Structuring and Restructuring Deals in 2014 (and Beyond)

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60th ANNUAL WILLIAM AND MARY TAX CONFERENCE

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Current Rate on Long Term Capital Gain ("LTCG") = 20% (plus state)

Current Rate on Ordinary Income = 39.6% (plus state)

Special 25% rate (plus state) on Section 1250 Gain

Special 28% rate (plus state) on art and collectibles

AMT Trap = 28%

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 income tax but other states may tax these nonresidents.
Phase down of itemized deductions – makes effective tax rate higher.

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.
3.8% NIIT applies to income and gain from passive activities. See Section 469.

Example: Father and Mother own an LLC equally. The LLC owns a hotel that generates income. Father and Mother are actively involved in the management and operation of the hotel. The income is not passive under Section 469.

Example: Father forms a grantor trust and transfers his 50% LLC interest to this trust. The trust has Daughter as its sole beneficiary. The trustee of the trust is Trusted Friend, an individual not involved in the hotel operations. Because the trust is a grantor trust, Father remains the taxpayer for income tax purposes and for NIIT purposes. NIIT is not applicable to the income of LLC flowing through the grantor trust.

Example: Same facts except the trust is not a grantor trust. Frank Aragona Trust, 142 T.C. No. 9 (2014) provides guidance in the Section 469 context.

- Trust owned various real estate investments. Can the Trust deduct losses by qualifying as a “real estate professional”?
  - More than half of personal services performed in trades or businesses by the taxpayer are where the taxpayer “materially participates.”
• Taxpayer performs more than 750 hours of service in the trades or business where the taxpayer materially participates.

➢ Tax Court concludes that a trust can qualify as a real estate professional. If trustees are individuals, their work as part of their trustee duties can qualify.

▪ Key in Frank Aragona Trust is that a non-grantor trust can avoid passive income and NIIT through the material participation and services of the trustees.
• 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"?
• Carried Interest – See Camp Proposal (imputed ordinary income on deemed capital loan).

• Fundamental Reform
  ➢ Subchapter C
  ➢ Subchapter K vs Subchapter S

• Buffett Rule?

• Will Extenders Legislation Be Passed This Year?
Ramesh Kumar, T. C. Mem. 2013-184: Taxpayer and another doctor formed an S corporation for their practice. Taxpayer owned 40% of stock. In 2003, the doctors started fighting and the taxpayer was excluded from the operations and management of the S corporation. The dispute was not resolved until 2012 when the taxpayer sold his stock to the other doctor.

In 2005, the taxpayer received a K-1 from the S corporation showing $215,000 of ordinary income. The S corporation had not made any distributions. Taxpayer did not report the K-1 income on his return, arguing that he had been excluded from the practice and was not a stockholder for tax purposes.

Tax Court rejects taxpayer's position. Taxpayer liable for unpaid tax, interest and penalties.

Doctors and dentists usually lose tax cases! See also Alexander v. Com’r, T.C. Mem. 2013-203.
Section 1060(a): When parties to an asset acquisition agree in writing to an allocation of purchase price among the assets, the agreement is binding unless the Commissioner determines otherwise (or the agreement is unenforceable due to fraud, mistake, undue influence, etc.)

In Peco Foods, Inc., T.C. Mem. 2012-18 (affirmed by 11th Circuit in July 2, 2013 unpublished opinion), the taxpayer purchased assets from two unrelated sellers. In both purchase agreements there were detailed allocations among the assets. Both agreements provided that the allocations were “for all purposes (including financial accounting and tax purposes).”

In its tax returns immediately following the acquisitions, Peco depreciated the acquired assets consistently with the purchase agreements. For real property, Peco did not use any “cost segregation.”
Subsequently, Peco commissioned a “cost seg study” of the purchased real property. The study subdivided the real estate into various subcomponents and, according to the valuation experts, entitled Peco to additional depreciation deductions going forward.

Peco began using the new depreciation schedules for 1998, attaching to its return Form 3115 (Application for Change in Accounting Method). Peco reclassified certain 1250 property to 1245 property and changed from straight line over 39 years to accelerated over 7 or 15 years.

IRS challenged this change on audit, arguing that the change was inconsistent with allocations in the purchase agreement. Peco argued that the purchase agreements were ambiguous.

- Allocation to “Processing Plant Building” was determined by Tax Court to mean a single real estate asset.
Allocations in the agreement to three assets: “Real Property: Land,” “Real Property: Improvements”, and “Machinery, Equipment, Furniture and Fixtures”. Tax Court determined that the parties did not intend to allocate to subcomponent assets.

- If buyers intend to allocate based upon a cost seg study, they need to have sellers agree to this in the purchase agreement in clear language. If there is no clear agreement, both parties are risking adjustments on audit.

- **Note:** parties to purchase agreements are not required to agree on an allocation of purchase price, and there is no requirement to report consistently on their tax return.
• ABC corporation acquired the assets of Target including a leasehold interest in a property used in the Target’s business. The rent owed under the lease was $1.1 million per year. ABC obtained appraisals that the fair market rent was $356,000 per year.

• The lease contained a purchase option with the price to be the FMV of the property defined to include the value of the unexpired lease (40 years remaining). ABC exercised the option in 1997 at a $9 million price (after further negotiations, $11 million was paid in 1999). Valuation experts concluded that the property without the lease was worth $2.75 million. On its 1997 return, ABC deducted $6.25 million as a deductible lease termination expense.

• ABC Beverage Corp. v. United States, 577 F. Supp 2d 935 (W.D. Mich. 2008), affirmed 2014 BL 164462 (6th Cir. 6-13-14). See also Cleveland Allerton Hotel, Inc. v. Com’r, 166 F. 2d 805 (6th Cir. 1948).

Ltr. Rul. 201330018 – Service confirms that a squeeze out merger does not terminate S election.

- S Corp has Majority Stockholders and Minority Stockholders. Majority want to force out Minority.
- Majority form Newco (a corporation) and contribute their stock in S Corp to Newco. Newco then merges with S Corp and S Corp survives and Minority is cashed out.
- Based on Rev. Rul. 78-250, the Service ruled that Newco and the merger should be disregarded and the transaction should be treated for tax purposes as a redemption of S Corp stock from Minority.
- The existence of Newco and the transfer of S Corp stock to Newco did not terminate S Corp’s S election.
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.
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 2011. Smith is a partner in XYZ Partnership that owns 1231 real property. If XYZ sells real property at a gain in 2013, 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
• 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 Section 1231 or 1239. cf. Rev. Rul. 72-172, 1972-1 CB 265 (husband and wife transfer all partnership interests to related corp – 1239 applied) 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 Collectibles Gain
• Note special rules (Rev. Rul. 99-5; Rev. Rul. 99-6) for going in and out of disregarded entity status.
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 20% capital gains rate. See Treas. Reg. § 1.1(h)-1(a).
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.
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 million – 0 = $2 million).

Under Section 1(h)(l), 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 20% instead of 25%.

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

• LLC uses loan proceeds to redeem out Richard.
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?
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.
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.
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.

Rescission doctrine was on the Treasury’s Business Plan until June 29, 2013 when it was dropped.

- Rev. Rul. 80-58 will continue to state the government’s position on rescission.
- Rescission will be a “no rule area for the indefinite future”.
Martin Ice Cream, 110 T.C. 189 (1998) – Tax Court concluded that "personal goodwill" is an identifiable intangible asset separate and apart from corporate owned assets. Opportunity to (i) avoid corporate level tax, (ii) obtain capital gain for seller and (iii) obtain 15 year amortization for buyer.

Arnold had strong relationships with owners and managers of supermarkets. Arnold was 51% stockholder of Martin Ice Cream Company with his son owning the balance of the stock. Arnold had no employment agreement and no noncompete.

Arnold had a long-time handshake distribution deal with Haagen-Dazs. After Pillsbury bought Haagen-Dazs, they attempted to buy out Arnold's distribution relationships.
Martin Ice Cream formed a subsidiary to which the supermarket business was contributed. Martin Ice Cream then distributed the subsidiary stock to Arnold in exchange for Arnold’s stock in Martin Ice Cream. The transaction was designed to qualify as a tax free split off under Section 355.

Government argued the split off triggered corporate tax because it was a “bad” split off. Arnold argued the asset involved was not a corporate asset – Rather, it was the personal goodwill of Arnold. Taxpayer won.

Another taxpayer victory is *Norwalk*, T.C. Mem. 1998-279. Liquidation of professional corporation (CPA practice); Tax Court found goodwill was owned by stockholder. See also *H&M Inc.*, T.C. Mem. 2012-290 (Taxpayer victory) and *Bross Trucking, Inc.*, T.C. Mem. 2014-107 (Taxpayer victory).

- **Taxpayer defeats:**
PURCHASE PRICE ALLOCATIONS TO PERSONAL GOODWILL (CONT’D)

- **James P. Kennedy**, T.C. Mem. 2010-206 – Sale of consulting business owned by a C corporation. Taxpayer, as a result of tax advice, restructured deal as sale of personal goodwill. Tax Court rejects this treatment.

- **Howard v. U.S.**, 106 AFTR 2nd 2010-5140 (E.D. Wa. 2010) - Taxpayer loses where he was sole stockholder of corporation and had a noncompete agreement with the corporation. Taxpayer did not own the goodwill; rather the corporation owned it.


**NOTE**: Even if taxpayer is successful in allocation consideration “away from” the corporation, this does not assure capital gain treatment. First, need to demonstrate that the existence of personal goodwill as an independent asset. Second, need to justify the allocation between sale of personal goodwill (capital gain) and employment/consulting/non compete agreements. Strong documentation and, if possible, independent evaluations are important.
Estate of Adell, T.C. Mem. 2014-155, is a recent pro-taxpayer case in the estate tax context. Relies on Martin Ice Cream, etc.

Decedent owned the stock of STN.Com on date of death. The facts demonstrated that a substantial portion of the enterprise value was attributable to the personal goodwill of the decedent’s son.

Tax Court found that the son had not transferred his personal goodwill to STN.Com through a covenant not to compete or other agreement. The son was free to leave STN.Com and use his relationships to directly compete against STN.Com. If the son quit, STN.Com could not exclusively use the relationships that the son had developed. Thus, the value of these relationships is not attributed to STN.Com.
William Cavallaro, T.C. Mem. 2014-189. Merger of companies triggered gift tax liability to parents. Tax Court determined that a merger of Knight Tool and Camelot Systems triggered $30 million of gifts by the parents. The main problem was that the taxpayers took the position that certain assets initially owned by Knight Tool had been transferred to Camelot Systems years earlier when these assets had no value. The Tax Court concluded that these assets had never been transferred to Camelot Systems.

No accuracy-related penalties were imposed because the taxpayer had relied in good faith on competent counsel and independent valuation experts.
The assets in question involved technology used to manufacture certain pieces of liquid dispensing equipment. Knight Tool was started as a tool making business that later developed technology to manufacture a liquid dispensing machine. For a variety of reasons, the parents determined to revert to the tool making business.

The sons did not give up on the liquid dispensing business. They formed Camelot Systems to exploit this business. Upon formation of Camelot, father gave the Camelot minutebook to the sons and said, "Take it, it is yours."

Knight continued to manufacture the liquid dispensing machines. The taxpayers took the position that Camelot Systems was the manufacturer and that Knight Tool was its contractor. The documents and tax returns did not support this position. The equipment and employees used to manufacture the equipment were Knight’s.

Lawyer for taxpayers took the position that "take it, it is yours" was analogous to "livery of seisin" where a feudal land owner would gift land by delivering twigs to the donor saying, "take it, it is yours!"
If redeemed stockholder is allocated payments for a noncompete, can these allocated amounts be amortized by the entity over the term of the noncompete or does Section 197 require 15 year amortization?

See Recovery Group, Inc. v. Com’r, 652 F.3d 122 (1st Cir. 2011); Frontier Chevrolet Co. v. Com’r, 329 F.3d 1131 (9th Cir. 2003).

In Recovery Group, an S corporation redeemed 23% of the outstanding stock from an individual stockholder for $255,000 and entered into a one-year noncompete for $400,000. Corporation amortized the $400,000 over one year.

Section 197 requires 15 year amortization where the noncompete is entered into in connection with the acquisition of an interest in a trade or business or a substantial portion thereof.
The Tax Court and the First Circuit concluded that the 15 year amortization rule for a noncompete applies in the case of any purchase or redemption of stock in a corporation engaged in a trade or business. Only in the case of an asset deal does the 15 year rule apply only if the noncompete is executed as part of the sale of a substantial portion of a trade or business.
Fitch v. Com’r, T.C. Mem. 2012-358 – Fitch was a CPA. Due to illness, he sold his practice to Buyer in 2003 for $900,000 all of which Fitch treated as long term capital gain. Fitch had deducted his costs of developing his CPA practice in prior years.

Within the same taxable year as the sale, Buyer suffered a severe illness and sold the practice back to Fitch for $900,000. Fitch did not treat the transaction as a rescission; rather he treated the two transactions separately and began amortizing the $900,000 over 15 years under Section 197.

Note: Government argued rescission. Alternatively, IRS argued that the regs prohibit amortization of self-created intangibles – unless acquired in an unrelated transaction. Taxpayer won.
• 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.
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?
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.
• 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).”
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]
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.

Phillip Sutton, T.C. Summ. Op 2013-6 (Feb. 6, 2013) — Loss from abandonment of option to purchase property was ordinary loss because the property subject to the option would have been held by the taxpayer as dealer property if it had been acquired by the taxpayer. Note taxpayer argued he was a dealer and government argued taxpayer was an investor!
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?
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.
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?
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 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.
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?

General Rule: A “long term contract” is subject to “percentage of completion” method of recognizing income and expenses. Home builders would include a portion of total contract price in gross income as the taxpayer incurs allocable contract costs (cost-to-cost method—percentage of a contract completed during a taxable year is determined by contract costs incurred during the year to total contract costs). Treas. Reg. § 1.460-4(b)(1).

Exception: Certain “home construction contracts” permit use of “completed contract method” where income and expenses are recognized when the entire contract is complete. Section 460(e).

In Shea Homes, the taxpayer was permitted to use the completed contract method in accounting for the income and expenses of developing a large residential community. The taxpayer was responsible for building and selling houses in the development as well as for completing the infrastructure and common amenities such as pools, golf courses and clubhouses. The Tax Court concluded that the contract was not “completed” until 95% of all costs to complete the common improvements were incurred (final road paving and bond release).

In Howard Hughes Co., however, the Tax Court concluded that the taxpayer’s contracts were not “home construction contracts” under Section 460(e). Taxpayers did not build the dwelling units on the land they sold.
• Utilization of Losses
  - § 704(d)

• Tax-Free Extraction of Cash
  - § 731

• Interaction with Disguised Sale Rules
  - Treas. Reg. § 1.707-5
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• Tax Capital Account Plus Share of Partnership Liabilities = Outside Tax Basis
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.

See Treas. Reg. §§1.1366-2 (final 7-23-14) regarding back-to-back loans and guarantees.
SH contributes Asset A to S Corp. Asset A has a basis and a value of $100. SH gets basis of $100 in his stock and S Corp retains $100 basis in Asset A. Asset A declines in value to $90. Asset A is distributed to SH.

SH reduces his stock basis by $90 to $10. Asset A has a basis of $90 in the hands of SH.

Section 311(a) provides that gain is recognized on a distribution of appreciated property from a corporation (including an S Corp), but loss is not recognized in this circumstance.

Is SH required to reduce his stock basis to $0? Yes. ILM201421015 (5-23-14). A Section 311(a) loss is treated as a non-deductible, non-capital expense under Section 1367(a)(2)(D). Thus SH’s basis and AAA are reduced by the unrecognized loss. See also Ltr. Rul. 8908016.

Note: This is a permanent loss of basis.

Compare: If Asset A were sold by S Corp for $900, SH would receive a $100 loss.
• **LeBlanc, Jr., v. U.S., 104 AFTR 2nd 2009-7611 (12-04-09), Court of Federal Claims.**

• 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.
Section 704(d) limits a partner's ability to deduct his share of partnership losses to basis. Excess losses are suspended and carried forward until the partner's basis is increased. The same rule applies to stockholders of S corporations under Sections 1366(d) and 1367.

In Barnes v. U.S., 2013-1 USTC ¶50,267 (4/5/13), affirming 103 T.C. Mem. 1424 (2012), The D.C. Circuit agreed with the Tax Court that an S stockholder must reduce stock basis in the first year that basis is available to absorb suspended losses. This is true even if the stockholder fails to deduct the loss in that taxable year [similar to "allowed or allowable" for depreciation].
Taxpayer had losses prior to 1997 from an S corporation and some of these losses were suspended because of basis limitations. In 1997, the taxpayer’s basis in the stock increased but the taxpayer failed to apply his suspended losses against basis that year (either on an original return or an amended return).

In 2003, the taxpayer deducted $280,000 of losses from the S corporation because he thought his stock basis was $280,000. However, on audit the government disallowed $125,000 of these losses because they could have been taken in 1997.
Taxpayer argued that in 1997, if no deduction was claimed, then the stock basis was not reduced. Court rejects this view. Note that the statute had run on 1997. Of course, the $125,000 disallowed loss can be carried forward.

To add insult to injury a Section 6662 substantial understatement penalty was also imposed.
R Ball For R Ball III, T.C. Memo 2013-39, aff’d No. 13-2247 (3d Cir. 2/12/14). QSUB election followed by sale of stock of parent S corporation.

Generally S corporation income (including tax exempt income) increases stock basis. Taxpayer contended that a QSUB election for a subsidiary triggers “income” that increases stock basis in parent S corporation’s stock.

A QSUB election is treated as a liquidation of the subsidiary under Section 332. Section 332 provides that this liquidation does not cause built in gain in the QSUB to be recognized.

Taxpayer contended that the built in gain in the QSUB was “tax exempt income” or income analogous to COD (see Gitlitz v. Com’r, 531 U.S. 206 (2001)). Tax Court rejected this argument.
The taxpayer’s position would convert the single level of taxation of an S corporation into a zero level of taxation. If taxpayer had won:

- Presumably, no duplicate basis boost on gain subsequently recognized by S corp attributable to QSUB.
- Possible character difference would still exist (e.g. QSUB recapture assets).
- §1374 would still be applicable for 10 years.

Note government waived accuracy-related penalties!! This is even though taxpayers attempted to boost basis by $240 million.
In the partnership context, a partner’s contribution of a self-created note (or a deferred capital contribution obligation) does not increase basis unless this personal recourse obligation causes partnership recourse debt to be allocated to that partner under Section 752.

In the corporate context, can a self-created note protect a stockholder from triggering gain under Section 357(c) in a Section 351 transaction? In Peracchi v. Com’r, 143 F.3d 487 (9th Cir. 1998), the Ninth Circuit concluded yes.

Taxpayer contributes a note equal to liabilities in excess of basis. Ninth Circuit concluded that a third party creditor can collect on the note. Therefore, it increases basis.

A, B and C form an LLC. C agrees to contribute and lend substantial funds to LLC if A and B contribute their personal recourse notes to LLC. A and B receive legal advice that the notes create basis.


Taxpayer argued the notes were analogous to Gefen, 87 T.C. 1471 (1986) where taxpayer assumed partnership recourse debt. Tax Court concluded that A and B were not assuming or guarantying debt of the LLC.

What about the loan made by C to LLC? Were A and B in effect liable for a portion of this loan?

What if A and B contributed cash to LLC as a capital contribution? They would get basis. What if LLC then loaned this cash back to A and B? They should still have basis for the capital contributions.
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.
Contrast unified basis of partnership interest with the "separate lot" basis approach to corporate stock. If a particular lot of stock can be "adequately identified" its basis and holding period are controlling. Treas. Reg. §1.1012-1(c).

Assume that a partner has both a general and limited partner interest. The partner has one basis and one unified allocation of liabilities.

Holding period rules under Treas. Reg. §1.1223-3(c) can result in a bifurcated holding period for a partnership interest.

What if a partner owns a pure profits interest in a partnership (Class A) and he subsequently subscribes for a separate preferred interest (Class B) for which he pays $1,000? If he sells his profits interest down the road, does he really get to use a portion of his basis in the Class B interest to reduce gain? If the holding periods of the two interests are different, does he really have to bifurcate? Does part of his Class B capital account really transfer to the buyer of the Class A interest?
Recourse liability
- A liability is recourse if a partner or a related person bears the "economic risk of loss" for that liability

Nonrecourse liability
- A liability is nonrecourse if no partner or related person bears the economic risk of loss for that liability
Recourse liability

- A recourse liability is allocated to the partner who bears the economic risk of loss for that liability

Nonrecourse liability

- A nonrecourse liability is allocated under the tiering rules of Treas. Reg. § 1.752-3
A recourse liability is allocated to the partner who bears the economic risk of loss for that liability.

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
- 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" [What about Economic Substance?]
  - 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)
• 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)
RECOUSE 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?
- 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
• 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 Lender fails to recover at least $2 million.

• Economic risk of loss is remote if assets are valued at $200 million and the nonrecourse debt is $40 million.

• Economic Substance?
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
• 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?
1. **Recognition Requirements**
   a) For EROL analysis, a partner's payment obligations w/respect to a partnership liability will not be recognized as existing (to any extent) unless the payment obligation satisfies 6 requirements.
   
   b) Recognition requirements are "intended to establish that the terms of the payment obligation are commercially reasonable and are not designed solely to obtain tax benefits."
   
   c) NOTE: Recognition requirements do not apply to obligations imposed by state law

2. **Net Value Limitation**
   a) A partner's payment obligation is recognized only to the extent of the partner's net value
   
   b) Net value limitation does not apply to individuals or estates
   
   c) Net value determined under existing rules for disregarded entities
1. **Net Worth.** The partner or related person is –
   a) Required to maintain a commercially reasonable net worth throughout the term of the payment obligation; or
   b) Subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration.

2. **Financial Statements.** Required to provide commercially reasonable documentation re: financial condition.

3. **Coterminous.** The term of the payment obligation does not end prior to the term of the partnership liability.

4. **Not Deceased/Funded.** The payment obligation does not require the Partnership to hold (directly or indirectly) money / liquid assets in excess of reasonable needs.

5. **Consideration.** The partner received arm's length consideration for assuming the payment obligation.
6. **Full Dollar Guarantee/Indemnity.**

   a) **Guarantee.** The partner is or would be liable up to the full amount of such partner's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

   b) **Indemnity/Reimbursement.** The partner is or would be liable up to the full amount of such partner's payment obligation if, and to the extent that, any amount of the indemnitee's payment obligation is satisfied. An indemnity or similar arrangement only satisfies this requirement if, before taking into account the indemnity or similar arrangement, the indemnitee's payment obligation is not disregarded under paragraph (b)(3).

   c) **Exception.** Does not apply to a right of proportionate contribution between partners who are co-obligors with respect to a joint and several payment obligation.
In determining EROL, a partner’s payment obligation is recognized only to the extent of the net value of the partner – treating it as if it were a disregarded entity.

1. **Net Value.** Net Value of a partner is determined by importing regulations dealing with disregarded entities [§1.752-2(k)].

   a) Net value is FMV of all assets of disregarded entity – excluding the partnership interest in the subject partnership – less all obligations other than the payment obligation

   b) Determined as of the “allocation date” – when liability is incurred and redetermined on events affecting valuation of disregarded entity.

2. **Exceptions.** The net value requirement does not apply to:

   a) Partners who are individuals or a decedent’s estate

   b) Trade payables
1. **General Rule**

   Proposed to apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability on or after the date of final regulations.

2. **Transitional Relief**

   a) A partner can continue to apply the existing §1.752-2 regs. for a 7-year period to the extent that the partner's allocable share of liabilities exceeds the partner's adjusted basis in its partnership interest on the date the regs. are finalized.

   b) The amount of transitional relief will be reduced for certain reductions in the amount of liabilities allocated to that partner under the transition rules and, upon the sale of any partnership property, for any excess of tax gain (including section 704(c) gain) allocated to the partner less the partner's share of amount realized.
1. **Opening Round of Negotiations.** There is a wide-spread view that the Proposed Regulations are really only an opening bid by the IRS/Treasury to negotiate changes with the tax community.

2. **Proposed Regs. on Allocation of Recourse Regs are “Commercially Unreasonable”.** Examples include:
   a) Payment of arm’s length guaranty fee
   b) Ignoring entire payment obligation if violate full dollar guaranty requirement
   c) Recognizing guaranty only to extent of partner net worth (dollar-to-dollar)

3. **Bias to NR Classification.** By making recognition requirements so strict, the “default” classification of partnership liabilities would be nonrecourse, which would be allocated in accordance with liquidation value percentages.
4. **Valuation Issues.** The liquidation value percentage approach is based on current fair market value (not book value), and will introduce valuation issues. For example, would appraisals now be required/suggested to support allocations of liabilities?

5. **Effect on Existing Tax Protection Arrangements.** Proposed Regs. could have unexpected results under existing tax protection agreements (if they do not have change in law provisions).

6. **Prospective Application.** Prognosis of practitioners is that – given the scope of changes, long history of existing regulations and issues with Prop. Regs. -- Prop. Regs. will not be finalized any time soon. For now, it is “business as usual” in using devices – such as bottom guarantees – to manage the allocation of partnership liabilities to partners.
If Lender seeks payment from GP, will LP bear any risk of loss? See Treas. Reg. §1.752-2(f), Ex. 3.
GP pay Lender
LP reimburses or indemnifies GP
Query contractual agreement regarding termination of Guaranty
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?
• 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?
1. **Under Existing Treas. Regs. §1.752-2(f) Example 3.**
   a) E as GP is obligated under law to make a net contribution of $15K.
   b) E is assumed to satisfy its obligation; therefore, also assumed F would not have to satisfy F's guarantee.
   c) $15K loan is treated as recourse obligation, with E's share = $15K and F's share = $0.
   d) "This would be so even if E's net worth at the time of the determination is less than $15,000, unless the facts and circumstances indicate a plan to circumvent or avoid E's obligation to contribute to the partnership."

2. **Under Proposed 752 Regulations.**
   a) Same result as under existing regulations, but qualified by Net Value limitation.
   b) "Because E has net value to the extent of its obligation, it is assumed that F would not have to satisfy F's guarantee."
1. A guarantees payment of up to $300 if any amount of the full $1,000 liability is not recovered by Bank.

2. B guarantees payment of up to $200, but only if the Bank otherwise recovers less than $200.

3. Both A and B waive their rights of contribution against each other.

4. A’s and B’s Net Value at all times exceeds guarantee amount.
1. **Under Existing Treas. Regs. §1.752-2(f) Example 3.**
   a) A has payment obligation and EROL = $300.
   b) B has payment obligation and EROL = $200.
   c) Remaining $500 is Nonrecourse Debt allocated to A, B and C under 1.752-3.

2. **Under Proposed 752 Regulations.**
   a) Same result for A.
   b) "[B]ecause B is obligated to pay up to $200 only if and to the extent that the Bank otherwise recovers less than $200 of the $1,000 partnership liability, B's guarantee does not satisfy the [Full Dollar Guaranty Requirement] and B's payment obligation is not recognized." B bears no EROL
   c) $700 of the liability is Nonrecourse Debt allocated to A, B and C under 1.752-3.
1. Same generally as Example 10, except for additional facts below.
2. C agrees to indemnify A for up to $50 that A pays on its guarantee.
3. C agrees to indemnify B fully with respect to its guarantee.
4. C’s Net Value at all times exceeds guarantee amount.
1. **Under Existing Treas. Regs. §1.752-2(f).**
   a) A's payment obligation and EROL is reduced by C indemnity to $250.
   b) B's payment obligation and EROL is reduced by C indemnity to $0.
   c) C has payment obligation and EROL of $250 under C indemnities.
   d) Remaining $500 is Nonrecourse Debt allocated to under 1.752-3.

2. **Under Proposed 752 Regulations.**
   a) A's payment obligation is modified by C indemnity, and as modified, does not satisfy the Full Dollar Guaranty Requirement. A's guarantee is not recognized to any extent (different from Example 10).
   b) B's guarantee does not satisfy the [Full Dollar Guaranty Requirement] and is not recognized. (same as Example 10).
   c) C's $50 indemnity obligation of A is recognized. However, "because B's obligation is not recognized ..., C's indemnity of B's guarantee does not satisfy the [Full Dollar Indemnity Requirement], and C's payment obligation to B is not recognized."
   d) $950 of the liability is Nonrecourse Debt allocated under 1.752-3.
1. Same generally as Example 10, except for additional facts below.

2. Only A provides guarantee to Bank. A guarantees $0.25 for each $1.00 (i.e., 25%) that Bank does not recover on $1,000 loan.

3. A’s Net Value at all times exceeds guarantee amount.
1. **Under Existing Treas. Regs. §1.752-2(f).**
   a) A has payment obligation and EROL = 25% of $1,000 loan (i.e., $250).
   b) Remaining $750 is Nonrecourse Debt allocated to under 1.752-3.

2. **Under Proposed 752 Regulations.**
   a) A's guarantee / payment obligation does not satisfy the Full Dollar Guaranty Requirement. A's guarantee is not recognized to any extent.
   b) Entire $1,000 liability is Nonrecourse Debt allocated under 1.752-3.
• CCA 201308028 (2/22/13) – member/guarantor of LLC debt may be at risk under Section 465 even if no waiver of subrogation rights as long as:
  ➢ Guaranty is bona fide and enforceable by creditor under state law.
  ➢ Guarantor is not otherwise protected against loss under Section 465(b)(4).

• In addition, if there are co-guarantors of LLC debt, guarantor is only at risk to the extent the guarantor has no rights of contribution or reimbursement against the co-guarantors under state law (or only after such rights are exhausted or extinguished).

• CCA 201308028 appears to distinguish LLCs from partnerships. Where an LLC is the borrower, a member/guarantor with subrogation rights does not have recourse against another member. In the case of a general or limited partnership, the guarantor would have recourse against the general partners if the guarantor did not waive rights of subrogation. The at risk regs were promulgated before the advent of LLCs.
AM 2014-003 (4-4-14) addresses the consequences of a member of an LLC guaranteeing qualified nonrecourse financing ("QNF") under Section 465.

- Guarantor boosts at risk amount assuming debt is bona fide and guarantor is not protected against loss.
- Other members will not be at risk with respect to this debt because the guarantee causes the debt to fail to satisfy the definition of QNF.
• 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 6th 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.
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

Note: ABA Section of Taxation has recommended, in its “Options For Tax Reform” (12-2-11), that the at risk rules be amended to provide that a partner is “at risk” for debt if the debt is treated as recourse to the partner under Section 752.
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)
- 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
- See also ILM 201324013 (3-14-13) (released on June 17, 2013) – Service rejected Tribune’s “Leveraged Partnership” transaction for Newsday.
**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
- 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.
- Tier One: § 704(b) Minimum Gain
  - To extent of § 704(b) minimum gain (i.e., excess of NRD over book basis of the property subject to NRD)

- Tier Two: § 704(c) Minimum Gain
  - To extent of § 704(c) minimum gain (i.e., partner's § 704(c) gain if property sold for NRD)
  - Shifts over time into § 704(b) minimum gain as book deductions are taken
Tier Three: Excess Nonrecourse Liabilities
- General Rule- Allocate remaining NRD in accordance with profit shares
- Alternative 1- Agreement may specify share of profits if such share is reasonably consistent with some other significant item of partnership income or gain
- Alternative 2- Allocate in accordance with anticipated allocation of deductions generated by NRD
- Alternative 3- Allocate to extent of remaining § 704(c) BIG (including reverse § 704(c) BIG)
- Only applies to § 704(c) BIG in excess of § 704(c) BIG accounted for in Tier II
- Does not apply for purposes of disguised sale rules under Treas. Reg. §1.707-5(b)
TAM 200436011 - IRS disallowed Tier III allocation of Gross Income that Matched Preferred Return
- Reference to a "significant item of partnership income or gain" refers to income of a certain character or type, such as gain from the sale of property, not a tranche of bottom-line gross or net income
- TAM conclusion is based upon distinction in § 704(b) regulations between allocations of "items of income" and allocations of partnership net or "bottom-line" income
- What about Treas. Reg. § 1.704-2(e)(2) and -2(m), example 1 (ii), which specifically allows allocations of nonrecourse deductions based upon varying tranches of bottom-line income?
- Results oriented analysis

Other implications
- Impact on real estate partnerships with preferred returns and residual sharing
- Impact on partnerships with varying sharing percentages
• Alternate Method - Allocate nonrecourse debt in accordance with manner in which nonrecourse deductions will be allocated
• Treas. Reg. § 1.704-2(e)(2): Allows for nonrecourse deductions to be allocated based upon varying traunches of income or expense associated with property securing the nonrecourse debt
• Query the result in TAM 200436011 if the agreement allocated 100% of the nonrecourse deductions to Seller?
1. **Excess NR Liabilities Allocated in accordance with Liquidation Value Percentage**
   a) Proposed Regulations would remove the significant item and alternative methods under existing regulations
   b) Excess NR Liabilities would be allocated in accordance with each partner’s Liquidation Value Percentage

2. **Liquidation Value Percentage**
   a) Liquidation Value Percentage = liquidation value of the partner's interest $\div$ aggregate liquidation value of all partners’ interests.
   b) Liquidation Value of = amount of cash partner would receive if partnership sold all its assets for cash at fair market value (taking into account section 7701(g))
   c) Determined (i) at partnership formation and (ii) redetermined on any event permitting “book-up” [§1.704-1(b)(2)(iv)(f)(5)], whether or not capital accounts are actually booked up
Proposed to apply to liabilities incurred or assumed by a partnership on or after the date the regulations are published as final.
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.
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).


IRS Notice 2012-52, 2012-35 IRB 317 – SMLLC owned by a U.S. charitable organization is disregarded. Gifts to SMLLC are treated as made to the sole member.

See Berkshire Bank v. Ludlow, Mass, No. 12-1625 (1st Cir. 2013) – SMLLC is "nominee" of owner for purposes of a federal tax lien attaching to SMLLC assets (Section 6321).
CCA201351018 – Partnership has two partners, A and B. Partnership becomes a disregarded entity ("DE") when B withdraws as partner and becomes an employee. See Rev. Rul. 99-6.

- DE should continue to use the former Partnership's EIN for employment tax purposes.

- Income and losses should be reported by A on Schedule C of Form 1040.

- Consents to extend statute of limitations must be signed by A.

• 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.
- 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).
- **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.
- 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.
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”).
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).
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.
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.
Structuring Taxable Acquisition of S Corp Targets.

- **Asset Deals.** Potential recapture to seller. Buyer gets basis step up in assets. Could be non-tax issues (consents, etc.).

- **Stock Deals.** Capital gain for seller. Buyer does not get basis step up in assets.

- **Stock Deals treated as Asset Deals – 338(h)(10) Election.**


**NOTE:** Same result on 338(h)(10) but no need for a corporate buyer of stock.
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?
What if Investor receives 21% of stock of QSUB?
- 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?
Acquisition Corp wishes to acquire S Corp in a tax free re-organ 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-organ.
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)
Treas. Reg. 1.368-2(b) provides that this is not a good re-org unless it qualifies under 368(a)(1)(C).
- 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.
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.
REV. RUL. 99-5: SITUATION 1

100% Taxpayer

50% SMLLC

50% Buyer

50% LLC

100% Taxpayer

$5,000
• 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

A \rightarrow B \quad 50\%

\text{LLC}

B \rightarrow A \quad 50\%

A \rightarrow SMLLC \quad 100\%

\text{\$10,000}
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
SHOULD REV. RUL. 99-6 BE REVOKED?

- AICPA issued a letter to the IRS on October 1, 2013 stating that Rev. Rul. 99-6 should be revoked and that the purchaser in this context should be treated as purchasing a partnership interest.
  
  ➢ This would preclude the purchaser from using the purchase as the replacement leg of a 1031 exchange.

- If Rev. Rul. 99-6 is not revoked, the AICPA identifies a number of issues where clarification is necessary.
  
  ➢ To what extent are liabilities of the entity treated as assumed by the purchaser?
  
  ➢ Sections 704(c)(1)(B) and 737 “mixing bowl” provisions should not apply to the deemed distribution of assets.
  
  ➢ Section 751(b) should not apply to the purchaser -- Purchaser should take a substituted basis in Section 751(b) assets increased by gain recognized by seller under 751(a).

- See also AICPA comments to IRS dated June 5, 2013 on Rev. Rul. 99-5.
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.
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.
Howard Mylander, T.C. Memo 2014-191. The taxpayer was a dentist who also engaged in real estate activities.

1980’s taxpayer invested in Hidden Paradise Ranch and invited Koch to invest $400,000 to help finance it. Koch agreed, provided taxpayer guaranteed Koch’s investment. The investment failed and Koch sought payment from taxpayer.

Around the same time, taxpayer met Ledbetter. Ledbetter had invested in a deal with Murray. That venture failed and Ledbetter filed bankruptcy. Murray and Ledbetter settled whereby Ledbetter executed $500,000 note to Murray. Murray conditioned the deal on taxpayer’s guarantying $300,000 of the $500,000 debt. Ledbetter convinced taxpayer to execute this guarantee by promising to pay the Koch debt.

Ledbetter owned a convenience store in Nevada which he led taxpayer to believe was worth at least $400,000 and could be transferred to Koch to satisfy taxpayer’s debt to Koch. Ledbetter also agreed to indemnify taxpayer for any payments made to Murray. The convenience store was worthless and taxpayer ultimately paid Koch.

Ledbetter is the deadbeat here. By 2010, taxpayer paid Murray all but $102,000 under the guaranty with Murray. Murray agreed with taxpayer that the remaining $102,000 need not be paid.
Government's position was that the guaranty became the primary obligation of the taxpayer and the forgiveness resulted in cancellation of indebtedness income to the taxpayer.

Taxpayer argued that the guaranty was merely a contingent obligation and the forgiveness did not trigger COD income. Hunt, 59 T.C. Mem. 635 (1990); Landreth, 50 T.C. 803 (1968).

Tax Court agrees with taxpayer. Obligation to Murray was secondary. However, the obligation became primary when Ledbetter defaulted and Murray obtained a judgment against taxpayer. Even so, taxpayer does not have COD income because he never enjoyed an increase in net worth from the arrangement. Taxpayer did not realize any untaxed increase in wealth any more than had he remained a secondary obligor.
EXCHANGE-100% LLC INTERESTS OF DISREGARDED ENTITY AS REPLACEMENT PROPERTY

Diagram:

- **Davis** (left) → **QI** (square) → **Proceeds** → **Relinquished Property** → **Buyer** (right)
Swap SMLLC owns like kind property. Davis acquires 100% of the membership interests. This is a good exchange.
EXCHANGE – 100% LLC INTERESTS OF PARTNERSHIP AS REPLACEMENT PROPERTY (CONT.)

QI

Proceeds

Davis

Relinquished Property

Buyer
Swap LLC is a tax partnership. Davis acquires 100% of the membership interests as replacement property.
- Davis treated as acquiring the assets of Swap: A good exchange.
BAD EXCHANGE - PURCHASE OF
PARTNERSHIP INTEREST

Buyer

Relinquished Property

Davis

10
• Davis only acquires the membership interests from Tom and Dick.
• Swap LLC remains a tax partnership. Davis is treated as having acquired membership interests: Bad Exchange!
- Davis is treated as having relinquished the assets of LLC.
Tom, Dick and Harry are treated as having acquired the assets of Swap LLC and then to have contributed the assets to a new tax partnership.
Davis is treated as having sold a 50% undivided interest in the assets of SMLLC. This is a good first leg of a like kind exchange.
EXCHANGE-100% QSUB STOCK AS RELINQUISHED PROPERTY

- This is treated as a sale of QSUB assets.
EXCHANGE -PARTNERSHIP INTEREST AS REPLACEMENT PROPERTY

Davis

Relinquished Property

QI

Buyer
The replacement property is Edward’s membership interest in Real Estate LLC.
Edward is treated as having sold a membership interest but Davis is treated as having purchased assets: A good exchange!
EXCHANGE-PARTNERSHIP INTERESTS AS RELINQUISHED PROPERTY

Diagram:

- Davis
- Edward
- LLCI

Each with 50% interest
EXCHANGE-PARTNERSHIP INTERESTS AS RELINQUISHED PROPERTY

- Davis
- Edward
- LLCII (continuation)
- Relinquished Property
  - 100% LLCI
- QI
- LLCI (disregarded)
- Buyer
HANDLING PARTNER EXITS IN 1031 EXCHANGE

A

1/3

B

1/3

C

1/3

Cash

1/3 Cash

Real Estate LLC

Buyer

2/3 Cash

QI
A, B, and C are equal members in Real Estate LLC. Buyer is proposing to purchase Property owned by Real Estate LLC. A and B would like to do an exchange.

What if Buyer pays 2/3 of the purchase price to a QI and 1/3 to Real Estate LLC. Real Estate LLC distributes the cash to C in liquidation of his interest.

What if Real Estate LLC dissolves before the sale so that A, B and C are tenants in common before the sale? What if Real Estate LLC distributes a 1/3 undivided interest to C in liquidation of his interest prior to the sale?

What if prior to the sale, A and B purchase C’s interest? Alternatively, what if A and B arrange for Real Estate LLC to borrow funds to liquidate C’s interest before or after the closing?
If Real Estate LLC receives cash, this will be taxable “boot.” This would not be a problem if all of the boot could be specially allocated to C. Even if the members amend the operating agreement to provide for such a special allocation, this allocation may not be viewed as having “substantial economic effect.”

One frequently used technique is for an installment note (secured by a standby letter of credit) to be used in lieu of cash. The installment note could provide for 95% of principal to be paid 3 days after closing and 5% to be paid the following January. The note would be received by Real Estate LLC and distributed to C. The receipt of the note does not trigger boot and the distribution of the note to C is not an acceleration event. Also, A and B have a smaller reinvestment requirement than would be the case if A and B bought out C using separate funds.

A dissolution of Real Estate LLC or a spin off of an undivided interest to C could create “holding” issues and/or the arrangement could still be viewed as a de facto partnership for income tax purposes.

If A and B cause C to be bought out using separate funds, A and B would be stuck with a larger reinvestment requirement.

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%).
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").
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.
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 (9th 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 (2011-2013). The proposed extender legislation would extend the 5 year rule for 2014 and 2015. See also H.R. 4453 offered by Rep Camp.
• 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.
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. Government has indicated informally that Section 7701(o) (codification of economic substance) should not be a concern in freeze transactions (see Tax Notes, 6-11-13)

- Valuation must be accurate to avoid constructive dividend/gift.
- §704(c) will apply
- §482 could apply
- Chapter 14 could apply
- Estate of Church, 268 F3d 1063 (5th 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!
• Rayford L. Keller v. United States, No.6:02-CV-00062 (S.D. Tex 2009), Aff’d No. 10-41311 (5th 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.
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!
Estate of Elkins, 140 T.C.86 (2013), reversed No. 13-60472 (5th Cir 9/15/14). Decedent owned fractional interests in various works of art. Based upon appraisals by Sotheby’s and Deloitte, the estate took a 44.75% discount. The government argued that zero discount was appropriate without producing an expert.

The Tax Court concluded that a 10% discount should apply even though there was no record evidence on which to base this conclusion.

The Fifth Circuit agreed with the estate. The fractional interests were held by family members subject to “co-tenants agreements.”

Hypothetical willing buyer would demand a substantial discount because the other owners had deep pockets and had no desire to sell, together with the legal restrictions on alienation and partition.
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'rr*, 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 (CONT’D)

- **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 10th 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 (9th 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.
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.
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
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.
**DISCOUNTING FAMILY INVESTMENT COMPANY – ESTATE OF RICHMOND**

- **Estate of Helen P. Richmond, T.C. Memo 2014-26.** A 23.44% stock interest in Holding Company, a C corporation, was valued by the estate at $5 million. The government argued the value was $7.3 million. The Tax Court found the value was $6.5 million and imposed a 20% valuation understatement penalty.

- Holding Company was a personal holding company (See 541). To avoid the PHC tax, it paid substantial dividends. Holding Company held marketable securities for long term investment. There was little turnover in the portfolio. There was substantial deferred tax liability on this portfolio ($18 million of potential tax liability).

- The estate reported the value of the decedent’s stock at $3.1 million based upon the capitalization of dividends approach. The notice of deficiency valued the stock at $9.2 million. At trial, the government expert determined the value to be $7.3 million based on a 40% discount from the Holding Company’s net asset value. At the same time, the estate’s expert reached the conclusion of $4.7 - $5 million.
Tax Court concludes that the $18 million deferred tax liability should be discounted to a present value of $7.8 million. In addition, a 7.75% lack of control discount and a 32.1% lack of marketability discount should apply.

The value increased from $3.1 million to $6.5 million. Thus, the understatement was "substantial". Further, there was no reasonable cause in good faith to rely on an unsigned draft valuation report in filing the estate tax return. Tax Court imposes the penalty.
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 $22 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!
• 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).
USE OF SELF-CANCELING NOTES

- Estate of William Davidson – pending in Tax Court. Owner of Detroit Pistons transferred stock to grantor trusts in exchange for self-canceling installment notes (“SCINs”) and died 6 months later.

- The case is described in ILM 201330033 (2-24-12) which was released on July 26, 2013. The decedent’s stock was valued by Duff & Phelps.

- The SCINs were interest only with balloons at the end of their 5 year terms. The face amount was double the value of the transferred stock. The excess represented the premium calculated under Section 7520 to compensate for the actuarial risk of the decedent dying before the SCINs were paid. The interest rate on the SCINs was 15.83%, again to compensate for the actuarial risk.

- The decedent had an actuarial life expectancy of 5.8 years based upon the IRS Mortality Tables. There are letters from doctors including his lead physician who concluded that the decedent had “no current conditions which would impact his actuarial life expectancy and continues to work in his usual capacity.”

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).
- **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? What about the 3.8% tax on net investment income under Section 1411?

- 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.