Federal Tax Update (PowerPoint)

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FEDERAL TAX UPDATE

63rd 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.

“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.
• Reduce C corporation income tax rate to 20%
• Reduce Pass-Through income tax rate to 25%
• Three individual tax brackets (12%, 25%, 35%)—There will be a fourth—39.6% for top 1%
• Repeal AMT
• 3.8% Obama Tax?
• Repeal State and Local Tax Deduction
• Repeal Death Tax
• Immediate Expensing. Carve out for "Structures." State decoupling?
• Effective Date? Transition Rules?
• Planning Using Installment Sales for 2017 Deals
Executive Order 13789. On October 4, 2017 Treasury announced withdrawal of two sets of proposed regulations and outlined possible future actions.

- Proposed Estate Tax Valuation Regs (2704) are Withdrawn
- Future Action Includes:
  - Partial Revocation of Debt/Equity Regs (385)
  - Partial Revocation of Partnership Debt Allocation and Disguised Sale Regs (707; 752)

Note: New Bottom Dollar Guaranty Rules will be retained.
**Fighting Doctors and Subchapter S**

- **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).
- LTCG requires one year holding period. Need to watch bifurcation traps.

  ➢ Holding period of Purchase Contract or Option does not tack with holding period of the real estate. Purchase Contract or Option could be a capital asset itself.

  ➢ Newly constructed property could have LTCG for the land but short term for the improvements. See, e.g. Rev. Rul. 75-524, 1975-2 C.B. 342.

  ➢ Partnership (LLC) interests could have bifurcated holding period under Treas. Reg. §1.1223-1(b) for capital contributions within 12 months of sale of interests.

  ➢ Holding period for interests in a partnership or LLC could be different than holding period of real estate owned by that entity.
SPECIAL RULE: SECTION 1231

- Real estate used in a trade or business (not dealer property)
- Net 1231 gains are LTCG if held for one year
- Net 1231 losses are ordinary
- Note Recapture for net 1231 gains as ordinary to the extent of net 1231 losses in prior five years
- Assume Smith recognized net 1231 losses in 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.
- S Corp owns an apartment complex worth $1 million with a basis of $1. The sole stockholder of S Corp was Smith. Smith dies and his basis in the stock of S Corp is stepped up to $1 million.

- Smith’s estate wants to liquidate S Corp. Liquidation of S Corp will trigger a deemed sale of the apartment complex to the estate.

  - If the gain is capital gain, the estate would pick up but with an offsetting capital loss on the liquidation.
  - Section 1239 causes sale of depreciable property to related party to be taxed at ordinary income. Not a good result!
  - Assume S Corp forms LLC with Y, a family member. S Corp contributes the apartment complex to LLC in exchange for an 80% LLC interest. Y contributes $250,000 cash in exchange for a 20% LLC interest.
  - S Corp liquidates and distributes the 80% LLC interest to the estate.
  - An LLC interest is not depreciable property. Is Section 1239 avoided?
  - Section 754 election produces basis step up for estate.
A and B are brothers. A and B own Blackacre as equal tenants in common. A and B also own the stock of AB Corp, an S Corporation, equally.

In 2016, B sold his interest in Blackacre to AB Corp in exchange for an installment note payable over five years in equal annual installments.

AB Corp resells its interest in Blackacre in 2017.

Under Section 453(e), if a taxpayer disposes of “property” to a related person and the related person disposes of “the property” before the taxpayer receives all payments under the installment note, the taxpayer’s gain is accelerated.

➢ To be a problem, second disposition of the property must be within two years of the first disposition.
➢ The amount of the gain accelerated is based upon the amount realized on the second disposition.

Here, AB Corp is a “related person” to B, so the disposition by AB Corp accelerates the installment gain to B even though B receives no money.
Suppose the facts change. A and B own AB LLC, AB LLC owns Blackacre. B sells his 50% interest in LLC to AB Corp in 2016. In 2017 AB LLC sells a 50% undivided interest in Blackacre to third party. Is B’s installment gain accelerated?

- B sold his LLC interest to AB Corp, not his interest in Blackacre.
- AB LLC’s sale of half of Blackacre should not accelerate any gain to B.
- The “property” disposed of by B was an LLC interest. Blackacre is not the same “property.”
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)(1), the federal tax rate would be 25% (the "unrecaptured Section 1250 gain" rate) -- $500,000.
CONTRIBUTION OF SELF-CREATED NOTE: PERACCHI

- 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.

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.
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.
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.
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.
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].
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 $90, SH would receive a $10 loss.
• 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.
- Tax Capital Account Plus Share of Partnership Liabilities = Outside Tax Basis
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IMPORTANCE OF BASIS IN PARTNERSHIP INTEREST

- Utilization of Losses
  - § 704(d)
- Tax-Free Extraction of Cash
  - §731
- Interaction with Disguised Sale Rules
  - Treas. Reg. § 1.707-5
COMPLETED CONTRACT METHOD FOR HOME BUILDERS

- Shea Homes Inc., 142 T.C. No. 3 (2014); The Howard Hughes Company, LLC, 142 T.C. No. 20 (2014). Shea Homes Inc. was affirmed by the 9th Circuit. Shea Homes Inc. v. Com'r, 2016 BL 274845 (9th Cir., August 24, 2016).

- 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.
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?
In *Pool*, Tax Court concluded: "The same business purpose exists here." However, Court found that the Elk purchase option at $7.6 million was inflated and there was no evidence to justify it when the property had just been purchased for $1.4 million for all 4 phases. It was also "noteworthy" that as part of the Elk purchase agreement, the parties had provided the development costs that Elk would incur. Why would Concinnity, as an "investor" have cared about the development costs? All of these facts weighed against Taxpayer.

Taxpayer liable for penalties. Section 6651(a).
Frequency and Continuity of Sales. The facts were unclear on this issue. It was not clear whether the sale of 81 lots was to Elk or to third parties. However, the Elk option agreement provided for a total sale price of $7.6 million and that the first 40 lots in phase 1 would be sold to Elk for $5,000 per lot, then $18,000 for next 60 lots and $32,000 for remaining phase 1 lots. The reference to $41,000 per lot suggested that Concinnity had "bypassed" Elk. These facts weighed against Taxpayer.

Nature and Extent of Business. Evidence suggested that Concinnity found buyers for lots, secured the water and wastewater systems and guaranteed performance on the improvements agreement. Taxpayer failed to provide evidence to explain the sale of the 81 lots. Plus Concinnity arranged a mortgage loan of $725,000 that covered the 300 acres including phase 1 which it had purportedly sold to Elk. These facts weighed against Taxpayer.

Extent and Substantiality of Transaction. Government argued that the "interlocking participation" of Concinnity and Elk was evidence that Elk was used principally to "evade or defeat Federal income tax." Tax Court says "We do not agree that the identical ownership between two companies dooms this transaction." Citing Phelan v. Com't, TC Mem 2004-206, where the Tax Court found a business purpose of protecting the seller's remaining assets from any action brought against the identically owned development company.
Pool v. Com’r, T.C. Mem 2014-3, involved a related party sale at an inflated purchase price where Taxpayer lost.

Concinnity, LLC, in which Taxpayer was a member, purchased 300 acres for $1.4 million in 2000. The land was already divided into four sections or phases. Concinnity then entered into an agreement with Elk Grove Development (“Elk”) where Elk had the right to purchase three phases consisting of 300 lots. Elk and Concinnity had identical ownership.

Nature of Property Acquisition. Concinnity’s Form 1065 for 2000 identified its principal business activity as “development.” (Note that in 2001-7, the Form 1065 said “investment”). In 2001, Concinnity delivered an affidavit to the county that said (i) it is the developer of proposed subdivision and (ii) as of June 13, 2001, it has “entered into buy-sell agreements for the sale of 81 lots in phase 1 at an average price of $41,000.” This factor goes to Government.
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.
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?
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.
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?
On appeal to the 11th Circuit, the decision of the Tax Court was affirmed on the dealer issue. However, the 11th Circuit rejected the application of a 20% penalty because of "reasonable cause and good faith." Boree v. Com’r, 2016 BL 296399 (11th Cir; September 12, 2016).

On the dealer issue the 11th Circuit focused on the taxpayer’s deduction of expenses as business expenses over several years. The court found this inconsistent with "investment status."

On the penalty issue, the 11th Circuit acknowledged that a taxpayer may avoid the penalty where there was reasonable reliance in good faith on the advice of an independent tax advisor; the taxpayer’s education and experience are also relevant. Taxpayer was a former logger with no accounting experience. He relied on the CPA for years. The CPA was a professor at University of Florida College of Law who was viewed as an expert.
Fargo et al v. Com’r, TC Mem 2015-96. An affiliate of Taxpayer purchased a leasehold interest in 2.2 acres in 1989 with intent to construct apartments and retail space. In 1991, Taxpayer was assigned the leasehold and purchased the fee from unrelated seller. In 2001, Centex Homes made an unsolicited offer and Taxpayer sold the property. Because Taxpayer purchased the property with intent to develop it and never abandoned this plan, even though it never did develop it, Tax Court concluded Taxpayer held the property for sale.

SI Boo LLC v. Com’r, TC Mem 2015-19. Taxpayer acquired tax liens on various properties. If liens were not redeemed, Taxpayer would acquire the underlying properties and sell them. Tax Court treated Taxpayer as a dealer because of the frequency of the acquisitions and sales (over 250).

For Taxpayer victories, see, e.g., Rice v. Com’r, T.C. Mem 2009-142; Phelan v. Com’r, TC Mem 2004-206; Gardner v. Com’r, TC Mem 2011-137.
Long v. Com’r, No 14-10288 (11th Cir 2014) (per curiam), aff’g and rev’g TC Mem 2013-233. Taxpayer owned a contract right to purchase land. Taxpayer sold the contract to a third party for $5.75 million and treated the gain as long term capital gain. Tax Court held that, because Taxpayer had intended to sell the land if he had closed on the purchase, the land would have been dealer property and, for this reason, dealer status was imputed to the sale of the contract. The 11th Court rejected this analysis and concluded that the contract to purchase and the underlying land were two separate assets that could have different tax character. Does this mean Sutton is wrong?

Boree v. Com’r, TC Mem 2014-85. Change in purpose and bulk sales did not protect Taxpayer from dealer status. Taxpayer bought 1900 acres. It sold 280 acres in bulk while developing and selling some lots on the remaining property. Ultimately Taxpayer sold the remaining 1067 acres in bulk because it did not want to expend funds for roads. This final sale was determined by Tax Court to generate ordinary income.
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!
“DEALER” STATUS

- Whether property is “dealer” property (i.e., held primarily for sale to customers in ordinary course of business) is a question of fact looking at the nature of the property involved, as well as the prior and current activities of the owners of the property.

- An individual could be a dealer with respect to certain property and an “investor” with respect to other property. Separate entities could help. Note: For property sold at a loss, taxpayer will argue he was a dealer.

- Factors to consider:
  - Marketing, pre-sale activities
  - Status of entitlements, record plats, etc.
  - Duration and history of holdings of property
  - Number of sales [sale to one buyer in one transaction]
  - Frequency of sales [“liquidation of investment” theory]
  - Intent/purpose at time of purchase of property; change in circumstances
  - Improvements made in context of sales [breaking ground/infrastructure]
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)."
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.
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?
- 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.
Tax Court concluded that worthlessness can be determined based upon a variety of factors:

- decline in debtor’s business
- overall business climate
- insolvency of debtor

Lohrey told Taxpayer in 2008 he was going bankrupt. Taxpayer knew in 2008 he would be wiped out by the Vestin first mortgage.
Section 166 permits a bad debt deduction (ordinary) if:

- Taxpayer was in a trade or business
- The loans were bona fide debt
- The debt became worthless

Taxpayer deducted his loss as a Section 166 bad debt on Schedule C for 2008. IRS challenged this treatment.

Tax Court found that Taxpayer was personally in the trade or business of making loans. Taxpayer was in the regular and continues business of making loans. The fact that he did not operate separately from OFG was irrelevant.

Tax Court found that the debt was bona fide. Terms were clearly debt. Service argued Taxpayer's admission to Lohrey Investments indicates debt was converted to equity, plus Taxpayer's subordination indicated equity. Tax Court found intent of parties that loans remained debt.

Tax Court found that debt became worthless in 2008. IRS said bankruptcy filing in 2009 was the first time there could be a position of worthlessness.
In 2002, Taxpayer met Lohrey who was in the laundry business. Lohrey’s business went bankrupt and he had an opportunity to buy it out of bankruptcy. Lohrey borrowed $7.5 million from OFG but Lohrey needed more. Taxpayer agreed to bridge the gap with loans made by Taxpayer personally. Initially, this was a $2.75 million second mortgage, 15% rate and maturity in 2005. It also had an equity kicker.

In 2005, Lohrey fell behind and Taxpayer was admitted to an LLC between Taxpayer and Lohrey (“Lohrey Investments”). Ultimately, Taxpayer loaned $16 million to Lohrey. Taxpayer was allocated $4 million of losses in 2006 and $2.8 million in 2007. Taxpayer deducted these losses against his share of the debt.

Lohrey still needed more money. Vestin Mortgage would lend $20 million to Lohrey if Taxpayer subordinated. Part of the $20 million that was used to repay OFG.

Lohrey went bankrupt in 2009 and Taxpayer received nothing when the bankruptcy case closed in 2010. The Lohreys individually guaranteed the loans. They went bankrupt as well.
This Tax Court Memorandum decision is a judicial masterpiece—a must read. 

Taxpayer’s father started a successful moneylending business that Taxpayer took over (Owens Financial Group, Inc. – “OFG”). Taxpayer was President and a majority stockholder. OFG made mortgage backed loans and bridge loans to businesses. Loans originated by OFG were funded by Owens Mortgage Investment Fund, a limited partnership in which OFG was general partner.

In addition to the OFG activities, Taxpayer made many loans from his revocable trust and sometimes from an FLP that he managed with his sisters. From 1999 to 2013, Taxpayer made approximately 90 loans personally or through the revocable trust or the FLP.

Taxpayer did not have a separate office for his personal lending activities nor did he have employees devoted to his personal activities. All overhead was OFG’s.
CRI-Leslie LLC, 147 T.C. No. 8 (9-7-16).

Taxpayer purchased a hotel on 2-25-05 for $13.8 million. Taxpayer operated the hotel thereafter. On 7-10-06, Taxpayer entered into a contract of sale with a third party buyer for $39 million.

Buyer paid Taxpayer a $9.7 million deposit. If the transaction had closed, this deposit would have been applied against the purchase price. The transaction did not close and the deposit was forfeited by the Buyer and retained by Taxpayer in 2008.

Taxpayer treated as long term capital gain. IRS contended ordinary income, Tax Court agrees with IRS.

Parties agreed that the hotel was property used in a trade or business under Section 1231(b)(1).

Section 1234A provides for capital gain treatment in case of a cancellation lapse, expiration or other termination of a right with respect to property that is a “capital asset” in the hands of the Taxpayer.

Tax Court determines that capital asset does not include Section 1231 property. If Congress intended to cover 1231 property, it would have expressly so provided.
BASIS CALCULATION IN PARTNERSHIP INTEREST ABANDONMENT


- 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.
Rev. Rul. 93-80, 1993-2 C.B. 239 – Abandonment of a partnership interest triggers an ordinary loss if there is no actual or deemed sale or exchange. If the partner shares in partnership recourse or nonrecourse debt, capital loss will be the result. See also Citron v. Com’r, 97 T.C. 200 (1991); Echols v. Com’r, 935 F.2d 703 (5th Cir. 1991).

Note: worthlessness and abandonment are two separate and distinct concepts as Pilgrims Pride demonstrates. See also Echols v. Com’r, 950 F.2d 209 (5th Cir. 1991) (per curiam) (“Echols II”).

In a partnership where the value of assets is less than nonrecourse debt, is the partnership interest worthless so that an ordinary loss can be triggered because there has been no sale or exchange? Commentators have offered strong arguments for this position based upon Echols and Echols II. When the partner has personal liability for recourse debt, compare Proesel v. Com’r, 77 T.C. 992 (1981) with In Re Kreidle, 91-2 USTC II 50,371 (Bankr. D. Col 1991), aff’d 143 B.R. 941 (D. Col 1992). See also Tucker v. Com’r, TC Mem 2015-185 (with recourse debt, no abandonment or worthless loss deduction; loss only available in year of Foreclosure or other disposition).
On appeal, the Fifth Circuit reversed the Tax Court concluding that an abandonment loss is not a loss "attributable to the cancellation, lapse, expiration or other termination of ... a right or obligation ... with respect to [a capital asset]" as required by Section 1234A(1). Abandonment of the property itself is distinguished from abandonment of a "right" with respect to the property.

When a partner (or member) holds an interest in an entity that is failing, he has several options.

- Hold the interest until the entity is liquidated and take a capital loss equal to excess of basis over amount realized (note: basis may be low due to prior losses).
- Sell the interest to a third party and trigger a capital loss.
- "Abandon" the interest and trigger a loss which could be ordinary or capital depending on the facts.
- Claim a "worthless" partnership interest loss which may be ordinary or capital depending on the facts.
Pilgrim’s Pride Corp v. Com’r, No 14-60295 (5th Cir 2015), rev. 141 T.C. No 17 (2013). In 1998, Taxpayer sold a business to Buyer. Buyer financed the purchase with a short-term bridge loan while planning to go public. If Buyer failed to go public, Taxpayer committed to purchase preferred stock from Buyer for $98.6 million. Taxpayer purchased the preferred stock.

In 2004, Taxpayer and Buyer attempted to negotiate a redemption price for the preferred stock. Taxpayer wanted $31.5 million; Buyer offered $20 million. Instead of accepting the $20 million offer, Taxpayer abandoned the preferred stock for no consideration.

If Taxpayer had accepted the $20 million offer, it would have recognized a $78.6 million capital loss on the sale. On the abandonment, Taxpayer took a $98.6 million ordinary loss under Section 165. After Taxpayer went bankrupt several years later, Service challenged the ordinary loss treatment.

Taxpayer argued that ordinary loss treatment was correct because no “sale or exchange.” Tax Court ruled in favor of the Service based upon Section 1234A which applies capital loss treatment when there is a termination of rights with respect to a capital asset.
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.
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 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!”
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.
➤ *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.
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.

Robert L. Solomon, T.C. Mem. 2008-102 – Amounts allocated to noncompete agreements and not to sale of personal goodwill.

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.
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:

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.
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”. See Rev. Proc. 2015-3, 2015-1 IRB ___ (§3.02(8)).
In Gateway Hotel Partners, LLC v. Com’r, TC Mem 2014-5, the Tax Court rejected a rescission of the sale of tax credits where the “same tax year” was violated. Taxpayer transferred credits on December 30, 2002. In January of 2003 it concluded that it would have been better if fewer credits had been sold. On January 8, 2003, the transaction was rescinded in order to transfer fewer credits.

Note: The Gateway Tax Court imposed penalties because there was no reasonable basis for the position when rescission straddled tax years.
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.
RESCISSION TRANSACTIONS (CONT’D)

- **Ltr. Rul. 201211009** (3-16-12). Two stockholders of an S corporation sold their stock to two buyers. The intention was that the transaction would qualify for Section 338(h)(10) election. The two buyers subsequently formed holding company and contributed the purchased stock to the holding company. They then discovered that the purchase was not a qualified purchase under Section 338. The Service permitted the parties to rescind the transaction and to “start over” where the rescission was in the same taxable year and the parties were put in the same position as if they had never done the first transaction.

- See also Ltr. Rul. 200843001 (7-2-08); Ltr. Rul. 200908016 (11-13-08); Ltr. Rul. 201016048 (12-22-09); Ltr. Rul. 201008033 (11-20-09). Compare Hutcheson, 71 TC Mem. 2425 (1996) (attempt at rescission of sale of Walmart stock not respected).
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.
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. See Rev. Rul. 80-58, 1980-1 CB 181, relying on Penn v. Robertson, 115 F.2d 167 (4th Cir. 1940).

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.
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?
- LLC borrows $2 million, guaranteed by James and Solomon.
- LLC uses loan proceeds to redeem out Richard.
- James and Solomon lend $2 million to the LLC.
- The LLC uses the loan proceeds to redeem out Richard.
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.
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?
Under Treas. Regs. § 1.1(h) – 1(b)(3)(ii), the recapture rate does not apply to a “redemption” of a partnership interest.
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.
X, Y and Z formed XYZ, LLC years ago. Each made capital contributions of $100.

XYZ, LLC owns 3 parcels of real estate. Each parcel was acquired years ago for $100. Each parcel is now worth $500.

X will withdraw from XYZ and receives one of the parcels from XYZ.

XYZ is not taxed on the distribution of property to X (§731(b))

X is not taxed on the receipt of property (§731(a))

X has a basis in the property received equal to his $100 basis in his LLC interest (§732)
- Same facts except X is in a dispute with Y and Z. The dispute is resolved by the parties entering into a settlement agreement.

- Settlement agreement provides that X will be redeemed. X does not want cash (taxable) nor does he want one of the existing properties. X wants XYZ to acquire and distribute to him Property A (worth $750,000). XYZ has $500,000 in available cash.
Settlement agreement provides:

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

Costello v. Com’r, TC Mem. 2016-184 – owner of SMLLC liable for employment taxes of SMLLC.
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.
Stockholder

S Corp

Investor

QSUB

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-org under Section 368. The sole consideration to be received by S Corp stockholders will be stock in Acquisition Corp.

Acquisition Corp does not want to have S Corp merge directly into Acquisition Corp. Acquisition Corp forms LLC (as a DE) and S Corp merges into LLC with LLC surviving.

Treas. Reg. § 1.368-2(b)(1) treats this as a valid (a)(1)(A) re-org.
• 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.
Acquisition Corp wishes to acquire S Corp in a tax free re-org under Section 368. The sole consideration to be received by S Corp stockholders will be stock in Acquisition Corp.

Acquisition Corp does not want to have S Corp merge directly into Acquisition Corp. Acquisition Corp forms LLC (as a DE) and S Corp merges into LLC with LLC surviving.

Treas. Reg. § 1.368-2(b)(1) treats this as a valid (a)(1)(A) re-org.
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.
S CORP owns all of the operations of a manufacturing business. S CORP has been an S Corporation for more than five years.

Buyer wants a basis step up in the S CORP assets.

A, B and C want to retain a 15% equity interest in S CORP.
Pure Stock Purchase. If Buyer purchases 85% of the stock owned by A, B and C with no 338(h)(10) election [need to be at least 80%/purchase], A and B would have all capital gain. Buyer would not step up asset basis. Transaction would likely cause S Corp’s S election to terminate—not good for A, B and C.

338(h)(10)/336(e). If an election under 338(h)(10) or 336(e) were made, the transaction would be treated as an asset sale. Buyer would get a basis step up in the assets. Gain would probably carry some ordinary income. Problem is A, B and C would be taxed even if they are rolling over equity.
A, B and C form New S Corp and they contribute all of their Old S Corp stock to New S Corp. Old S Corp becomes a QSUB. This is an F reorganization.

Old S Corp converts to a New LLC. This could be done by merger. Disregarded entity converts to a disregarded entity—transaction disregarded.

Buyer purchases 85% of LLC interests from New S Corp. New S Corp retains 15% LLC interest.
A, B and C only taxed on the 85%, not 100%.

Buyer gets basis step up on 85% of the assets. Section 704(c) would apply.

Pass Through treatment for A, B and C is preserved.

Note: What if A, B and C want their rollover equity to be at the parent level of Buyer. Could the 15% interest in New LLC be contributed by New S Corporation to the Buyer entity in exchange for equity in Buyer? If Buyer is a tax partnership, then Section 721 would permit a tax-free rollover. If Buyer is a corporation, New S Corp’s contribution would only work if the “control” test of Section 351 were satisfied.
A, B and C only taxed on the 85%, not 100%.

Buyer gets basis step up on 85% of the assets. Section 704(c) would apply.

Pass Through treatment for A, B and C is preserved.

Note: What if A, B and C want their rollover equity to be at the parent level of Buyer. Could the 15% interest in New LLC be contributed by New S Corporation to the Buyer entity in exchange for equity in Buyer? If Buyer is a tax partnership, then Section 721 would permit a tax-free rollover. If Buyer is a corporation, New S Corp’s contribution would only work if the “control” test of Section 351 were satisfied.
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)).
S Corp owns all of the operations of a manufacturing business. S Corp has been an S Corporation for more than five years.

- Buyer wants a basis step up in the S Corp assets.
- A, B and C want to retain a 15% equity interest in S Corp.
Pure Stock Purchase. If Buyer purchases 85% of the stock owned by A, B and C with no 338(h)(10) election [need to be at least 80% purchase], A and B would have all capital gain. Buyer would not step up asset basis. Transaction would likely cause S Corp’s S election to terminate—not good for A, B and C.

338(h)(10)/336(e). If an election under 338(h)(10) or 336(e) were made, the transaction would be treated as an asset sale. Buyer would get a basis step up in the assets. Gain would probably carry some ordinary income. Problem is A, B and C would be taxed even if they are rolling over equity.
A, B and C form New S Corp and they contribute all of their Old S Corp stock to New S Corp. Old S Corp becomes a QSUB. This is an F reorganization.

Old S Corp converts to a New LLC. This could be done by merger. Disregarded entity converts to a disregarded entity—transaction disregarded.

Buyer purchases 85% of LLC interests from New S Corp. New S Corp retains 15% LLC interest.
A, B and C only taxed on the 85%, not 100%.

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Note: What if A, B and C want their rollover equity to be at the parent level of Buyer. Could the 15% interest in New LLC be contributed by New S Corporation to the Buyer entity in exchange for equity in Buyer? If Buyer is a tax partnership, then Section 721 would permit a tax-free rollover. If Buyer is a corporation, New S Corp’s contribution would only work if the “control” test of Section 351 were satisfied.
A, B and C only taxed on the 85%, not 100%.

Buyer gets basis step up on 85% of the assets. Section 704(c) would apply.

Pass Through treatment for A, B and C is preserved.

Note: What if A, B and C want their rollover equity to be at the parent level of Buyer. Could the 15% interest in New LLC be contributed by New S Corporation to the Buyer entity in exchange for equity in Buyer? If Buyer is a tax partnership, then Section 721 would permit a tax-free rollover. If Buyer is a corporation, New S Corp’s contribution would only work if the “control” test of Section 351 were satisfied.
REV. RUL. 99-5: SITUATION 1

1. Taxpayer  ->  Buyer
   50%
   $5,000

2. 100%  
   SMLLC

3. Taxpayer  ->  Buyer
   50%
   50%

   LLC
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 ➔ $10,000 ➔ B

50% ➔ LLC ➔ 50%

A ➔ 100% ➔ SMLLC
- 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
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.
CCA 201415002 (2-11-14) – A purchases real property for $1 million which is financed with a $1 million recourse mortgage. The property is leased and the losses allocated to A are passive under Section 469. A has no passive income so the passive losses are suspended.

Several years later, A defaults on the loan and the lender forecloses. The value of the property is $825,000, the debt is $900,000 and the basis is $800,000. As part of the foreclosure, lender cancels the $75,000.

A has $75,000 of COD. Because A is insolvent, he can exclude from income the COD (to the extent he is not rendered solvent). A has gain on the foreclosure of $25,000.

Does the foreclosure trigger a complete disposition of the passive activity so that A can deduct his suspended losses? Yes.

The fact that the COD is excluded from A’s income because he is insolvent does not cause a reduction in the suspended losses eligible for deduction.
HANDLING PARTNER EXITS IN 1031 EXCHANGE

A \[1/3\]

B \[1/3\]

C \[1/3\]

Real Estate LLC

Cash \[1/3 \text{Cash}\]

Buyer

QI

2/3 Cash
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.

➢ EAT – “Exchange Accommodation Titleholder” will be treated as the beneficial owner for tax purposes.

➢ “Qualified Exchange Accommodation Arrangement”

➢ Time limits – 45 days and 180 days. Thus safe harbor only permits parking for 180 days.

Taxpayers may need to park property for more than 180 days. In this case, taxpayers attempt to structure the terms so the exchange accommodation party has benefits and burdens of ownership for tax purposes. Estate of Bartell, 147 T.C. 140 (2016) is a taxpayer victory in this context. On August 14, 2017, the government issued an Action On Decision (AOD 2017-06, 2017-33 IRB 194) in which it indicated that it does not acquiesce in Bartell.

Taxpayer contracted to purchase Replacement Property in 1999 at a time when Taxpayer did not have any Relinquished Property. The Replacement Property was to be a drug store to be constructed.
Taxpayer arranged to have an exchange facilitator ("EF") acquire the Replacement Property in August of 2000 with bank financing guaranteed by Taxpayer.

Taxpayer managed construction of the improvements and leased the finished property from EF.

On December 31, 2001, Taxpayer sold its Relinquished Property and purchased the Replacement Property from EF.

Tax Court held that EF was respected as the tax owner of the Replacement Property during the period of August 2000 until December 31, 2001. As a result, Taxpayer had a good 1031 exchange.
Assume that Taxpayer owns real estate having a value of $1 million and a basis of $300,000. The property is subject to a nonrecourse debt of $1.1 million. Taxpayer and Bank agree that Taxpayer will transfer the property to Bank. Can Taxpayer structure this as a like-kind exchange to defer the $800,000 gain?

Yes – see Ltr. Rul. 201302009 (10-10-12).

Taxpayer needs to assign its contract with Bank to a QI just as in any deferred exchange.

Taxpayer will need to fund the replacement property with new money and will need to arrange $1.1 million of new debt on the replacement property.

If the debt were recourse debt, an exchange would also work except that the excess of $1.1 million over $1 million will be COD income which cannot be avoided by Section 1031. The $700,000 of gain can be deferred using an exchange.
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.
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 is now a 5-year trap instead of a 10-year trap.
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?

➢ 5 year BIG under 1374 will apply on S election.
➢ If Whiteacre is liquidated after BIG period, gain will be triggered.
➢ If liquidate Whiteacre after BIG period and after Bob’s death then no gain to Bob’s estate (but if gifts of stock had been made, could still be a problem for those stockholders).

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!

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’r, T.C. Mem. 2012-88.

Parents made gifts of “a sufficient number of [LLC interests] so that the fair market value of such [LLC interests] for federal gift tax purposes shall be [$__________].”

Gifts of LLC interests were made based upon an independent appraisal. The amount of LLC interests gifted was equal to the specific dollar amount as determined by the appraisal.

On audit, the IRS sought to increase the value of the gifted interests, thereby triggering a gift tax liability. The Tax Court rejected this argument and concluded that the gifts were intended to be of a specific dollar amount of LLC interests and not of a fixed percentage of LLC interests.

This means that if there is a finally determined valuation increase, taxpayers made smaller percentage interest transfers. This is not a case where gifted property is “taken back” by the taxpayer. Rather the excess percentage interests were never transferred by gift.
Wandry 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).
- 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.
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.
**OTHER RECENT FLP CASES**

- **Estate of Natale Giustina v Com’r**, No. 12-71747 (9th Cir 2014), rev’g TC Mem 2011-141. Decedent owned a 41% limited partnership interest in a timber company. Under the partnership agreement, the general partners had full control but limited partners owning 2/3 of the partnership interest could remove the general partner, appoint a successor general partner and vote to dissolve the entity.

  - The partnership assets were worth $150 million. The estate valued Giustina’s 41% interest at $12 million. The Service valued the interest at $33 million. The Tax Court found the interest to be worth $27 million. The Ninth Circuit reversed and remanded.

  - Taxpayer’s expert “tax affected” the discounted cash flows by 25% for income taxes (to put pass through entity on par with a C corporation). At the same time, the expert applied a discount rate associated with a pre-tax earnings stream. See **Gross v. Com’r**, TC Mem 1999-254. Tax affecting is an unsettled area of valuation. Tax Court rejected tax affecting.
• Tax Court concluded that there was a 25% likelihood that the entity would be liquidated so it applied a 75% weight to discounted cash flow value and a 25% weight to net asset value. This was done even though there was no indication that the liquidation was contemplated and the family had been in the timber business for 80 years. The Tax Court assumed that there was a 25% chance that a willing buyer of the 41% interest would be admitted to the partnership by the general partners and that this hypothetical buyer would join with other limited partners to cause the removal of the general partner and the liquidation.

• The Ninth Court rejected the Tax Court’s analysis as clear error. The case was remanded for further valuation calculations.

• Estate of Beyer, T.C. Mem. 2016-183 (9-29-16). Taxpayer defeat. Transfers to FLP not respected.
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** - 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."

- The IRS claim for $2.7 billion was settled for $500 million. Estate then sued Deloitte claiming it failed to disclose the risks. This malpractice claim was dismissed by NY court because the engagement letter signed by Davidson barred any malpractice claim against the estate.

Graegin Estate v. Com’r, 56 T.C. Mem 387 (1988). Estate permitted to deduct interest on a loan to fund estate taxes as an administration expense for estate tax purposes (Section 2053). “Graegin loans” work if they have fixed terms with no prepayment permitted so the amount of interest can be calculated with certainty. The estate must also show that the loan is a last resort to fund the estate tax to avoid economic loss on a forced sale, and that the terms are otherwise at arm’s-length.

In Estate of Koons v. Com’r, 2017-1 USTC 60,700 (11th Cir. 2017), the 11th Circuit affirmed the Tax Court (105 TC Mem 1567) in rejecting the interest deduction by the estate. In Koons, the estate borrowed funds from a family LLC in which the estate held 47% of the voting interests and 52% of the nonvoting interests. The loan had an 18-year term generating an interest deduction of over $70 million. The Court concluded that the estate tax could have been funded by pro rata distributions from the LLC.

Because the estate intended to repay the loan with LLC distributions, the loan was not necessary to avoid forcing the estate to sell assets at a loss.
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.
- S Corp owns rental real estate having a basis of $1 million and a value of $5 million. S Corp forms an LLC with Investor. S Corp contributes the real estate and Investor contributes $5 million cash. Investor has voting control.
Tax distribution clause provides that LLC will distribute cash equal to each member’s annual tax obligations attributable to the income of the LLC. Careful: S Corp has no tax obligations – it is a pass through! Fix is to key the tax distribution based on highest rate of a US resident individual.

- Is 704(c) income allocated to S Corp eligible for a tax distribution?
- What if the stockholder of S Corp does not have basis in his stock? Tax distribution will be taxable which creates additional tax. Does the tax distribution clause cover this?
- What if S Corp has losses from other activities? Should these losses be considered in measuring the required tax distribution?
- What if LLC arranged refinancing and the loan documents do not permit any distributions for 5 years? Does LLC make tax distributions and risk defaulting on the loan?