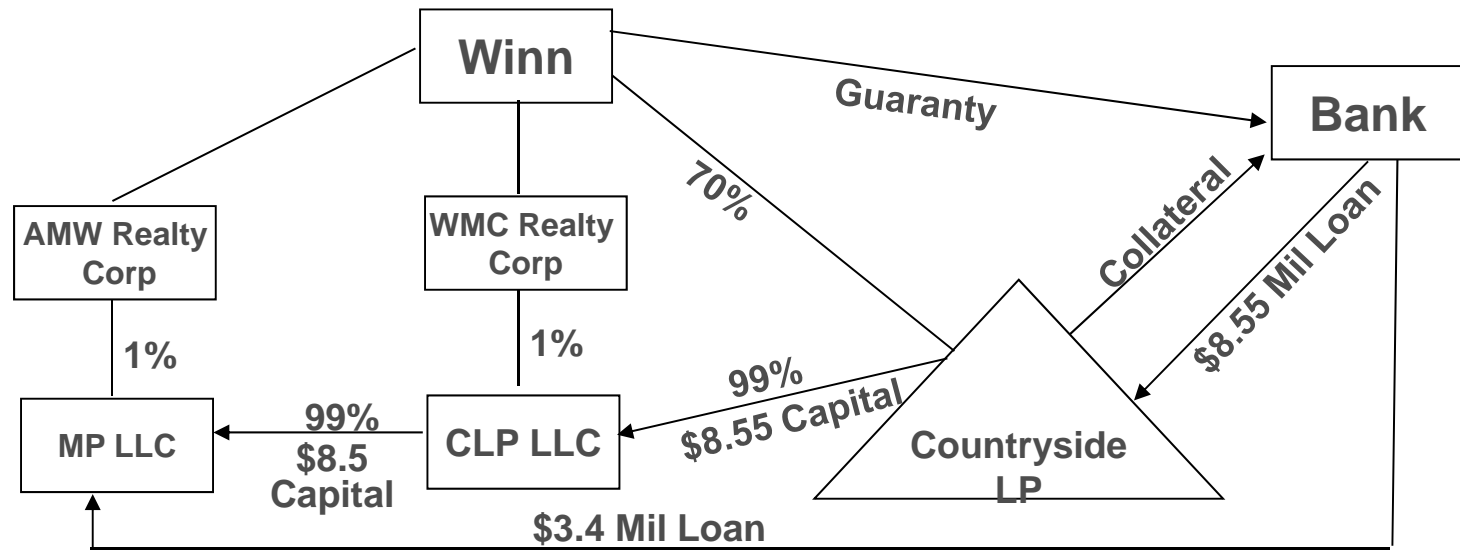
## ■ Settlement agreement provides:

- LLC will use its cash together with \$250,000 cash borrowed from X's relative to purchase Property A. XYZ will purchase Property A through a SMLLC owned by XYZ.
- Within 60 days of the purchase, X will borrow \$250,000 from Bank secured by Property A. X will contribute \$250,000 to XYZ and XYZ will distribute Property A to X in liquidation of his interest in XYZ. X agrees to reimburse XYZ for carrying cost of Property A.
- X has no right to possession of Property A prior to distribution.
- If X can't arrange the \$250,000, XYZ can sell Property A, and any profit and balance of funds will be paid to X.
- IRS audits and concludes X is taxed on the \$500,000 even though X acquired Property A. XYZ acquired Property A shortly before distribution. Property A was never XYZ's property for tax purposes – XYZ was X's agent
- IRS also applied 1.701-2 "anti-abuse" regs to recast the transaction. Also, step transaction doctrine
- Where is the line between a "good" structure and "bad" structure?



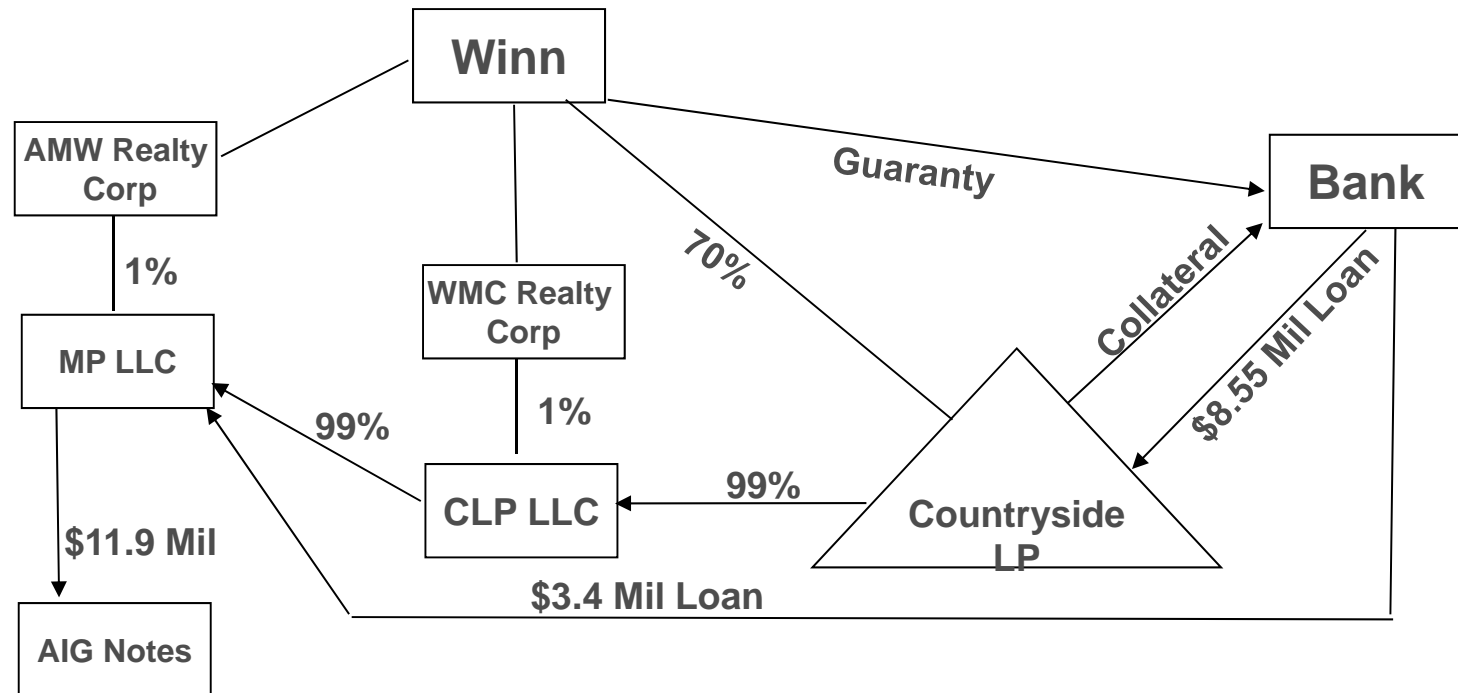
- Countryside LP acquired apartment building (“Manchester property”) in 1993.
- In May or June, 2000, parties had negative capital accounts. Countryside contemplates selling the Manchester property.

# COUNTRYSIDE, T.C. MEM 2008-3 (1-2-08) (CONT'D)



- 9/00, WMC formed CLP Promissee LLC ("CLP"). At the same time, AMW formed Manchester Promissee, LLC ("MP").
- 10/27/00, WMC contributed \$86,000 cash to CLP for a 1% interest in CLP. At the same time, AMW contributed \$85,000 to MP for a 1% interest in MP.
- At the same time, Countryside borrowed \$8.55 million from Bank (due date 5/1/01). On 10/30/00, Countryside contributed \$8.55 million to CLP in exchange for a 99% interest in CLP. CLP contributed \$8.5 million to MP in exchange for 99% interest in MP.
- MP borrows \$3.4 million from Bank (due date 11/1/03). Both loans are guaranteed by Winn and secured by deed of trust on the Manchester property. Both loans are 175 over LIBOR.

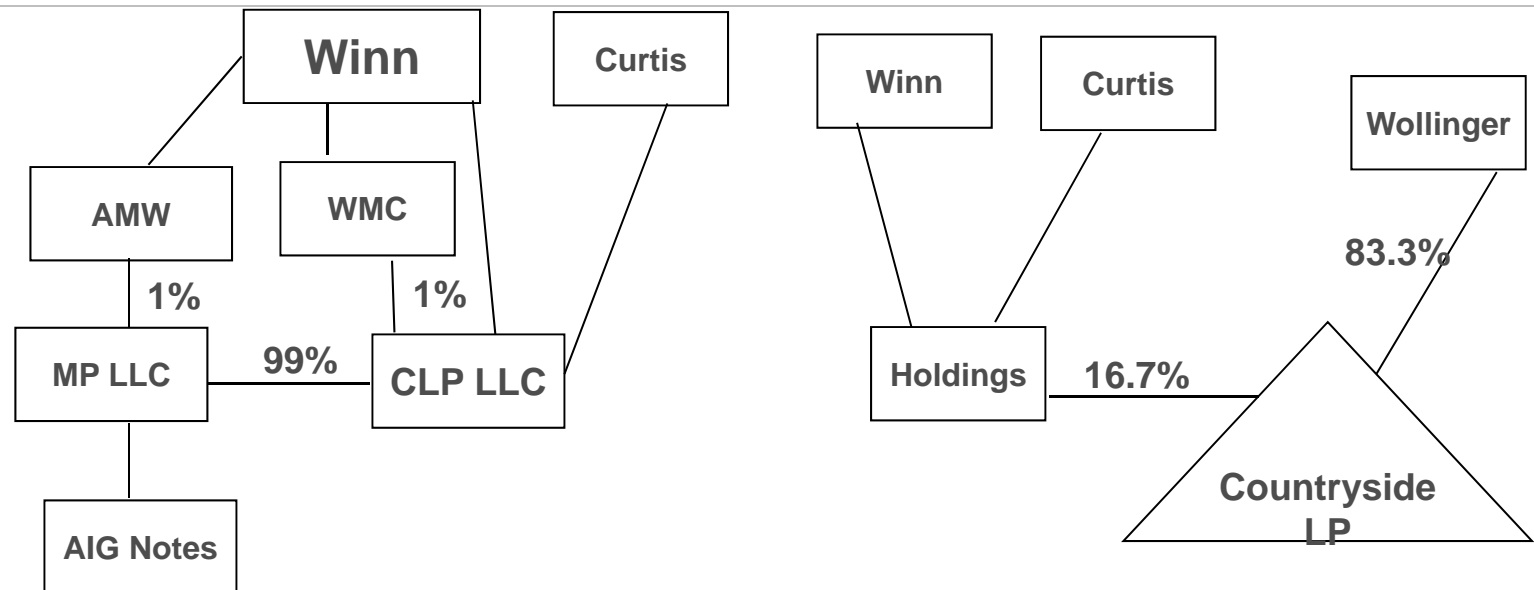
# COUNTRYSIDE, T.C. MEM 2008-3 (1-2-08) (CONT'D)



- MP purchased four privately issued notes from AIG
- Each AIG note was due 10/31/00. Holder has right to redeem on 4/30/03.
- Interest at LIBOR minus 55 until 5<sup>th</sup> anniversary; then LIBOR minus 35 thereafter.
- AIG notes were assigned by MP to the Bank as collateral for \$3.4 million loan.



# COUNTRYSIDE, T.C. MEM 2008-3 (1-2-08) (CONT'D)



- 12/26/00, Countryside distributed its 99% interest in CLP to Winn and Curtis in complete liquidation of their interests in Countryside.
- Countryside and CLP make 754 elections. MP does not make a 754 election.
- 1/26/01, Countryside contracts to sell Manchester property. Winn and Curtis own 24% of buyer.

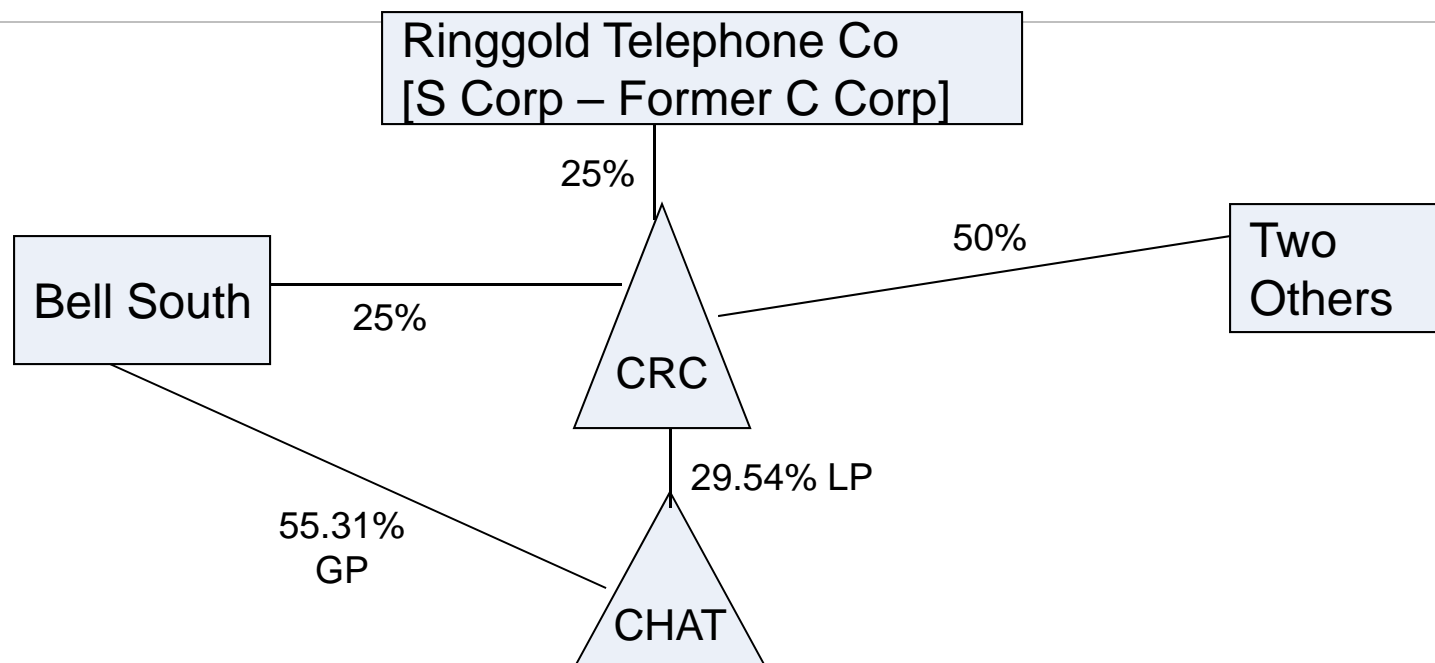
- Sale of Manchester property closes 4/19/01. Countryside repays \$8.55 million to Bank plus interest.
- MP redeems AIG notes 4/30/03. MP repays \$3.4 million loan. MP retains \$8.5 million cash (Winn and Curtis indirectly own it).
- Winn and Curtis had negative capital accounts in Countryside (approximately \$2.6 million).
- Prior to the distribution, Winn had a negative capital account of approximately \$2 million - Winn's basis in Countryside interest (including his share of liabilities under 752) was stipulated to be approximately \$20 million with his share of Countryside liabilities being approximately \$22 million [this included 70% of the \$8.55 million and \$3.4 million debts -- Note: these were guaranteed by Winn. Why did Curtis share in these debts?] Curtis had a negative capital account of approximately \$600,000. Curtis' stipulated basis in his Countryside interest was approximately \$7.5 million [including a portion of the \$8.55 million and \$3.4 million debts].
- Immediately after the distribution of the 99% CLP interest to Winn and Curtis, their share of Countryside liabilities under 752 had decreased but their continuing share of MP liabilities was sufficient to protect them from gain.

## COUNTRYSIDE, T.C. MEM 2008-3 (1-2-08) (CONT'D)



- When property is distributed to a partner in complete liquidation of the partner's interest in the distributing partnership, no tax is triggered (§731), but the basis in the distributed property takes the distributed partner's lower basis in his liquidated interest (§732). The \$3.4 million borrowing was designed to cover the negative capital accounts of Winn and Curtis.
- The 754 election for Countryside permitted Countryside to step up the basis of Manchester property equal to the basis step down on the distributed property (§734). Thus, Manchester property sale did not generate gain.
- §734 step up does not apply if the distributed property is an interest in another partnership with respect to which a 754 election is not in effect. CLP made a 754 election. IRS argues should ignore CLP to prevent Manchester property basis step up.

# DISCOUNTING TO AVOID BIG TAX: RINGGOLD TELEPHONE CO.



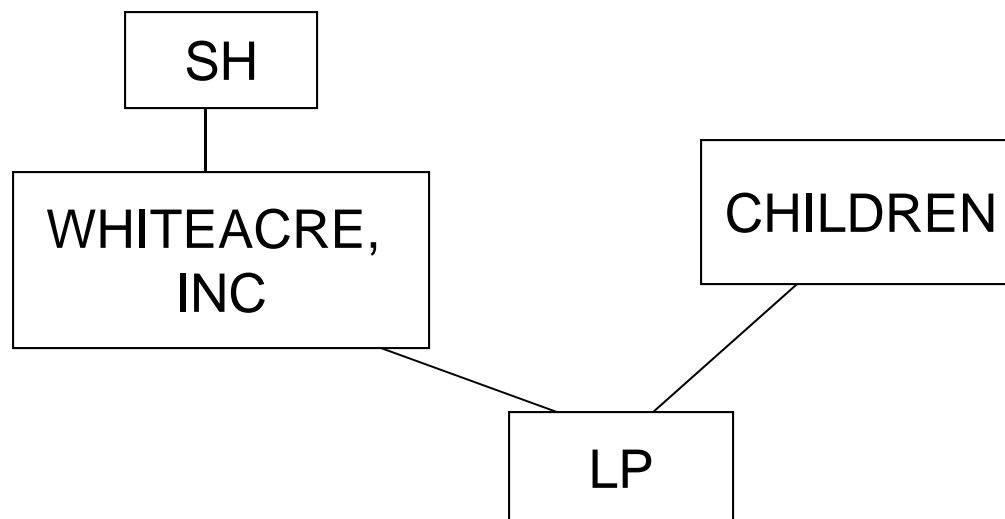
- Ringgold Telephone Co., TCM 2010-103 (5-10-10). The taxpayer was a C corporation that elected S status effective Jan 1, 2000. March, 2000, the taxpayer hired an investment banking firm to market its 25% interest in CRC. In November, 2000, Bell South purchased the 25% interest for \$5.2 million.

# DISCOUNTING TO AVOID BIG TAX: RINGGOLD TELEPHONE CO. (CONT'D)



- Question presented is the amount of BIG under Section 1374. Taxpayer's experts valued the interest at \$2.98 million as of Jan 1, 2000 (applying discounts for lack of marketability and minority interests). IRS experts argued best evidence of value was "reasonably contemporaneous arms'-length sale."
- Tax Court determined \$3.7 million value as of January 1, 2000. Thus \$1.5 million of amount realized escaped double tax.
- What if CHAT had sold all of its assets, with CRC receiving \$20.8 million of cash (Ringgold receiving \$5.2 million). Would the discount at \$3.7 million still apply? Yes. Treas. Reg. §1.1374-4(i)(2) & (i)(8), Ex. 3.
- But also see Treas Reg. §1.1374-4(i) for post election contributions to and distributions from partnerships. Also, anti-abuse rule.
- Compare Pope & Talbot, Inc. v. Com'r, 162 F.2d 1236 (9<sup>th</sup> Cir 1999) (no discounts permitted under Section 311 for distributions of limited partnership interests to stockholders). See also TAM 200443032 (7-13-04).
- Note: Section 1374 has a temporary 7 year rule (2009 and 2010) and 5 year rule (2011).

# THE FREEZE PARTNERSHIP



- Whiteacre, Inc. is a C corporation all of the stock of which is owned by Bob White. Whiteacre, Inc. owns a large ranch in Texas (of course, all ranches in Texas are large!) The ranch has substantially appreciated from its cost of \$2 million in 1965 to a present value of \$40 million. The ranch generates income from oil and gas working interest as well as from livestock. The ranch will appreciate in the future.
- Bob is 68 years old and has three children. Bob would like to shift value out of his estate. He is planning to make an S election for Whiteacre but this will not help with future appreciation. Bob could make gifts of minority interests in Whiteacre, Inc. to his children but he needs to cap the appreciation on what he retains.



# THE FREEZE PARTNERSHIP



- Bob's tax advisor developed the following plan: Whiteacre will contribute the ranch to a newly formed limited partnership ("LP"). The children will also contribute to the LP. Whiteacre will receive a "preferred interest" in the LP that will have a cumulative preference on cash flow of \$2 million per year and a 5% residual share thereafter. The preferred interest will have a right to the first \$40 million on a sale or refinancing and a 5% residual. If the ranch appreciates in the future, substantially all of the appreciation will be deflected to the younger generation. Will this work?
- Partnerships between a corporation and its stockholders have been respected. But what is the business purpose?
  - Watch "Sham" argument
  - Watch §701 anti abuse regs.
- Valuation must be accurate to avoid constructive dividend
- §704(c) will apply
- §482 could apply
- Chapter 14 could apply



- Estate of Church, 268 F3d 1063 (5<sup>th</sup> Cir. 2001).
- October 22, 1993. Mrs. Church and her two children contributed undivided interests in a ranch to an FLP. Mrs. Church also contributed \$1 million in liquid assets. Mrs. Church received LP interest; children controlled corporate GP.
- October 24, 1993. Mrs. Church dies. She had been diagnosed with cancer but died of heart attack. Documents had been executed but LP certificate had not been filed with state of Texas. Corporate GP was not formed until several months later. \$1 million brokerage account was not retitled to the LP for months.
- Estate took 58% discount on LP interest. Government did not produce a valuation expert - - thought the facts were compelling that taxpayer could not prevail.
- Taxpayer wins! Partnership “wrapper” should not be disregarded. Sloppy documentation evidence of no tax avoidance intent or devious motive!

# KELLER GOES TO CHURCH!



- Rayford L. Keller v. United States, No.6:02-CV-00062 (S.D. Tex 2009), Aff'd No. 10-41311 (5<sup>th</sup> Cir 2012).
- Taxpayer intended to form an investment partnership consisting of an existing Vanguard bond portfolio. The two LPs were trusts (included in taxpayer's estate) and a corporation was to be the GP.
- Taxpayer was to initially own all of the membership interests in the GP but she intended to sell these interests to family members.
- March 2000 – Taxpayer diagnosed with cancer but death not imminent.
- May 2000 – Documents were finalized and advisers visited taxpayer in hospital and had documents signed although there were blanks for the values of the capital contributions. Taxpayer also signed documents to form the GP. Advisers filed for EINs and called Vanguard.
- May 11, 2000 – Certificates filed with Texas
- May 15, 2000 – Taxpayer dies. At the time no assets had been retitled in the name of the partnership and “Schedule A – Contributions” remained blank.

## KELLER GOES TO CHURCH (CONT'D)



- Taxpayer's advisers initially did not feel the entities had been fully formed at date of death. Estate pays tax based on no discounts.
- May 17, 2001 [One Year after Death!] – Taxpayer's adviser attends seminar and learns of Church case. Advisers then moved forward to complete the entities; transfer assets.
- On November 15, 2001 – Claim for refund filed.
- Based on reasoning in Church, court in Keller sides with Taxpayer. Partnership was validly formed.
- Better late than never!

# DISCOUNTING A DISREGARDED ENTITY?



- Suzanne J. Pierre, 133 T.C. No. 2 (Aug. 24, 2009)
- Discounting value of LP or LLC interest is premised on respecting the “entity wrapper.” What happens when interests in a single member LLC are transferred? Can the values be discounted because of lack of marketability and minority interest?
- In Pierre, taxpayer formed a single member LLC (Pierre LLC) and contributed \$4 million in cash and marketable securities to it on September 15, 2000. On September 27, 2000, taxpayer transferred 100% of her membership interests to 2 trusts, one for the benefit of her son and one for the benefit of her grandson.
- More specifically, taxpayer made 2 gifts – 9.5% interest gifted to each trust; and taxpayer made 2 sales – 40.5% interest to each trust in exchange for notes.
- Note: if the trusts were grantor trusts, taxpayer still treated as owner for income tax payment – so Pierre LLC would remain a disregarded entity after the transfers.

# DISCOUNTING A DISREGARDED ENTITY (CONT'D)



- IRS argues disregarded entity must be disregarded for gift and estate tax valuation purposes – entity “wrapper” must be disregarded – taxpayer deemed to have made gifts of undivided interests in assets.
- Taxpayer argues, and Tax Court agreed, state law attributes control. Willing buyer/willing seller. The “fiction” under the check-the-box regs of a disregarded entity does not apply to ignore attributes of the LLC interest being transferred. Thus, another example of disregarded entities not being disregarded. See also Treas. Reg. §1.752-2(k) (disregarded entity not disregarded in testing recourse debt).
- What about Rev. Rul. 99-5, 1999-1 C.B. 434? Sale of an interest in a single member LLC treated as sale of undivided interest in each asset!
- In Suzanne J. Pierre, T.C. Mem 2010-106 (“Pierre II”), the Tax Court considered whether the “step transaction” doctrine should apply to cause the gift and the sale of two 50% interests to be aggregated. While the Tax Court agreed with the government, the change in the applicable discounts was less than 1% (from 36.55% to 35.6%).



# WANDRY V. COM'R – DEFINED VALUE GIFTS



- Tax Court ruled that a “stated dollar amount” of gifted LLC interest is effective to avoid a gift tax liability if the interests are revalued by the IRS on audit. Wandry v. Com’r, T.C. Mem. 2012-88.
- Parents made gifts of “a sufficient number of [LLC interests] so that the fair market value of such [LLC interests] for federal gift tax purposes shall be [\$\_\_\_\_\_].”
- Gifts of LLC interests were made based upon an independent appraisal. The amount of LLC interests gifted was equal to the specific dollar amount as determined by the appraisal.
- On audit, the IRS sought to increase the value of the gifted interests, thereby triggering a gift tax liability. The Tax Court rejected this argument and concluded that the gifts were intended to be of a specific dollar amount of LLC interests and not of a fixed percentage of LLC interests.
- This means that if there is a finally determined valuation increase, taxpayers made smaller percentage interest transfers. This is not a case where gifted property is “taken back” by the taxpayer. Rather the excess percentage interests were never transferred by gift.



# WANDRY V. COM'R – DEFINED VALUE GIFTS (continued)



- Wandry is a very important decision that has implications in a variety of contexts.
  - Sales to intentionally defective grantor trusts
  - Sales between related parties
  - Structuring “preferred partnerships”
  - Structuring corporate “frozen” partnership interests
- The government filed a Notice of Appeal to the 10<sup>th</sup> Circuit in August, 2012. This appeal was withdrawn in October, 2012. Many practitioners were hoping that Wandry would have been affirmed on appeal and that this would have provided more certainty. See also Estate of Petter v. Com’r, 653 F.3d 1012 (9<sup>th</sup> Cir. 2011), aff’g T.C. Mem 2009-280 (2009), where defined value clause was valid where valuation increases would cause excess to go to charitable beneficiaries (thereby increasing the taxpayer’s charitable contribution deductions).

# ANNUAL EXCLUSION GIFTS OF LP INTERESTS



- Estate of George H. Wimmer, T.C. Mem 2012-157 (6-4-12). This decision from Judge Paris shows that, notwithstanding contrary authority, it is possible for a gift of a limited partnership interest (or LLC interest) to qualify for the Section 2503(b) annual exclusion (“present interest” gifts).
  - FLP held marketable securities that generated predictable income and cash flow.
  - FLP agreement restricted transfers of LP interests by requiring consent of GPs plus 70% of LPs. However, gifts to other partners and family members were permitted without the consent requirement.
  - Gifts of LP interests were made in 1996 through 2000. In 1996-1998 cash distributions were made to the LPs for taxes. In 1999-2000 all cash flow was distributed to the partners.

# ANNUAL EXCLUSION GIFTS OF LP INTERESTS (CON'T)



- In Wimmer, the Tax Court found that the taxpayer had satisfied the 3 requirements for a present interest gift.
  - The partnership generated income. Yes, the LP received dividends from its marketable securities.
  - A portion of the income would flow steadily to the donees. Yes, the GPs had a fiduciary duty to make distributions and in fact distributions were made each year.
  - The income to be distributed could be readily ascertained. Yes, the LP held marketable securities that generated predictable cash flow.

# ANNUAL EXCLUSION GIFTS OF LP INTERESTS (CON'T)



- For the leading anti-taxpayer case, see A.J. Hackl v. Com'r, 118 T.C. 279 (2002), aff'd 335 F.3d 664 (7th Cir. 2003). See also J. W. Fisher, DC-Ind, 2010-1 USTC Para 60, 588 (2010); W.M. Price, T.C. Mem 2010-2 (2010). The following are “bad facts”:
  - Non-income producing property held by FLP
  - Discretionary cash distributions
  - Restrictions on ability of LP to withdraw
  - Restrictions on ability of LP to sell FLP interest

# ANNUAL EXCLUSION GIFTS OF LP INTERESTS (CON'T)



- What does this mean?
  - If possible, use cash or other liquid assets for annual exclusion gifts
  - Trying to structure FLPs to qualify for annual exclusion gifts may cause valuation discounting problems. Predictable cash distributions and giving LP a “put” or other right to exit will cause discounts to be much less.

- Estate of Rankin M. Smith, 109 AFTR 2d 2012-987 (Ct. Fed. Ct. 2012). Decedent and his family members owned an S corporation that owned the Atlanta Falcons. Decedent owned shares that had “super voting” rights but, pursuant to a shareholders agreement, these shares converted to shares with reduced voting rights at death of the holder. Decedent died in 1997 at which point the voting rights of the stock included in the estate went from 81.75% to 32.65%. Court of Federal Claims agreed with IRS that Section 2704(a) required the valuation of the stock based upon the pre-lapse voting attributes (pre-lapse value was \$30 million; post-lapse value was \$2.2 million). The lapse at death was treated as a transfer of property to other family members includible in the gross estate of the decedent.
  - See also Rev. Rul. 89-3, 1989-1 CB. 278 (exchange of shares with no lapse for shares with lapse is a present gift)
  - In 2002, Falcons were sold for \$595 million!

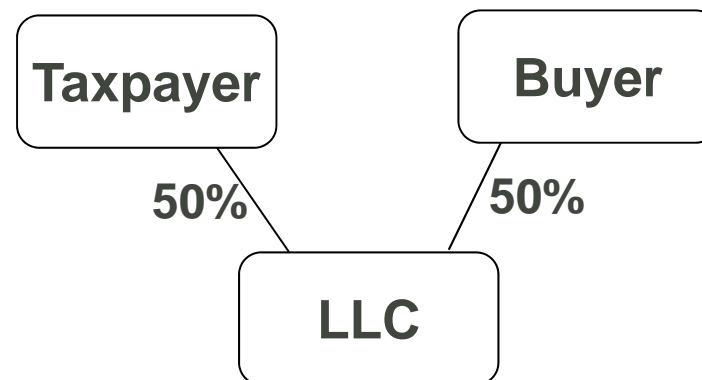
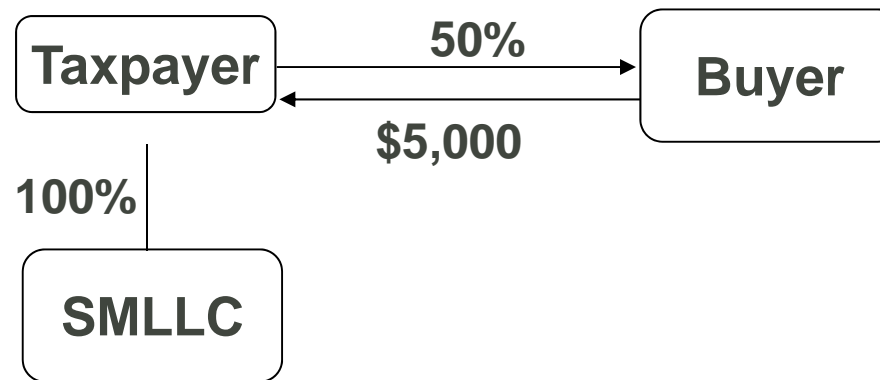


## OTHER RECENT FLP CASES (CONT'D)

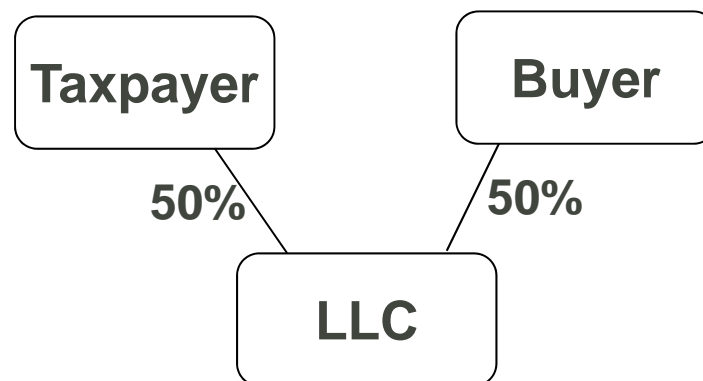
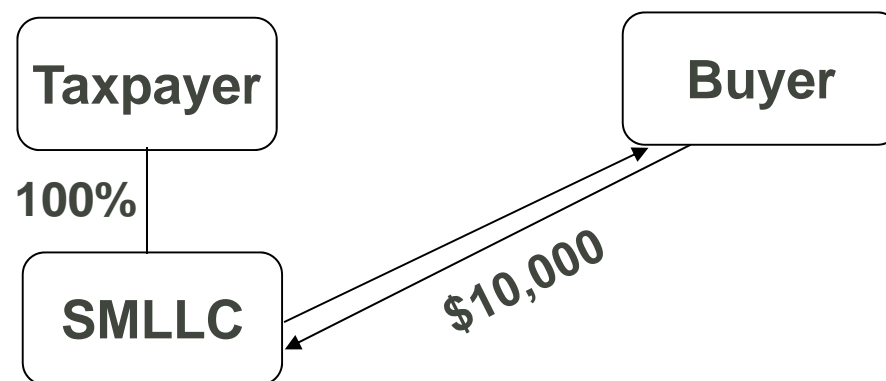


- Estate of Kelly, T.C. Mem 2012-73 (March 19, 2012). Tax Court ruled in favor of estate that assets contributed to four FLPs were not included in the gross estate under Section 2036(a). Rather, the LP interests were included at a discounted value. The facts were not very favorable to taxpayer. Among other things, the four children orchestrated the formation of four separate FLPs (each intended to ultimately go 100% to a different child) pursuant to their authority as co-guardians of their mother who was incompetent. The formation of the FLPs was approved by a Georgia court with full disclosure of the reasons for the FLPs and the fact that the estate would save over \$2 million in estate taxes.
- Estate of Clyde Turner, 138 T.C. No. 14 (March 29, 2012). This decision in favor of the government (Judge Marvel is clearly pro-government in the FLP context) is a follow up to Estate of Turner, T.C. Mem 2011-209 (2011) where the Tax Court concluded that Section 2036(a) applied to cause the underlying assets of an FLP to be included in the decedent's gross estate. In the subsequent case, the estate is requesting that the FLP assets included in the gross estate be deemed eligible for the marital deduction. Judge Marvel rejected this argument. A portion of the FLP interests were gifted to family members (or trusts) during life. However, under Section 2036, all of the FLP assets were included in the estate. The Tax Court ruled that the marital deduction was not available to the extent the FLP assets are attributable to gifted LP interests because these assets are not passing to the surviving spouse (or the marital trust).

# REV. RUL. 99-5: SITUATION 1



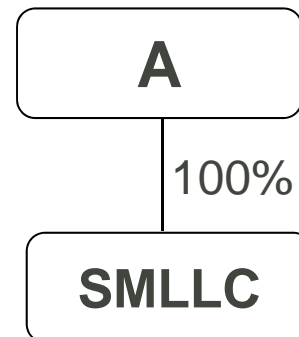
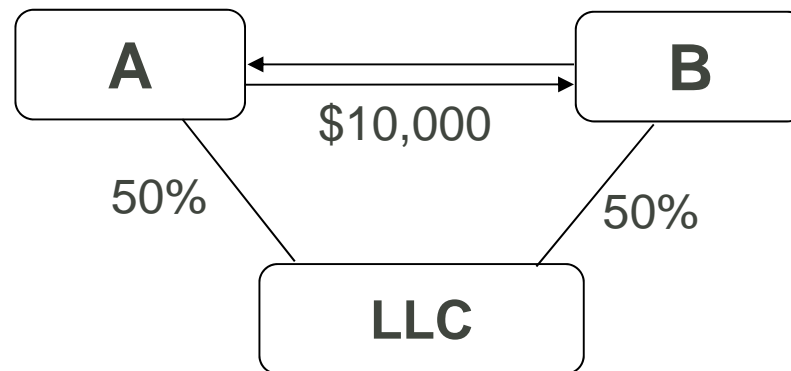
## REV. RUL. 99-5: SITUATION 2



- Taxpayer deemed to have sold a 50% undivided interest in assets. Taxable (except 1031).
- Buyer deemed to have purchased a 50% undivided interest in assets.
- Taxpayer and Buyer are deemed to have formed a new partnership.
- 704 (c) allocations.
- No 721(b) investment company issue because no diversification.

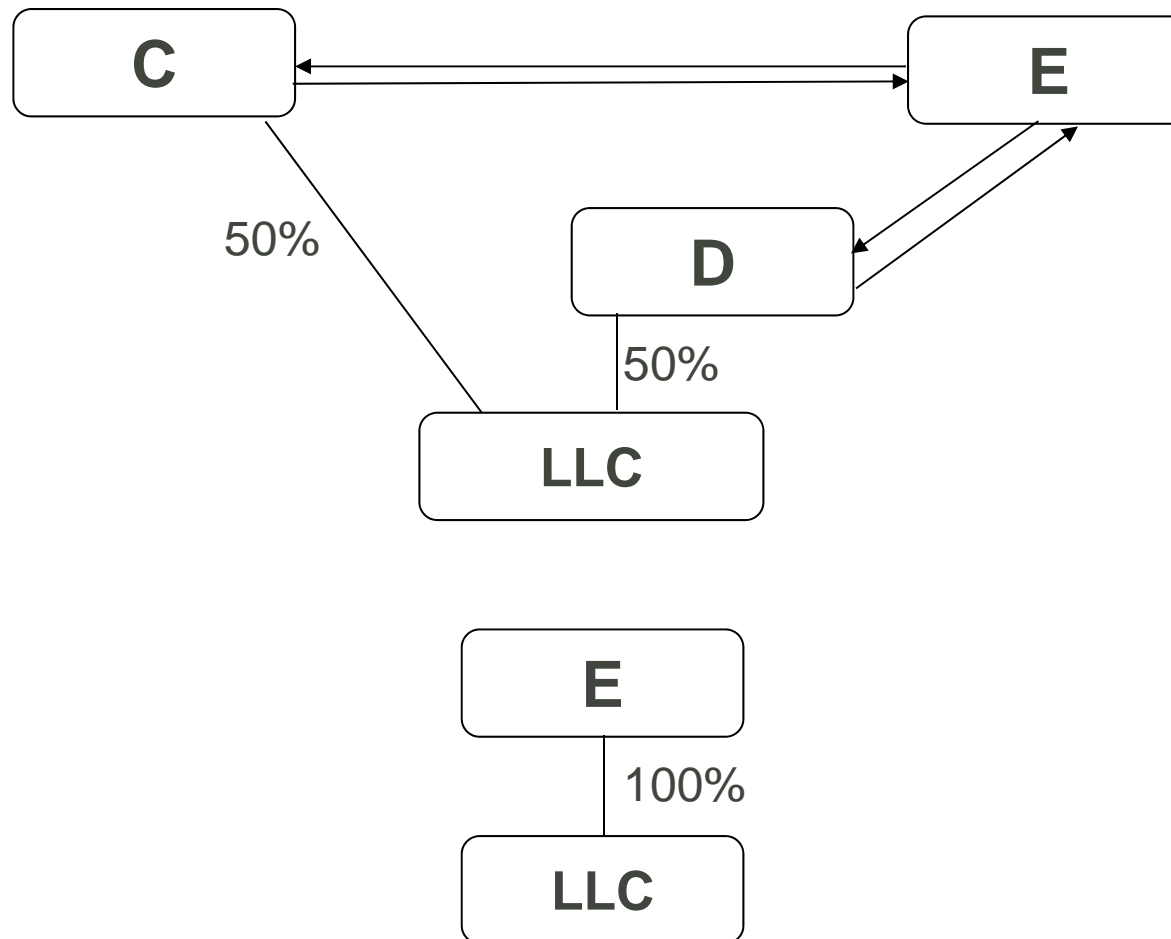
- Buyer and Taxpayer are deemed to have formed a new partnership
- Buyer contributes \$10,000
- Taxpayer contributes assets of SMLLC
- Generally, nontaxable under 721 (except could have investment company problem under 721(b)).

# REV. RUL. 99-6: SITUATION 1





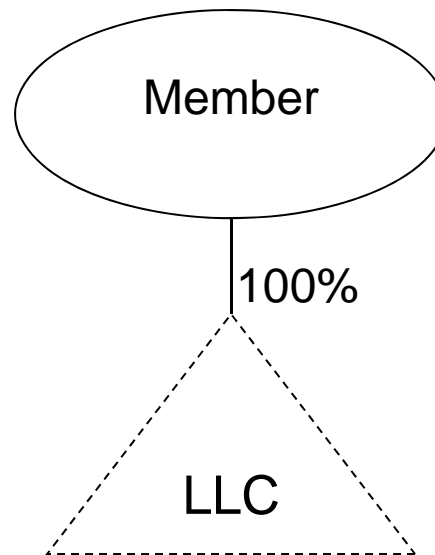
## REV. RUL. 99-6: SITUATION 2



- B deemed to sell his LLC interest to A
- A deemed to purchase B's share of AB's assets
- AB becomes a disregarded entity
- Note: A could use the purchase as 1031 replacement
- What if AB redeems B's interest? Does A get any basis step up? Does B avoid 25% recapture?

- C and D deemed to sell CD LLC interests to E
- E deemed to purchase former CD LLC assets
- CD LLC is now a disregarded entity
- Note: E could use purchase as 1031 replacement

# Single Member LLC



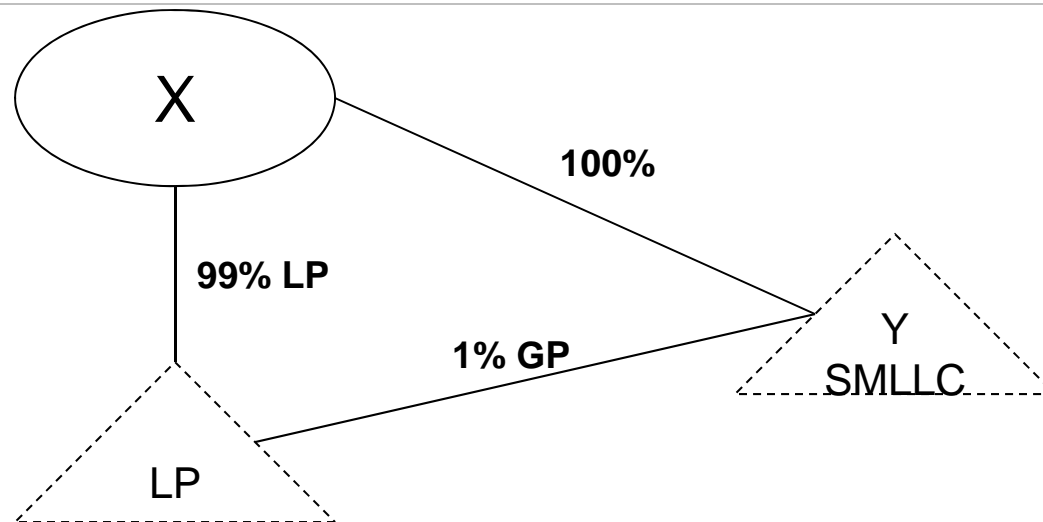
- Treas Reg. §301.7701-2. A single member LLC (“SMLLC”) that does not elect to be a corporation is a “disregarded entity” (“DE”).
- If an entity is disregarded, its assets and activities are treated as a sole proprietorship, branch or division of the sole owner.

# Single Member LLC (cont'd)



- Note that a SMLLC could elect (“check the box”) to be taxed as a corporation (and could make an S election). Treas. Reg. §301.7701-3(c).
- Rev. Proc. 2002-69, 2002-2 C.B. 831 (spouses in community property state can elect DE or tax partnership status).

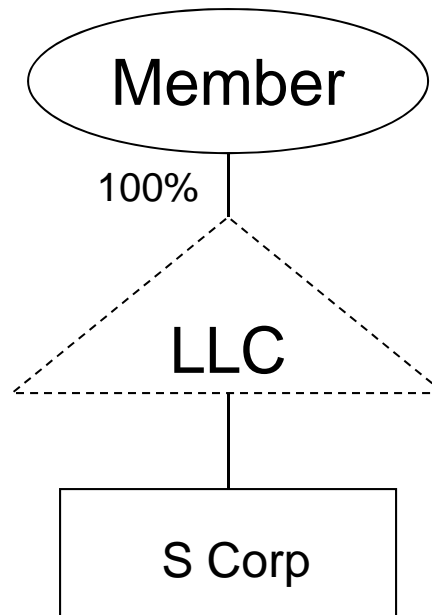
# Multi-Member Disregarded LLC



- Rev. Rul. 2004-77, 2004-2 C.B. 119.
- LP is a limited partnership for state law purposes. LP has not checked the box to be taxed as a corporation.
- Y is a SMLLC that has not checked the box.
- X is deemed to own 100% of LP; thus LP is a DE.

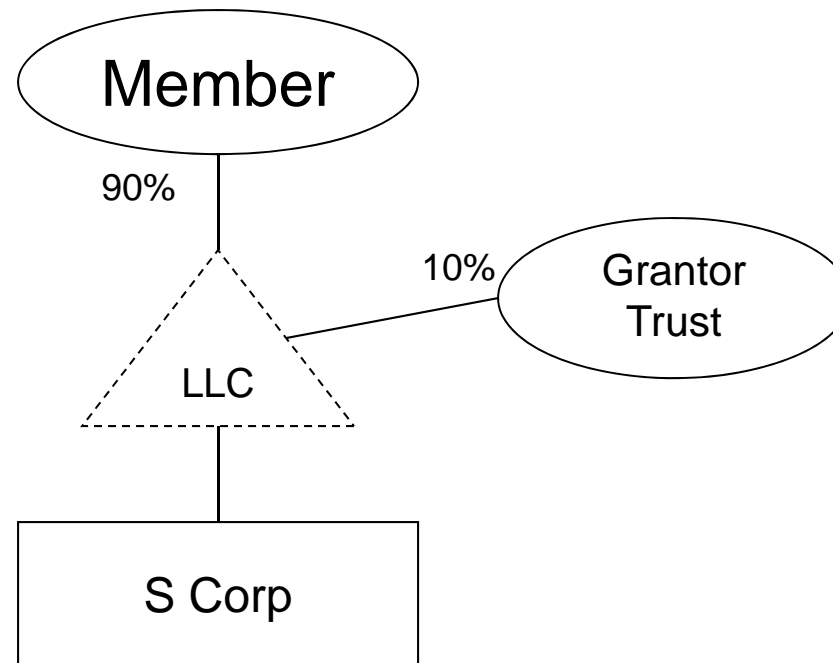


# Eligible S Corp Stockholder



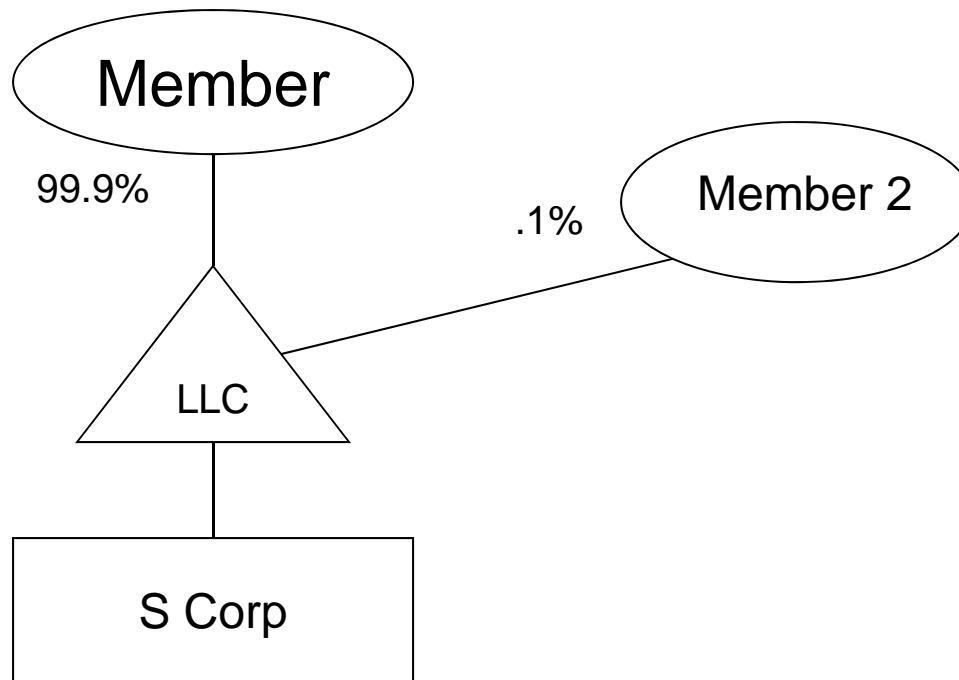
- LLC is a DE. Member is deemed stockholder of S Corp. Assuming Member is a permitted S stockholder, having LLC as intervening entity is not a problem.
- Note: if LLC checked the box, it could make an S election and S Corp could become a QSUB (see below).

# Eligible S Corp Stockholder (cont'd)



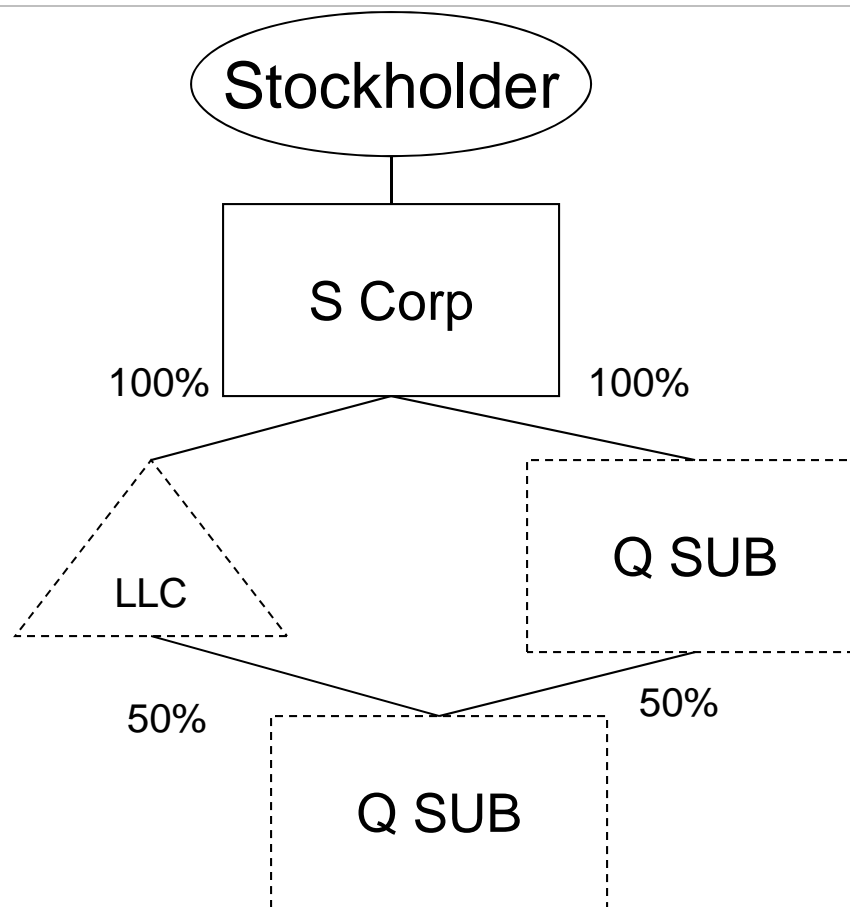
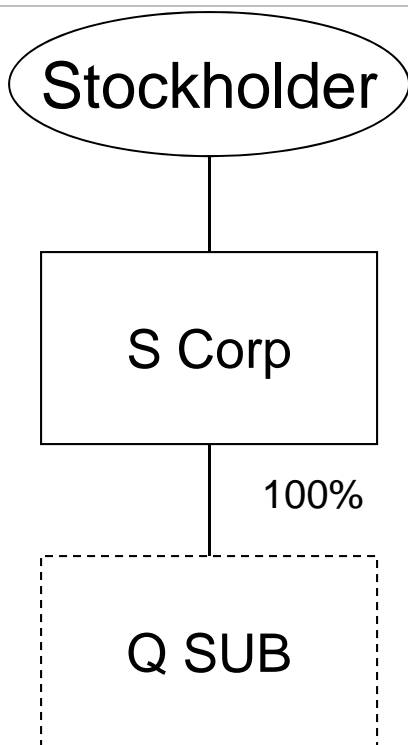
- Ltr. Rul. 200439027 (9/24/04). Member treated as the (income tax) owner of LLC interests owned by Grantor Trust. Thus LLC treated as SMLLC and a DE.

# (In)Eligible S Corp Stockholder



- A partnership is not an eligible S Corp stockholder. LLC is now a tax partnership; thus, S status is gone.
- Note: LLC could check the box and make an S election. S Corp could become a QSUB if 100% owned by LLC.

# QSUB = DE



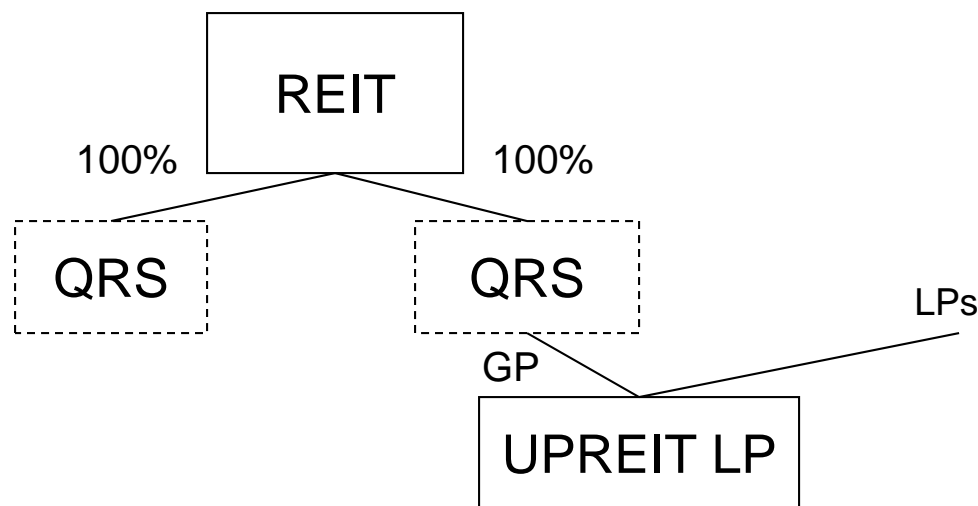
- Section 1361(b)(3)(B) – a corporation wholly owned by an S Corporation can, by election, be treated as a DE (Qualified S Subsidiary, or “QSUB”).

## QSUB = DE (Cont'd)



- Note that a merger between DEs is disregarded for tax purposes. Thus, a QSUB could merge into a SMLLC owned by the S Corp parent without tax consequences.
- Actual Retitling of assets from a QSUB to the S Corp and from the S Corp to the QSUB is disregarded for income tax purposes (but watch state and local transfer taxes).

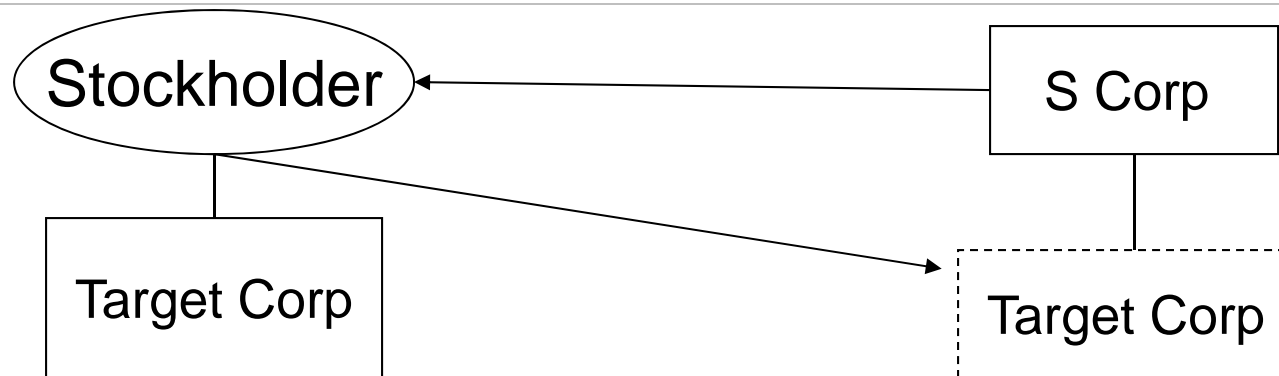
# QRS = DE



- Section 856(i) – a corporation, wholly owned by a REIT, that does not elect to be a “taxable REIT subsidiary” (“TRS”) is a “qualified REIT subsidiary” (“QRS”). A QRS is a DE.
- Note: Unlike a QSUB, no special election is required.

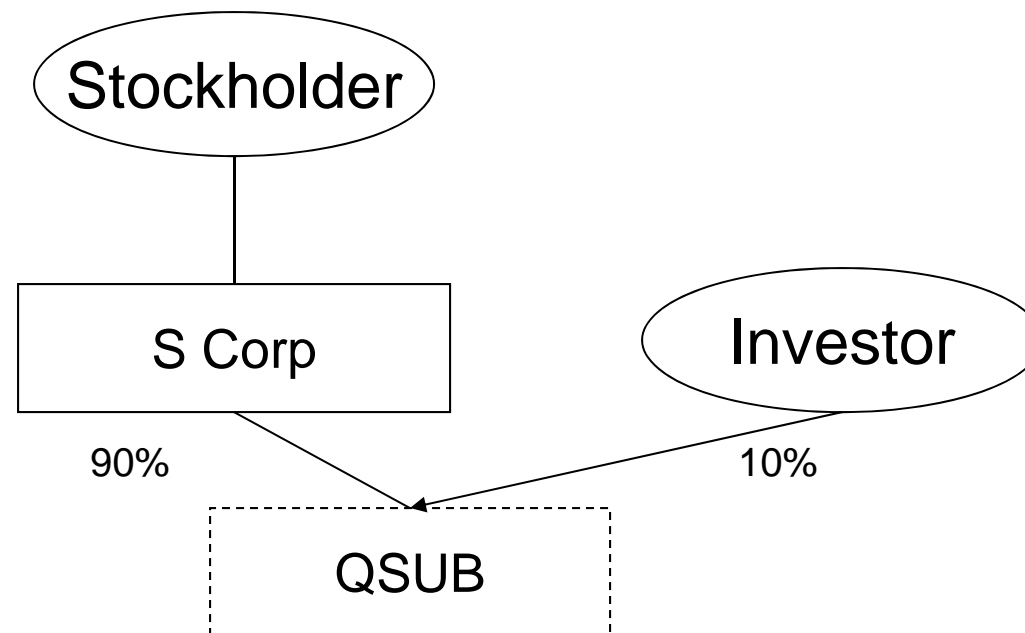


# QSUB Election For Target



- Assume all of the stock of Target Corp is purchased by S Corp for \$1 million. Target Corp has a basis in its assets of \$200,000. No 338(h)(10) election is made.
- Target Corp becomes a QSUB.
  - Basis of Target Corp's assets remains \$200,000. Target Corp's assets treated as owned by S Corp for tax purposes.
  - \$1 million purchase price for Target stock "disappears" since the stock of Target, as a QSUB, has disappeared.
  - The \$1 million purchase price will show up in the basis of S Corp's stockholders, either as a capital contribution or as a loan. If the purchase price is funded from existing cash of S Corp, it is already in stock basis unless debt financed in which case outside basis will increase as taxable income is used to repay principal.
  - Problem: Down the road, S Corp sells stock of Target for \$1 million. There is gain of \$800,000. Offsetting loss is deferred if S Corp is not liquidated in same the next year.

# From QSUB to Corporation (Including S Corp)



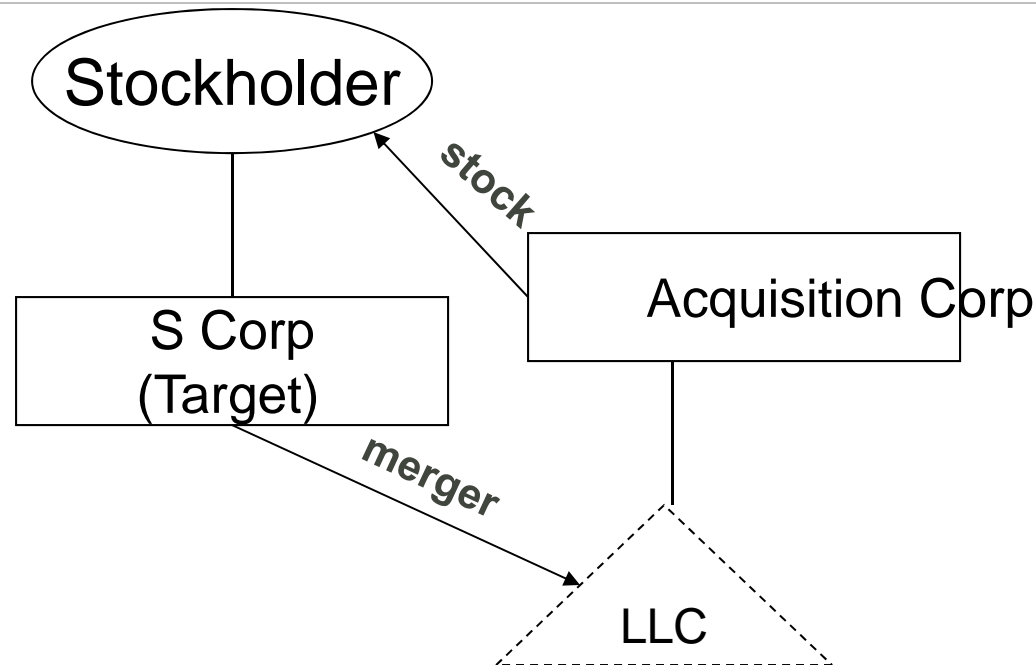
- Treas. Reg. §1.1361-6(b)(1) – if QSUB election terminates, the QSUB is treated as a new corporation.
- Section 351 Analysis
- Note QSUB cannot make an S election on these facts.
- Solution: convert QSUB to LLC before admission of Investor?

# From QSUB to Corporation (Including S Corp) (Cont'd)



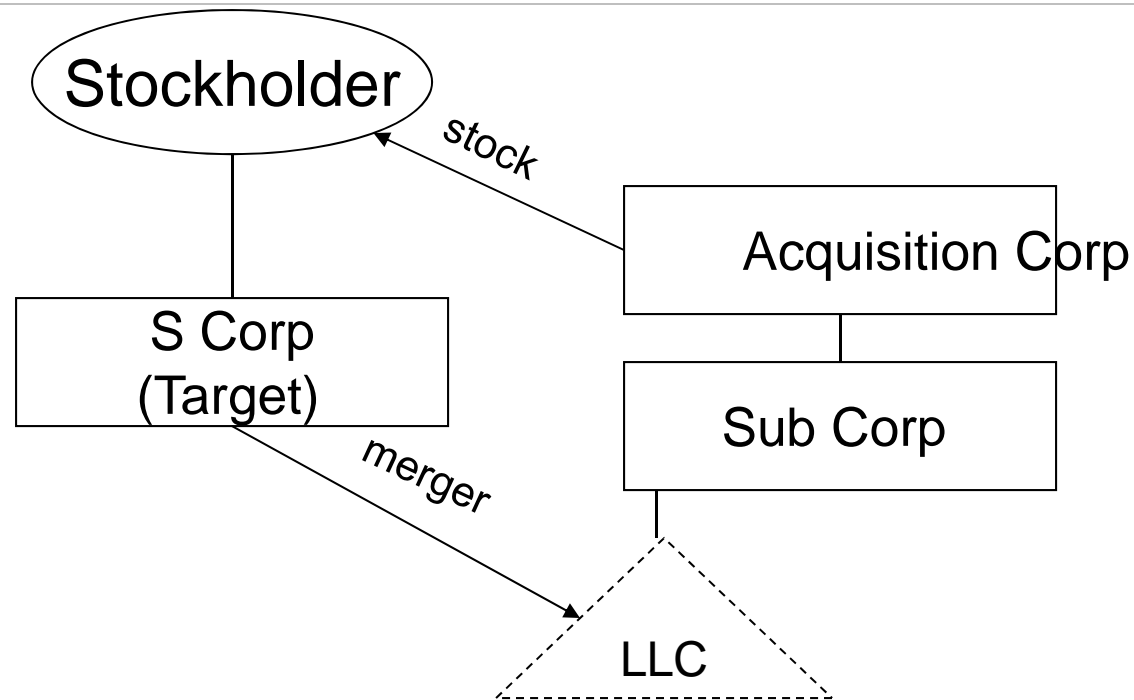
- What if Investor receives 21% of stock of QSUB?
  - Treas. Reg. § 1.1361-5(b)(3), Ex. 1.
  - Treas. Reg. § 1.1361-5(b)(3), Ex. 2.
  - Section 1361(b)(3)(C) - Statutory change to mirror tax consequence if QSUB were an LLC.
- What if Investor purchases 100% of stock of QSUB?
- Treas. Reg. § 1.1361-5(b)(3), Ex. 9 – Sale of assets followed by a deemed incorporation by buyer. See also Rev. Rul. 2004-85, 2004-2 CB 189.

# 368 (a)(1)(A) Merger



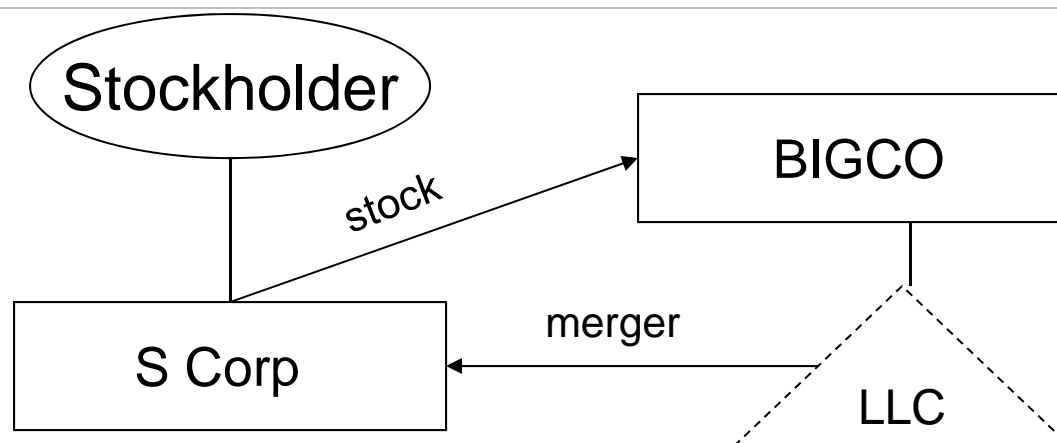
- Acquisition Corp wishes to acquire S Corp in a tax free re-org under Section 368. The sole consideration to be received by S Corp stockholders will be stock in Acquisition Corp.
- Acquisition Corp does not want to have S Corp merge directly into Acquisition Corp. Acquisition Corp forms LLC (as a DE) and S Corp merges into LLC with LLC surviving.
- Treas. Reg. § 1.368-2(b)(1) treats this as a valid (a)(1)(A) re-org.

# 368 (a)(2)(D) Triangular Merger



- Regulations also approve the merger into a DE owned by a subsidiary corporation in exchange for stock of the parent corporation when the DE survives.
- Section 368(a)(2)(D)

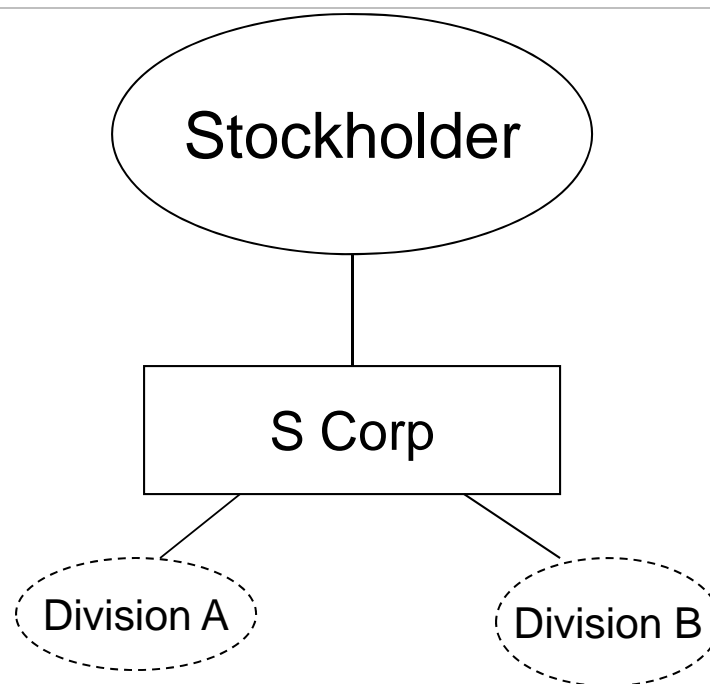
# “Bad” Merger



- Treas. Reg. 1.368-2(b) provides that this is not a good re-org unless it qualifies under 368(a)(1)(C).

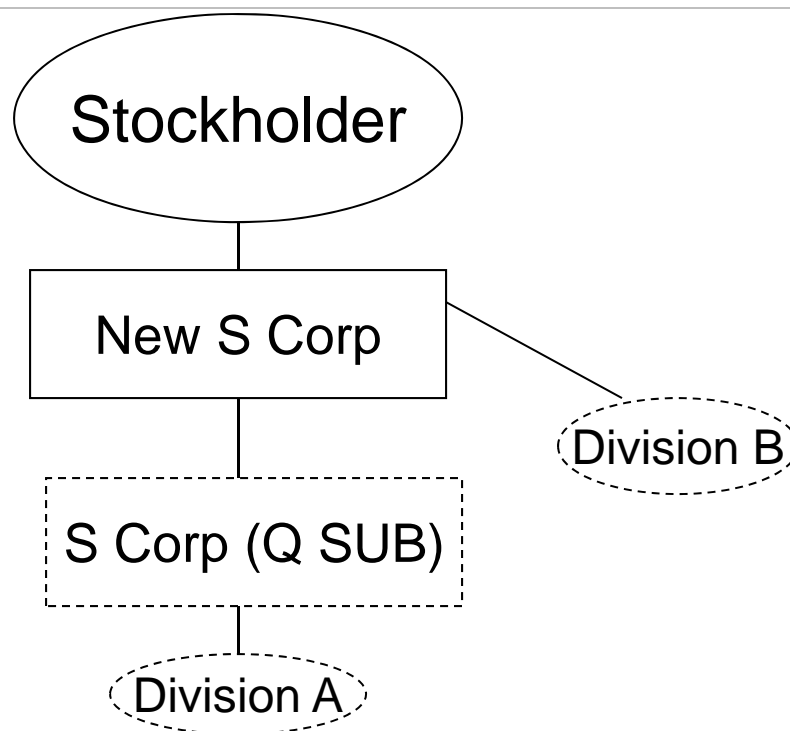


# Dividing a Corporation



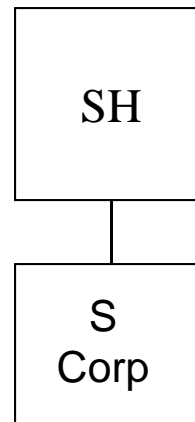
- S Corp has two business divisions, A and B.
- Stockholder is marketing S Corp and it appears that a Buyer wants to purchase all of S Corp stock (and elect under 338(h)(10)) but Buyer does not want to acquire division B.

# Dividing a Corporation (Cont'd)



- Stockholder forms New S Corp and contributes all of the stock of S Corp to New S Corp.
- S Corp becomes a QSUB
- S Corp then distributes Division B to New S Corp (disregarded transaction).
- New S Corp can now sell stock of S Corp to Buyer. Note that Buyer will not need 338(h)(10) election because deemed asset acquisition.

# COMPLETE LIQUIDATIONS USING CHECK-THE-BOX REGS



- S Corp has \$50 million in cash, \$30 million of real estate, a widget business worth \$20 million, a \$25 million casino business which includes a nonassignable casino license.
- S Corp has been an S corporation for more than 10 years. It has \$5 million of AAA and \$50 million of C corp E & P. S Corp has a low basis in its real estate and widget business assets. Its basis in the casino assets is equal to value.
- The sole stockholder has an outside basis in the S Corp stock of \$100 million [Note: this could happen if stockholder died or if stockholder purchased the stock for a high number.]
- Stockholder wants to get cash out of corporate solution. He also wants to have the real estate assets separated from the widget business. For several reasons, a tax free spinoff is not available.

# COMPLETE LIQUIDATIONS USING CHECK-THE-BOX REGS (CONT'D)



- If S Corp distributes its cash to the stockholder, once the distribution eats through the AAA, the remaining distribution is taxed as a C corporation dividend – wasted money!
- The E&P problem goes away in a complete liquidation. Problem with a “traditional” complete liquidation is the need to assign the casino assets including the nonassignable license.
- Step 1: Stockholder forms Holding LLC. Stockholder contributes all of the stock of S Corp to Holding LLC in exchange for 100% of the membership interests in Holding LLC. Note: if Holding LLC is a disregarded entity, it is ignored in determining whether S Corp has permitted stockholder. Further Note: if Holding LLC is disregarded, nothing is accomplished because we still need to liquidate S Corp without assigning the casino license.
- Step 2: Holding LLC elects to be taxed as a corporation and it makes an S election. By this, S Corp becomes a QSUB and a disregarded entity for tax purposes. This would constitute an F reorg and S Corp’s E&P would travel upstream to Holding LLC (i.e., it does not evaporate!). At this point, there has been no actual asset ownership change. All assets are still owned by S Corp, although for tax purposes they are all deemed owned by Holding LLC.
- Note: See Rev Proc 2009-41, 2009-39 IRB 1, where guidance is provided for late elections under check-the-box regs.

# COMPLETE LIQUIDATIONS USING CHECK-THE-BOX REGS (CONT'D)

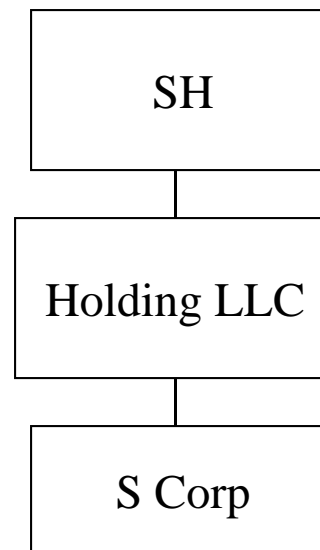


- Step 3: S Corp actually distributes to Holding LLC all of its assets except the casino license (and perhaps other casino assets) These actual distributions are ignored for tax purposes because S Corp is a disregarded entity.
- Step 4: Holding LLC now reverses the check-the-box election, thus becoming a disregarded entity. This election triggers a deemed liquidation of Holding LLC (an S corporation for tax purposes). Even though assets do not get retitled, all assets of Holding LLC are treated, for income tax purposes, as having been distributed by Holding LLC (an S corp) to the stockholder who in turn contributed them back to Holding LLC, now treated as a single member LLC, disregarded entity for tax purposes. Moreover, the casino license and assets are treated as having been contributed by Holding LLC to S Corp which is converted from disregarded entity (QSUB) to a new S corporation (assuming an S election is made).
- Note that the deemed liquidation of Holding LLC as S corporation, triggers gain at the entity level which increases outside basis. Because of the high outside basis prior to liquidation, the result is taxable gain may be offset by a capital loss on the deemed liquidation.
- Note: if retained assets (i.e., casino) are more than 20% - could have liquidation/reincorporation On these facts, it is a close call.
- Note: What if S Corp is owned by two stockholders so Holding LLC will not be disregarded after the deemed liquidation? The analysis is similar except that Holding LLC would need to actually distribute the stock of S Corp up to the two stockholders in order to have S Corp make a new S election (a partnership is not a permitted S stockholder).

# COMPLETE LIQUIDATIONS USING CHECK-THE-BOX REGS (CONT'D)



## STEP 1

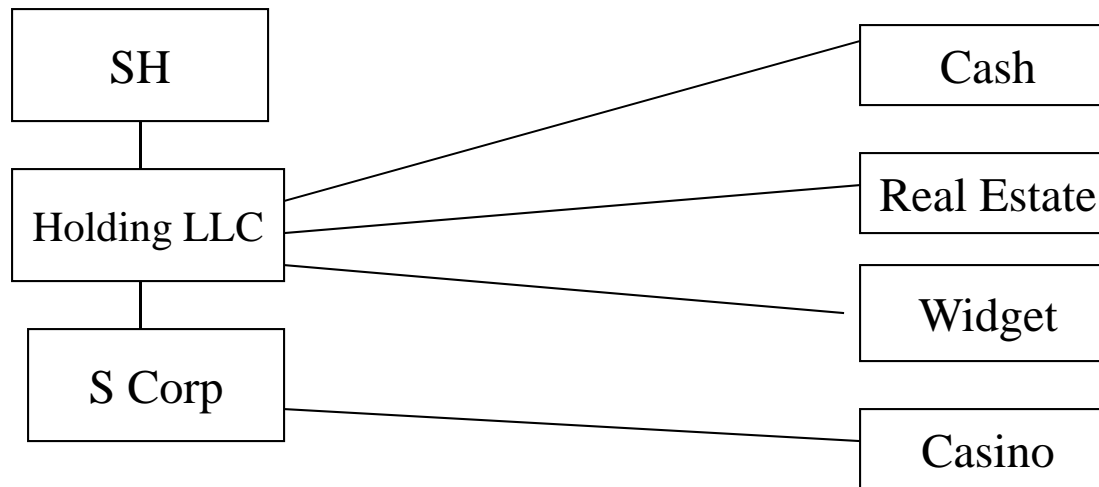


- Holding LLC – checks the box
- Holding LLC – S election
- S Corp becomes QSUB

# COMPLETE LIQUIDATIONS USING CHECK-THE-BOX REGS (CONT'D)



## STEP 2



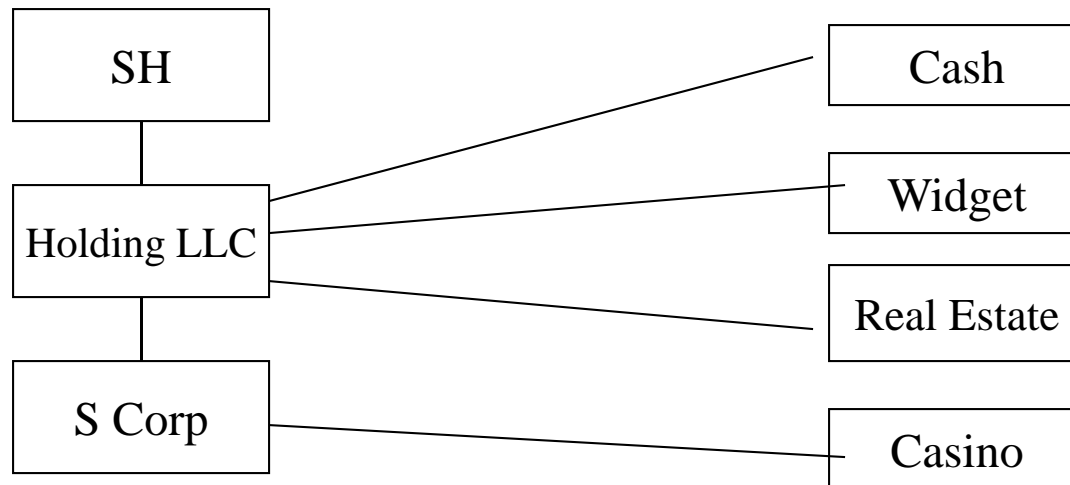
- Deemed distribution of assets from S Corp to Holding LLC. Also want actual distribution for state law purposes as well.
- Actual (and deemed) distributions are disregarded for tax purposes.



# COMPLETE LIQUIDATIONS USING CHECK-THE-BOX REGS (CONT'D)



## STEP 3



- Holding LLC reverses check-the-box election, triggering a deemed liquidation of Holding LLC (then an S corp for tax purposes)
- No actual change in ownership need occur (but they can occur if desired (e.g. SH wants the cash; real estate should be in separate entity etc.)
- S Corp becomes a regarded corporation and S election is made. Note: casino never retitled.

- Noncontrolling owners of interests in pass-thru entities attempt to negotiate a provision that requires annual distributions to cover taxes.
- Is the distribution mandatory or does it only require commercially reasonable efforts? Do loan documents prohibit or permit such distributions? Is the entity required to borrow funds to make the tax distribution?
- Careful: The tax distribution should only apply if regular distributions do not cover.
- Careful: The tax distribution should only apply to bottom line taxable income of the entity. Special income allocations under Section 704(c) are usually carved out. Tax distributions are generally computed without regard to Section 743 basis adjustments (Section 734 basis adjustments would be taken into account).

# Drafting Tax Distribution Clauses (cont'd)



- Careful: Is the tax distribution an override to a distribution waterfall or is it an advance with a “clawback”?
- Is the tax distribution formula a fixed percent of taxable income or is it based on the highest blended marginal rate as determined each year by the entity’s CPA? Does it assume all ordinary income or does it incorporate ordinary income and capital gain rates?
- Is the distribution determined annually or is it determined on a cumulative basis? Assume in Year 1 the entity has a loss of \$1,000 and in Year 2 it has income of \$1,000. If the determination is annual then there would be a tax distribution in Year 2. If it is cumulative, there would be no tax distribution in Year 2.