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Business Combinations: Mergers and Sales and Purchases of Ownership Interests and Entity Assets (Related Articles)

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RECENT DEVELOPMENTS AFFECTING PASS-THROUGH ENTITIES

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Tax Tip

By Stephen L. Owen

Using Business Entities to Achieve Real Estate Capital Gains

Real estate entrepreneurs are always looking for ways to minimize taxes. Maximum federal ordinary income tax rates for individuals are at 35 percent and, in many instances, state and local jurisdictions impose taxes as well. The maximum federal rate applicable to long-term capital gains is only 15 percent, plus state and local taxes. A 20-percent rate “spread” is significant. It appears that this spread will continue to exist at least through 2008.

If real estate is held as a capital asset or for use in a trade or business other than as “dealer property,” favorable capital gain rates will be available in the event of a taxable disposition of the property (assuming the property has a holding period of over one year). However, there are special rules that may cause a different result. Ordinary income recapture could apply, to the extent gain is attributable to accelerated depreciation. In addition, gain recognized on the disposition of depreciable real property is taxed at a special 25-percent federal rate to the extent of any straight-line depreciation previously taken. Sellers of depreciable real estate can still take advantage of the 15-percent federal capital gains rate to the extent that the purchase price is either allocated to land or is in excess of the original cost of the depreciable improvements. Of course, if the real property has a holding period of no more than one year or if the property is “dealer property,” the gain will be taxed at ordinary income rates.

What is “dealer property”? Dealer property is “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” The question of whether property is dealer
property is determined by the specific facts of each case. The Supreme Court has interpreted "primarily" to mean "principally" or "of first importance." Factors to be considered include the following:

- The purpose of the property's acquisition
- The frequency, continuity and size of sales
- The activities of the taxpayer in the improvement and sale of the property
- The extent of the improvements made to the property
- The proximity of the sale to the purchase of the property

Example: Taxpayer has owned land for two years. Taxpayer has subdivided the land into 50 lots for sale to homebuilders. Taxpayer will likely be viewed as a "dealer," with the result that the gain from the sale of the individual lots will be ordinary income.

Example: Taxpayer has owned an apartment building for 10 years. Taxpayer converts the apartments to condos and sells the condos to third parties. Taxpayer will likely be viewed as a dealer, and the gain will be taxed as ordinary income.

There are ways for real estate entrepreneurs to achieve capital gains treatment in a variety of contexts through the use of business entities. Let's consider some of the possibilities.

Real Estate Held by a C Corporation

It is elementary tax planning that real estate (an appreciating asset) should not be owned by a C corporation. This is because extracting the real estate via a sale or distribution will trigger a corporate-level tax on the gain. There will also be a stockholder-level tax on the distribution if the sale proceeds or the property, as the case may be. Owners of C corporations would be well-advised to own the real estate used in their business activities outside of the corporation (in a partnership or LLC) and lease the real estate to the C corporation.

Notwithstanding the above advice, there are C corporations that own real estate. If the stockholders sell their stock, they will achieve favorable capital gains. This is true even if the corporate-owned real estate is dealer property (note that the old "collapsible corporation" rules were repealed in 2003). In addition, because there is no "look-through" rule in the C corporation context, the gain on a stock sale is not subject to any of the recapture rules. The problem is that the purchaser in this context is unable to step-up the basis of the C corporation's assets to reflect the price paid for the stock.

Real Estate Held By an S Corporation

If real estate is owned by an S corporation, the S corporation stockholders can sell their stock with the same capital gain consequences as in the C corporation sale of stock context. There is no "look-through" for depreciation recapture. The collapsible corporation rules, although once applicable to S corporations as well as to C corporations, have been repealed. However, if the purchaser of the S corporation stock is a corporation, the parties could agree to make a Code Sec. 338(h)(10) election as part of the stock sale. The result would be a deemed asset sale, giving the buyer a stepped-up basis in the target's assets. The result to the selling stockholder(s) would depend on the allocation of consideration under Code Secs. 338 and 1060: to the extent the gain is allocated to an asset subject to the recapture rules or dealer property, ordinary income (or special 25-percent gain) would result.

Real Estate Held By a Partnership or LLC

Suppose that X and Y, individuals, own the XY LLC. XY LLC owns Blackacre as its only asset. Blackacre is 100 acres of raw land that has been held by XY LLC for five years for investment purposes. Blackacre was purchased for $1 million cash and is now worth $10 million. X and Y are advised that, if Blackacre is subdivided into 200 building lots, and if the necessary infrastructure is completed (at an additional cost of $1 million), Blackacre would be worth $15 million. What can X and Y do?

If X and Y proceed with the subdivision and infrastructure plan that culminates in the sale of finished lots to homebuilders, the odds are good that the gain will be taxed at ordinary income rates because XY LLC will likely be viewed as a dealer. What if X and Y (based upon the advice of their CPA) decide to form a new LLC (XY II LLC)? XY II LLC will have as its stated purpose to engage in the real estate development business. X and Y capitalize XY II with
$1 million each. XY II then contracts with XY LLC to purchase Blackacre today for $10 million, of which $2 million will be paid in cash and $8 million will be evidenced by a three-year promissory note secured by Blackacre. Because XY LLC has not yet "gone too far" in the subdivision process, the $9 million of gain would be long-term capital gain. However, there is a fundamental problem. Code Sec. 707(b)(2) provides that, because XY II will be a dealer and because X and Y own more than 50 percent of the capital or profit interests in both LLCs, the gain will be ordinary, and not capital. If X and Y are willing to give up at least 50 percent of the capital and profits interests in XY II to an unrelated third party, the structure proposed by their CPA may well result in achieving capital gain on the $10 million sale. However, if the projections are accurate, they will be giving up at least 50 percent of the $4 million additional profit to be realized on the "dealer side" of the arrangement. Do X and Y have another option? Yes.

Instead of establishing XY II LLC as the purchaser, what if X and Y form an S corporation, XY Corp, with X and Y as the two stockholders? In this case, there is no Code provision analogous to Code Sec. 707(b)(2), in the context of a sale to an S corporation that would treat the gain on the $10 million sale as ordinary income. Thus, XY LLC could sell Blackacre to XY Corp for $10 million, payable $2 million down, with the balance evidenced by an $8 million promissory note. X and Y would report the long-term capital gain on the installment method. The additional $4 million of gain realized by XY Corp on the ultimate sale to the homebuilders would be ordinary income, but X and Y can pocket all of the net proceeds. Although the IRS does not like this result, there are a number of cases that provide substantial authority supporting the position of X and Y, including the recent Tax Court decision in T.J. Phelan.24

Notwithstanding the likelihood of taxpayer success, taxpayers and their advisers should consider a number of factors that may bolster their position. First, the IRS could argue that the sale of Blackacre to the S corporation should be recharacterized as a "capital contribution" to the S corporation if the S corporation is "thinly capitalized."25 Such an argument, if successful, would mean that XY Corp would receive a carryover basis, and the entire $13 million of gain would be recognized by XY Corp as ordinary income.26 Taxpayers can likely defend against this argument by making sure the S corporation stockholders make substantial capital contributions (which are used as the down payment on the sale).27 In addition, a fairly short-term note having a market interest rate and adequate security (a mortgage and/or personal guarantees of the stockholders or affiliates) will be more easily defended than a long-term note with little, if any, collateral.

The IRS could also argue that the S corporation is a mere agent acting not on its own behalf but, in fact, acting on behalf of the seller (here, XY LLC). For this reason, the S corporation should operate as a bona fide, separate entity. Although the cases do not require it, the facts may be better if the stock ownership of the S corporation does not mirror that of the seller. X and Y could consider having family members and/or key employees as stockholders in addition to themselves. A charity could also be a stockholder.28 These steps could also help overcome any "substance-over-form" challenge from the IRS.

What if Blackacre were an apartment complex instead of raw land? Code Sec. 1239 provides that a sale to a related party29 will be taxed at ordinary income rates if the property is depreciable in the hands of the transferee. Because the S corporation in this context will be a dealer, Blackacre should not be depreciable in the hands of the S corporation. Thus, Code Sec. 1239 should not apply.

What if the sale of Blackacre would trigger substantial state and local transfer, and recordation taxes that could be avoided if X and Y instead were to sell their interests in XY LLC to the S corporation? The income tax analysis would generally be the same as in the case of a direct sale of Blackacre. If Blackacre were dealer property, Code Sec. 751 would cause ordinary income to result from the sale of interests.30 If Blackacre were depreciable, the recapture look-through rules (discussed above) would apply.31 However, in the case of a sale of interests, the holding period (for determining long-term capital gain) would be tested not by the holding period of Blackacre, but rather by the holding period of the LLC interests.32 In particular, X and Y should focus on the potential application of Reg. §1.1223-3. Under these regulations, if X and Y made capital contributions to XY LLC within the twelve-month period prior to the sale of interests, a portion of the gain could be recharacterized as short-term instead of long-term capital gain. This trap can be avoided by having any such capital infusion treated as a bona fide loan, instead of as a capital contribution.

In evaluating the treatment of the sale as an installment sale, there are several matters to address.
First, a taxpayer might not want installment sale treatment. If this is the case, the taxpayer could "elect out" of installment sale treatment. Even if the taxpayer does not elect out of installment sale treatment, Code Sec. 453(e) requires acceleration of deferred gain, to the extent there is a resale of the property within two years following the initial installment sale. Finally, Code Sec. 453A subjects taxpayers to a special interest charge on the deferred gain, to the extent the taxpayer holds installment notes at the end of a taxable year in excess of $5 million. In the case of a partnership or LLC seller, this $5 million test is applied at the partner/member level.

ENDNOTES

1. Code Sec. 1032. All Code Sec. references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

2. Code Sec. 1031(a)(2).

3. There is currently a sunset provision effective for taxable years beginning after 2008 (under which the maximum rate reverts to 30 percent), Act Sec. 303 of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Pub. L. No. 108-27) (the "2003 Act").

4. See Code Sec. 1221(a).

5. See Code Sec. 1231. But see Code Sec. 1231(b), which provides ordinary income recapture to the extent of Code Sec. 1231 losses taken by the taxpayer during the preceding five years.


7. Of course, the taxpayer can frequently structure the disposition as an exchange under Code Sec. 1031.

8. Code Sec. 1222(a).

9. Code Sec. 1245. Such depreciation is not available under today's law, but existed with respect to property acquired in the early to mid-1980s.

10. Code Sec. 1011(a)(1). In the case of sale or exchange of a partnership interest, the taxpayer is required to "look through" to the assets of the partnership in applying the 25-percent rate, Reg. 1.1011-1(b)(3). Note that, a "redemption" of a partnership interest does not require a look-through for this purpose, Reg. 1.1011-1(b)(3).

11. Code Sec. 1033(b)(1).

12. Code Sec. 1031 exchange treatment is potentially available for property held for less than one year, provided it is held for investment or used in a trade of business. Code Sec. 1031 exchange treatment is not available for real property.

13. Code Sec. 1221(a)(1). See the special rules provided in Code Sec. 1237. Note that gain from the sale of dealer property would constitute "unrelated business taxable income" for an exempt organization under Code Secs. 511 and 512(b)(15) (B). Further, gain from the sale of dealer property would be "built-in tax" (H) under Code Sec. 854C and could attract a special 10-percent tax as a prohibited transaction for a RRT under Code Sec. 857(m)(6)(A).


15. See Mall v. Riddle, 66-1 ustc 9317, 383 US 369, 86 SCt 1030.


17. But see, e.g., C.R. Gfits, 54 TCM 1048, Dec. 44,319(M), TC Memo. 1987-551 (capital gain on sale of condominiums).

18. Code Secs. 1222(a)(1) and 1231(a). (Note that there is no favorable capital gain tax rate for C corporations.


20. But see Code Sec. 707(b), providing that capital gain treatment is not available for certain sales to partnerships or LLCs where the purchaser is "related" to the seller.

21. If the target corporation is either an S corporation or a member of an affiliated group, the buyer may be able to get a stepped-up basis in the assets through the use of an election under Code Sec. 338(h)(10), Reg. 1.338(h)(10)-1(b). In this case, the seller will be viewed as having sold assets.

22. Note that there is a "look-through" rule in the S corporation context where the S corporation owns "collectibles." Code Sec. 1013(b)(3). The federal capital gain rate is 25 percent on collectibles.

23. Code Sec. 334(h)(10).


25. In Aqualine Shores, Inc., CA-5, 59-2 ustc 196,322, 269 F.2d 110 (1959), the Fifth Circuit accepted this argument, noting that the contractual obligations offered by the Newco were practically contingent upon the survival of the development of the property, and thus constituted "risk capital." Cfr. L.S. Bradshaw, CICL 82-2 ustc 9454, 662 F.2d 365 (1982), wherein the Court of Claims upheld the transaction as a sale, noting that the formalization of a sale had been "strictly observed" and that there had been little business risk that the development project would fail.

26. Note, if the promissory note held by XYZ LLC is viewed as equity instead of debt, the 5 election of XYZ Corp would terminate because XYZ LLC (the holder of the promissory note) would not be a permitted S stockholder. Additionally, if the promissory note does not qualify under the â€œstraight debtâ€ safe harbor of Code Sec. 1361(a)(5), the equity may then be reclassified as preferred stock (see Bur Oak Corp., infra), which would also serve to terminate the S election.

27. Note that this series of transactions results in "phantom gain" to X and Y. They have ostensibly received a "payment" under Code Sec. 453; in reality they were merely receiving In return their capital contributions made to Newco.

28. See Code Sec. 1361(a)(6), which provides that an organization described in Code Sec. 401(a) or Code Sec. 501(c)(3) that is exempt from tax under Code Sec. 501(a) is a permitted stockholder in an S corporation. However, Code Sec. 512(a) provides that the (1) all items of S corporation income (or loss) allocated to the exempt organization and (2) any gain (or loss) recognized by the exempt organization on the disposition of its stock in the S corporation are unrelated business taxable income. Code Sec. 512(a) does not apply to ESOPs.

29. See Bur Oak Corp., CA-7, 66-2 ustc 19806, 365 F.2d 24, cert. denied, 385 US 1007, 87 SCt 713 (1967), wherein, based on the facts of that case, the Seventh Circuit accepted both the contribution to capital and substance over form arguments from the IRS.

30. See Code Sec. 1239(b).

31. Code Sec. 751(d).

32. It is unclear whether there is a look-through in testing the application of Code Sec. 1239(b).

33. Note that, if XYZ owns property used in a trade or business but held for less than one year, under Code Secs. 751(b) and 1231 the portion of the consideration for the interest acquired would be classified as ordinary income.

34. Code Sec. 453(d).

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Tax Tip

By Stephen L. Owen

Using Disregarded Entities in Corporate Reorganizations

Code Sec. 368 describes the different transactions that qualify as "reorganizations" under the Code. A transaction qualifying as a "reorganization" generally results in deferral of tax on gain built into the assets and the receipt of stock of the participating corporations.

One of the transactions that Code Sec. 368 includes as a "reorganization" is a "statutory merger or consolidation" pursuant to Code Sec. 368(a)(1)(A). This form of "reorganization" offers considerable flexibility over other forms of "reorganizations," in that there is no statutory restriction on the permissible consideration; the only limit on consideration being imposed by the "continuity of proprietary interest" rules, which are generally interpreted to permit as much as 50 to 60 percent of consideration, other than stock of the acquiror. Additionally, statutory mergers and consolidations can allow merging corporations to transfer valuable assets, such as contract rights, by operation of state law, rather than by a deed, assignment or other private instrument of transfer.

A "statutory merger or consolidation" clearly includes the merger of two corporations accomplished by operation of state corporate law. State corporate laws, however, also provide for the merger of corporations with entities other than corporations, such as partnerships and limited liability companies. These other entities have the potential to be classified as entities disregarded as separate from their owners for federal income tax purposes. This raises the question whether "statutory merger or consolidation" encompasses the merger of a corporation into a disregarded entity, as in the following situation:
Example 1: Acquiror, a C corporation, wishes to acquire Target Corp., an S corporation, all of the stock of which is owned by A. The parties would like to structure a merger of Target Corp. into Acquiror, with A receiving Acquiror's stock. However, a direct merger into Acquiror would subject the assets of Acquiror to Target Corp.'s liabilities. The transaction could also require an Acquiror stockholder vote. The deal is revised so that Acquiror forms a single-member LLC (SMLLC) into which Target Corp. merges. SMLLC is the survivor and A receives Acquiror's stock.

Would the fact that SMLLC is a disregarded entity allow the transaction to qualify as a "statutory merger or consolidation" under Code Sec. 368(a)(1)(A)?

In proposed regulations issued in 2000, the IRS's initial conclusion was that this transaction would not qualify as a statutory merger or consolidation under Code Sec. 368(a)(1)(A). This was not the answer that tax professionals wanted to hear. However, updated proposed regulations were issued in 2001, which provided that this transaction would qualify for non-recognition treatment under Code Sec. 368(a)(1)(A). In Temporary Regulations issued on January 24, 2003, generally effective for transactions occurring on or after January 24, 2003, the IRS followed the approach of this second set of proposed regulations.

On January 23, 2006, the IRS issued final regulations (the "Final Regulations") on this topic. While the IRS has acknowledged that there remain many unanswered questions in this area, the Final Regulations offer significant guidance to entrepreneurs and their tax advisors in structuring acquisitions and dispositions of business entities. Here are some illustrative examples.

In Example 1 above, why would Acquiror not simply form a wholly owned subsidiary corporation and structure the transaction as a tax-free reorganization under Code Sec. 368(a)(2)(D) (i.e., a "forward-triangular merger")? Acquiror would then be able to isolate the liabilities of Target Corp., and the transaction would not require the vote of Acquiror's stockholders. First, there may be state income tax benefits in operating the Target Corp.'s business in a single-member LLC (e.g., some states, such as Maryland, do not permit consolidated returns, so losses of a subsidiary corporation may be trapped in the subsidiary). In addition, qualifying as a merger under Code Sec. 368(a)(1)(A) is easier than in the case of a triangular merger under Code Sec. 368(a)(2)(D).

The Final Regulations provide absolute clarity that the transaction described in Example 1 qualifies for tax-free treatment under Code Sec. 368(a)(1)(A). What if Acquiror has a wholly owned subsidiary corporation ("Sub") that has substantial assets? Acquiror, for business reasons, desires to acquire Target Corp. under the Sub "umbrella" in exchange for Acquiror's stock, but does not want Sub's assets to be exposed to the liabilities of Target Corp.

Example 2. Sub forms an SMLLC. Target Corp. merges into SMLLC with SMLLC surviving. The stockholders of Target Corp. receive stock of Acquiror.

Whether it is a single-member LLC, a QSub or a QRS, a disregarded entity offers business planners a variety of potential opportunities to achieve tax as well as non-tax objectives.

The Final Regulations provide that this transaction will qualify for tax-free treatment as if Target Corp. had merged into Sub, assuming that the forward triangular merger requirements of Code Sec. 368(a)(2)(D) are satisfied.

What if a target corporation is merged into a disregarded entity in exchange for interests in the disregarded entity?

Example 3. Acquiror, an S corporation, owns all of the interests of SMLLC. Target Corp. merges into SMLLC and the Target Corp. stockholders receive 50 percent of the interests in SMLLC. SMLLC survives in the merger.

The Final Regulations provide that this transaction does not qualify as a "statutory merger or consolidation." As a result of the merger, SMLLC is treated as having converted from a disregarded entity to a partnership for federal income tax purposes. Acquiror is deemed to have contributed to the partnership all of the assets, subject to all of the liabilities, held by SMLLC immediately before the merger. Target Corp. is deemed to have contributed all of its assets, subject to all of its liabilities, to the partnership and to have simultaneously distributed 50 percent of the SMLLC interests to

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the Target Corp. stockholders in complete liquidation. The deemed liquidation of Target Corp. would trigger gain to the extent the value of the Target Corp. assets exceeds basis.19

What if Acquiror and Target Corp. are partners in the A/TC Partnership, and Acquiror wishes to acquire Target Corp. in exchange for Acquiror’s stock?

**Example 4.** Acquiror forms SMLLC, Target Corp. merges into SMLLC, and the Target Corp. stockholders receive Acquiror stock.

This transaction qualifies as a “statutory merger or consolidation,” as discussed in Example 1 above. The twist is that the A/TC Partnership becomes a disregarded entity as a result of the merger because all of its interests are held by Acquiror, directly or indirectly (through SMLLC). The conversion of A/TC Partnership to a disregarded entity should not have adverse tax consequences.

**Example 5.** Target Corp. merges into A/TC Partnership. The A/TC Partnership stockholders receive Acquiror’s stock. As a result of the merger, A/TC Partnership becomes a disregarded entity because all of its interests are owned by Acquiror.

The Final Regulations conclude that this transaction qualifies as a statutory merger or consolidation for purposes of Code Sec. 368(a)(l)(A). All of the assets and liabilities of Target Corp. become the assets and liabilities of A/TC Partnership, a disregarded entity.

Note that, in all cases that are deemed to be statutory mergers or consolidations for purposes of Code Sec. 368(a)(l)(A), the target is not a disregarded entity. What happens if the target in the merger is a disregarded entity?

**Example 6.** Target Corp. owns 100 percent of the interests of Target LLC, a disregarded entity. Acquiror wishes to acquire Target LLC by having it merge into SMLLC, a disregarded entity wholly owned by Acquiror. Acquiror will issue its stock to Target Corp. pursuant to the merger. As a result of the merger, all of the assets and liabilities of Target LLC (but not those of Target Corp.) will become assets and liabilities of SMLLC.

The Final Regulations conclude that this transaction does not satisfy the requirements of Code Sec. 368(a)(l)(A). (Note that this transaction might qualify for tax-free treatment under Code Sec. 368(a)(l)(C) if the requirements applicable to such a reorganization are satisfied).

A QSub also is a disregarded entity. What happens if the parent corporation of a QSub merges with another entity?

**Example 7.** Target Corp. is an S corporation. Target Corp. owns all of the stock of Target Sub, a QSUB. Target Corp. will merge into SMLLC, a single-member LLC owned by Acquiror. SMLLC will survive. The stockholders of Target Corp. will receive stock of Acquiror.

As a result of the merger, all of the assets and liabilities of Target Corp., including the stock of Target Sub, will become assets and liabilities of SMLLC. Under applicable regulations,18 the transaction is treated as a deemed transfer of the assets of Target Sub to SMLLC, followed by a deemed contribution of these assets to a new Target Sub by SMLLC in exchange for Target Sub stock. This deemed “drop-down” of assets as part of the merger does not cause the merger to fail to qualify for tax-free treatment under Code Sec. 368(a)(l)(A). It should be noted that Target Sub’s QSUB status terminates upon the merger. Target Sub will thereupon become a C corporation immediately following the merger, unless Acquiror is an S corporation and a new election is made to treat Target Sub as a QSUB.15 Under Rev. Rul. 2004-85, new QSUB election must be made effective immediately following the merger.15 If the QSUB election is not made effective immediately following the merger, Target Sub will not be eligible to be treated as a QSUB (or as an S corporation if, for example, its stock is spun off and it would otherwise be eligible to be an S corporation) until the expiration of the five-year re-election prohibition period under Code Sec. 1361(b)(3)(D). Rev. Proc. 2004-49 offers a way to request relief from the IRS for a late QSUB election in this context.

The foregoing rules regarding QSUBs are applicable to QSUBs where the parent S corporation transfers all of the QSUB stock to another S corporation in a taxable sale or in a tax-free reorganization under Code Sec. 368(a), except where the tax-free reorganization qualifies under Code Sec. 368(a)(l)(F).

**Example 8.** S-1 Corp. is an S corporation that owns all of the stock of QSUB-1. A. the sole
stockholder of S-1 Corp., forms S-2 Corp. S-2 Corp. has no assets or liabilities and is eligible to be an S corporation. S-1 Corp. merges into S-2 Corp.

This transaction qualifies as a tax-free reorganization under Code Sec. 368(a)(1)(F). Under Rev. Rul. 64-250 when an S corporation merges into a newly formed corporation in a transaction qualifying under Code Sec. 368(a)(1)(F), and the newly formed corporation meets the requirements of Subchapter S, the merging corporation's S election does not terminate, but instead, remains in effect for the newly formed surviving corporation. The newly formed corporation is treated as a "continuation" of the merging S corporation. As a result, the QSub elections for subsidiaries of the merging S corporation will not terminate.

The concept of a "disregarded entity" is relatively new. Whether it is a single-member LLC, a QSub or a QRS ("qualified REIT subsidiary"), a disregarded entity offers business planners a variety of potential opportunities to achieve tax as well as non-tax objectives. This column has considered a few of these opportunities.

ENDNOTES

1 All Code Section references are to the Internal Revenue Code of 1986 (the "Code"), as amended, unless otherwise indicated.
2 See, e.g., Code Sec. 354, which provides for nonrecognition of gain or loss on exchange of securities in a corporation that is a party to a reorganization or for other securities in that corporation or another corporation also a party to the reorganization; Code Sec. 361, which provides for nonrecognition of gain or loss on exchange by a corporation, which is a party to a reorganization, of all property for securities in another corporation also a party to the reorganization; and Code Secs. 358, 362 and 281, which provide for the carryover of certain tax attributes between corporations that are party to a reorganization and between shares of stock in such corporations surrendered and received in the transaction.
3 Reg. §1.368-1(e).
4 Compare, for example, "reorganizations" under Code Sec. 368A(f)(18) (role consideration allowed is voting stock), Code Sec. 368A(a)(1)(C) (in addition to voting stock, other limited forms of consideration allowed; also "substantially all" assets of target must be transferred) and Code Sec. 368A(a)(2)(D) ("substantially all" assets of target must be transferred).
7 Reg. §301.7701-3(a). In addition to "eligible entities" that are disregarded under Reg. §301.7701-3(b), the potential for a merger involving a qualified subchapter S subsidiary or "QSub" (as defined in Code Sec. 1361(b)(3)(B) or a qualified REIT subsidiary (as defined in Code Sec. 855(a)(2)), both of which are disregarded entities, further necessitated the establishment of a rule regarding mergers and disregarded entities. See T.D. 9034, 58 FR 3384, January 24, 2003 (announcing the January 2003 Proposed Regulations).
8 65 FR 31115.
9 Even under the proposed regulations, this transaction might have qualified for tax-free treatment under Code Sec. 368A(a)(1)(C), but the requirements of this provision are more difficult to satisfy.
10 66 FR 57400.
12 Reg. §1.368-2(b)(iii), Ex. 2.
13 Reg. §1.368-2(b)(iii), Ex. 4.
14 Reg. §1.368-2(b)(iii) Ex. 7.
15 Code Sec. 336. This could be even more costly if Target Corp. were subject to the built-in gain provisions of Code Sec. 1374.
16 Reg. §1.1361-5(b)(1) and §1.1361-5(b)(3) Ex. 9.
17 Code Sec. 368A(a)(2)(C).
19 Id.
20 Under Reg. §1.1361-3(b)(4), a QSub election cannot be effective more than 2 months and 15 days prior to the date of filing nor more than 12 months after the date of filing.

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Tax Tip

By Stephen L. Owen

Tax “Complification”: Dealing With Contributions To, and Distributions From, Partnerships and LLCs

In the “good old days,” the tax laws and regulations applicable to partnerships ("Subchapter K") were relatively short and straightforward. Contributions of appreciated property to a partnership were tax-free.1 Distributions of appreciated property from a partnership were tax-free.2 Even distributions of cash to a partner were tax-free to the extent of the partner’s basis in his partnership interest.3

Example 1. A owns land having a basis of $1,000 and a value of $2,000. A contributes the land to the AB LLC in exchange for a 50 percent interest in AB. B contributes $1,000 to AB in exchange for a 50 percent interest in AB. AB distributes $1,000 to A in order to equalize capital accounts, because A’s capital account was credited with the full fair market value of the land.

If the form of the transaction is respected, A’s contribution of the land to AB is tax-free under Code Sec. 721 and A’s receipt of $1,000 from AB is a tax-free return of capital under Code Sec. 731.4 Note that, in reality, A “sold” a 50 percent interest in the land to B. However, in a sale transaction, A would recognize gain of $500.

Even in the good old days, the IRS was concerned that creative taxpayers would attempt to use a partnership to avoid tax in a transaction that was, in substance, a taxable sale. Regulations5 provided that if there was a contribution of property to a partnership and “within a short period” (1) there was a distribution of other property to the contributing partner or (2) the contributed property was distributed to...
another partner, the transaction could be recharacterized as taxable. Notwithstanding the existence of these regulations, the IRS was largely unsuccessful in convincing courts to recharacterize the form of a contribution/distribution transaction as a sale. 6

Disguised Sales of Property. In 1984, Congress attempted to end the "disguised sale" of property using a partnership. Code Sec. 707(a)(2)(B) provides that if there is a direct or indirect transfer of money or other property by a partner to a partnership, and there is a related direct or indirect transfer of money or other property by the partnership to the contributing partner (or to another partner), then the transfers, when viewed together, will be characterized and treated as a sale of property, rather than as a contribution to, and a distribution from, a partnership.

The regulations promulgated under Code Sec. 707(a)(2)(B) ("Property Regs") do not offer bright-line, objective standards. Rather, the Property Regs offer a "facts and circumstances" analysis to determine whether a sale has occurred. Based upon the facts and circumstances, (1) would the transfer of money or other consideration have been made "but for" the transfer of property and (2) where the transfers are not simultaneous; is the subsequent transfer dependent upon the "entrepreneurial risks of partnership operations"? 7

The Property Regs apply a two-year presumption. 8 If a contribution and a distribution occur within a two-year period, the transfers are presumed to be part of a sale transaction. If the contribution and the distribution occur more than two years apart, the transfers are presumed not to be a sale transaction. These presumptions can be overcome only if the facts and circumstances "clearly establish" that the transfers do not constitute a sale (or transfers within two years) or constitute a sale (for transfers not within two years). In Example 1 above, the transaction would be presumed under the Property Regs to be a sale of a 50 percent interest in the Property for $1,000, causing A to recognize gain of $500.

Example 2. A transfers land to the AB Partnership in exchange for an interest in AB. AB will construct improvements on the land. The land has a basis of $7,000 and a value of $2,000. The AB partnership agreement provides that, upon completion of construction, AB will distribute $900 to A.

If the $900 distribution occurs within two years of A's land contribution, the contribution/distribution will be presumed to be part of a sale of the land to AB. A may rebut the presumption if the facts and circumstances clearly establish (1) that the transfer of cash to him would have been made without regard to his contribution of the land to AB or (2) that AB's obligation or ability to make the transfer to A was dependent, at the time of contribution of the land, on the entrepreneurial risks of AB's operations.

Distributions of Contributed Property. Code Sec. 704(c)(1)(A) provides that income, gain, loss and deduction with respect to property contributed to a partnership by a partner, are required to be shared among the partners to take into account the variation between the basis of the contributed property to the partnership and its value at the time of contribution.

Example 3. Suppose that A and B form the AB LLC. A contributes land having a value of $15,000 and a basis of $10,000 (this appreciated property is known as "Section 704(c) property"). B contributes $15,000 cash. If the land is subsequently sold by AB for $25,000, the $5,000 of built-in gain at the time of contribution (i.e., the "Section 704(c) gain") would be allocated solely to A, with the remaining $10,000 of gain being allocated equally between A and B.

What if the Section 704(c) property was not sold, but was distributed from the LLC to another member? In Example 3, if the land was distributed by AB to B, A would no longer be obligated to recognize the built-in gain upon a sale of the land once it had "left" Partnership AB. Code Sec. 704(c)(1)(B) was enacted to close this "loophole" in Code Sec. 704(c)(1)(A). Code Sec. 704(c)(1)(B) provides that, if a partnership distributes Section 704(c) property to a partner other than the contributing partner within seven years of the contribution, the contributing partner must
recognize the Section 704(c) gain as if the Section 704(c) property had been sold by the partnership at its fair market value at the time of contribution. This provision is onerous because it triggers a tax liability to the contributing partner at a time when there may not be cash to pay the tax.

Note. In representing the contributing partner, tax advisors often should insist that the partnership will not have the ability to distribute contributed property in a manner that would trigger Code Sec. 704(c)(1)(B).

The applicable regulations offer various exceptions to Code Sec. 704(c)(1)(B). For example, Code Sec. 704(c)(1)(B) does not apply if a partnership holding Section 704(c) property transfers all of its assets and liabilities to another partnership in a Code Sec. 721 transaction and the transferring partnership distributes the interests in the transferee partnership to the partners in the transferor partnership in liquidation of the transferor partnership. An “assets-over” merger of partnerships would fall within this exception. Reg. §1.704-4(c)(4) provides that a subsequent distribution of Section 704(c) property by the transferee partnership to a partner of the transferor partnership is subject to Code Sec. 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to Section 704(c)(1)(B)." 

Example 4. On January 1, 2004, A, B, and C formed ABC LLC. A contributed cash of $10,000 and Property A having a value of $10,000 and a basis of $4,000. B contributed cash of $10,000 and Property B having a value and basis of $10,000. C contributed $20,000 in cash. Also on January 1, 2004, D, E, and F formed DEF LLC. D contributed Property D having a value of $10,000 and a basis of $2,000. E and F each contributed $10,000 in cash. On January 1, 2007, ABC LLC merges with DEF LLC in an “assets over” merger, with ABC being the survivor and the “continuing partnership” under Code Sec. 708. Immediately prior to the merger, Property A had appreciated to $20,000, Property B had appreciated to $20,000 and Property D had appreciated to $15,000. On January 1, 2012, ABC LLC distributes Property D to A.

Prior to Rev. Rul. 2004-43, most practitioners interpreted this exception literally, so that a new seven-year period would not begin as a result of the merger, and that any appreciation (after the initial contribution) in the Section 704(c) property would not be considered in applying Code Sec. 704(c)(1)(B).

On this basis, there would be no problem because the distribution of Property D to A will have occurred more than seven years after the original contribution of Property D to DEF LLC by D.

However, in Rev. Rul. 2004-43, the IRS reasoned that ABC will receive Property D in 2007 with a basis of $2,000 and a value of $15,000, thus, Property D will have $13,000 of Section 704(c) gain. Of this amount, $8,000 results from D's contribution of Property D to DEF ("704(c) Pre-Merger Layer") and $5,000 results from the merger ("704(c) Post-Merger Layer"). Note that D, E, and F share in the 704(c) Post-Merger Layer even though E and F contributed cash to DEF. On the distribution of Property D to A in 2012, the IRS concludes that D, E, and F will recognize gain totaling $5,000 because the 704(c) Post-Merger Layer is subject to Code Section 704(c)(1)(B) (the 704(c) Pre-Merger Layer is not subject to Code Sec. 704(c)(1)(B) because more than seven years has elapsed). A is not taxed under Code Sec. 737 because more than seven years has elapsed since A's contribution of Property A to ABC (see discussion below).

Rev. Rul. 2004-43 has been revoked by Rev. Rul. 2005-10. However, the IRS has indicated in Notice 2005-19 that regulations will be promulgated, effective for distributions occurring after January 19, 2005, that apply the position set forth in Rev. Rul. 2004-43.

Distributions to Contributing Partners. Another "anti-mixing bowl" provision is found in Code Sec. 737. Code Sec. 737 requires a partner who contributes Section 704(c) property to a partnership, to recognize gain on a subsequent distribution of property from the partnership to the contributing partner, within seven years after the contribution. The amount of gain recognized is the lesser of (1) the net pre-contribution gain in the contributed property or (2) the excess of value of distributed property over the adjusted basis of the partner's interest in the partnership. This provision is designed to prevent a contributing partner from avoiding Section 704(c) gain by shifting it to another property (at least during the seven-year post contribution period).

Example 5. On January 1, 2005, A, B, and C form ABC LLC as equal members. A contributes Blackacre, having a value of $20,000 and a basis of $6,000. B contributes $10,000 in cash and
Whiteacre, having a value and basis of $10,000. C contributes $20,000 cash. On December 31, 2007, ABC distributes Whiteacre to A. Whiteacre is still valued at $10,000. A recognizes $4,000 of gain on the distribution under Code Sec. 737, even though no cash is generated from the transaction. Note that B does not recognize gain under Code Sec. 704(c)(1)(B) because Whiteacre was not Section 704(c) property at the time it was contributed by B (i.e., Whiteacre's value and basis were equal).

Disguised Sales of Partnership Interests. To this point in the discussion, we have considered potential traps where the government could tax a taxpayer who has contributed appreciated property to a partnership or an LLC. On November 26, 2004, the government issued proposed regulations addressing disguised sales of partnership interests (the "Partnership Interest Regs").

Example 6. A and B own all of the membership interests in the AB LLC. A owns 40 percent of AB LLC and has a basis in his LLC interest of $400. B owns 60 percent of AB LLC and has a basis in his LLC interest of $600. AB LLC owns real estate that has appreciated. C contributes $1,000 to AB LLC in exchange for a 50 percent membership interest. A's interest in AB LLC is reduced to 20 percent. B's interest in AB LLC is reduced to 30 percent. AB LLC distributes $400 to A and $600 to B. If the form of the transaction is respected, A and B do not recognize gain because each has sufficient basis to cover the cash distributions to them. However, if the transaction is characterized as a sale, a sale by each of 50 percent of his LLC interest, A would recognize gain of $200 and B would recognize gain of $300.

The Partnership Interest Regs have their statutory foundation in Code Sec. 707(a)(2)(B), as is the case of the Property Regs described above. The government, in crafting the Partnership Interest Regs, followed the general structure of the Property Regs. Thus, the Partnership Interest Regs provide that a transfer of consideration by a partner (contributing partner) to a partnership, and a transfer of consideration by the partnership to another partner (selling partner), will constitute a sale of the selling partner's partnership interest only if, based upon all facts and circumstances, (1) the transfer by the partnership to the selling partner would not have made "but for" the transfer to the partnership by the contributing partner and (2) in cases involving nonsimultaneous transfers, the subsequent transfer is not dependent upon the "entrepreneurial risks" of partnership operations.

The Partnership Interest Regs adopt a two-year presumption. Transfers (regardless of the order) to and from a partnership, occurring within two years of each other, are presumed to be part of a sale transaction. Transfers occurring more than two years apart are presumed not to constitute a sale. These presumptions can be rebutted by facts and circumstances that "clearly establish" the contrary.

As in the case of the Property Regs, the Partnership Interest Regs have a number of exceptions. One exception is provided for transfers by a partnership to a partner in complete liquidation of a partner's interest. However, even this exception is not 100 percent certain as the Partnership interest Regs provide that a complete liquidation transaction could be treated as a sale of a partnership interest if the facts and circumstances "clearly establish" a sale.

The Partnership Interest Regs can cause unexpected results. This is clearly the case where a contribution of cash to, and a distribution of cash from, a partnership are not simultaneous (or nearly simultaneous).

Example 7. A, B and C own, in equal shares, the membership interests in ABC LLC. ABC has been engaged in the real estate development business for many years. On May 1, 2005, ABC sells an asset and distributes $100 to each of A, B and C. A, B and C each has a basis in their ABC interest of $100, so they assume the distributions will not trigger gain. On January 1, 2007, ABC admits D as a 25 percent member in exchange for a $300 contribution. The interests of A, B and C are diluted to 25 percent each. Do these facts present a problem?

Under the Partnership Interest Regs, because the contribution and the distributions occur within two years of each other, it is presumed that there has been a sale by A, B and C of a portion of their ABC interests to D. Clear evidence would need to exist to rebut the presumption. If the presumption cannot be rebutted, the Partnership Interest Regs say that the sale is deemed to have occurred on May 1, 2005. This obviously triggers a host of practical issues. Would returns have to be amended? Did D really think it would be a partner for tax purposes as of May 1, 2005? The list of potential problems is long.
Based upon this brief discussion, one thing is clear: planning partnership transactions is not as easy as it was in the “good old days.” Devious taxpayers (and their advisors) now must negotiate a variety of special rules designed to prevent disguised sales and mixing bowl transactions (in addition to the general partnership anti-abuse rules). At the same time, innocent and well-intended taxpayers (and their advisors) must understand these rules in order to avoid falling into one or more of the traps now presented.

ENDNOTES

1 Code Sec. 721. But see Code Sec. 721(b) for contributions to an “investment company.”
2 Code Sec. 771.
3 Id.
4 As long as his interest in the partnership was $1,000 immediately before the distribution.
5 Code Sec. 721.
6 Reg. §§1.721-1(a) and 1.731-1(c)(3).
7 See, e.g., J.H. Odeg, 70TC 315, Dec. 35,167 (1978), aff'd per curiam, CA-6, 80-2 ustc 9817, 634 F2d 1046.
8 Reg. §§1.707-3(b)(1).
9 Reg. §§1.707-7(c) and (d).
14 Prop. Reg. §1.707-7(b)(1).
15 Prop. Reg. §1.707-7(c).
16 Prop. Reg. §1.707-7(d).

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Tax Tip

By Stephen L. Owen

A Random Walk Through Choice of Entity Planning

While limited liability companies have become the entity of choice for many business and investment activities, other entities remain attractive and frequently offer tax savings opportunities. Limited partnerships, for example, may prove beneficial in minimizing franchise taxes in certain states. For existing corporations, a conversion to an LLC or to a limited partnership is usually unattractive because of the adverse tax consequences. For this reason, existing C corporations may consider making an S election (generally without adverse tax consequences) to obtain the benefit of flow-through treatment, and existing S corporations will usually decide to maintain their S election.

S Corporations

As a result of the recently enacted American Jobs Creation Act of 2004 (AJCA), S corporations will be used more frequently. Prior to 2005, an S corporation could not have more than 75 stockholders. In applying this rule, the statute did not permit "aggregation" of family members except that a husband and wife were treated as a single stockholder for this purpose. Effective for tax years beginning after December 31, 2004, the maximum number of stockholders of an S corporation is now 100. In addition, in applying this rule, the statute now permits all members of a "family" to be aggregated and treated as one stockholder for this purpose.

One special rule in subchapter S relates to tax exempt organizations. Code Sec. 1361(c)(6) provides that an organization described in Code Sec. 401(a) or Code Sec. 501(c)(3) that is exempt from tax under Code Sec. 501(a) is a permitted S corporation stockholder. This means, for example, that S corporation stockholders can make gifts of stock to charities without causing the S election to terminate. However, the "quid pro quo" for this benefit is found in Code Sec.
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512(e): The tax exempt organization must treat its ownership interest in the S corporation as an interest in an unrelated trade or business. All items of income, loss or deduction and any gain or loss from the sale of S corporation stock must be taken into account in computing the tax exempt organization’s unrelated business taxable income.

Example. S corporation owns marketable securities. An exempt organization owns stock in the S corporation. S corporation has income from dividends, interest and capital gains. The exempt organization must treat its share of this income as unrelated business taxable income (subject to tax at corporate tax rates). This is true notwithstanding that, if received directly by the exempt organization (or indirectly through a partnership or an LLC), this income would generally not be taxable as unrelated business taxable income.

More on Tax-Exempt Investors

Tax-exempt investors may also present special challenges when they are partners in partnerships or members of LLCs. First, certain types of income and gain generated by a partnership or LLC will automatically constitute unrelated business taxable income. For example, gain from the sale of dealer property, and income from the operations of a hotel or widget manufacturing business will be unrelated business taxable income. Other types of income, such as real estate rental income, will generally only constitute unrelated business taxable income if the property is “unrelated debt financed property.” Unrelated debt financed property held by a partnership will generate unrelated business taxable income unless the partnership or LLC complies with the so-called fractions rule. The fractions rule frequently limits the flexibility of taxable investors and the tax exempt investors to allocate tax items in a manner that they would otherwise prefer.

AJCA has now imposed (perhaps inadvertently) another challenge for partnerships and LLCs that have tax exempt investors. New Code Sec. 470 creates onerous limitations on the deductibility of losses related to “tax exempt use property.” To the extent that, with respect to each tax exempt use property, aggregate deductions (including interest deductions allocable to the property) exceed aggregate income from the property, this excess is not allowed as a deduction (it is carried over to future years). For this purpose, tax exempt use property includes property owned by a partnership or LLC that has both tax exempt entity investors and taxable investors.

Example. Mogul forms an LLC with Exempt Org and Taxable Investor to purchase a shopping center. Exempt Org and Taxable Investor contribute $1 million to the LLC. Mogul will manage the shopping center. Exempt Org and Taxable Investor will have a preference, but after the preference is satisfied, Mogul will receive a 20-percent “promote” (the allocations would satisfy the fractions rule). The shopping center generates substantial losses. Under Code Sec. 470, a portion of Taxable Investor’s losses may not be currently deductible.

There is an exception to the application of Code Sec. 470 if the partnership tax allocations have substantial economic effect and if the allocations are “straight up” or proportionate. In the above example, the allocations are not “straight up” because the preference allocation may cause Exempt Org’s distributive share of tax items to vary over time.

 Needless to say, the application of Code Sec. 470 in the partnership context is controversial and it is unclear whether the full impact of this provision was understood or intended by Congress. Fortunately, the IRS has provided temporary relief from this problem for tax years beginning before January 1, 2005. However, whether there will be permanent relief remains to be seen. Until this issue is clarified, having tax exempt investors in deals that are not straight up may cause some sleepless nights for real estate entrepreneurs and their tax advisors.

Private REITs

In the case of real estate ownership, not only have publicly traded real estate investment trusts (REITs) become popular, but so-called private REITs are now frequently used to minimize tax problems for tax-exempt and foreign investors. REITs are generally “passthrough” entities for income tax purposes. However, REITs are very inflexible entities because of the various statutory restrictions on the types of investments and activities that a REIT may have. For example, REITs will potentially lose their REIT status if certain income and asset tests are not satisfied. In addition, a REIT must have at least 100 stockholders and more than 50 percent of the value of the entity’s
outstanding stock may not be held by five or fewer individuals. These ownership restrictions may make a private REIT unattractive or unavailable in many situations. However, these requirements can be satisfied in many other situations.

The 100 stockholder requirement is satisfied typically by the private REIT’s issuing stock to more than 100 investors, each of whom, for example, may subscribe for $1,000 worth of preferred stock carrying a fixed dividend rate. The “five or fewer/50%” requirement is typically satisfied by using “look-through” rules to determine ultimate beneficial ownership of stock. For example, suppose that Mogul has formed a “real estate fund.” The fund is structured as a limited partnership having 20 limited partners, each of whom (1) is an individual (unrelated to the other limited partners) and (2) owns a five-percent interest in the capital and profits of the fund. The fund invests in a private REIT. In testing the five or fewer/50% requirement, each partner in the fund is viewed as owning his proportionate share of the private REIT stock owned by the fund. This makes the five or fewer/50% rule easily avoidable with careful planning. The look-through rule also permits corporations (and other REITs) that own a substantial portion of a private REIT to look through to the stockholders in testing the five or fewer/50% rule.

Assuming that structuring a private REIT is feasible, what are the benefits to investors? Generally, the dividends and capital gains derived from the private REIT by a tax-exempt investor will not be unrelated business taxable income (assuming the REIT stock is not debt financed). In the case of foreign investors, gain recognized upon the sale of REIT shares is exempt from U.S. tax under Code Sec. 897(h) provided the REIT is “domestically controlled.”

While private REITs are not going to surface as the entity of choice in plain vanilla local real estate deals, private REITs will remain popular for many large real estate entrepreneurs who raise funds from tax exempt and foreign sources.

**Partnership Nonrecourse Debt in Basis**

Under current law, a partner in a partnership or a member of an LLC obtains basis in his interest in the entity not only for his capital contributions but also for his “share” of entity debt. Generally, an owner's share of partnership recourse debt is equal to that portion of the debt with respect to which the owner bears the economic risk of loss (e.g., because of a personal guaranty or deficit restoration obligation). An owner's share of entity nonrecourse debt is generally based upon his share of entity profits.

Basis in a partnership or LLC interest is important, not only for measuring gain or loss on a sale of the interest, but also in determining the amount of entity losses allocated to the owner that can be deducted. In the case of subchapter S corporations, the basis rules are different. A stockholder of an S corporation does not boost basis by virtue of entity-level debt. This is the case even if the stockholder guarantees the debt. If an S stockholder needs basis to take losses, he must contribute cash or property to the S corporation (or make a loan to the S corporation). This means that an S stockholder seeking a basis boost may have to borrow funds personally and then contribute or lend the proceeds to the S corporation.

Recently, the Joint Committee on Taxation issued a voluminous report called “Options to Improve Tax Compliance and Reform Tax Expenditures.” Buried in the middle of this report is a proposal to exclude nonrecourse liabilities from the basis of an interest in a partnership or LLC. Such a provision would tend to put partnerships and LLCs on a more level playing field with S corporations, so this report contends.

Whether this proposal will ever become law is unknown at this point. However, with the current Administration's focus on “tax reform” and with the government in need of revenue, it is certainly possible that this proposal could become law. Existing nonrecourse debt would probably be protected (but even this is uncertain). However, when this debt is refinanced, the owners could face disastrous consequences unless the refinanced debt is recourse.

Who says that the practice of tax law is boring?
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ENDNOTES

1 See, e.g., Code Secs. 331(b), 331 and 336.
2 See Code Sec. 1363(f)(8) relating to recapture of UFO benefits.
4 Code Sec. 1361(b)(1)(A).
5 Code Sec. 1362(c).
6 Code Secs. 511 and 512.
7 Code Sec. 514.
8 Code Sec. 514(c)(9)(B)(v) available only to certain tax-exempt entities—e.g., pension plans.
9 Under Code Sec. 160(h)(6)(A) tax-exempt use property is the portion of the partnership's property equal to the tax-exempt entity's "proportionate share" of partnership property.
10 Code Secs. 160(h)(6)(B) and (C).
12 See Code Secs. 856-859.
13 Code Sec. 856.
14 Code Sec. 857(h)(2) and (4)(B).
15 Reg. §1.752-2.
16 Reg. §1.752-3.
17 Code Secs. 1366(h)(1) and 1367.
18 As noted above, partners and members could still boast bases with entity recourse debt while S stockholders cannot.
To Disregard or Not To Disregard ... Some Recent Guidance on Disregarded Entities

Disregarded entities are relatively new concepts in the Internal Revenue Code ("the Code"). A disregarded entity is an entity, such as a limited liability company, a partnership or a corporation, that is a separate legal entity for state law purposes, but that is ignored or "disregarded" for tax purposes. A single-member LLC is a disregarded entity unless an election is made to be taxed as a corporation. A qualified S subsidiary (QSub) is a disregarded entity if an election is made. A qualified REIT subsidiary (QRS) is also a disregarded entity. Disregarded entities offer flexibility in tax planning. Separate legal entities may be necessary or desirable for nontax reasons such as liability protection. At the same time, from a tax perspective there is no policy reason to treat the activities of these entities separately from the ultimate owner.

The IRS has been very busy evaluating the treatment of disregarded entities in a variety of contexts. Let's first consider the plain vanilla disregarded entity. Assume that Smith, an individual, owns 100 percent of the membership interests in Owner LLC. Owner LLC owns an office building. No election has been made to treat Owner LLC as a corporation for tax purposes. Thus, Owner LLC is disregarded for tax purposes, although for state law purposes Owner LLC will offer asset protection for Smith. Because Owner LLC is disregarded, a sale by Smith of all or a portion of the Owner LLC membership interests will be treated for income tax purposes as a sale of all or a portion of the underlying office building owned by Owner LLC.

What if we make life more complicated. Suppose that Smith operates a business in a state that imposes a franchise tax on business entities except for limited partnerships. Smith wants to achieve the simplicity of using a disregarded entity, but needs to use a limited partnership for state law purposes to minimize franchise taxes. Smith forms a limited partnership (LP). The 99-percent limited partner of LP is Smith. The one-percent general partner of LP is Owner LLC, 100-percent owned by Smith and, therefore, a disregarded entity. Because Owner LLC is a disregarded entity, LP is deemed to be 100-percent owned by Smith. LP will be a disregarded entity for tax purposes. Because it is deemed to be 100-percent owned by Smith, LP will not be treated as a partnership for federal tax purposes. The IRS has made this conclusion clear in Rev. Rul. 2004-77.

This analysis can be applied in the context of QSubs and QRSs as well. Let's assume that S Corp is an S corporation, all of the stock of which is owned by Jones, an individual who is a U.S. resident and citizen. S Corp has two wholly owned corporate subsidiaries (QSub1 and QSub2). Elections have been made to treat QSub1 and QSub2 as qualified S subsidiaries. QSub1 and QSub2 each own 50 percent of the stock of QSub3. Can QSub3 be a qualified S subsidiary? Yes. Because QSub1 and QSub2 are disregarded entities, all of the stock of QSub3 is deemed owned by S Corp, thereby clearing the way for a qualified S subsidiary election for QSub3. What if Jones transfers all of the stock of S Corp to Owner LLC, 100-percent owned by Jones and, therefore, a disregarded entity? Even though partnerships and LLCs are generally not permitted S corporation stockholders, because Owner LLC is disregarded, all of the stock of S Corp is deemed owned by Smith, a permitted S stockholder. Of course, if Smith transfers a one-percent interest in Owner LLC to his wife (in a noncommunity property state), Owner LLC will be treated as a partnership for tax purposes and the S election for S Corp will be blown.

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But consistency is the hobgoblin of small minds. The IRS has recently taken the position that disregarded entities may not be disregarded in some contexts. Consider the result in Rev. Rul. 2004-88. Code Sec. 6231 provides special audit procedures for partnerships (these are frequently referred to as the "TEFRA audit rules"). Certain small partnerships are exempt from the TEFRA audit rules. Code Sec. 6231(a)(1)(B) defines a "small partnership" as a partnership in which there are 10 or fewer partners, each of whom is an individual (other than a nonresident alien), an estate of a deceased partner or a C corporation. The regulations provide that the small partnership exception does not apply if any partner during the tax year is a "pass-thru partner." A "pass-thru partner" is a "partnership, estate, trust, \\n
proceeds to, or distribution from, the disregarded entity."

In Rev. Rul. 2004-88, LP, a limited partnership, has a general partner and four individual limited partners. The general partner is an LLC that is 100-percent owned by A, an individual. LLC is a disregarded entity. First, the IRS concluded that, in determining the tax matters partner of LP, LLC is not disregarded. Because, under applicable state law, LLC is the general partner of LP, LLC is the tax matters partner, even though for tax purposes A is treated as the partner. In addition, the IRS concluded that LP does not qualify as a "small partnership" under the TEFRA audit rules because LLC, even though it is a disregarded entity, is viewed as a "pass-thru partner." In other words, a disregarded entity is not disregarded for these purposes.

Another context where a disregarded entity will not be disregarded is found in recently promulgated proposed regulations under Code Sec. 752 dealing with the allocation of partnership recourse liabilities. Suppose that Smith and Jones form a limited partnership. LP. Smith contributes $1 million to LP as a limited partner. Jones forms Jones LLC, a wholly owned LLC, and Jones LLC becomes the 50-percent general partner in LP. Jones contributes $1 million to Jones LLC and Jones LLC, in turn, contributes the $1 million to LP. LP purchases Blackacre for $10 million, using the $2 million cash plus $8 million partnership recourse debt. LP generates substantial losses. If Jones were the general partner, the LP recourse debt would be solely allocated to him because he would be bearing the entire economic risk of loss once the equity of LP is depleted. This is true even if Jones has no other assets than his interest in LP. Does this analysis change when Jones LLC is the general partner?

Jones LLC is a disregarded entity. Should it be disregarded in determining whether the LP recourse debt is a recourse liability of Jones? The IRS has concluded that Jones LLC cannot be disregarded and, on these facts, the LP recourse debt will be treated as nonrecourse, thereby allocating 50 percent to Smith and 50 percent to Jones. Proposed Reg. §1.752-2(k)(1) provides that, in determining the extent to which a partner bears the economic risk of loss for a partnership liability, obligations of a disregarded entity are taken into account only to the extent of the net value of the disregarded entity (assuming that the owner of the disregarded entity has no personal liability with respect to the liability of the disregarded entity). Thus, the presumption of solvency under Reg. §1.752-2(b)(6) only applies in testing the economic risk of loss of the taxpayer/partner (or a related person). A disregarded entity is not the taxpayer/partner, nor is it a related person. In the case of a disregarded entity, the taxpayer/partner is the owner of the disregarded entity and because the disregarded entity offers the taxpayer/partner statutory limitation of liability, the owner of the disregarded entity does not have an obligation to satisfy the liabilities of the disregarded entity.

Once the net value of a disregarded entity is initially determined, the net value is not redetermined unless the obligations of the disregarded entity change by more than a de minimis amount or there is more than a de minimis contribution to, or distribution from, the disregarded entity. The proposed regulations also have an anti-abuse rule. Proposed Reg. §1.752-2(k)(6) provides that the net value of a disregarded entity is determined by taking into account a subsequent reduction in the net value of the disregarded entity if, at the time of determination of net value, it is anticipated that the net value of the disregarded entity will subsequently be reduced and the reduction is part of a plan that has one of its principal purposes creating the appearance that a partner bears the economic risk of loss for a partnership liability.

What if, in 2005, Jones LLC receives a contribution from Jones of $1 million and Jones LLC purchases Whiteacre with the cash. As of December 31, 2005 (when liabilities shares are determined), the value of Whiteacre is $800,000. Because Jones' contribution of $1 million is more than de minimis, the net value of Jones LLC is redetermined as of December 31, 2005. As of this date, $800,000 of LP debt is recourse to Jones and the balance of $7.2 million is nonrecourse and shared equally between Smith and Jones (assuming that 50-50 is the appropriate manner of allocating the LPs nonrecourse debt). If Jones had a deficit restoration obligation for $7.2 million, the entire $8 million LP debt would be viewed
as recourse and would all be allocated to Jones. What happens if Jones has no deficit restoration obligation and, in 2006, Jones makes a gift of a one-percent interest in Jones LLC to Mrs. Jones (in a noncommunity property state)? Jones LLC is now considered to be a partnership for tax purposes. Under Reg. §1.752-2(b)(6), Jones LLC is deemed to bear the entire risk of loss on the LP recourse debt even though, at that time, Jones LLC does not have assets sufficient to satisfy the debt, unless the anti-abuse provisions of Reg. §1.752-2(j) were to apply.

The proposed regulations also address the proper allocation of recourse liabilities where one or more disregarded entities have recourse liabilities with respect to multiple liabilities or liabilities of more than one partnership. In this case, the net value of each disregarded entity must be allocated among partnership recourse liabilities in a "reasonable and consistent manner, taking into account priorities among partnership liabilities."12

Based upon the IRS's recent guidance, it should be clear that a disregarded entity may not be disregarded in some contexts. Unfortunately, this may create some degree of uncertainty in planning. For example, assume that A owns all of the interests in LLC, a disregarded entity. LLC owns $1 million worth of land. A wishes to gift a 50-percent nonvoting interest in LLC to his daughter, D. If the typical valuation standard of "willing buyer/willing seller" is applied, the value of this 50-percent nonvoting interest would be subject to a substantial discount for minority interest and lack of marketability. On the other hand, if the LLC is disregarded for valuation purposes, A would be deemed to have gifted a 50-percent undivided interest in the land, followed by a deemed contribution of assets by A and D to a newly formed partnership, a situation where the value of A's gift may be subject to a lesser discount. Reg. §301.7701-3 provides that a disregarded entity is disregarded "for federal tax purposes." Because the federal gift tax is based upon valuation, does this mean that the state law LLC "wrapper" must be ignored? While the government may take this position, the better position would seem to be that the state law LLC wrapper should not be disregarded. The value of A's gift is based upon an analysis of attributes of the gifted LLC interest (subject only to the special rules under Chapter 14 of the Code). The LLC should not be disregarded in this context because the LLC operating agreement (and applicable state law) defines the attributes of the gifted interest.

Unanswered questions such as these will insure full employment for tax practitioners.

FN NOTES

1 Reg. §301.7701-1(c). An election to be treated as a corporation is made by filing Form 8832. See also Temporary Reg. §301.7701-1T, where the entity desires S corporation status.

2 To be a QSub, a corporation must be 100-percent owned by an S corporation and the S corporation must properly elect to treat the subsidiary corporation as a QSub under Reg. §1.756-1(c). Code Sec. 1361(a)(3).

3 To be a QRS, a corporation must be 100-percent owned by a REIT and an election is made to treat the subsidiary as a "taxable REIT subsidiary." Code Sec. 856(c).


5 If an LLC or other eligible entity is wholly owned by husband and wife as community property, the owners may elect to treat the entity as disregarded or as a partnership. Reg. §1.756-1(c). Code Sec. 756(a).


7 Proposed Reg. §1.752-2(k).

8 Reg. §1.752-2(b)(11).

9 The regulations provide that, in testing economic risk of loss, the taxpayer/partner is presumed to be solvent. Reg. §1.752-2(b)(6). There is an anti-abuse rule under Reg. §1.752-2(j) where there is a plan to avoid the obligations to pay recourse debt.

10 See preamble to Proposed Reg. §1.752-2(b).

11 Proposed Reg. §1.752-2(b)(5) places the burden on the owner of a disregarded entity to provide the partnership with the net value of the disregarded entity partner "on a timely basis."

12 Proposed Reg. §1.752-2(j)(6) provides that the net value of a disregarded entity includes "the entity's enforceable rights to contributions from its owner." A deficit restoration obligation in the operating agreement of the disregarded entity (or other enforceable obligation of the owner) would be counted as an asset of the disregarded entity. Note that this is true under the Reg. §1.752-2(b)(6) presumption of solvency, even if the owner of the disregarded entity does not have sufficient assets to satisfy the deficit restoration obligation (unless the anti-abuse rule applies). The same result would obtain for any payment obligation that entities Reg. §1.752-2(b)(1).

13 Note that, in the preamble to Proposed Reg. §1.752-2(b), the IRS and the Treasury indicate that they are "considering and request comments regarding whether the rules of the proposed regulations should be extended to the payment obligation of other entities, such as entities that are capitalized with nominal equity." This author believes that this would be a slippery slope for the government and that the existing anti-abuse rules should provide sufficient protection for the government.

14 Proposed Reg. §1.752-2(b)(4). See also Proposed Reg. §1.752-2(b)(9).

Example 3.
Tax Tip

By Stephen Owen

Boosting Basis for S Corporation Stockholders

Determining a stockholder's basis in an S corporation would appear to be straightforward. An S stockholder's basis in his stock is increased by the cash contributed to the corporation. The stockholder's basis in S stock is also increased by the share of income allocated to the stockholder. An S stockholder's basis in his stock is decreased by distributions and by the share of losses allocated to him.

Stock basis is important not only for measuring gain or loss on the disposition of stock, but also in determining whether the S stockholder can deduct losses allocated to the stockholder. That is, an S stockholder can deduct losses only to the extent of his stock basis.

In evaluating whether an S stockholder has sufficient basis to deduct losses, the stockholder is permitted to boost basis by the amount of loans made by the stockholder to the S corporation.

Example 1. Earl is the sole stockholder of S Corp, an S corporation. Earl's stock basis is $100. In addition, Earl has made a loan to S Corp of $500. If S Corp generates $300 of losses, Earl will have sufficient basis to deduct the losses. His stock basis first will be reduced to zero, and his basis in his loan will be reduced to $300. When the $500 loan is repaid, Earl will have a gain of $200 (if the basis of the loan has not been increased or decreased by subsequent income or loss).

An S stockholder does not receive a basis boost by virtue of entity-level debt. This is true even if the stockholder personally guarantees the debt. In this case, well-advised S stockholders structure the borrowing as a direct loan to the stockholder, with the
stockholder then contributing (or lending) the loan proceeds to the S corporation.

Example 2. S Corp borrows $100 from Bank. Earl personally guarantees the debt. Earl does not receive a basis boost until he actually makes a payment under the guaranty.

Example 3. Earl borrows $100 from Bank. Earl then contributes $100 to S Corp as a capital contribution. Earl's stock basis is increased by $100. If Earl instead lends $100 to S Corp, he also will have $100 of basis against which he can deduct losses allocated to him.

Back-to-Back Loans

In considering the proper structuring of borrowings in the S corporation context, the recent Tax Court decision of T.J. Miller* is instructive. The taxpayer, Miller, formed his S corporation ("S Corp") in 1988 to engage in the business of manufacturing mobile and modular medical diagnostic facilities. Shortly after its formation, S Corp established a relationship with Huntington National Bank ("Bank"), which provided financing to S Corp on a "per project" basis.

S Corp issued additional stock to an investor group in 1992. The investor group received 15 percent of the outstanding stock of S Corp in exchange for a capital contribution of $800,000. It was a condition to their capital infusion that S Corp arrange a $1 million revolving line of credit from Bank. S Corp arranged this line of credit by having Miller execute an unlimited personal guaranty secured by a second mortgage on his house. In addition, each member of the investor group executed limited guarantees aggregating $1 million (these guarantees waived all rights to subrogation, contribution and indemnification).

From inception, S Corp generated substantial losses. In December of 1992, Miller was advised by his accountant that the loan structure needed to be revised so that Miller could take his share of S Corp losses (which included suspended losses from prior years). The accountant correctly pointed out that a mere guaranty does not generate basis for an S stockholder. As a result, the existing loan was restructured as a direct loan to Miller on the same terms, with each member of the investor group serving as guarantor. To implement the restructuring, Bank advanced funds to Miller who in turn made a "back-to-back" loan to S Corp. S Corp then repaid its existing debt to Bank. Miller's loan to S Corp was evidenced by a promissory note secured by S Corp's assets. Miller's personal loan from Bank was secured by the second mortgage on his house plus a collateral assignment by Miller of S Corp's promissory note. The back-to-back-loans were due at the same time and carried the same interest rate. Advances made by Bank to Miller were deposited in a restricted account for transfer to S Corp; payments from S Corp to Miller were required to be deposited in a restricted account to be held in trust for the benefit of Bank.

Miller deducted substantial losses in 1992; the $750,000 outstanding balance on Miller's personal loan on December 30, 1992, was intended to boost basis. In 1993, the back-to-back loans increased to $1.2 million. In 1994, S Corp became insolvent when the back-to-back loans totaled $1.375 million. The investor group, as guarantors, paid $900,000 to Bank in partial satisfaction of Miller's obligation to Bank. The investor group satisfied the remaining $475,000 by borrowing this amount from Bank and purchasing the Miller loan from Bank.

Based upon these facts, the Tax Court concluded that Miller successfully boosted his basis by restructuring the loan. Critical to this conclusion was the fact that an unrelated lender was involved. The fact that a principal motivation of the loan restructuring was to generate tax basis was deemed irrelevant by the Tax Court.

Circular "Juggling" of Funds

In contrast to the facts in Miller, where the taxpayer was left "poorer in a material sense, the courts have not treated S stockholders favorably where there is a mere circular flow of funds in an attempt to create basis. For example, in D.G. Oren, the taxpayer owned multiple S corporations, two of which generated losses. To boost his basis in the loss corporations, the taxpayer borrowed funds from one S corporation ("S-1"), and then loaned these funds to the S corporations that generated the

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*Continued on page 47

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In reviewing the estate tax inclusion issues under Code Secs. 2036, 2038 and 2041, and in determining that the facts did not demonstrate the dominion and control that would warrant estate tax inclusion under those sections of the Code, the critical fact was that neither the grantor nor the beneficiaries of a trust could directly participate in both the initial decisions of the private trust company and any review of such decisions regarding discretionary distributions.

On March 29, 2006, the AICPA issued a Letter and Comments on Planned Guidance for Estate, Gift, GST Tax Provisions of Using Private Trust Companies as Trustee. The AICPA letter urged the IRS to rule when providing guidance with respect to family-owned private trust companies as follows: (1) that estate inclusion will not result "as long as adequate safeguards are in place to prevent the grantor or beneficiary from participating in decisions that, acting as an individual trustee, would have caused the trust assets to be included in his or her estate"; (2) that a safe harbor should apply "as long as the private trust company's bylaws prohibit a grantor or current beneficiary from participating in any discretionary distributions with respect to any trust of which they are a grantor or beneficiary while serving on the distribution committee"; and (3) that family members should be able to participate fully in the ownership and management of the private trust company, as long as their authority with respect to discretionary distributions is limited in the manner described in (1) and (2).

The focus of the AICPA is on estate inclusion under Code Secs. 2036, 2038 and 2041; income tax issues seem not to be discussed. The goal of having safe harbors is a good one, especially in such a fact intensive area like this one, where not only do trust provisions vary, but also there is no uniformity with respect to governing state law.

Pending a safe harbor ruling, families will need to structure their private trust company in a manner that specifically considers the grantor trust income tax rules and the estate tax inclusion rules. In doing so, families appear to have great flexibility on issues of ownership and investment, but are far more restricted in how discretionary distribution decisions may be made.

ENDNOTES
1. The volume of documents required to be reviewed by the IRS coupled with the highly factual nature of the rulings probably is one reason why the IRS has advised taxpayers that its current position is not to issue private letter rulings regarding private trust company conversions. See Rev. Proc. 2006-3, IRB 2006-1, 122.
2. LTR 200623003 (March 8, 2006).
3. LTR 200546055 (August 2, 2005).
4. LTR 200548035 (August 2, 2005).

Discharge of Indebtedness Income

Having lost on the basis and at risk issues, the government then argued that the $900,000 payment under their guarantees, the taxpayer had $900,000 of income. The Tax Court agreed with the government because the investor group had waived their rights to subrogation and contribution. However, because the taxpayer was insolvent at the time of the discharge of indebtedness, no income was recognized.16

Conclusion

At first blush, the S corporation basis (and at-risk) rules appear to be simple. An S stockholder can-
not boost basis (or amount at risk) by guaranteeing corporate debt; he must borrow the funds directly from the lender. Even then, the lender should be an unrelated party, and there needs to be more than a mere circular “juggling” of funds.

**Endnotes**

1. Code Sec. 1012.
2. Code Sec. 1367(a)(1).
3. Code Sec. 1367(b)(2).
4. Note that losses can also be suspended under the “at risk” rules of Code Sec. 463 and under the “passive activity loss” rules of Code Sec. 469.
5. Code Sec. 1366(d).
6. Code Sec. 1367(b).

Code Sec. 1001(a). Multiple stockholder loans are treated as one indebtedness if they constitute “open account indebtedness,” so that partial repayments will need to exceed aggregate basis in the indebtedness before income is recognized. See, e.g., Brooks, 90 T.C.M. 172, Dec. 56, 127(M), TC Memo. 2005-204. However, if multiple stockholder loans are treated as separate loans, partial repayment may trigger income to the lending stockholder, even if other loans remain outstanding.

8. This seems to be the standard applied by most courts. See, e.g., Perry, 54 TC 1283 at 1296, Dec. 30, 176 (1976); id., 71-2 1132 at 115020.
11. Code Sec. 465(b)(2)(A) and (B).
14. Although unclear from the opinion, presumably the taxpayer did not have a right of contribution against the investor group structure.
15. Code Sec. 108(A)(1)(B). The taxpayer was required to reduce certain tax attributes (net operating losses, etc.). Code Sec. 108(b)(1) and (2).

### Recent Developments

**Automatic Stay Protection**

**Members’ Automatic Stay Protection Does Not Extend To LLC’s Employment Tax Proceedings in Tax Court**

A recent Tax Court decision holds that the automatic stay provisions of the Bankruptcy Code do not bar a limited liability company's (LLCs) employment tax proceedings in Tax Court, even though the LLC was defunct, and all of the LLC's members were under the jurisdiction of the Bankruptcy Court.

The LLC had two members, both of whom had filed Chapter 7 bankruptcy petitions and were under the jurisdiction of the Bankruptcy Court. The Commissioner asserted an employment tax deficiency against the LLC, which, by that time, was defunct and had no assets. The LLC's members claimed that Tax Court proceedings to determine whether the LLC had an employment tax deficiency would violate 11 USC §362(a)(8) (2000). That provision temporarily barred Tax Court proceedings “concerning the debtor.”

The Tax Court interpreted the phrase “concerning the debtor” narrowly to apply to tax liability of the debtor. Here, the employment tax liability belonged to the LLC, not its members. Accordingly, 11 USC §362(a)(8) did not apply. The Tax Court noted that it would reach the same conclusion under 11 USC §362(a)(8), as recently amended.

The case is interesting because the Tax Court suggested that the LLC may have another venue through which the employment tax proceedings may be stayed. The Bankruptcy Court may stay proceedings against a nonbankrupt third party (i.e., the LLC) if there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment or finding against third-party-defendant will in effect be a judgment against debtor. Accordingly, the taxpayers may be able to obtain relief by proceeding through the Bankruptcy Court instead of the Tax Court.

**Endnotes**

2. When a taxpayer receives property in exchange for performing services, he generally includes the excess of (1) the fair market value of the property, determined on the first day that the property is transferable or no longer subject to a substantial risk of forfeiture, whichever comes first, over (2) the amount paid for the property in income in the taxable year that includes such day. Under Code Sec. 43(a), a taxpayer can elect to include the excess of (1) the fair market value of the property at the time of transfer (determined without regard to any lapse restriction) over (2) the amount paid for the property in income in the taxable year of the transfer.
3. Code Sec. 83(3).
4. Id. Reg. 1.61-2(f).
5. TAM 2006-19021 (Feb. 7, 2006).
7. Code Sec. 1366(b)(1)(A)-B.