Recent Developments Affecting Real Estate and Pass Through Entities

Stefan F. Tucker
Richard M. Lipton

Copyright © 2005 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository. https://scholarship.law.wm.edu/tax
Recent Developments Affecting Real Estate and Pass Through Entities

Stefan F. Tucker, Esq. / Venable LLP
Washington, D.C.

Richard M. Lipton, Esq. / Baker & McKenzie LLP
Chicago, IL

November 10 – 11, 2005
(Williamsburg, Virginia)
# TABLE OF CONTENTS

I. LEGISLATIVE DEVELOPMENTS ........................................................................... 6  
   A. American Jobs Creation Act of 2004 .............................................................. 6  
      1. S Corporation Reform and Simplification .............................................. 6  
      2. Depreciation and Cost Recovery ............................................................... 7  
      3. Real Estate Investment Trusts ................................................................. 8  
      4. Qualified Production Activities Income Deduction .............................. 12  
      5. Other Provisions Affecting Real Estate and Pass Through Entities ....... 14  

II. 2005-2006 PRIORITY GUIDANCE PLAN ......................................................... 18  
   A. General Tax Issues ..................................................................................... 18  
   B. Partnerships .................................................................................................. 18  
   C. Subchapter S ............................................................................................... 19  

III. PROPOSED, TEMPORARY AND FINAL REGULATIONS ............................... 19  
   A. Sections 83 and 721 (Partnership Equity for Services) .............................. 19  
   B. Section 121(c) (Reduced Maximum Exclusion of Gain from Sale or Exchange of Principal Residence) ................................................................. 20  
   C. Section 121(d)(9) (Suspension of 5-Year Period) ....................................... 22  
   D. Section 168(i) (Changes in Use of MACRS Property) .............................. 22  
   E. Section 179 (Extension of Election through 2008) .................................... 24  
   F. Section 460 (Special Rules Relating to the Treatment of Certain Partnership Transactions Involving Long-Term Contracts) ......................... 24  
   G. Sections 704(c) and 737 (Treatment of Installment Obligations and Property Acquired Pursuant to Contributed Contract) ................................. 27
H. Section 707 (Disguised Sale of Partnership Interests) ................................................. 28
I. Section 752 (Assumption of Partner Liabilities) ......................................................... 28
J. Section 752 (Treatment of Disregarded Entities) ......................................................... 31
K. Sections 856, 1361 and 7701 (Modification of Check the Box) ................................. 32
L. Section 1031(a) (Replacing the SIC System) ............................................................ 33
M. Section 1374 (Adjustment to Net Unrealized Built-in Gain) .................................... 33
N. Section 7701 (Classification of a Dual-Chartered Entity) ........................................ 34
O. Section 7701 (Classification of Certain Business Entities) ..................................... 34

IV. ANNOUNCEMENTS AND NOTICES ............................................................................. 35

G. Chief Counsel Notice 2004-007 ........................................................................... 37

V. REVENUE PROCEDURES .......................................................................................... 37

VI. REVENUE RULINGS ........................................................................................................... 38

VII. LETTER RULINGS ......................................................................................................... 43
A. Priv. Ltr. Rul. 200440002 (October 1, 2004) ................................................................. 43
E. Priv. Ltr. Rul. 200507004 (October 25, 2004) ................................................................. 45
H. Priv. Ltr. Rul. 200513010 (December 6, 2004) .............................................................. 46
I. Priv. Ltr. Rul. 200515007 (December 29, 2004) .............................................................. 46
K. Priv. Ltr. Rul. 200518033 (February 4, 2005) ............................................................... 47
L. Priv. Ltr. Rul. 200518038 (January 13, 2005) ......................................................... 47
M. Priv. Ltr. Rul. 200518047 (January 27, 2005) ......................................................... 47
N. Priv. Ltr. Rul. 200518063 (January 10, 2005) ......................................................... 48
O. Priv. Ltr. Rul. 200518064 (January 10, 2005) ......................................................... 48
P. Priv. Ltr. Rul. 200519007 (March 7, 2005) .............................................................. 49
Q. Priv. Ltr. Rul. 200521002 (February 24, 2005) ......................................................... 49
R. Priv. Ltr. Rul. 200521014 (February 17, 2005) ......................................................... 50
S. Priv. Ltr. Rul. 200525013 (March 22, 2005) .............................................................. 51
T. Priv. Ltr. Rul. 200528021 (April 8, 2005) .............................................................. 52

VIII. FIELD ATTORNEY ADVICE .................................................................................. 53
A. Field Attorney Advice 20044101F (July 29, 2004) ............................................. 53
B. Field Attorney Advice 20050203F (November 30, 2004) .......................... 53

IX. CASES .......................................................................................................................... 53
A. Estate of Abraham v. Comm’r, 408 F.3d 26 (1st Cir. 2005) ......................... 53
B. Estate of Bongard v. Comm’r, 124 T.C. No. 8 (March 15, 2005) ............... 54
C. Jelke v. Commissioner, T.C. Memo 2005-141 ............................................... 56
F. Teruya Brothers Ltd. v. Comm’r, 124 T.C. No. 4 (Feb. 9, 2005) .......... 60
A. American Jobs Creation Act of 2004. The American Jobs Creation Act ("AJCA" or the "Act"), which President Bush signed on October 22, 2004, represents the first significant broad-based modification of the Internal Revenue Code with respect to business entities since 1986. Although the main impetus for enacting AJCA was the repeal of the extraterritorial income tax provisions declared illegal by the World Trade Organization, AJCA, as discussed more fully below, includes a full array of provisions affecting real estate and pass through entities.

1. S Corporation Reform and Simplification.

(a) Expanded eligibility rules. The IRS is expected to publish guidance regarding the determination of the number of shareholder in an S Corporation and the treatment of family members in the near future.

(1) Family members (up to seven generations) may elect to be treated as one shareholder. Section 1361(c)(1).

(2) The number of eligible S corporation shareholders is increased from 75 to 100. Section 1361(b)(1)(A).

(3) Under Section 1361(c)(2)(A), an IRA (including Roth IRAs) holding stock in an S corporation that is a bank on the date of enactment (October 22, 2004) is a permissible shareholder. Conforming amendments were made to Section 512(e)(1) (application of unrelated trade or business rules) and 4975(d) (exempting from prohibited transaction treatment a sale by the IRA of the bank stock to the IRA beneficiary under certain circumstances).

(4) For purposes of counting the number of shareholders, a husband and wife and their estates are automatically treated as one shareholder. It should be noted, however, that these rules only apply for counting the number of S shareholders. Each shareholder still must satisfy the shareholder-level eligibility requirements separately. For example, the S status of the corporation will be terminated if either the husband or the wife (or any member in the case of a family election) is not a U.S. citizen.

(b) Simplification

(1) Electing Small Business Trust ("ESBT"). For purposes of determining the potential current beneficiaries of an electing small business trust, amended IRC Section 1361(e)(2) disregards unexercised powers of appointment. AJCA also extended the period from 60 days to one year in which an ESBT may dispose of all of its S corporation stock after an ineligible shareholder becomes a potential current beneficiary.
2. Qualified Subchapter S Trust ("QSST") Suspended Losses.

The disposition of S corporation stock by a QSST is now treated as a disposition by the QSST beneficiary, thereby allowing the QSST beneficiary (instead of the QSST) to recognize losses suspended under the passive activity and at risk rules. Section 1361(d)(1)(C).

3. Amended Section 1366(d)(2) now enables spouses and former spouses who transfer S corporation stock in a transfer under Section 1041(b) to transfer the related suspended losses.

4. Amended Section 1361(b)(3)(A) provides authority for IRS to provide guidance regarding QSub information returns, such as those under Section 6031 and 6060.

5. Invalid QSub Elections and Inadvertent Termination of QSub Status. Amended Section 1362(f) now provides authority for IRS to grant relief for inadvertent invalid QSub elections and for inadvertent terminations of QSub status.

6. Section 4975, as amended by the Act, provides a relief provision effective retroactively for distributions with respect to S corporation stock made after December 31, 1997. A distribution with respect to S corporation stock that constitutes qualifying employer securities, which is used in accordance with the ESOP plan provisions to make payments on a loan the proceeds of which were used to acquire the qualifying employer securities, will not cause an ESOP to be treated as violating qualification requirements or as engaging in a prohibited transaction. In the case of a distribution with respect to S corporation stock that is allocated to a participant, as a condition to relief, the plan must provide that stock with a fair market value of not less than the amount of such distribution will be allocated to the plan participant for the year in which the distribution would have been allocated to the participant.

7. AJCA provides an exclusion from passive investment income, effective for taxable years beginning after Dec. 31, 2004, for interest income and dividends on assets required to be held by an S corporation that is a bank, a bank holding company or a financial holding company.

(c) Effective Date. The above provisions, unless specifically noted otherwise, are effective for taxable years beginning after December 31, 2004.

2. Depreciation and Cost Recovery.

(a) 15-Year Useful Life for Leasehold Improvements and Restaurant Property. The 15-year recovery period applies to any "qualified leasehold improvement property" or any "qualified restaurant property" placed in service after October 22, 2004 and before January 1, 2006. Section 168(e)(3)(E). Under prior law, the applicable recovery period for such property was 39 years.
(1) **Qualified Leasehold Improvement Property.** In determining what is “qualified leasehold improvement property” for purposes of the reduced recovery period, AJCA added new Section 168(e)(6), which incorporated by reference the definition of “qualified leasehold improvement property” in Section 168(k)(3) with one modification. New Section 168(e)(6) expressly states that, if a lessor makes a leasehold improvement that qualifies for the 15-year recovery period, a subsequent owner of the leasehold improvement property may not depreciate the leasehold improvement over the reduced recovery period.

(2) **Qualified Restaurant Property.** New Section 168(e)(7) defines “qualified restaurant property” as any Section 1250 improvement to a building if (i) the improvement is placed in service more than three years after the date the building was first placed in service and (ii) more than 50% of the building’s square footage is devoted to the preparation, seating and consumption of prepared meals.

(b) **2-Year Extension of Increased Section 179 Expensing.** The Jobs and Growth Tax Relief Reconciliation Act of 2003 increased the maximum amount deductible under Section 179 from $25,000 to $100,000. This increase was set to sunset in 2006. AJCA extended the availability of the increased Section 179 expense through 2008.

3. **Real Estate Investment Trusts (“REITs”).**

(a) **10% Value Test—Expansion of Straight Debt Safe Harbor**

(1) **New Rules Relating to Permissible Contingencies.** AJCA provides that interest or principal shall not be treated as failing to satisfy Section 1361(c)(5)(B)(i) (defining “straight debt”) solely by reason of the fact that the timing or the amount of the payment is subject to a contingency under the following circumstances:

(A) The time of payment may be contingent if (i) such contingency does not have the effect of changing the effective yield to maturity other than a change in the annual yield to maturity that does not exceed the greater of 1/4 of 1% or 5% of the annual yield to maturity, or (ii) neither the aggregate issue price nor the aggregate face amount of the debt instruments held by the REIT exceeds $1 million and not more than 12 months of unaccrued interest can be required to be prepaid thereunder. Section 856(m)(2)(B)(i).

(B) The time or amount of any payment may be subject to a contingency upon a default or the exercise of a prepayment right by the issuer of the debt, provided that such contingency is consistent with customary commercial practice. Section 856(m)(2)(B)(ii).

(2) **Special Rules for Corporate or Partnership Issuers.**

(A) New Section 856(m) eliminates the rule under the prior law that required a REIT to own a 20% equity interest in a partnership in order to qualify the debt issued by that partnership as “straight debt”. AJCA provides new “look-through” rules
for determining a REIT partner’s share of partnership securities, generally treating debt to the
REIT as part of the REIT’s partnership interest for this purpose, except in the case of otherwise
qualifying debt of the partnership.

(B) Certain corporate or partnership debt issues that
otherwise would be permitted to be held without limitation under the special straight debt rules
will not be permitted if the REIT holding such securities and any of its taxable REIT
subsidiaries
hold any securities of the issuer which are not permitted securities and have an aggregate value
greater than 1% of the issuer’s outstanding securities. Section 856(m)(2)(C).

(3) **Securities Exempt from the 10% Value Limitation**

(A) Any loan to an individual or an estate;

(B) Any Section 467 rental agreement, other than with a
person described in Section 856(d)(2)(B);

(C) Any obligation to pay rents from real property;

(D) Any security issued by a State, or any political
subdivision thereof, the District of Columbia, a foreign government, foreign government or any
political subdivision thereof, or the Commonwealth of Puerto Rico, but only if the determination
of any payment received or accrued under such security does not depend in whole or in part on
the profits of any entity not described in this category, or payments on any obligation issued by
such an entity;

(E) Any security issued by a REIT; and

(F) Any other arrangement as determined by the
Treasury Secretary. Section 856(m)(1).

(b) **Clarification of TRS Limited Rental Exception.** AJCA clarifies the
rules that prevent the inappropriate shifting of rental income from the TRS, which is subject to
two levels of tax, to the REIT, which is subject to only one level of tax.

(1) Rent paid by a TRS to its controlling REIT qualifies as
rental income only if the following conditions, referred to as the 90% rental threshold, are
satisfied: (i) at least 90% of the space is rented by unrelated parties; and (ii) the TRS pays rent
comparable to that paid by the unrelated parties.
(2) Section 856(d)(8)(A)(iii)(I)-(III), as amended, provides safe-harbor dates for testing the comparability of rents. Rental income from the TRS will continue to qualify under the limited rental exception if the 90% rental threshold test is satisfied at each of the following three testing dates: (a) at the beginning of a lease term, (b) upon a lease extension, and (c) upon a lease renegotiation when the rent between a REIT and its TRS is increased.

(3) Retroactive Effective Date. The amendments to Section 856(d)(8)(A)(iii). this section are effective retroactively to tax years beginning after 2000.

(c) TRS Excise Tax Safe Harbor Exception.

(1) The AJCA eliminated an ambiguous safe harbor allowing rents paid by a TRS to the related REIT to be exempt from the 100% excise tax if the rents were for customary services performed by the TRS.

(2) Section 857(b)(7)(v), as redesignated by the AJCA, provides a safe harbor from the excise tax for amounts paid by the TRS to the related REIT if the REIT pays the TRS at least 150% of the TRS’s cost in providing the service. See Rev. Rul. 2002-38, 2002-26 I.R.B. 4.

(3) Section 857(b)(7)(v) is effective for taxable years beginning after October 22, 2004.

(d) Conformity with General Hedging Definition. Section 856(c)(5)(G), as amended by AJCA, conforms the definition of a hedging transaction to the general hedge provision in Section 1221 and disregards any hedge income in computing the 95% test. For taxable years beginning after October 22, 2004, amended Section 856(c)(5)(G) provides that any income of a REIT derived from a clearly identified hedging transaction (as defined in Section 1221) does not constitute gross income for purposes of the 95% of gross income requirement for REITs.

(e) Conformity with RIC Rules. The AJCA prospectively amends the tax liability owed by the REIT when it fails to meet the 95% of gross income test by applying a taxable fraction based on 95%, rather than 90%, of the REIT’s gross income. Section 857(b)(5)(A)(i).

(f) REIT Savings Provisions (effective prospectively). In recognition of the harshness of all-or-nothing qualification with respect to the asset tests, Congress added flexibility by imposing at most monetary penalties, in lieu of disqualification, for failure to satisfy the tests in certain cases. The new rules are contained in Sections 856(c)(6), 856(c)(7) and 856(g)(5) and are effective prospectively.

(1) De Minimis Asset Failures of 5% or 10% Tests. A REIT that fails to satisfy the asset requirements of Section 856(c)(4)(B)(iii) for a particular quarter will nevertheless be considered to have satisfied the requirements of such paragraph if such failure
was due to the ownership of assets the total of which does not exceed the lesser of (i) 1% of the total value of the REIT’s assets at the end of the quarter, and (ii) $10 million, and if, within 6 months after the last day of the quarter in which such failure was identified, the REIT disposes of the assets. Section 856(c)(7)(A).

(2) Substantial Violations of 5% and 10% Assets Tests, 75% Tests and Other Asset Tests. The offending REIT, nevertheless, will be considered to have satisfied the requirements of Section 856(c)(4)(B)(iii) if disclosure of the failure is made as required by the Regulations, the failure was due to reasonable cause and not willful neglect, the REIT pays a penalty tax, and the asset violation is corrected within 6 months of the last day of the quarter in which such failure was identified. Section 856(c)(7)(B). The penalty tax will equal the greater of (i) $50,000 or (ii) the amount determined by multiplying the net income generated by the subject assets by the highest tax rate for corporations. Section 856(c)(7)(C). This tax is deducted from the REIT’s taxable income in determining the amount the REIT must distribute under the 90% distribution requirement. Section 857(b)(2)(E).

(3) Other Failures. If a REIT fails to satisfy one or more of the qualification requirements (other than Sections 856(c)(6) and (7)), AJCA added subparagraph (5) to Section 856(g), which provides that the REIT may retain its REIT status if the failure was due to reasonable cause and willful neglect and the REIT pays a penalty of $50,000. This tax is also deducted from the REIT’s taxable income in determining the amount the REIT must distribute under the 90% distribution requirement. Section 857(b)(2)(E).

(4) Expansion of Deficiency Dividend Procedures. AJCA expanded the circumstances in which a REIT may declare a deficiency dividend, by allowing a declaration to occur after the REIT unilaterally has identified a failure to pay the relevant amount. Effective for taxable years beginning after Oct. 22, 2004, new Section 860(e)(4) provides that a “determination” includes a statement by the taxpayer attached to its amendment or supplement to its tax return for the relevant tax year.

(g) Clarification of FIRPTA Look-Through Rule for REIT Distributions

(1) Capital Gain Distributions. AJCA modified Section 897(h)(1) to conform the REIT rules for capital gain distribution to the rules of Section 897(c)(3). Under amended Section 897(h)(1), a REIT capital gain distribution to a foreign investor is treated as if it were an ordinary income dividend for FIRPTA purposes provided the following two conditions are met: (a) The distribution is with respect to stock that is publicly traded on a U.S. exchange; and (b) the foreign investor owns 5% or less of the class of stock at all times during the taxable year in which such distribution is made.

(2) Dividend Treatment. Such distributions described above will treated as ordinary dividends. Section 857(b)(3)(F).

(3) Effective Date. Section 897(h)(1) is effective for taxable years beginning after October 22, 2004.
Modification of Safe Harbor Rules for Timber REITs

(1) Certain Sales Not to Constitute Prohibited Transactions. AJCA modified Section 857 to provide that the sale of real estate assets by a timber REIT is not a prohibited transaction if the following conditions are met:

(A) the REIT held the property for not less than four years in connection with the trade or business of producing timber;

(B) the aggregate capital expenditures made by the REIT (or a partner of the REIT) in connection with the timber business during the four-year period preceding the date of sale do not exceed 30% of the net selling price of the property;

(C) the aggregate capital expenditures made by the REIT (or a partner of the REIT) that are not directly related to the timber business do not exceed 5% of the net selling price of the property;

(D) either (1) the REIT does not make more than seven sales of property (other than sales of foreclosure property or sales to which Section 1033 applies) during the taxable year, or (2) the aggregate adjusted bases of property sold during the taxable year do not exceed 10% of the aggregate bases of all REIT assets held at the beginning of the taxable year;

(E) if the requirement of (d)(2) above is not satisfied, then substantially all of the marketing expenditures with respect to the property were made through an independent contractor from whom the trust itself does not derive or receive any income; and

(F) the sales price of the property sold by the REIT is not based in whole or in part on income or profits, including income or profits derived from the sale or operation of such property. Section 857(b)(6)(D).

(2) Effective Date. This modification applies to sales after December 31, 2004.

4. Qualified Production Activities Income Deduction.

(a) Overview. For taxable years beginning after December 31, 2004, qualifying taxpayers can claim the Section 199 qualified production activities income (“QPAI”) deduction. Section 199, which was enacted as part of the Act, allows an eligible taxpayer to claim a deduction equal to 9% (when fully phased-in after 2009) of the lesser of its (i) QPAI or (ii) taxable income (adjusted gross income in the case of an individual). In 2005 and 2006, the deduction percentage is 3%, and for taxable years 2007 through 2009, the deduction percentage is 6%.
(b) **Wages Paid Limitation.** The QPAI deduction is limited to 50% of wages paid to employees during the taxable year. Section 199(b). For purposes of determining the amount of the wage limitation, a person that is allocated QPAI from a pass-thru entity is treated as having been allocated W-2 wages from such entity in an amount equal to the lesser of: (i) such person’s allocable share of such wages or (ii) 2 times 9% (3% in 2005 and 2006, and 6% in 2007, 2008 and 2009) of the QPAI allocated to such person for the taxable year. Section 199(d)(1)(B).

(c) **Qualified Production Activities Income Defined.** Section 199 is replete with new terms and concepts that over time will become known simply by their acronyms. The chief new term is QPAI, which is the excess of domestic production gross receipts ("DPGR"), another new term, over the sum of: (a) the cost of goods sold allocable to such receipts, (b) other deductions, expenses or losses directly allocable to such receipts, and (c) a ratable portion of deductions, expenses and losses not directly allocable to such receipts or another class of income. Section 199(e)(1). Because DPGR includes gross receipts derived from "construction performed in the United States", persons in the real estate construction industry can claim the QPAI deduction.

(d) **Initial IRS Guidance.** On January 19, 2005, the IRS issued Notice 2005-14, 2005-7 I.R.B. 498, a lengthy notice dealing with the QPAI deduction. Notice 2005-14 defined the term "construction performed in the United States" to mean "the construction of real property (that is, residential and commercial buildings (including items that are structural components of such buildings), inherently permanent structures other than tangible property in the nature of machinery, inherently permanent land improvements, and infrastructure).” Taxpayers must allocate their gross receipts from construction activities between real property and tangible personal property. To that end, Notice 2005-14 provided that if the gross receipts from tangible personal property, such as appliances, furniture and fixtures) sold in connection with a real estate project represent more than 5% of a taxpayer’s total gross receipts derived from a construction project, the gross receipts attributable to the tangible personal property do not constitute real property and are excluded from DPGR (assuming the taxpayer did not manufacture the tangible personal property).

Notice 2005-14 also provided that multiple taxpayers deriving gross receipts from construction with respect to the same activity and the same construction project may claim the QPAI deduction. For example, assume that Building Owner, who is not in the construction trade or business, hires General Contractor to oversee a substantial renovation of his building. As part of the renovation project, General Contractor hires Subcontractor to install a new electrical system in the building. Pursuant to Notice 2005-14, the amounts that General Contractor receives from Building Owner and the amounts that Subcontractor receives from General Contractor both qualify as DPGR.

The IRS is expected to issue additional guidance under Section 199 in the near future.

(a) Capital Gain Treatment of Timber Sales. AJCA modified Section 631(b) to provide that land owners selling timber after December 31, 2004 are no longer required to retain an economic interest in the timber in order to treat their gains as capital gains.

(b) Treatment of Gain/Loss on Sale of Brownfield Sites. For property acquired by the taxpayer or a qualifying partnership during the period beginning January 1, 2005 and ending December 31, 2009, any gain or loss from the qualified sale, exchange or other disposition of any qualifying brownfield property is excluded from unrelated business taxable income. Section 512(b)(18). Property acquired during the five-year acquisition period need not be disposed of by the termination date to qualify for the exclusion.

(c) Disallowance of Certain Partnership Loss Transfers.

(1) Contributions of Property with Built-In Loss. Section 704(c)(1)(A) provides that income, gain, loss and deduction with respect to property contributed to a partnership by a partner must be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. The purpose of the statute is to ensure that any built-in gain or loss associated with contributed property is allocated to the partner who contributed such property. In addition, the Regulations provide that if a contributing partner transfers a partnership interest, any built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. Reg. Section 1.704-3(a)(7).

The application of these rules created the possibility for abuse in the form of built-in loss duplication. For example, assume X owns an asset with a fair market value of $100,000 and a basis of $120,000 (a built-in loss of $20,000). X contributes the asset to the XY partnership and Y contributes $100,000 cash to the XY partnership such that X and Y each own a 50% interest in the XY partnership. If X were to sell his interest in the XY partnership to Z for $100,000, X would recognize a loss of $20,000. Assuming the XY partnership did not have a Section 754 election in effect, the XY partnership would not adjust the basis of its asset upon the sale of X's interest to Z. Accordingly, if the XY partnership were to sell the asset contributed by X for $100,000, it would recognize a loss of $20,000 (XY partnership's basis in the asset of $120,000, equal to X's basis in the asset, over the sales proceeds of $100,000), which must be allocated to Z pursuant to Reg. Section 1.704-3(a)(7). Thus, through the use of a partnership, the built-in loss inherent in the asset contributed by X generated two losses, (i) a $20,000 loss recognized by X upon the sale of his interest in the XY partnership to Z, and (ii) a $20,000 loss recognized by Z upon the sale of the asset by the XY partnership. (Note, however, that Z would recognize a gain of $20,000 if the XY partnership were to liquidate, as the basis of his interest in the XY partnership would be $80,000, compared to $100,000 of liquidation proceeds, thereby offsetting his earlier recognized loss. Nevertheless, until such liquidation, loss duplication will have been achieved).
In order to prevent the abuse illustrated above, AJCA added new Section 704(c)(1)(C). Section 704(c)(1)(C) provides that if built-in loss property is contributed to a partnership, such built-in loss will be taken into account only in determining the amount of items allocated to the contributing partner. Further, except as provided for in regulations, in determining the amount of items allocated to other partners, Section 704(c)(1)(C) provides that the basis of the contributed property in the hands of the partnership will be treated as being equal to its fair market value at the time of contribution.

Applying Section 704(c)(1)(C) to the example above, upon X’s sale of his partnership interest, the partnership’s basis in the contributed asset would be reduced to its fair market value, $100,000 and, upon a subsequent sale of the asset, the partnership would recognize no gain or loss. Thus, Section 704(c)(1)(C) should prevent loss duplication.

(2) Transfers of Partnership Interests. Prior to AJCA, a partnership had the option to adjust the basis of its property following the sale or exchange of a partnership interest, or upon the death of a partner under Section 743. Under Section 743(b), a partnership increases or decreases the basis of its property by the difference between the transferee’s basis for his partnership interest and his share of the adjusted basis to the partnership of all partnership property. The basis adjustment, however, under Section 743 is made only with respect to the transferee partner.

AJCA amended Section 743 to provide that the basis adjustments under Section 743(b) are mandatory upon the sale or exchange of a partnership interest or upon the death of a partner where, immediately after such transfer, the partnership has a “substantial built-in loss.” A partnership has a “substantial built-in loss” with respect to a transfer of an interest in a partnership if the partnership’s adjusted basis in the partnership property exceeds by more than $250,000 the fair market value of such property.

An exception to the Section 743 mandatory basis adjustments is provided for securitization partnerships. Also, the Section 743 mandatory basis adjustments do not apply to an “electing investment partnership.” Instead of mandatory basis adjustments, a transferee partner of an interest in an electing investment partnership is subject to a special partner-level loss disallowance rule.

The elective nature of the basis adjustments under Section 743 prior to AJCA provided the opportunity for loss duplication. For example, assume A, B, and C each contributes $2,000,000 to the ABC partnership which purchases property for $6,000,000, and the property subsequently declines in value to $3,000,000. If A sells his partnership interest to D for $1,000,000 (1/3 of the current value of the partnership’s sole asset), A will recognize a loss of $1,000,000. Assuming that the partnership did not have a basis adjustment election in effect and the partnership subsequently sold the property for $3,000,000, D would be allocated his $1,000,000 share of the $3,000,000 loss. Thus, both A (the selling partner) and D (the purchasing partner) will have recognized a loss with respect to the property. (Note, however, that D would recognize a gain of $1,000,000 if the partnership were to liquidate, as the basis of
his interest in the partnership would be zero, compared to $1,000,000 of liquidation proceeds, thereby offsetting his earlier recognized loss. Nevertheless, until such liquidation, loss duplication will have been achieved).

As a result of AJCA, however, a basis adjustment under 743 would be mandatory in the example above, since the ABC partnership has a substantial built-in loss (the property’s basis of $6,000,000 exceeds its fair market value of $3,000,000 by more than $250,000) immediately after the sale of A’s interest to D. Accordingly, the ABC partnership is required to decrease the basis of its asset with respect to D by $1,000,000 and, as a result, D would recognize no gain or loss when the ABC partnership sells the asset for $3,000,000.

If there is a substantial built-in loss (more than $250,000), AJCA modified Section 743(a) to provide that the basis adjustment under Section 743(b) is mandatory. AJCA, however, provided an exception for “electing investment partnerships”.

(3) Distributions of Partnership Property. Prior to AJCA, a partnership had the option, under Section 734, to adjust the basis of its property following a distribution of property to a partner. Under Section 734(b), a partnership increases or decreases the adjusted basis of its assets in an amount equal to either (1) the gain or loss recognized by the distributee partner, or (2) the difference in basis comparing the property’s adjusted basis while held by the partnership with the basis when held by the distributee partner.

AJCA amended Section 734 to provide that the basis adjustments under Section 734(b) are mandatory upon a distribution of property to a partner if there is a “substantial basis reduction.” A “substantial basis reduction” exists if (1) the loss recognized by the distributee partner, or (2) the excess of the basis of the distributed property to the distributee partner over the adjusted basis of the distributed property to the partnership immediately before the distribution, exceeds $250,000. An exception to the mandatory Section 734 basis adjustments is provided for securitization partnerships.

Just as with the mandatory adjustments under Section 743, the purpose of the mandatory adjustments under Section 734 is to prevent loss duplication.

(d) No Reduction of Basis Under Section 734 in Stock Held by Partnership in Corporate Partner. AJCA added new subsection (c) to Section 755, which applies to distributions after October 22, 2004. Section 755(c) provides that, in applying the basis allocation rules of Section 755 to a distribution in liquidation of a partner’s interest, a partnership is precluded from decreasing the basis of corporate stock of a partner or a related person. To that end, any basis that would have been allocated to the stock is now allocated to other partnership assets. If the decrease in basis exceeds the basis of the other partnership assets, then gain is recognized by the partnership in the amount of the excess.
(e) **Recognition of Gain from the Sale of a Principal Residence Acquired in a Like-Kind Exchange within 5 Years of Sale.** After October 22, 2004, the exclusion of gain on the sale or exchange of a principal residence provided in Section 121 does not apply if the taxpayer acquired the principal residence in a like-kind exchange in which any gain was not recognized within the prior five years. Section 121(d)(10).

(f) **Recognition of Cancellation of Indebtedness Income on Satisfaction of Debt with Partnership Interest.** Effective for cancellations of indebtedness occurring on or after October 22, 2004, AJCA amended Section 108(e)(8) to provide that, when a partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of partnership debt, the partnership generally recognizes cancellation of indebtedness income in the amount that would be recognized if the debt were satisfied with money equal to the fair market value of the partnership interest. This income will be allocated among the partners who held interests in the partnership immediately prior to the satisfaction of the debt.

(g) **Tax-Exempt Entity Leasing.** In an attempt to further lessen the benefits of leasing transactions involving tax-exempt entities, AJCA enacted new Section 470, which generally prohibits a current deduction for expenses related to property leased to a tax-exempt entity, generally consisting of depreciation, amortization, taxes, maintenance expenses, etc., to the extent that such deductions exceed the income generated from the property. Any deduction disallowed under Section 470 is carried over to the next tax year and is treated as a deduction with respect to the property. When a taxpayer disposes of its entire interest in the tax-exempt property, the previously disallowed losses will generally become available under rules similar to the passive activity losses.

The disallowance provision of Section 470 will not apply, however, if a leasing transaction satisfies the following four requirements. First, the lessee may not monetize its lease obligations, by means of, for example, a defeasance arrangement or sinking fund arrangement, in an amount that exceeds 20% of the lessor's adjusted basis in the property at the time the lease is entered into. Second, for any lease with a lease term of more than five years, the lessor must have unconditional at-risk equity investment in the property of at least 20 percent of its adjusted basis in the property at the inception of the lease and all throughout the lease term. Third, for any lease with a lease term of more than five years, the lessee may not bear (i) any portion of the loss that would occur if the fair market value of the leased property were 25% less than its reasonably expected fair market value at the time the lease is terminated, or (ii) more than 50% of the loss that would occur if the fair market value of the leased property at the time the lease is terminated were zero. Fourth, and finally, with respect to property with a class life of more than seven years, if the lease includes an option for the lessee to purchase the property, the purchase price under the option must be for the fair market value of the property at the time of exercise of the option.
II. 2005-2006 PRIORITY GUIDANCE PLAN

A. General Tax Issues

1. Final regulations under Section 168 relating to like-kind exchanges. Temporary regulations were published on March 1, 2004.

2. Final regulations under Sections 168 and 1400L regarding the special depreciation allowance. Temporary regulations will sunset in September 2006.

3. Final regulations under Section 168 regarding changes in classification of property. Temporary regulations were published on January 2, 2004.

4. Guidance under Section 168 regarding property eligible for the extended placed-in-service date for the special depreciation allowance.

5. Guidance under Section 469 regarding the limitation on losses and credits relating to passive activities.

6. Proposed regulations under Section 199 regarding the deduction for income attributable to domestic production activities. Interim guidance was issued as Notice 2005-14.

B. Partnerships

1. Guidance under Section 704(b)(2) regarding whether partnership allocations have substantial economic effect.

2. Guidance under Section 706(d) regarding the determination of distributive share when a partner's interest changes.

3. Final regulations under Section 707 regarding disguised sales. Proposed regulations were published on November 26, 2004.

4. Final regulations under Section 721 regarding partnership interests issued for services or non-compensatory partnership options. Proposed regulations were issued on January 22, 2003 and May 24, 2005. Additional guidance was issued as Notice 2005-43.

5. Update the Section 751 regulations.

6. Guidance under Section 752 where a general partner is a disregarded entity.

7. Guidance under Sections 704, 734, 743 and 755, as amended by the AJCA, regarding the disallowance of certain partnership loss transfers, and no reduction of basis in stock held by a partnership in a corporate partner. Interim guidance was issued as Notice 2005-32.
C. **Subchapter S**

1. Guidance under Section 1367 regarding adjustments in basis of indebtedness.

2. Guidance under Section 1361, as amended by the AJCA, regarding the determination of the number of shareholders in an S corporation and the treatment of family members.

**III. PROPOSED, TEMPORARY AND FINAL REGULATIONS**

A. **Sections 83 and 721 (Partnership Equity for Services).**

1. **Overview:** On May 24, 2005, the Treasury issued Proposed Regulations addressing the treatment of a transfer of partnership equity in connection with the performance of services. Concurrently with the issuance of the Proposed Regulations, the IRS issued Notice 2005-43, 2005-24 I.R.B. 1221, announcing a proposed revenue procedure that provides a safe harbor election for determining the value of the transferred partnership interest.

2. **New Rules:** The Proposed Regulations introduce the following new rules:
   
   (a) The Proposed Regulations apply Section 83 to all partnership interests, without distinguishing between partnership capital interests and partnership profits interests. Hence, a partnership capital or profits interest is Section 83 property, and the transfer of a partnership interest in connection with the performance of services is subject to Section 83.

   (b) The partnership recognizes no gain or loss on the transfer of a partnership interest in exchange for the performance of services.

   (c) In the case of a transfer of a substantially non-vested partnership interest, if an Section 83(b) election is made, the transferee is treated as a partner for Federal income tax purposes. If no Section 83(b) election is made, then the holder of the partnership interest will not be treated as a partner until the partnership interest becomes substantially vested. These rules differ from Rev. Proc. 2001-43, 2001-2 C.B. 191, which provides that the holder of a partnership profits interest may be treated as a partner under certain circumstances, even if no Section 83(b) election is made.

   (d) The rules of Section 83(h) govern the timing and amount of any compensation deduction to the partnership.

   (e) The amount includible in income by the transferee and the amount deductible by the partnership generally is equal to the fair market value of the transferred partnership interest.

   (f) Upon receipt of the partnership interest, the service provider's capital account is increased by the amount taken into income plus any amounts paid for the transferred partnership interest.
(g) In determining the value of the transferred partnership interest, the partnership and its partners can elect to treat the fair market value of the partnership interest as equal to its liquidation value pursuant to a safe harbor procedure provided in Notice 2005-43.

3. Valuation Safe Harbor: Notice 2005-43 provides the safe harbor procedure because of the difficulties in valuing partnership interests and so that partnership capital accounts can be properly maintained. Notice 2005-43 is in the form of a draft revenue procedure that describes the rules and conditions relating to the safe harbor election. For further discussion of this Notice, see infra Section IV.F.

4. Effective Date: The Proposed Regulations would apply to transfers of property on or after the date Final Regulations are published in the Federal Register.

B. Section 121(c) (Reduced Maximum Exclusion of Gain from Sale or Exchange of Principal Residence).

1. Overview: On August 13, 2004, the Service issued Final Regulations providing a reduced maximum exclusion limitation for a taxpayer who has sold or exchanged property owned and used as his principal residence for less than two of the preceding five years or who has excluded gain on the sale or exchange of a principal residence within the preceding two years. These Regulations replace Temporary Regulations issued on December 24, 2002. The reduced maximum exclusion applies if the sale or exchange is by reason of a change in employment, health or unforeseen circumstances. Reg. Section 1.121-3(b). Under the Final Regulations, if one of these safe harbors applies, a sale or exchange is deemed to be by reason of a change in place of employment, health or unforeseen circumstances. However, if one of the safe harbors does not apply, the primary reason test applies (i.e., the primary reason for the sale or exchange must be due to a change in place of employment, health or unforeseen circumstances).

2. Change in Place of Employment: The Regulations provide that a sale or exchange is by reason of a change in place of employment if the taxpayer’s primary reason for the sale or exchange is a change in the location of the employment of a qualified individual (taxpayer, taxpayer’s spouse, co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer). Reg. Section 1.121-3(c)(1).

(a) The Regulations adopt a safe harbor providing that the primary reason for the sale or exchange is deemed to be a change in the place of employment if the new place of employment of a qualified individual is at least 50 miles farther from the residence sold or exchanged than was the former place of employment. Reg. Section 1.121-3(c)(2).

(b) To qualify for the safe harbor, the change in place of employment must occur during the period of the taxpayer’s ownership and use of the property as his or her principal residence. A facts and circumstances test applies for taxpayers that do not satisfy the safe harbor.
3. **Health:** The Regulations provide that a sale or exchange is by reason of health if the taxpayer’s primary reason for the sale or exchange is (1) to obtain, provide or facilitate the diagnosis, cure, mitigation or treatment of disease, illness or injury of a qualified individual; or (2) to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness or injury.

(a) A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale or exchange by reason of health. Reg. Section 1.121-3(d)(1).

(b) The definition of qualified person for purposes of this provision is broader than the definition that applies to the exclusions by reason of change in the place of employment and unforeseen circumstances to encompass taxpayers who sell or exchange their residence in order to care for sick family members. Reg. Section 1.121-3(f)(5).

(c) The primary reason for the sale or exchange is deemed to be health if a physician (as defined in Section 213(d)(4)) recommends a change of residence for reasons of health. Reg. Section 1.121-3(d)(2).

4. **Unforeseen Circumstances:** The Regulations provide that a sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. Reg. Section 1.121-3(e)(1). The reduced maximum exclusion is not available by reason of unforeseen circumstances if the primary reason for the sale or exchange is a preference for a different residence or an improvement in financial circumstances.

(a) The safe harbor events include the involuntary conversion of the residence, natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence.

(b) The safe harbor events also include, in the case of the qualified individual: (1) death; (2) the cessation of employment as a result of which the individual is eligible for unemployment compensation; (3) a change in employment or self-employment status that results in the taxpayer’s inability to pay housing costs and reasonable basic living expenses for the taxpayer’s household; (4) divorce or legal separation under divorce decree or separate maintenance; and (5) multiple births resulting from the same pregnancy. Reg. Section 1.121-3(e)(2).

5. **Effective Date:** These Regulations apply to sales and exchanges on or after August 13, 2004.
C. **Section 121(d)(9) (Suspension of 5-Year Period).**

1. **Overview:** On August 13, 2004, the Service issued Final Regulations relating to the suspension of the 5-year period for certain members of the uniformed services and Foreign Service. Reg. Section 1.121-5(a). Under Section 121(d)(9), such taxpayers may elect to suspend the running of the 5-year period of ownership and use during their service but not for more than 10 years.

2. **Manner of Making Election:** File a return for the taxable year of sale or exchange of the taxpayer’s principal residence that does not include the gain on the taxpayer’s gross income. Reg. Section 1.121-5(b).

3. **Application of Election to Closed Year:** A taxpayer who would otherwise qualify under Regs. Sections 1.121-1 through 1.121-4 to exclude gain from a sale or exchange of a principal residence on or after May 7, 1997 may elect to apply Section 121(d)(9) for any tax years for which a claim for refund is barred by operation of any law or rule of law by filing an amended return before November 11, 2004.

4. **Effective Date:** These Regulations are applicable for sales or exchanges on or after May 7, 1997.

D. **Section 168(i) (Changes in Use of MACRS Property).**

1. **Overview:** On June 16, 2004, the Service issued Final Regulations that provide guidance on how to depreciate MACRS property for which the use changes in the hands of the same taxpayer. Changes in use include a conversion of personal use property to a business or income-producing use, a conversion of MACRS property to personal use, or a change in use of MACRS property that results in a different recovery period, depreciation method or both.

2. **Change in Use**
   
   (a) **Conversion to Business or Income-Producing Use:** The Regulations treat the property as placed in service on the date of the conversion. Reg. Section 1.168(i)-4(b)(1). Accordingly, the taxpayer may choose any applicable depreciation method, recovery period and convention prescribed under Section 168 for the property in the year of the change. Id. The depreciable basis of the property for the year of change is the lesser of its fair market value or its adjusted depreciable basis at the time of the conversion. Id.

   (b) **Conversion to Personal Use:** The Regulations treat this change in use as a disposition. Reg. Section 1.168(i)-4(c). Upon the conversion to personal use, no gain, loss or depreciation recapture under Section 1245 or 1250 is recognized. These provisions, however, still apply when the taxpayer actually disposes of the property at a later date.
(c) **Change in MACRS Use:** A change in the use of MACRS property occurs when the primary use of the MACRS property in the current taxable year differs from the primary use in the immediately preceding taxable year. Reg. Section 1.168(i)-4(d). Such changes in use may result in a different recovery period and/or depreciation method. Examples of MACRS use changes include:

1. the property’s predominant use outside the United States begins or ends,
2. the property changes to tax-exempt bond financed property,
3. the property changes to or from tax-exempt use property, or
4. the property changes to imported property covered by an Executive Order.

3. **Use Changes After Placed-in-Service Year**

   (a) **Mid-Year Use Change:** The depreciation allowance for the MACRS property for the year of change is determined as though the change in the use of the MACRS property occurred on the first day of the year of change. Reg. Section 1.168(i)-4(d)(2)(iii).

   (b) **Shorter Recovery Period and/or More Accelerated Depreciation Method Post-Change in Use:** Under the Regulations, taxpayers should depreciate the property over the shorter recovery period and/or by the more accelerated depreciation method beginning with the year of change as though the MACRS property was first placed in service in the year of change. Reg. Section 1.168(i)-4(d)(3)(i). This rule can adversely affect a taxpayer if the remaining portion of the original recovery period is less than the “shorter” recovery period determined by the property’s new use. To avoid this adverse result, the Regulations allow a taxpayer to elect to continue to depreciate the MACRS property as though the change in use had not occurred. Reg. Section 1.168(i)-4(d)(3)(ii).

   (c) **Longer Recovery Period and/or Slower Depreciation Method Post-Change in Use:** In this case, the taxpayer must depreciate the property over the longer recovery period and/or by the slower depreciation method beginning with the year of the change as though the taxpayer originally placed the MACRS property in service with the longer recovery period and/or slower depreciation method. Reg. Section 1.168(i)-4(d)(4). The rules also provide guidance for MACRS property depreciated under the optional depreciation tables in Rev. Proc. 87-57, 1987-2 C.B. 687, before the change in use. Reg. Section 1.168(i)-4(d)(5).

4. **Use Changes During Placed-in-Service Year:** If the use of MACRS property changes during its placed-in-service year, the depreciation allowance generally is determined by the primary use of the property during the taxable year. Reg. Section 1.168(i)-4(e).
5. **Effective Date:** These Regulations are applicable for any changes in the use of MACRS property in taxable years ending on or after June 17, 2004. For any change in the use of MACRS property after December 31, 1986 in a taxable year ending before June 17, 2004, the Service will allow any reasonable method of depreciating the property under Section 168 in the year of change and the subsequent taxable years that is consistently applied to the MACRS property for which the use changes in the hands of the same taxpayer.

E. **Section 179 (Extension of Election through 2008).**

1. **Overview:** On July 13, 2005, the Service issued Final Regulations that extend the changes made to Section 179 by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) through 2008. Temporary and Proposed Regulations issued on August 4, 2004 reflected the changes made by JGTRRA. These Final Regulations replace the Temporary and Proposed Regulations, and, pursuant to the AJCA, extend the changes made by JGTRRA by an additional two years.

2. **Increased Section 179 Expensing:** Prior to JGTRRA, a taxpayer could elect to deduct up to $25,000 of the cost of tangible business property placed in service during the taxable year. This amount, however, was phased out for each dollar of qualifying property placed in service during the taxable year in excess of $200,000. JGTRRA expanded considerably the tax savings available under this provision. Specifically, JGTRRA increased the amount of the maximum deduction to $100,000 and doubled the phase-out threshold to $400,000. JGTRRA also expanded the categories of property qualifying for this election to include off-the-shelf computer software used in a trade or business. The Final Regulations retain the rules relating to these changes.

3. **Two Year Extension:** Pursuant to the AJCA, the Final Regulations apply a two-year extension of the JGTRRA changes to run through 2008. Reg. Section 1.179-5(c).

4. **Manner of Making or Revoking a Section 179 Election:** Beginning in 2002 and before 2008, an election or revocation of an election under Section 179 may be made on an amended Federal income tax return for the year that the election or revocation applies. Reg. Section 1.179-5(d) adds that, in general, an election or revocation of an election under Section 179 must be made in the manner stated above.

5. **Effective Date:** The Final Regulations apply to property placed in service in the taxable years starting after 2002 and before 2008. Reg. Section 1.179-6(b). The requirement of Reg. Section 1.179-5(d) applies on or after July 12, 2005.

F. **Section 460 (Special Rules Relating to the Treatment of Certain Partnership Transactions Involving Long-Term Contracts).**

1. **Overview:** On August 5, 2005, the Service issued Proposed Regulations relating to partnership transactions involving mid-contract changes in contracts accounted for under a long-term contract method of accounting. The Proposed Regulations address issues reserved in Final Regulations under Section 460 that were issued on May 14, 2002.
2. **Contribution of a Contract to a Partnership:** The Proposed Regulations require the partner to increase the basis of the partnership interest by the amount of gross receipts that the partner has recognized under the contract, and reduce the basis of the partnership interest by the amount of gross receipts the partner has received or reasonably expects to receive under the contract. Prop. Regs. Sections 1.460-4(k)(2)(iv)(D), 1.460-4(k)(3)(iv)(A). If the decrease exceeds the partner’s basis in the partnership interest, the partner must recognize income equal to the excess. To prevent double taxation, the Proposed Regulations require the partnership to reduce its total contract price by the amount of income recognized by the contributing partner.

3. **Built-in Income and Loss:** The Proposed Regulations determine the amount of built-in income or built-in loss attributable to a contributed contract that is subject to Section 704(c) in the following manner:

   (a) The contributing partner first takes into account any income or loss required under the step-in-the-shoes rules for the period ending on the date of the contribution;

   (b) Next, the partnership determines the amount of income or loss that the contributing partner would take into account if the contract were disposed of for fair market value in a constructive completion transaction, while treating the calculation as occurring immediately after the partner has applied the step-in-the-shoes rules, but before the contribution to the partnership; and

   (c) Finally, the above amount is reduced by the amount of income, if any, that the contributing partner is required to recognize as a result of the contribution. Prop. Reg. Sections 1.460-4(k)(3)(v).

4. **Transfer of a Partnership Interest:** The Proposed Regulations provide that contracts accounted for under a long-term contract method of accounting are unrealized receivables within the meaning of Section 751(c). Prop. Reg. Section 1.460-4(k)(2)(iv)(E). The amount of ordinary income or loss attributable to such contract is the amount of income or loss the partnership would take into account under the constructive completion rules if it disposed of the contract in a constructive completion transaction at fair market value.

5. **Adjustments to the Basis of Partnership Property:** If all or part of a basis adjustment under Section 743(b) or the partnership’s basis adjustment under Section 734(b) is allocated to a contract accounted for under a long-term contract method of accounting, the Proposed Regulations provide that the adjustment shall reduce or increase, as appropriate, the transferee partner’s distributive share of income or loss from the contract. Prop. Reg. Section 1.460-4(k)(3)(v)(B). For contracts under the completed contract method ("CCM"), the basis adjustment is taken into account in the year in which the contract is completed. As to contracts under a long-term contract method of accounting other than the CCM, the portion of the basis that is recovered in each taxable year of the partnership must be determined by the partnership in a manner that reasonably accounts for the adjustment over the remaining term of the contract.
6. **Closing of the Books:** The Proposed Regulations provide that, upon the transfer or liquidation of an interest in a partnership holding a contract accounted for under a long-term contract method of accounting, the step-in-the-shoes rules apply to such contract only if the partnership’s books are properly closed with respect to that contract under Section 706. If the partnership’s books are not closed with respect to the contract, then the partnership must compute its income or loss from each contract accounted for under a long-term contract method of accounting for the period that includes the date of the transfer or liquidation as though no change in the taxpayer had occurred with respect to that contract, and may pro rate income from the contract under a reasonable method complying with Section 706.

7. **Look-Back Method:** The Proposed Regulations provide that, if the step-in-the-shoes transaction is a contribution of property (other than a contract accounted for under a long-term contract method of accounting) to a partnership, the distribution of property (other than a contract accounted for under a long-term contract method of accounting) by a partnership, or a transfer of a partnership interest, the old taxpayer is not required to provide the information required in Prop. Reg. Section 1.460-6(g)(3)(ii)(D) to the new taxpayer, because the information necessary for the new taxpayer to apply the look-back method is provided by the partnership. Prop. Reg. Section 1.460-6(g)(3)(ii)(D)(2). A similar exception is provided if the step-in-the-shoes transaction is a transfer of stock in an S corporation, or a conversion to or from an S corporation.

8. **Distribution of a Contract by a Partnership:** The Proposed Regulations state that, in determining the partnership’s income on the constructive completion transaction, the fair market value of the contract is treated as the amount realized from the transaction. The Proposed Regulations also clarify that, for purposes of determining each partner’s distributive share of partnership items, any income or loss resulting from the constructive completion must be allocated among the partners of the partnership as though the partnership closed its books on the date of distribution.

In addition, the Proposed Regulations provide that, if a contract accounted for under a long-term contract method of accounting is distributed to a partner, then, for purposes of determining the partner’s basis in the contract under Section 732 and the amount of any basis adjustment under Section 734(b), the partnership’s basis in the contract immediately prior to the distribution is the partnership’s allocable contract costs, increased (or decreased) by the amount of cumulative taxable income (or loss) recognized by the partnership on the contract through the date of the distribution, and decreased by the amounts that the partnership has received or reasonably expects to receive under the contract. Similarly, if a contract accounted for under a long-term contract method of accounting is distributed to a partner, then, in computing the total contract price for the new contract, the partner’s basis in the contract after the distribution is treated as consideration paid by the partner that is allocable to the contract. Accordingly, the total contract price of the new contract is reduced by the partner’s basis in the contract immediately after the distribution.
The Proposed Regulations also provide an ordering rule under which a partnership that distributes a contract accounted for under a long-term contract method of accounting would apply the constructive completion rules before applying the rules of Section 751(b) to the distribution.

9. **Effective Date:** The regulations are proposed to apply to contributions, transfers and distributions occurring on or after May 15, 2002.

G. **Sections 704(c) and 737 (Treatment of Installment Obligations and Property Acquired Pursuant to Contributed Contract).**

1. **Overview:** On March 21, 2005, the Service issued Final Regulations to clarify the tax treatment of installment obligations and property acquired pursuant to a contract under Sections 704(c) and 737. The Final Regulations adopt, without change, Proposed Regulations issued on November 21, 2003.

2. **Anti-Mixing Bowl Rules**

   (a) **Contributed Property:**

   (1) **Disposition in an Installment Sale:** The Final Regulations amend Reg. Section 1.704-3(a)(8) to provide that, if a partnership disposes of Section 704(c) property in exchange for an installment obligation, the installment obligation is considered Section 704(c) property with the same amount of built-in gain as the disposed of property. Reg. Section 1.704-3(a)(8)(ii). The allocation method for the installment obligation must be consistent with the allocation method chosen for the original property.

   (2) **Contributed Contracts:** The Final Regulations amend Reg. Section 1.704-4(d)(1) to provide, if a partner contributes to the partnership a contract that is Section 704(c) property, and the partnership subsequently acquires property pursuant to that contract in a transaction in which less than all of the gain or loss is recognized, the acquired property is treated as Section 704(c) property with the same amount of built-in gain or loss as the contract, net of any gain or loss recognized on the acquisition. Reg. Section 1.704-3(a)(8)(iii).

   (b) **Distribution of Contributed Property:** If the installment obligation or property acquired pursuant to a contributed contract is distributed by a partnership to a partner other than the contributing partner within 7 years of the contribution, the contributing partner may recognize gain or loss under Section 704(c)(1)(B). See Regs. Section 1.704-4(d)(1)(ii), (iii). The Final Regulations include a similar rule under Section 737. Regs. Sections 1.737-2(d)(3)(ii), (iii).

3. **Effective Date:** The Final Regulations apply to installment obligations received by a partnership on or after November 24, 2003 in exchange for Section 704(c) property and to property acquired on or after November 24, 2003 by a partnership pursuant to a contract that is Section 704(c) property.
H. **Section 707 (Disguised Sales of Partnership Interests).**

1. **Overview:** On November 26, 2004, the Service issued Proposed Regulations regarding disguised sales of partnership interests.

2. **Disguised Sales of Property Regulations.** On September 25, 1992, the Service issued Final Regulations concerning disguised sales of property between a partner and a partnership (the “Property Regulations”). At that time, however, the Service did not address disguised sales of partnership interests, as Reg. Section 1.707-7, entitled “Disguised Sales of Partnership Interests” was shown as “[Reserved]”. The Property Regulations generally provide that a partner’s transfer of property to a partnership and the partnership’s transfer of money or other consideration to the partner constitute a sale of the property, in whole or in part, by the partner to the partnership only if, based on all the facts and circumstances, (i) the transfer of money or other consideration would not have been made but for the transfer of property (the “but for” test), and (ii) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations (the “entrepreneurial risks” test).

3. **Proposed Regulations Generally Patterned after the Property Regulations:** The Proposed Regulations concerning disguised sales of partnership interests generally follow the Property Regulations and, therefore, employ the “but for” and “entrepreneurial risk” tests. In addition, the Proposed Regulations set forth a non-exclusive list of facts and circumstances, many of which are similar to those employed in the Property Regulations, that may tend to prove the existence of a disguised sale of a partnership interest. See Prop. Reg. Section 1.707-7(b)(2). The Proposed Regulations also adopt a presumptive rule, similar to that of the Property Regulations, which provides that a transfer of consideration by a purchasing partner to a partnership and a transfer of consideration by the partnership to a selling partner that are made within two years of each other are presumed to be a sale, unless the facts and circumstances clearly establish that such transfers do not constitute a sale.

4. **Effective Date:** The Proposed Regulations are to be effective for transactions with respect to which all transfers that are considered part of a sale occur on or after the date the regulations are published as Final Regulations.

I. **Section 752 (Assumption of Partner Liabilities).**

1. **Overview:** On May 23, 2005, the Service issued Final and Temporary Regulations relating to the assumption of partner liabilities under Section 752. Briefly stated, these regulations are designed to crack down on the abusive “Son of BOSS” (bond and options sales strategy) tax shelter strategy identified in Notice 2000-44, 2000-2 C.B. 255.

(a) General Rule: If a partnership assumes a liability of a partner (other than a liability to which Section 752(a) and (b) apply) in a transaction described in Section 721(a), then, after application of Section 752(a) and (b), the partner’s basis in the partnership is reduced (but not below the adjusted value of such interest) by the amount (determined as of the date of the exchange) of the liability. Reg. Section 1.752-6(a).

(b) Exceptions: A reduction in the partner’s basis is not required after a partnership’s assumption of that partner’s liability if:

1. the trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange; or

2. substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange. Reg. Section 1.752-6(b)(1) (incorporating the exceptions listed in Section 358(h)(2)).

3. In the Service’s view, these exceptions are broad enough such that Reg. Section 1.752-6(a) will be limited to transactions that are abusive in nature and that lack a business purpose. Further, the Service noted that the Regulations permit taxpayers to elect into Reg. Section 1.752-7 in order to avoid the immediate basis reduction under Reg. Section 1.752-6(a). This election must be filed with a Federal income tax return filed by the partnership on or after September 24, 2003, and on or before December 31, 2005. Reg. Section 1.752-7(k)(2).

3. Assumption of Liability on or after June 24, 2003

(a) Overview: Broadly stated, Reg. Section 1.752-7 provides rules regarding a partnership’s assumption of certain fixed and contingent obligations (i.e., “Reg. Section 1.752-7 liability”). The Regulations define a “Reg. Section 1.752-7 liability” as either (1) an obligation not described in Reg. Section 1.752-1(a)(4)(i) (“Reg. Section 1.752-1 liability”) or (2) the amount of the obligation that exceeds the amount of the Reg. Section 1.752-1 liability. Reg. Section 1.752-7(b)(3). Thus, an obligation can be treated in part as a Reg. Section 1.752-7 liability and in part as a Reg. Section 1.752-1 liability.

Reg. Section 1.752-1(a)(4)(i) defines “liability”, for purposes of Section 752 and the Regulations thereunder, to include an obligation if and to the extent that incurring the obligation:

1. creates or increases the basis of any of the obligor’s assets (including cash);

2. gives rise to an immediate deduction to the obligor; or

3. gives rise to an expense that is not deductible in computing the obligor’s taxable income and is not properly chargeable to capital.
(b) General Rules:

(1) Any Reg. Section 1.752-7 liability of a partner assumed by a partnership in a Section 721(a) transaction is treated under Section 704(c) principles as having a built-in loss equal to the amount of the Reg. Section 1.752-7 liability as of the date of the partnership’s assumption of the Reg. Section 1.752-7 liability. Reg. Section 1.752-7(c)(1). Thus, any items of deduction or loss with respect to the Reg. Section 1.752-7 liability must be allocated, first, to the Reg. Section 1.752-7 liability partner to the extent of the built-in loss. Deductions or losses with respect to the Reg. Section 1.752-7 liability that exceed the built-in loss are shared among the partners in accordance with Section 704(b) and the Regulations thereunder. Consistent with the principles of Reg. Section 1.704-3, if there is a post-assumption change in the value of the Reg. Section 1.752-7 liability, resulting in an obligation amount that is either greater or less than the initial amount of the obligation, the change in the amount will be treated as a Section 704(b) and not a Section 704(c) item, thereby creating book income or loss to be allocated to the partners. Reg. Section 1.752-7(d).

(2) If the Reg. Section 1.752-7 liability partner sells or exchanges all or part of its partnership interest, immediately before the sale or exchange the partner’s basis in the partnership interest is reduced by the Reg. Section 1.752-7 liability reduction, which is the lesser of (i) the excess of the Reg. Section 1.752-7 liability partner’s basis in the partner’s partnership interest over the adjusted value of that interest; or (ii) the remaining built-in loss associated with the Reg. Section 1.752-7 liability. Reg. Sections 1.752-7(e)(1); 1.752-7(b)(7) (defining Reg. Section 1.752-7 liability reduction). However, in non-recognition transactions where the transferee’s basis in the partnership interest is determined in whole or in part by reference to the transferor’s basis in the partnership interest, the Reg. Section 1.752-7 liability reduction does not apply. Reg. Section 1.752-7(e)(3).

(3) Liquidation of the Reg. Section 1.752-7 liability partner’s interest also triggers a reduction in that partner’s basis. Reg. Section 1.752-7(f)(1).

(4) When another partner assumes part or all of a partner’s Reg. Section 1.752-7 liability, the partnership must reduce the basis of the partnership assets by the remaining built-in loss associated with the Reg. Section 1.752-7 liability. The reduction in the basis of partnership assets must be allocated among partnership assets as if that adjustment were a basis adjustment under Section 734(b). Reg. Section 1.752-7(g)(3). As for the assuming partner, no deduction or capital expense is allowed to an assuming partner (other than the Reg. Section 1.752-7 liability partner) on the economic performance of a Reg. Section 1.752-7 liability assumed from a partnership to the extent of the remaining built-in loss associated with the Reg. Section 1.752-7 liability. Upon economic performance of the Reg. Section 1.752-7 liability, the assuming partner must adjust the basis of the partnership interest, any assets (other than cash, accounts receivable, or inventory) distributed by the partnership to the partner, or gain or loss on the disposition of the partnership interest. Reg. Section 1.752-7(g)(4). Nevertheless, if the Reg. Section 1.752-7 liability partner is a partner in the partnership at the time another partner assumes the Reg. Section 1.752-7 liability and remains such, the Reg. Section 1.752-7 liability partner must reduce its basis in its partnership interest by the Reg. Section 1.752-7 liability reduction.
(c) **Exceptions:** The rules regarding the subsequent sale or exchange or liquidation of a Reg. Section 1.752-7 liability partner’s interest and the rules applicable when another partner assumes the Reg. Section 1.752-7 liability from the partnership do not apply if:

1. the partnership assumes the Reg. Section 1.752-7 liability as part of a contribution to the partnership of the trade or business with which the liability is associated, and the partnership continues to carry on that trade or business after the contribution;

2. immediately before the testing date, the amount of the remaining built-in loss with respect to all Reg. Section 1.752-7 liabilities assumed by the partnership in one or more transactions governed by Section 721(a) is less than the lesser of (i) 10% of the gross value of partnership assets or (ii) $1 million. Reg. Section 1.752-7(d)(2).

(d) The Regulations also provide rules under Section 358(h) for assumptions of liabilities by corporations from partners and partnerships. Reg. Section 1.358-7. Specifically, if a corporation assumes a Section 358(h)(3) liability from a partnership in an exchange to which Section 358(a) applies, then, for purposes of applying Section 705 and Reg. Section 1.704-1(b), any reduction, under Section 358(h)(1), in the partnership’s basis in corporate stock received in the transaction is treated as an expenditure of the partnership described in Section 705(a)(2)(B). Reg. Section 1.358-7(b). This expenditure is allocated among the partners in accordance with Section 704(b) and (c) and Reg. Section 1.752-7(c).

J. **Section 752 (Treatment of Disregarded Entities).**

1. **Overview:** On August 11, 2004, the Service issued Proposed Regulations under Section 752 taking into account certain obligations of a disregarded entity for purposes of characterizing and allocating partnership liabilities.

2. **Effect of a Disregarded Entity:**

   (a) **General Rule:** The Proposed Regulations provide that, in determining the extent to which a partner bears the economic risk of loss for a partnership liability, payment obligations of a disregarded entity are taken into account for purposes of Section 752 only to the extent of the net value of the disregarded entity as of the date on which the partnership determines the partner’s share of partnership liabilities pursuant to Regs. Sections 1.752-4(d) and 1.705-1(a). Prop. Reg. Section 1.752-2(k)(1). The Proposed Regulations do not apply to an obligation of a disregarded entity to the extent that the owner of the disregarded entity otherwise is required to make a payment with respect to such obligation. Id.

   (b) **Net Value of a Disregarded Entity:** The net value of a disregarded entity equals the fair market value of all assets owned by the entity that may be subject to creditors’ claims under local law, including the entity’s enforceable rights to contributions from its owner, but excluding the entity’s interest in the partnership (if any) and the fair market value of property pledged to secure a partnership liability, less obligations of the disregarded entity that do not constitute, and are senior or of equal priority to, payment obligations of the disregarded entity. Prop. Reg. Section 1.752-2(k)(2). The net value of the disregarded entity 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 of property other than property pledged to secure a partnership liability. Id.

(1) Reduction in Net Value of a Disregarded Entity – The net value of a disregarded entity is determined by taking into account a subsequent reduction in the net value of the entity if the subsequent reduction is anticipated and is part of a plan that has as one of its principal purposes creating the appearance that a partner bears the economic risk of loss for a partnership liability. Prop. Reg. Section 1.752-2(k)(3).

(2) Allocation of Net Value – If one or more disregarded entities have obligations that may be taken into account with respect to one or more partnership liabilities, or liabilities of more than one partnership, the partnership must allocate the net value of each disregarded entity among partnership liabilities in a reasonable and consistent manner, taking into account priorities among partnership liabilities. Prop. Reg. Section 1.752-2(k)(4).

3. Information Disclosure: The Proposed Regulations impose a requirement to disclose the entity’s tax classification and net value to the partnership on a timely basis on partners that may be treated as bearing the risk of loss for a partnership liability based upon the obligation of a disregarded entity. Prop. Reg. Section 1.752-2(k)(5).

4. Effective Date: The Proposed Regulations apply to liabilities incurred or assumed by the partnership on or after the date they are published as Final Regulations.

K. Sections 856, 1361 and 7701 (Modification of Check the Box).

1. Overview: On February 24, 2005, the Service issued Final Regulations clarifying that qualified REIT subsidiaries, qualified Subchapter S subsidiaries and single owner eligible entities that are disregarded as entities separate from their owners are treated as separate entities for purposes of any Federal tax liability for which the entity is liable.

2. Separate Entity Treatment of Certain Disregarded Entities: Although a disregarded entity generally is not liable for Federal tax liabilities of its owner with respect to taxable periods during which it is disregarded, the Final Regulations identify the following three situations in which a disregarded entity may be treated as a separate entity for Federal tax purposes:

   (a) Federal tax liabilities incurred during the taxable period for which the disregarded entity was treated as a separate entity;

   (b) Federal tax liabilities of any other entity for which the disregarded entity is liable (e.g., successor or transferee of a taxable entity); and

   (c) Refunds or credits of Federal taxes. Regs. Sections 1.856-9(a), 1.1361-4(a)(6)(i) and 301.7701-2(c)(2)(iii)(A).
3. **Effective Date:** The Final Regulations are effective April 1, 2004.

L. **Section 1031(a) (Replacing the SIC System).**

1. **Overview:** On May 19, 2005, the Service issued Final Regulations replacing the use of the Standard Industrial Classification (“SIC”) system with the North American Industry Classification System (“NAICS”) for determining what properties are of a like class for purposes of Section 1031. These Regulations adopt proposed regulations issued on August 12, 2004, and remove temporary regulations issued on August 12, 2004.

2. **NAICS Product Classes:** Within NAICS, product classes are designated using 6-digit codes, rather than the 4-digit codes assigned to product classes under the SIC system. Properties within the same product class under the 4-digit SIC system generally will be of the same product class under the 6-digit NAICS. The Final Regulations generally incorporate the existing provisions of Reg. Section 1.1031(a)-2(b)(3) relating to the use of product classes but substitute NAICS codes for SIC codes.

3. **Modifications of NAICS Product Classes:** Taxpayers may rely on modifications to NAICS product classes as they become effective. Modifications typically occur every five years, in years ending in a 2 or 7. Reg. Section 1.1031(a)-2(b)(4).

4. **Administrative Procedures for Revising General Asset Classes and Product Classes:** The Final Regulations generally incorporate the existing provisions of Reg. Section 1.1031(a)-2(b)(5) relating to the Commissioner’s ability to supplement, modify, clarify, or update property classifications, but substitute the NAICS Manual and NAICS codes for the SIC Manual and SIC codes.

5. **Effective Date:** The Final Regulations apply to property transfers made by taxpayers on or after August 12, 2004. Taxpayers, however, may apply these Regulations to transfers of property made on or after January 1, 1997, in taxable years for which the period of limitation for filing a claim for refund or credit under Section 6511 has not expired. Reg. Section 1.1031(a)-2(d).

M. **Section 1374 (Adjustment to Net Unrealized Built-in Gain).**

1. **Overview:** On February 22, 2005, the Service published Final Regulations that provide for an adjustment to the amount that may be subject to tax under Section 1374 in certain cases in which an S corporation acquires assets from a C corporation in an acquisition to which Section 1374(d)(8) applies. Section 1374(d)(8) imposes a tax on any net unrecognized built-in gain (“NUBIG”) attributable to any assets acquired by an S corporation the basis of which is determined by reference to the basis of such asset in the hands of a C corporation.

2. **NUBIG Adjustment:** If Section 1374(d)(8) applies to an S corporation’s acquisition of assets, some or all of the stock of the corporation from which such assets were acquired was taken into account in the computation of the NUBIG for a pool of assets of the S corporation, and some or all of such stock is redeemed or canceled in such transaction, subject to certain limitations discussed below, the NUBIG of the pool of assets that included the C
corporation stock redeemed or canceled in the transaction is adjusted to eliminate any effect any built-in gain or built-in loss in the redeemed or canceled C corporation stock had on the initial computation of NUBIG for that pool of assets. Reg. Section 1.1374-3(b)(1).

3. **Limitations on Adjustment**

(a) Recognized Built-In Gain or Loss. NUBIG is only adjusted to reflect the amount of the built-in gain or built-in loss that was inherent in the redeemed or canceled stock at the time the pool of assets became subject to tax under Section 1374 that has not resulted in recognized built-in gain or recognized built-in loss at any time during the recognition period, including on the date of the acquisition to which Section 1374(d)(8) applies. Reg. Section 1.1374-3(b)(2)(i).

(b) Anti-Duplication Rule. Simply stated, an adjustment cannot be made if it is duplicative of another adjustment to the NUBIG for a pool of assets. Reg. Section 1.1374-3(b)(2)(ii). This rule is intended to prevent more than one adjustment to the NUBIG of a pool of assets for the same built-in gain or built-in loss stock.

4. **Effective Date:** The Final Regulations apply to Section 1374(d)(8) transactions that occur in taxable years beginning on or before February 23, 2005, if the S corporation (and any predecessors or successors) and all affected shareholders file original or amended return that are consistent with the Final Regulations for taxable years of the S corporation during the recognition of the pool of assets the NUBIG of which would be adjusted pursuant to the regulations that are not closed as of the first date after February 23, 2005 that the S corporation files an original or amended return. Reg. Section 1.1374-10(a).

N. **Section 7701 (Classification of a Dual-Chartered Entity).**

1. **Overview:** On August 11, 2004, the Service issued Temporary Regulations providing that when an entity is considered to be created or organized in more than one jurisdiction (i.e., a dual-chartered entity), the entity will treated as a corporation if it would be treated as a corporation in any of the jurisdictions in which it is organized. Temp. Reg. Section 301.7701-2T(b)(9). The Temporary Regulations were issued to clarify that dually chartered entities are not disregarded. The Temporary Regulations also provide that a business entity that is created or organized in the United States and in a foreign jurisdiction is a domestic entity. Temp. Reg. Section 301.7701-5T(a).

2. **Effective Date:** The Temporary Regulations apply as of August 12, 2004 to all business entities existing on or after that date.

O. **Section 7701 (Classification of Certain Business Entities)**

1. **Overview:** On May 23, 2005, the Service issued Final Regulations that treat certain eligible entities, which have filed timely elections for S corporation treatment, as also having elected classification as associations taxable as corporations. The entities would not have to make a separate entity classification election under Reg. Section 301.7701-3(c)(1)(i). The filing entity must meet all the other requirements of Section 1361(b) as of the day it makes

2. Effective Date: The Final Regulations apply to timely S corporation elections that were filed on or after July 20, 2004. Eligible entities that filed before July 20, 2004 may still rely on the provisions of this Regulation. Reg. Section 301.7701-3(h)(3).

IV. ANNOUNCEMENTS AND NOTICES

A. Notice 2004-39, 2004-22 I.R.B. 982. This notice describes how the reduction in rates made by JGTRRA and the JGTRRA transition rule (for taxable years that include May 6, 2003), applies to capital gain distributions of RICs and REITs. In general, RICs and REITs may designate some of their dividends as capital gain dividends. Since 1997, when Congress introduced multiple long-term capital gains rates, RICs and REITs have made an additional designation regarding the appropriate rate for capital gain dividends. In this notice, the Service clarified that, if a RIC or REIT designates a dividend as a capital gain dividend, it may further designate the dividend as a distribution taxable at the new 15% rate.

B. Notice 2004-41, 2004-28 I.R.B. 31. This Notice advised taxpayers that the Service intends to disallow improper charitable contribution deductions for transfers of easements on real property to charitable organizations and for transfers of easements in connection with purchases of real property from charitable organizations. Taxpayers claiming improper charitable contribution deductions for such transfers may be subject to accuracy-related penalties. The Notice focused specifically on transactions in which the charitable organization purchases the property and places a conservation easement on the property and then sells the property subject to the easement for a price that is substantially less than the price paid for the property. In connection with this sale, the buyer makes a second payment, designated as a “charitable contribution”, to the charitable organization. The total payments from the buyer to the charitable organization fully reimburses the charitable organization for the cost of the property. The Service stated it may treat the sum of the buyer’s payments to the charitable organization as the purchase price paid by the buyer.

C. Notice 2005-13, 2005-9 I.R.B. 630. This Notice requires taxpayers who engage in abusive “sale-in lease-out” (“SILO”) arrangements to disclose on their U.S. tax returns their participation in such transactions. In addition, SILO promoters must keep lists of participants who invest in such transactions and may also be required to register such transactions with the Internal Revenue Service.

A SILO transaction involves a purported sale by a U.S. taxpayer of an asset from a foreign entity and the simultaneous lease of the asset back to that entity. The U.S. taxpayer then claims depreciation and interest expenses. The Internal Revenue Service has determined that a U.S. taxpayer in a typical SILO transaction does not acquire the benefits and burdens of ownership of the asset it purports to purchase and, therefore, is not entitled to claim the tax benefits associated with ownership of the asset.
D. Notice 2005-29, 2005-13 I.R.B. 796. This Notice provides transition relief under New Section 470, as enacted by the AJCA, to partnerships and other pass-thru entities that are treated as holding tax-exempt use property as a result of Section 168(h)(6). In the case of partnerships and pass-thru entities described in Section 168(h)(6)(E), for taxable years that begin before January 1, 2005, the Service will not apply Section 470 to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of Section 168(h)(6).

E. Notice 2005-32, 2005-16 I.R.B. 895. This Notice provides interim guidance for partnerships and their partners to comply with mandatory basis provisions of Sections 734 and 743, as amended by AJCA. This Notice also provides interim procedures for electing investment partnerships and their partners to comply with Sections 743(e) and 6031(f), as provided by AJCA.

Until further guidance is provided, partnerships subject to the mandatory basis adjustment requirements of Section 734 must comply with the reporting requirements of Regulation Section 1.734-1(d) as if an election under Section 754 were in effect at the time of relevant distribution. In addition, until further guidance is provided, partnerships subject to the mandatory basis adjustment requirements of Section 743 must comply with the reporting requirements of Regulation Section 1.743-1(k)(1) as if an election under Section 754 were in effect at the time of relevant transfer. With respect to electing investment partnerships, the Notice provides guidance on the manner in which such an election should be made, as well as reporting requirement responsibilities of electing investment partnerships.

F. Notice 2005-43, 2005-24 I.R.B 1221. This Notice is in the form of a proposed revenue procedure that provides rules for the elective liquidation value safe harbor under Prop. Reg. Section 1.83-3(l) when a partnership transfers a partnership interest in connection with the performance of services. The safe harbor is intended to simplify the application of Section 83 to partnership interests and to coordinate the provisions of Section 83 with the principles of partnership taxation.

1. Liquidation Value. The proposed revenue procedure allows a safe harbor election by all parties—the partnership, its partners and the service provider—to use liquidation value in determining the value of the transferred partnership interest.

2. Safe Harbor Tax Consequences. In the case of the transfer of a partnership capital interest, the safe harbor election would result in income inclusion and deduction in the amount of the liquidation value of the partnership capital interest at the time of its grant. In the case of a transfer of a partnership profits interest, the safe harbor election would result in no income inclusion and no deduction at the time of its grant. Hence, the election to use liquidation value preserves the existing nonrecognition treatment of the transfer of a profits interest, but must be approved by all partners in a partnership.
3. **Effective Date.** It is expected that the Notice will be finalized and made effective in conjunction with the finalization of the related Proposed Regulations under Section 83 and the Proposed Regulations under Subchapter K.

4. **Interim Treatment.** The Notice, when finalized, will obsolete both Rev. Proc. 93-27, 1993-2 C.B. 343 (receipt of a partnership profits interest in connection with the performance of services not a taxable event under certain circumstances), and Rev. Proc. 2001-43, 2001-2 C.B. 191 (service provider treated as a partner upon receipt of substantially non-vested partnership profits interest under certain circumstances). Until the proposed revenue procedure is finalized, taxpayers may not rely upon the safe harbor set forth in the proposed revenue procedure, but may continue to rely upon current law, including Rev. Proc. 93-27 and Rev. Proc. 2001-43.

G. **Chief Counsel Notice 2004-007.** This Notice announced a change in the Service’s litigating position concerning whether a change in computing depreciation under Section 167, 168 (MACRS), 197, 1400L(b) or 1400L(c), or former Section 168 (ACRS), is a change in method of accounting under Section 446(e). The Service’s litigating position had been that a change in computing depreciation under any of these Sections generally constituted an accounting method change for which the consent of the Commissioner was required. Following several successful taxpayer challenges to this position, the Service changed its position with respect to depreciable or amortizable property placed in service in taxable years ending before December 30, 2003. For such property, the Service will not assert that a change in computing depreciation under any of the above Sections is change in method of accounting.

Reg. Section 1.446-1T(e)(2)(ii)(d) was issued on December 30, 2003. This Temporary Regulation distinguishes the changes in computing depreciation or amortization that do (and do not) constitute an accounting method change.

V. **REVENUE PROCEDURES**

A. **Rev. Proc. 2004-49, 2004-33 I.R.B. 210.** In light of the holding with respect to Situation 2 in Rev. Rul. 2004-85 discussed below, this Revenue Procedure provides a simplified procedure for a qualified S corporation to request relief for a late qualified Subchapter S subsidiary (“QSub”) election for a qualified subsidiary whose stock was acquired from another S corporation in a sale or as part of a reorganization under Section 368(a)(1)(A), (C) or (D), but not as part of an F reorganization. To qualify for the relief, the acquiring qualified S corporation must attach a completed Form 8869, Qualified Subchapter S Subsidiary Election, to its timely filed return for the taxable year during which it acquired the stock of the qualified subsidiary. The Form must state at the top “FILED PURSUANT TO REV. PROC. 2004-49” and must specify as the effective date for the QSub election the date on which the transaction described above occurred. The Revenue Procedure also provides relief under certain circumstances for such transactions that occurred prior to its effective date of August 16, 2004.

B. **Rev. Proc. 2004-51, 2004-33 I.R.B. 294.** This Revenue Procedure modified Rev. Proc. 2000-37 such that the safe harbor provided therein does not apply to replacement property held in a qualified exchange accommodation arrangement if the property is owned by
the taxpayer within the 180-day period ending on the date of the transfer of ownership to the
parking transactions as like-kind exchanges in situations in which the taxpayer has a genuine
intent to accomplish a like-kind exchange at the time that the taxpayer arranges for the
acquisition of the replacement property and actually accomplishes the exchange within a short

Service explained that, in certain cases, the exchange of a principal residence can qualify both
for nonrecognition under Section 1031 and for exclusion under Section 121. The Procedure
applies where the property had been used consecutively and concurrently as a home and
business, and applies only to taxpayers who satisfy the held for productive use in a trade or
business or for investment requirement of Section 1031(a)(1) with respect to the relinquished
business property and the replacement property. In such a case, the exclusion of Section 121
must be applied to any gain realized before applying Section 1031.

The Procedure also addressed unrecaptured Section 1250 gain, boot and basis rules.
Pursuant to Section 121(d)(6), Section 1250 gain cannot be excluded under Section 121(a).
However, a taxpayer may still use Section 1031 to avoid immediate recognition of this gain. If
the taxpayer receives boot in a transaction to which both Sections apply, the boot will count as
recognized taxable income for the taxpayer only to the extent that it exceeds the amount of gain
excluded by Section 121. Finally, if the taxpayer excludes gain under Section 121 on the
exchange of property to which both Sections apply, the taxpayer may treat the excluded gain as
recognized gain for Section 1031(d) basis calculations, and step up the carry-over basis by the
amount of the excluded gain. This last rule only applies to the excluded amount attributable to
the relinquished business portion of the property.

VI. REVENUE RULINGS

may make reverse Section 704(c) allocations (including curative and remedial allocations) of
amortization to take into account the built-in gain or loss resulting from the revaluation of a
Section 197 intangible that was amortizable in the hands of the partnership. However, if the
revalued Section 197 intangible was not amortizable in the hands of the partnership, the
partnership may only make remedial, and not traditional or curative, allocations of amortization
to take into account the built-in gain or loss from the revaluation of the intangible. The reason
for the distinction is that the anti-churning rules under Section 197 do not apply if the
Section 197 intangible was amortizable in the hands of the partnership.

The Ruling described two situations in which a partnership revalued a Section 197
intangible under Reg. Section 1.704-1(b)(2)(iv)(f) following a cash contribution by a nonpartner
in exchange for a partnership interest. In the first situation, the Section 197 intangible was
amortizable in the hands of the partnership; in the second situation, it was not amortizable in the
hands of the partnership. With respect to the first situation, the Service stated that the
partnership was able to make traditional, curative or remedial allocations of amortization under
Reg. Section 1.704-3 to take into account the built-in gain or loss from the revaluation of the
Section 197 intangible. Reg. Section 1.197-2(g)(4)(i). In the second situation, because the Section 197 intangible was not amortizable in the hands of the partnership, the anti-churning rules applied. Thus, under Regs. Sections 1.197-2(g)(4)(ii) and -2(h)(12)(iv)(B), the partnership may make deductible remedial, but not traditional or curative, allocations of amortization to take into account the built-in gain or loss from the revaluation of the Section 197 intangible.

B. Rev. Rul. 2004-59, 2004-24 I.R.B. 1050. This Ruling provides that, for Federal tax purposes, a partnership that converts to a corporation under a state law formless conversion statute will be treated in the same manner as one that makes an election to be treated as an association under Reg. Section 301.7701-3(c)(1)(i). Thus, when unincorporated entity A converts, under state law, to corporation A, the following steps are deemed to occur: unincorporated entity A contributes all of its assets and liabilities to corporation A in exchange for stock in corporation A, and immediately thereafter, unincorporated entity A liquidates, distributing the stock of corporation A to its partners. The Service noted that Rev. Rul. 84-111, 1984-2 C.B. 88, which describes the three methods of incorporating a partnership, does not apply where a partnership incorporates under a state formless conversion statute.

C. Rev. Rul. 2004-64, 2004-27 I.R.B. 7. This important Ruling held that the discretionary power of an independent trustee to reimburse the grantor of a trust for income taxes owed as a result of the trust's status as a “grantor trust” will not cause the inclusion of trust assets in the estate of the grantor. On the other hand, with respect to any trust created on or after October 4, 2004, a provision in the trust (or state law) requiring the mandatory reimbursement of such taxes will trigger estate tax inclusion under Section 2036 because the mandatory reimbursement provisions will be viewed as a retained right to have trust assets applied to discharge a legal obligation of the grantor.

The facts of the Ruling are as follows. A establishes and funds an irrevocable inter vivos trust for the benefit of A’s descendants. The trust agreement requires that the trustee be a person not related or subordinate to A within the meaning of Section 672(c). Under the terms of the trust, A retains no beneficial interest in or power over trust income or corpus that would cause the transfer to the trust to be an incomplete gift for gift tax purposes, or that would cause trust corpus to be included in A’s gross estate. However, A retains powers sufficient to cause A to be treated as the owner of the trust under Sections 671–679.

Under these facts, the Ruling addresses three situations. In the first situation, neither state law nor the trust agreement contains any provision requiring or permitting the trustee to reimburse A for the amount of A’s income tax liability attributable to the trust, and A pays the trust income tax liability from A’s own funds. In the second situation, the trust agreement provides that the trustee shall distribute to A trust income or principal sufficient to satisfy A’s personal income tax liability attributable to the inclusion of the trust’s income in A’s taxable income. Accordingly, the trustee makes a distribution to A. In the third situation, the trustee has discretion to reimburse A for the amount of A’s income tax liability attributable to the trust. Pursuant to the exercise of the trustee’s discretionary power, the trustee reimburses A for A’s income tax liability attributable to the trust.
1. **Situation 1.** A's payment of the income tax liability attributable to the trust with his own funds does not constitute a gift by A to the trust beneficiaries for Federal gift tax purposes because A, and not the trust, is personally liable for the taxes. In addition, no portion of the trust is includible in A’s gross estate under Section 2036 because A has not retained the right to have trust property expended in discharge of A’s legal obligation.

2. **Situation 2.** A’s payment of the income tax liability does not constitute a gift by A, because A is liable for the tax. The trustee’s distribution of trust principal and income to A to reimburse A for the income taxes attributable to the trust is not a gift by the trust beneficiaries to A, because the distribution from the trust is mandated by the terms of the trust. However, A has retained the right to have trust property expended in discharge of A’s legal obligation. This retained right causes the full value of the Trust’s assets at A’s death to be included in A’s gross estate under Section 2036(a)(1). The result would be the same if, under state law, the trustee must, unless the governing instrument provides otherwise, reimburse A for A’s personal income tax liability attributable to the trust, and the governing instrument does not so provide otherwise.

3. **Situation 3.** As is the case in Situations 1 and 2, A’s payment of the income tax liability attributable to the trust is not a gift by A because A is liable for the tax. Further, the amount paid from the trust to reimburse A for his income tax liability was distributed pursuant to the exercise of the trustee’s discretionary authority granted under the terms of the trust instrument. Accordingly, this payment is not a gift by the trust beneficiaries to A. In addition, assuming there was no understanding, express or implied, between the trustee and A regarding the trustee’s exercise of discretion, the trustee’s discretion to reimburse A would not alone cause the inclusion of the trust in A’s gross estate for estate tax purposes. This is the case regardless of whether or not the trustee actually reimburses A. The result in Situation 3 would be the same if state law, rather than the trust instrument, granted the trustee the discretion to reimburse A.

Nonetheless, the trustee’s discretion combined with other facts (such as an understanding or pre-existing arrangement between the trustee and A regarding the trustee’s exercise of this discretion; a power retained by A to remove the trustee and name A as successor trustee; or applicable local law subjecting the trust assets to the claims of A’s creditors) may cause inclusion of the trust assets in A’s gross estate.

D. **Rev. Rul. 2004-77, 2004-31 I.R.B. 119.** This Ruling held that an eligible entity with two members, one of which is disregarded for Federal tax purposes, cannot be classified as a partnership and thus is either disregarded itself or taxable as a corporation. To illustrate, X, a domestic corporation, is the sole owner of L, a domestic LLC that is disregarded for Federal tax purposes. L and X are the only members under local law of P, a state law limited partnership or LLC. L and P do not elect to be treated as associations. Under this ruling, X is treated as owning all of the interests in P because L is a disregarded entity. Thus, P has only one owner for Federal tax purposes. Because P did not “check-the-box”, P is also a disregarded entity.
E. Rev. Rul. 2004-85, 2004-33 I.R.B. 189. As illustrated by the following three situations, this Ruling concludes that (1) a QSub election remains valid after the parent S corporation merges into another S corporation in a Section 368(a)(1)(F) reorganization; (2) a QSub election, however, terminates when the parent S corporation transfers all of its QSub stock to another S corporation by any type of reorganization other than an F reorganization; and (3) an entity classification election of an eligible entity does not terminate solely because the owner transfers all of the membership interest in the eligible entity to another person.

1. Situation 1. X, a State A S corporation, owns 100% of the stock of Sub 1, a corporation that X has elected to treat as a QSub. The shareholders of X form U, a State B corporation. X merges with and into U in a transaction qualifying as a reorganization under Section 368(a)(1)(F). Following the reorganization, the shareholders of X own 100% of the stock of U, and U is eligible to be an S corporation under Section 361(b)(1). Under Rev. Rul. 64-250, 1964-2 C.B. 333, U will be treated as a continuation of X. Consequently, U will be an S corporation immediately after the merger. Because U is treated as a continuation of X, the reorganization does not terminate X’s election to treat Sub 1 as a QSub.

2. Situation 2. Y is an S corporation that owns 100% of the stock of Sub 2, a corporation that Y has elected to treat as a QSub. Y (whether by sale or reorganization under Section 368(a)(1)(A), (C) or (D)) transfers its assets, including 100 percent of Sub 2 stock, to M, an S corporation, in a transaction that is not an F reorganization. Because the transaction was not an F reorganization, M will not be treated as just a continuation of Y. After the transaction, Y no longer owns Sub 2, and Y’s QSub election for Sub 2 does not carry over to M. Consequently, the QSub election of Sub 2 terminates at the close of the day on which Y transfers its assets, including 100% of the Sub 2 stock to M, unless M makes a QSub election for Sub 2, effective immediately following the termination. Regs. Sections 1.1361-5(a)(1)(iii) and 1.1361-5(c)(2). Rev. Proc. 2004-49, discussed above, provides relief for M to make a QSub election if M realizes that Sub 2 is not a QSub more than 2 months and 15 days after its acquisition of Sub 2.

3. Situation 3. Z is a corporation that owns 100% of the membership interests in LLC, an eligible entity that elected to be classified for Federal tax purposes as an association, contrary to its default classification. Z (whether by sale, reorganization under Section 368(a)(1)(A), (C), (D) or (F), or otherwise) transfers all of the membership interests in LLC to N, another person. LLC’s classification continues until LLC elects otherwise or no longer remains eligible for that classification. Therefore, the sale or transfer of the LLC membership interests to N does not affect LLC’s election to be classified as an association.

F. Rev. Rul. 2004-86, 2004-33 I.R.B. 191. In this Ruling, the Service concluded that (1) the Delaware statutory trust ("DST") described therein was an investment trust, under Reg. Section 301.7701-4(c), that will be classified as a trust for Federal tax purposes and (2) a taxpayer may exchange real property for an interest in a DST without recognition of gain or loss under Section 1031.

Under the facts of the Ruling, A, an individual, borrows money from BK, a bank, on January 1, 2005, and signs a 10-year note bearing adequate stated interest. On the same day that A borrows the funds, A uses the loan proceeds to purchase Blackacre, rental real property. The
note is secured by Blackacre and is nonrecourse to A. Immediately following A’s purchase of Blackacre, A enters into a net lease with Z for a term of 10 years. Under the terms of the lease, Z is to pay all taxes, assessments, fees or other charges imposed on Blackacre by Federal, state or local authorities. In addition, Z is to pay all insurance, maintenance, ordinary repairs and utilities relating to Blackacre. Z’s rent is a fixed amount that may be adjusted by a formula described in the lease agreement that is based upon a fixed rate or objective index.

Also on January 1, 2005, A forms DST, a Delaware statutory trust, to hold property for investment. A contributes Blackacre to DST. Upon contribution, DST assumes A’s rights and obligations under the note with BK and the lease with Z. Neither DST nor any of its beneficial owners are personally liable to BK on the note. The Service distinguished Rev. Rul. 92-105, 1992-2 C.B. 204, which held that the taxpayer-beneficiary was the owner of real property transferred to an Illinois land trust because the trustee served as the mere agent of the taxpayer, on the basis that (1) DST assumed A’s obligations on the lease with Z and on the loan with BK and (2) unlike A, the taxpayer-beneficiary in Rev. Rul. 92-105 retained the right to manage and control the trust property.

The trust agreement provides that interests in DST are freely transferable and that DST will terminate on the earlier of 10 years from the date of its creation or the disposition of Blackacre. The trustee is required to distribute all available cash less reserves quarterly to each beneficial owner in proportion to their respective interests in DST. The trustee is also required to invest cash received from Blackacre between each quarterly distribution and all cash held in reserve in short-term U.S. treasury bills or CDs. Per the trust agreement, the trustee’s activities are limited to the collection and distribution of income.

In determining the proper classification of DST, the Service distinguished the instant situation from Rev. Rul. 78-371, 1978-2 C.B. 344, which concluded that a trust established by the heirs of a number of contiguous parcels of real estate was an association taxable as a corporation, because DST’s trustee did not have any of the powers described in Rev. Rul. 78-371 that evidenced an intent to carry on a profit-making business. Thus, because all of the interests in DST are of a single class representing undivided beneficial interests in the assets of DST, and because DST’s trustee has no power to vary the investment of the certificate holders to benefit from variations in the market, the Service held that DST is an investment trust.

On January 3, 2005, B and C exchange Whiteacre and Greenacre, respectively, for all of A’s interests in DST through a qualified intermediary. Whiteacre and Greenacre were held for investment and are of like kind to Blackacre. In concluding that this exchange qualified as a like kind exchange, the Service noted that B and C are grantors of the trust under Reg. Section 1.671-2(e)(3) when they acquire their interests in the trust from A. Because they have the right to distributions of all trust income attributable to their undivided fractional interests in the trust, B and C are each treated, by reason of Section 677, as the owner of an aliquot portion of the trust and all income, deductions and credits attributable to that portion are includible by B and C under Section 671 in computing their taxable income. Further, because the owner of an undivided fractional interest of a trust is considered to own the trust assets attributable to that interest for Federal income tax purposes, B and C are each considered to own an undivided fractional interest in Blackacre for Federal income tax purposes.
G. **Rev. Rul. 2005-11, 2005-14 I.R.B. 816.** This Ruling held that interest paid on a home mortgage that has been refinanced more than one time is deductible as qualified housing interest for purposes of the alternative minimum tax to the extent the interest on the mortgage that was refinanced is qualified housing interest and the amount of the mortgage indebtedness is not increased.

H. **Rev. Rul. 2005-42, 2005-28 I.R.B. 67.** This Ruling extended the IRS’s decision in Rev. Rul. 2004-18. In that Ruling, the Service concluded that environmental remediation costs incurred in cleaning land contaminated by the taxpayer corporation’s manufacturing activity could not be deducted, and instead had to be capitalized as inventory costs under Section 263A. This Ruling altered the facts in five slightly different situations and held that the remediation costs must be allocated to the inventory produced during the taxable year the costs were incurred.

In Situation 1, N was a corporation that owned and operated a stove manufacturing plant on its own land. The stoves, the only item N produced, were inventory in N’s hands. These manufacturing activities produced hazardous waste, which N had legally buried on its land in past years. Due to new environmental requirements, N incurred costs to remediate the contaminated soil and groundwater, which returned the land to its original condition. Production of stoves was ongoing throughout this process and continued afterwards.

In Situation 2, N manufactured clothes dryers instead of stoves. In Situation 3, N temporarily halted production of stoves during the cleaning process. In Situation 4, N stopped manufacturing stoves at the newly cleaned site and restarted at a new location. In situation 5, N dumped the waste at a remote dump on land it did not own, and ceased dumping at the remote location following the remediation.

The Service’s conclusion for each situation was identical. In each situation, N incurred remediation costs caused by its production activities, as contemplated by Reg. Section 1.263A-1(e)(3)(i). The remediation costs were allocated to the inventory produced in the year the costs were incurred, pursuant to Regs. Sections 1.263A-1(c)(1) and 1.263A-1(c)(2), which call for this outcome, even though the cause for the necessary remediation dated back to previous years. Finally, the allocation of remediation costs to inventory would be done using an allocation method allowed under Reg. Section 1.263A-1(f).

VII. LETTER RULINGS

A. **Priv. Ltr. Rul. 200440002 (October 1, 2004).** In this Ruling, the Service clarified the circumstances under which related parties can engage in a like-kind exchange through a qualified intermediary without triggering gain pursuant to Section 1031(f). The ruling involved two related partnerships (“Partnership 1” and “Partnership 2”), each of which engaged in a like-kind exchange through a qualified intermediary. The replacement property for Partnership 1’s exchange was to be the property that Partnership 2 relinquished in its exchange, and the replacement property for Partnership 2’s exchange was to be acquired from a third party. The Service contrasted the facts of this ruling with the facts of Rev. Rul. 2002-83, where Section 1031(f) was held to apply to a like-kind exchange by related parties through a qualified
intermediary which resulted in one of the parties “cashing out” in the transaction. Because in this case both related parties ended up with like-kind property, and not cash, the Service held that Section 1031(f) would not apply.

B. Priv. Ltr. Rul. 200448024 (November 26, 2004). The Service granted a ruling by an investment partnership that it be allowed to make Section 704(c) allocations on an aggregate basis. The Service ruled that the partnership’s method of making reverse Section 704(c) allocations was a reasonable method within the meaning of Reg. Section1.704-3(e)(3), provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to the property were not made with a view to shifting the tax consequences of built-in gain or loss among the partnership in a manner that substantially reduced the present value of the partner’s aggregate tax liability.

C. Priv. Ltr. Rul. 200450005 (December 10, 2004). In this Ruling, the Service ruled that sport utility vehicles (SUVs) and passenger automobiles are like-kind property for purposes of Section 1031. The Service noted that the standard for determining whether properties are of like-kind is interpreted more narrowly with respect to exchanges of personal property than for exchanges of real property. Moreover, because depreciable tangible personal property is considered of like kind if it is either like kind or like class, an exchange can qualify under Section 1031 even if the properties being exchanged are not of like class. The Service concluded that the differences between an automobile and SUV are merely differences in grade or quality, not differences in nature or character. As a result, they can be exchanged pursuant to Section 1031.

D. Priv. Ltr. Rul. 200451020 (August 31, 2004). In this Ruling, the Service addressed whether a private social club formerly exempt under Section 501(c)(7) should be treated as a tax-exempt entity within the meaning of Section 168(h). If so, the taxpayer’s renovation activities described below would not qualify for the Section 47 rehabilitation credit.

The taxpayer operated its club in a building listed on the National Register for historic building that it intends to substantially renovate. In connection with the renovation, the taxpayer plans to structure the transaction to qualify for the Section 47 rehabilitation credit. Prior to placing the renovated building back in service, the taxpayer will convert from a section 501(c)(7) organization to a taxable corporation. For state law purposes, the taxpayer will remain a non-profit corporation. To finance the renovations and qualify the renovation expenditures for the Section 47 credit, the taxpayer plans to structure the transaction as follows.

1. The taxpayer will lease the facility to a limited partnership (the “Tax Credit Partnership”), which will operate as a for-profit entity under a 29-year lease.

2. The Tax Credit Partnership will issue a 99% limited partner interest to a corporate investor which will contribute equity capital to the Tax Credit Partnership to partially fund the renovations.

3. The 1% general partner of the Tax Credit Partnership will be a for-profit subsidiary of the taxpayer.
4. In order to operate the club, the Tax Credit Partnership will lease the historic building back to the taxpayer for a lease term of 10 years.

The taxpayer represented that it expects to remain the owner of the historic building for tax purposes throughout the 29-year term of the lease with the Tax Credit Partnership.

The critical issue for the taxpayer was whether Section 168(h)(2)(E)(i) applied. Under Section 168(h)(2)(E)(i), a taxable corporation is deemed a tax-exempt entity for purposes of the tax-exempt use property rule if the corporation was a tax-exempt entity within the 5-year period ending when the former tax-exempt first used the property. The Service, however, noted that Section 168(h)(2)(E)(i) does not apply if the property in question was actually “held” by the former tax-exempt entity. The Service also cited the legislative history for this provision, which provided that the 5-year lookback rule “does not treat property owned by any such former tax-exempt organization as tax-exempt use property.”

E. Priv. Ltr. Rul. 200507004 (October 25, 2004). In this Ruling, the Service held that, for purposes of the test for closely held status under Sections 856(a)(6) and 856(h)(1)(A), REIT stock held by a charitable trust that is not an organization described in Sections 401(a), 501(c)(17), or 509(a) was not be treated as stock held by an individual under Section 542(a)(2) or as constructively owned by another person under Section 544(a)(1). To reach this conclusion, the Service concluded that because the charitable trust does not identify a particular beneficiary, no person holds a beneficial ownership interest in the charitable trust as contemplated in Section 542. See Rev. Rul. 58-556, 1958-2 C.B. 355. Accordingly, the stock owned by the charitable trust was not be treated as constructively owned by another person under Section 544(a)(1).

F. Priv. Ltr. Rul. 200510002 (November 19, 2004). In this Ruling, a self-administered and self-managed REIT specializing in acquiring, leasing, financing, managing and developing Class A office buildings through operating partnerships sought to have employees of the operating partnerships, rather than the employees of an independent contractor, perform routine cleaning services (e.g., dusting, emptying wastepaper baskets, cleanings floors, and other general janitorial services). The Service concluded that the REIT’s performance of routine cleaning services customarily furnished or arranged for by landlords in connection with the leasing of office space in the local area would not cause the amounts received by the REIT to fail to qualify as “rents from real property” under Section 856(d).

G. Priv. Ltr. Rul. 200513002 (December 28, 2004). The taxpayer in this Ruling was a publicly-traded mortgage REIT that wholly owned a taxable REIT subsidiary (“TRS”). TRS owned all of the stock of Corporation engaged in the business or originating, purchasing, pooling, holding, selling, securitizing and servicing mortgage loans and selling securities in pools of mortgages. When Corporation originates and acquires mortgage loans for inclusion in a pool to be securitized, it obtains short-term financing from several sources, including the REIT. The method of financing is commonly referred to as “warehouse financing”. In general, a warehouse lender takes a security interest in the mortgage pool. Under this arrangement, Corporation treats the REIT as in possession of the mortgage loans that serve as the collateral on the warehouse line of credit. Corporation generally remits payments due the REIT on the warehouse line of credit directly to the Taxpayer and then remits the difference, if any, to its own
account. The warehouse line of credit bears interest indexed to the same objective index factor as the mortgages assigned as collateral security. The terms of the warehouse line of credit are comparable to that charged by unrelated lenders under similar conditions.

Prior to the submission of this Ruling request, the REIT was not treating the loans it makes to the Corporation on its existing warehouse line of credit as real estate assets. Taxpayer has proposed to restructure the warehouse line of credit as an assignment of the mortgage loans from Corporation to the REIT on a nonrecourse basis. The REIT will collect the payments due on the mortgages either directly or through Corporation (acting as the REIT’s agent), and credit to Corporation any funds in excess of the amount due of the warehouse line of credit.

The Service noted that the loans from the REIT to Corporation are generally analogous to those made a real estate investment trust to developers in Rev. Rul. 80-280, 1980-2 C.B. 207, which held that the loans to developers (commonly referred to as hypothecation loans) qualified as real estate assets under Section 856 and that the interest on such loans qualified as “interest on obligations secured by mortgages on real property”.

In light of the foregoing, the Service concluded that if the value of the real property securing the mortgages assigned as collateral for these loans exceeds the principal amount due on the warehouse line of credit, interest paid on the warehouse line of credit will qualify as interest on obligations secured by mortgages on real property or on interests in real property within the meaning of Section 856(c)(3)(B). Consequently, the warehouse line of credit in this case constitutes a real estate asset within the meaning of Section 856(c)(5)(A) and thus is not a security for purposes of the REIT assets tests under Section 856(c)(4).

H. Priv. Ltr. Rul. 200513010 (December 6, 2004). This is the Service’s second ruling under the tenancy-in-common (“TIC”) guidelines of Rev. Proc. 2002-22, and its first ruling dealing with the permanent retention of an undivided TIC interest in property by a TIC sponsor. The Service considered the issue of whether the co-tenancy agreement creates a partnership. It found that Company’s co-ownership arrangement satisfies all the conditions of Rev. Proc. 2002-22. Most significantly, the Service concluded that an undivided fractional interest in the property will not constitute an interest in a business entity under Treas. Reg. Section 301.7701-2(a) for purposes of qualification of the undivided fractional interest as eligible replacement property under Section 1031(a), notwithstanding the sponsor’s permanent retention of an undivided TIC interest in the property.

I. Priv. Ltr. Rul. 200515007 (December 29, 2004). In this Ruling, the Service granted an extension of time to elect REIT status pursuant to Reg. Section 301.9100-1 and Reg. Section 301.9100-3. The taxpayer was a corporation that sought treatment as a REIT beginning in its first taxable year. It filed a Form 7004 for an automatic extension of time to file a Form 1120-REIT. Due to an unintentional error, the wrong box was checked on the Form 7004 (the box for an extension for filing Form 1120 rather than for Form 1120-REIT). An officer of the taxpayer discovered the mistake a few weeks later and made this request. The Service concluded that the taxpayer had good cause for an extension, and granted the extension through the date the taxpayer would originally have had if there had not been an error on the Form 7004.
J. **Priv. Ltr. Rul. 200517011 (December 8, 2004).** The taxpayer in this Ruling is a company, a State corporation, that intends to elect S corporation status and treat the corporation as a qualified subchapter S subsidiary after acquiring all of the corporation’s outstanding stock. The company owns, leases, and manages nonresidential real estate both directly and indirectly through partnerships and has requested that rents derived from this property not be considered passive investment income under 1362(d)(3)(C)(i). Through employees (some of whom are officer-shareholders) and independent contractors, the company provides various services in leasing and managing the property. Section 1362(d)(3)(C) states that “passive investment income” refers to gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchange of stocks or securities. However, Section 1.1362-2(c)(5)(ii)(B)(2) indicates that “rents” does not include those derived in the active trade or business of renting property where the corporation provides significant services or incurs substantial costs in the rental business. Relevant facts for the determination of an active trade or business of renting property include the number of persons employed to provide services and types and amounts of costs and expenses incurred. Based on the services performed and costs incurred by the taxpayer, the Service concluded that the rents received were not passive investment income.

K. **Priv. Ltr. Rul. 200518033 (February 4, 2005).** The Service set out an equation to determine whether a mortgage loan on an acute care hospital insured by HUD pursuant to Section 242 of the National Housing Act would constitute an, “obligation principally secured by an interest in real property,” under Section 860G(a)(3) and Reg. Section1.860G-2(a)(1)(i)(A). If the value of the land securing the mortgage loan plus the value of real property improvements securing the mortgage loan equaled at least 80 percent of the adjusted issue price of the obligation at the time that HUD approved the loan, then the loan would meet the requirements of Section 860G(a)(3). The value of the land was determined by an appraisal as part of the process of obtaining a commitment from HUD. The value of real property improvements was determined by their actual replacement costs. The Service concluded that mortgage loan met the above requirements and constituted an “obligation principally secured by an interest in real property.”

L. **Priv. Ltr. Rul. 200518038 (January 13, 2005).** In this Ruling, an S corporation with subchapter C earnings and profits that owned, operated, leased and managed commercial real estate requested a ruling that the rental income not be considered passive investment income within the meaning of 1362(d)(3)(C)(i). Under applicable law, rents derived from an active trade or business of renting property are not considered passive investment income. As the inquiring taxpayer corporation performed substantially all services and was responsible for all costs necessary to maintain and operate the property, the Service concluded that the rents received were not passive investment income.

M. **Priv. Ltr. Rul. 200518047 (January 27, 2005).** In this Ruling, the Service determined whether Section 6166 installment payments could be made for decedent’s interests in two partnerships, five properties, one sole proprietorship and one corporation. The level of activity was determinative in differentiating between closely held business assets and passive assets held merely for investment.
The Service concluded that the two properties that had no active development plans were simply passive assets, and did not qualify under Section 6166(b)(1) for Section 6166(a) treatment. The work done by decedent, his employees and agents on three other properties went beyond mere investment management, and qualified as closely held businesses under Section 6166(b)(1)(A). The two partnerships had less than 45 partners and owned property that was deemed to be engaging in a trade or business, thus qualifying as a closely held business under Section 6166(b)(1)(B). However, one property owned by the second partnership was found to be a passive asset, and was not included in the value of the partnership for Section 6166(a) purposes. The corporation had less than 45 shareholders, and it owned and operated some of the properties in which decedent was engaging in a trade or business. Therefore, the corporation was treated as a closely held business under Section 6166(b)(1)(C). The sole proprietorship qualified under Section 6166(b)(1)(A) as a closely held business because the decedent used it to oversee, manage and develop the properties that were engaging in a trade or business. Finally, all of the Section 6166(b) assets were treated as a single integrated business under Section 6166(c).

The Service also concluded that these interests still qualified for installment treatment after being passed to a marital trust for decedent’s spouse. Since decedent’s son and a co-trustee continued to operate these assets after decedent’s death, they remained active trades and businesses. Therefore, these assets held in decedent’s spouse’s gross estate under Section 2044 still received Section 6166(a) treatment.

N. Priv. Ltr. Rul. 200518063 (January 10, 2005). In this Ruling, the Service considered a request for extension of time to elect TRS status for one of the taxpayer’s subsidiaries. Taxpayer was a corporation that elected to be taxed as a REIT. The taxpayer had ownership interests in three corporations that it wished to be treated as taxable TRSs. It had already elected TRS treatment for Corporation C under Section 856(i). Corporation C owned greater than 35 percent of the total voting power and outstanding securities of Corporation A, a second subsidiary of the taxpayer. As a result, Corporation A automatically qualified as a TRS under Section 856(i)(2)(A).

Taxpayer’s third subsidiary, Corporation B, had no such automatic qualification, since it was not more than 35 percent owned by a TRS of the taxpayer. The taxpayer did not make a timely election for TRS status under Section 856(i) because it believed that such status would be automatic, as it was with Corporation A, and because Corporation B did not yet own assets or conduct activities. When the taxpayer realized its mistake, it immediately took steps for relief. Pursuant to Reg. Section 301.9100-1 and Reg. Section 301.9100-3, the Service granted a reasonable extension for the taxpayer to file an election on Form 8875 to treat Corporation B as a TRS.

O. Priv. Ltr. Rul. 200518064 (January 10, 2005). Taxpayer was a corporation that had elected to be treated as a REIT. Taxpayer was the sole general partner in a limited liability partnership (LLP), which held title to taxpayer’s real property. Taxpayer and LLP owned LLC, which provided management services for the property. The income from LLC threatened to create REIT qualification problems for the taxpayer. To avoid such a problem, taxpayer’s
advisor recommended checking the box to treat LLC as a corporation and then electing to treat LLC as a TRS under Section 856(i). Alternatively, taxpayer could form a new entity, transfer some of LLC’s employees, and elect TRS status for the new entity.

The advisor instructed the taxpayer to file the election no more than two months and 15 days after the desired effective date or after creation of the new entity. The taxpayer chose to create a new entity and elect TRS status. However, an officer of the taxpayer misunderstood the advice; he formed the new entity within two months and 15 days of the start of the tax year, but did not file a Form 8875 electing TRS status. The officer thought he could file the form later when he filed Forms 1120 for the REIT and TRS.

Upon realizing the mistake, the taxpayer immediately requested relief pursuant to Reg. Section 301.9100-1 and Reg. Section 301.9100-3. The Service allowed the taxpayer additional time to file a Form 8875 to elect to treat the new subsidiary as a TRS.

P. Priv. Ltr. Rul. 200519007 (March 7, 2005). Taxpayer is a U.S. corporation that planned to invest in and purchase net-leased industrial and commercial real property located outside the United States. The taxpayer would raise capital through an IPO and use the proceeds to fund its investments and purchases. In addition, the taxpayer would form 23 REITs, each a domestic corporation, to facilitate its foreign investment.

Each REIT would operate its business in the “designated currency” of the location in which it invests. The taxpayer would denominate the designated currency for the following: funding for acquiring and improving property, proceeds from dispositions of investments, income from investments (that is, rents, interest and gains), general financial decisions, and transactions between each REIT and its shareholders (including dividends and capital contributions). In addition, each REIT would use the designated currency for its books and records.

The taxpayer sought a ruling that would allow each REIT to use the principles of Reg. Section 1.985-1(c) to determine its functional currency for Section 985 purposes. The Service noted that, absent such a ruling, the REITs would recognize foreign currency gain or loss on every Section 988 transaction, and any QBU of a REIT with a functional currency other than the dollar would be subject to Section 987. In addition, Sections 856(c)(2) and 856(c)(3) do not list foreign currency gain or loss as qualifying income, and currency fluctuations could affect Section 856(c)(4) calculations. These could lead to the REITs losing REIT status if they could not use their designated currencies as functional currencies.

The Service concluded that the taxpayer may use Reg. Section 1.985-1(c)(2)(i) to determine the designated currency for each REIT. Once a REIT adopts its designated currency as its functional currency, it must compute its taxable income or loss in its designated currency and translate its taxable income into dollars using the average exchange rate for the taxable year.

Q. Priv. Ltr. Rul. 200521002 (February 24, 2005). The taxpayer was a private testamentary trust due to terminate at a future date, whose assets consisted mainly of real estate held for investment. The taxpayer wished to exchange real property in a like-kind exchange
under Section 1031, and then transfer the replacement property to a single member LLC (which would continue the investment operations), with the trust holding all the shares. The shares would then be distributed upon termination of the trust, resulting in a de facto partnership between the beneficiaries.

The Service concluded that, since the LLC only had one member (the trust) and would not elect to be taxed as a corporation, the transfer of property from the trust to the LLC would be disregarded, and the trust would be considered the direct owner of the replacement property, as necessitated by the holding requirements of Section 1031(a). The Service also noted that the trust’s termination was set by the decedent’s will and could not be changed, and so concluded that the like-kind exchange was independent of the distribution of property under the termination plan. As a result, the trust was not seen as acquiring the replacement property only to dispose of it pursuant to a pre-arranged plan.

Based on these conclusions, the Service ruled that the termination of the trust and distribution of its assets would not prevent the replacement property from being considered “property held either for productive use in a trade or business or investment,” thus meeting the requirement of Section 1031(a).

R. Priv. Ltr. Rul. 200521014 (February 17, 2005). In this Ruling, the Service applied Section 6166 to the following facts: Decedent’s spouse had formed a trust, containing three other trusts (A, B and C). Trust A was to be funded with assets that qualified for the marital deduction, for the benefit of decedent. Upon decedent’s death, the assets of Trust A would be divided, with some going to Trust B and the rest to Trust C, with their son as the beneficiary. Decedent, her spouse and her son had managed and supervised a proprietorship that had 20 employees and dealt with real estate rentals. Following the death of decedent’s spouse, Trust A was entitled to ownership of three LLCs, each of which owned one of the proprietorship’s properties.

The taxpayer wished to apply Section 6166(a) to the real estate interests in question. The Service relied on Rev. Ruls. 75-365, 75-366 and 75-367 to differentiate between a “trade or business” and merely managing investment property, which would not qualify for Section 6166(a) treatment. The Service concluded that the level of activity for all properties (including activity by agents and employees) went beyond mere passive investment, qualified as a closely held business under Section 6166(b)(1), and therefore qualified for Section 6166(a) installment payments. However, the value of the “closely held business” did not include any of the LLCs’ passive assets.

The taxpayer also requested a ruling that the transfer of assets from Trust A to Trusts B and C following decedent’s death would not accelerate installment payments under Section 6166(g)(A). The Service noted that the executor of the decedent’s spouse’s estate had made a Section 2056(b)(7) election, so that the value of Trust A was included in decedent’s estate (at her
death) under Section 2044. In addition, Section 2044(c) provides that Section 2044(a) property is treated as “passing from the decedent to the recipient of the property.” This qualifies for Section 6166(g)(1)(D) treatment, excluding the transfer from acceleration of installment payments under Section 6166(g). Additionally, Reg. Section 20.2044-1(b) calls for Section 6166(a) treatment of Section 2044 property.

S. Priv. Ltr. Rul. 200525013 (March 22, 2005). This Ruling deals with three issues: (i) whether the special TRS rule of Section 856(d)(8)(A) applied to rents received from a TRS/tenant occupying a unique piece of a property, with no comparable tenant at the same property with which to compare rent; (ii) whether cart rental for use by shopping patrons met the definition of “rent attributable to personal property” under Section 856(d)(1)(C); and (iii) whether certain reimbursements between related entities were counted as realized gross income for Section 856(c)(2) purposes.

The REIT was a corporation engaged in the business of retail and entertainment-oriented shopping centers, community centers and other properties. The REIT was the sole general partner and a limited partner in LP, a limited partnership, which conducted substantially all of the REIT’s business and owned, solely or in joint venture with unrelated third parties, the properties in question. LP also owned Sub 1, a subsidiary of the REIT, which elected TRS treatment under Section 856(i). Sub 1 provided property management services for each joint venture property. Sub 1 had many subsidiaries, each a TRS under the 35 percent rule of Section 856(i)(2), which were tenants in the properties.

1. Related Party Rents

These TRSs and other related entities were tenants under lease at various properties owned by LP. For all but one related tenant, there were other unrelated tenants at the same property, and in the same business, for rental comparison purposes under Section 856(d)(8)(A). However, one subsidiary of Sub 1, a tenant in various properties owned by LP, was engaged in a business unique to those properties. There were, however, multiple unrelated tenants engaged in other service businesses at each of these properties.

In its conclusion, the Service mentioned Congress’s concern about maintaining an arms-length relationship in dealings between a REIT and its TRS. However, Congress did not disqualify a TRS from using a comparable rent standard to avoid the related party rent rules of Section 856(d)(2)(B) if it occupied space that was unique to the property. Instead, such a TRS could satisfy the comparable rent standard of Section 856(d)(8)(A) if the rent is substantially comparable to rents paid by unrelated tenants for comparable space in the same geographic area.

2. Cart Rentals

Each property owner provided shopping carts to general public patrons by using a coin operated vending device to release the carts. The Service noted that the cart rental was closely related to the lease of real property to the each of the tenants, since the carts helped
facilitate sales to customers. The Service therefore concluded that the amounts received by the property owners from the cart rental operations would be rent attributable to personal property that is leased in connection with the lease of real property under Section 856(d)(1)(C). However, pursuant to Section 856(d)(1)(C), the cart rental amounts could not exceed 15 percent of the total rent for the taxable year attributable to both the real property and personal property leased in connection with real property.

3. **Mall Expense Reimbursements**

   For purposes of efficiency, control and cost savings, the administration of payroll and benefits for the individual employees of the REIT and its affiliates were centralized in two related entities: LP3, a limited partnership owned indirectly by LP, and Corporation B, a TRS. LP3 also provided property management services to the wholly owned properties (Sub 1 provided property management services for the joint venture properties).

   Due to Sub 1’s property management obligations for the joint venture properties and LP3’s payroll and human resource responsibilities, the two entities entered into an expense sharing and cost reimbursement arrangement. Under this agreement, LP3 would perform many of the administrative duties required of Sub 1 in its property management agreement with the joint venture property owners. In addition, Sub 1 agreed to reimburse LP3 for many of the expenses that would be incurred under the arrangement.

   LP3 represented that: i) the reimbursement amount would not exceed the actual amount of expenses incurred by LP3 on behalf of Sub 1, ii) LP3 would not profit from the reimbursements, and iii) LP3 would not deduct any expenses that were offset by reimbursements. In addition, the Service noted that Sub 1 did not compensate LP3 for a service that it was in the business of providing to others. Reimbursements made under a similar arrangement in Rev. Rul 84-138 were described as repayments of advances made on behalf of the entity receiving the services. The Service therefore concluded that LP3 did not realize gross income for Section 856(c)(2) purposes upon receipt of the reimbursements.

T. *Priv. Ltr. Rul. 200528021 (April 8, 2005).* Taxpayer is an S corporation that wanted to convert to an LLC, for business reasons. As a newly formed LLC, it would elect treatment as an association taxable as a corporation, and would never exist as a partnership for Federal income tax purposes. The taxpayer sought to qualify this conversion as a reorganization pursuant to Section 368(a)(3)(A).

   The new LLC would be essentially the same entity as the old S corporation. The fair market value of the membership interests in the LLC would be the same as the fair market value of the stock in the corporation. No shareholder would sell or dispose of any shares; neither the corporation nor the LLC would redeem or reacquire any shares; and there would be no new shareholders or members. In addition, the new LLC would take all the assets, which it would not sell, and assume all the liabilities of the old corporation.
Given these and other facts, the Service concluded that the conversion to an LLC, to be treated as an association and taxed as a corporation, qualified as a reorganization under Section 368(a)(1)(F). No party would recognize any gain or loss; the basis in all assets and shares would be carried over; and holding periods would be tacked. In addition, the new entity would retain the S corporation status for tax purposes.

VIII. FIELD ATTORNEY ADVICE

A. Field Attorney Advice 20044101F (July 29, 2004). In this FAA, the Service ruled that if a pipeline is personal property under state law, then it is of like-kind to other property that is either in the same General Asset Class or Product Class. The Service noted that it is well-settled that state law determines the proper classification of property as real or personal for purposes of Section 1031. The Service noted further that if the pipelines are personal property under state law, they are of like kind if they are either of like kind or like class. Under the Regulations, depreciable personal property is like kind or like class if the exchanged properties are either within the same General Asset Class or within the same Product Class.

B. Field Attorney Advice 20050203F (November 30, 2004). In this FAA, the Service concluded that a reverse exchange did not qualify under Section 1031 for a number of reasons. Firstly, the Service noted that because the replacement property was acquired by the intermediary prior to the effective date of Rev. Proc. 2000-37, the exchange would not qualify under the reverse like-kind exchange “safe harbor” established by Rev. Proc. 2000-37. Further, even if the transaction had followed the effective date of Rev. Proc. 2000-37, it would still fail to qualify as a tax-free like-kind exchange because the taxpayer did not satisfy the 180-day time limit of Rev. Proc. 2000-37. Finally, the Service used a “benefits and burdens” analysis to conclude that under federal income tax principles, the taxpayer was the beneficial owner of the replacement property prior to formally acquiring it pursuant to the exchange. Consequently, Section 1031 would not apply.

IX. CASES

A. Estate of Abraham v. Comm’r, 408 F.3d 26 (1st Cir. 2005). The First Circuit affirmed a decision by the Tax Court that included assets transferred by the decedent to several family limited partnerships in the decedent’s gross estate because she retained beneficial enjoyment of those assets under Section 2036(a)(1).

Ida Abraham’s daughters, acting as her court-appointed guardians, entered into a court-approved plan to rearrange her financial affairs to reduce estate taxes. The plan required that three pieces of Ida’s commercial real estate (which generated steady rental income) be transferred to three separate family limited partnerships, each having a corporate general partner that would be owned by a trust for Ida’s benefit. The state court decree that authorized the creation of the partnerships also provided that Ida’s needs for support must be satisfied from the partnerships before the children could receive their proportionate shares of income distributions.
The estate argued that the partnership's payments for Ida's maintenance never exceeded what she was legally entitled to by virtue of her ownership of a substantial percentage of the partnership interests. The Court rejected this argument, noting that Section 2036(a)(1) is applicable because the daughters, as guardians for their mother, had the option to divert all of the partnership income to Ida's maintenance, whether or not the option was exercised. Therefore, the Tax Court and the First Circuit agreed that the decedent had continued to enjoy the right to support and maintenance from all the income of the partnerships.

Next, the estate argued that Ida sold a remainder interest in the partnership to her family while retaining a life estate, and the value of only the remainder interests should be measured for Section 2036 purposes. The Court rejected this argument because the estate provided no evidence to suggest that the parties ever contemplated the transfers as sales by Ida of remainder interests in the partnerships.

The Court held the "bona fide sale for an adequate and full consideration" exception to Section 2036 could not apply because the estate did not prove that the daughters paid adequate consideration for their partnership interests. In addition, the daughters paid the partnership, and not their mother, for their partnership interests.

B. Estate of Bongard v. Comm'r, 124 T.C. No. 8 (March 15, 2005). The Tax Court held that stock in an operating company that was transferred by Wayne Bongard to an LLC was not includible in his gross estate under Code Section 2036(a) because the transfer was a bona fide sale for full and adequate consideration. However, the Court's second holding was that membership units in the LLC transferred by Bongard to a family limited partnership were includible in his estate under Section 2036(a). The transfer did not qualify for the bona fide sale exception to the retained interest rules of Section 2036.

Bongard incorporated Empak, Inc. in 1980 and served as its president, sole director and sole shareholder. Six years later, he established an irrevocable stock accumulation trust (ISA Trust) for the benefit of his children and funded it with approximately 15% of his Empak stock. Empak made and manufactured compact disc "jewel boxes" and other electronic packaging materials, and was worth well over $100 million. In the mid-nineties, Empak's corporate attorneys determined that pooling the Empak stock owned by Bongard and ISA Trust in a holding company would better position Empak for a corporate liquidity event, which was necessary to raise capital and remain competitive. To this end, in late 1996, Bongard and ISA Trust capitalized WCB Holdings, LLC by transferring to it their respective shares of Empak stock. In exchange, they received WCB Holdings class A and class B membership units in proportion to the value of the stock they transferred.

At about the same time, Bongard formed the Bongard Family Limited Partnership (BFLP). To capitalize BFLP, Bongard transferred all of this WCB Holdings class B (nonvoting) membership units in exchange for a 99% limited partnership interest, and ISA Trust transferred a portion of its WCB Holdings class B membership units to BFLP in exchange for a 1% general partnership interest. Several months after WCB Holdings was capitalized and BFLP was created, Bongard transferred some of his class A membership units in WCB Holdings to three
trusts that he had established – one for his children, one for his grandchildren, and a third that was an inter vivos QTIP. As a result of this transfer, Bongard no longer had a controlling interest in WCB Holdings.

About one year later, on December 10, 1997, Bongard made a gift of a 7.72% limited partnership interest to his wife, in consideration for a post-nuptial agreement. He made no other gifts of his BFLP interest before his sudden death on a hunting and business trip in Austria in 1998. Bongard was only 58 years old at his death and appeared to be in good health. His estate reported a tax liability of $17M. The government’s notice of deficiency was over $50M.

Two issues were presented to the tax court. First, whether the shares of Empak that Bongard transferred to WCB Holdings were included in his gross estate pursuant to Sections 2035 and 2036. Second, whether the WCB Holdings membership units Bongard transferred to BFLP were included in his gross estate under the same Code sections. Of the 17 judges who heard the case, 16 agreed that Section 2036 did not apply to Bongard’s transfer of the Empak stock to WCB Holdings because the bona fide sale exception was met. On the other hand, 14 out of 17 judges agreed that Bongard did retain an interest in the WCB Holdings units that he transferred to BFLP.

Section 2036 includes property in a decedent’s estate if the decedent made a transfer of the property and retained the possession or enjoyment of the property. The bona fide sale for adequate and full consideration is an exception to the application of 2036. The Court stated that the exception is met where there are “legitimate and significant nontax reasons for creating the partnership, and the transferors received partnership interests proportionate to the value of the property transferred”. This test is different from some of the past 2036 cases in the following respects. First, the traditional “business purpose test” was replaced with a “significant nontax purpose” test. The Court stated there must be “an actual motivation, not just a theoretical justification” for the transfer to the LLC. In the past, courts had agreed that a plausible business purpose was sufficient for the sale to be bona fide. Second, the “full consideration test” is met if the transferor’s interest in the new entity is proportionate to the property contributed. In addition, assets must be properly credited to the partner’s capital account. This test veers away from the “recycling of value” and “gift on formation” arguments that were applied in past Tax Court cases (the concurring opinions disagreed with the formulation of this test and argued the question should be whether the transferor receives consideration equal to the value of the property transferred).

The Tax Court agreed with the Estate that there was a significant and legitimate nontax reason for the transfer of the Empak shares to WCB Holdings; namely, to position Empak for a corporate liquidity event. The Tax Court next held that Bongard and the ISA Trust each received an interest in WCB Holdings that represented adequate and full consideration reducible to money value, stressing that Bongard and ISA Trust received interests in WCB Holdings proportionate to the number of shares each contributed. The Court’s holding that Section 2036(a) did not apply precluded the application of Section 2035 to the gifts Bongard made of WCB Holdings to the three trusts within three years of his death.
The Tax Court next considered whether the bona fide sale exception applied to Bongard’s transfer of WCB Holdings membership units to BFLP, and held that it did not. Bongard had written a letter to his family explaining the rationale for the creation of BFLP. He listed several benefits the entity would provide; namely, the entity would serve as a vehicle for a gifting program, it would facilitate transfers to Bongard’s spouse in consideration for a postmarital agreement, it would provide creditor protection, greater flexibility as compared to trusts, and it would provide tutelage to Bongard’s children with respect to managing family assets.

The Court rejected each of these reasons, stating that BFLP was not needed as a vehicle for gifting, as Bongard made gifts of his WCB Holdings units and never made a gift of partnership interests to his children. Similarly, the Court said Bongard could have just as easily transferred WCB Holding units (as opposed to BFLP interests) to his spouse to satisfy his obligations under the postmarital agreement. Next, the Court said BFLP was not needed for creditor protection, as WCB Holdings LLC already offered such protection. In addition, the Court reasoned that Bongard had no particular aversion to trusts, as he created several throughout his life and gifted WCB Holdings interests to them. Lastly, the Court said that the management of assets purpose was not met, as BFLP never diversified its assets.

Because BFLP failed the legitimate and significant nontax purpose test, the court did not need to consider whether there was full and adequate consideration. The Court then determined that Bongard retained possession or enjoyment of the transferred property under an implied agreement. In reaching this result, the Court noted that Bongard controlled whether BFLP could transform its sole asset, the class B WCB Holdings units, into a liquid asset. As CEO and sole member of Empak’s board of directors, he determined when Empak redeemed its stock. By not redeeming the WCB membership units held by the BFLP, Bongard ensured that BFLP would not engage in asset management. In this way, he exercised practical control over BFLP. Thus, the Tax Court concluded that Bongard’s gross estate included the value of the WCB Holdings class B membership units held by BFLP on Bongard’s death. The Court also found that Code Section 2035(a) required his estate to include the 7.72% limited partnership interest Bongard transferred to his wife within three years of his death. The dissenting opinion points out several factual, legal and logical flaws in the majority’s analysis, and is particularly concerned by the fact that the majority does not even consider the case of Byrum, which is controlling Supreme Court precedent in 2036(a) cases.

C. Estate of Jelke v. Commissioner, T.C. Memo 2005-131. The Tax Court resolved a dispute between the IRS and a decedent’s estate regarding the discount for built-in capital gain applicable to the value of the estate’s holding company stock.

At the death of Frazier Jelke III, his revocable trust owned a 6.44% interest in Commercial Chemical Corporation ("CCC"), which ceased active business operations in 1974 and existed to hold and manage investments for the benefit of its shareholders. Trusts for Jelke’s relatives owned the remaining interests in CCC. The primary objective of CCC’s portfolio was long-term capital growth, resulting in unrealized capital gains of approximately $51 million.
The IRS and the estate agreed that a discount for the built-in capital gain tax is proper, but the parties disagreed as to the amount. The IRS argued that the built-in capital gain liability of CCC should be discounted to reflect when it is reasonably expected to be incurred, rather than reducing the stock's value by the full amount of the built-in capital gain tax liability as of the date of death, which is what the estate contended.

Before deciding on the proper approach for taking the capital gain liability into account, the Court undertook a complete review of the judicial history of the valuation discount for built-in capital gain. Prior to 1986, no reduction for built-in capital gain was allowed because, under the General Utilities doctrine, corporations could avoid the capital gain tax by distributing the assets to the shareholders. Since the repeal of the General Utilities doctrine, the Tax Court’s approach to adjusting the value of a company to account for built-in capital gain tax liability has been inconsistent and has often been overruled on appeal.

For example, the Court of Appeals for the Fifth Circuit, in reversing the Tax Court in Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002), held that the use of an asset-based approach to value assets generally assumes a liquidation of the corporation on the valuation date, requiring a dollar-for-dollar reduction for the entire built-in capital gain liability as a matter of law. In that case, however, the Court of Appeals indicated that the likelihood of liquidation would be relevant in assigning weights to the asset and income approaches of valuation where both methods were used.

The estate relied on the Fifth Circuit’s holding in Dunn in contending that the asset-based valuation method requires an assumption that the assets were sold on the valuation date, regardless of whether the company was contemplating liquidation. The Tax Court distinguished Dunn by reasoning that it applied to a majority interest in a company, whereas here only a small minority interest was at issue. Jelke’s 6.44% interest in CCC would be insufficient to cause liquidation.

The approach taken by the Service’s expert was to calculate the built-in gains tax liability by determining when it would likely be incurred. From CCC’s historical data, the expert determined that the average annual turnover of the company’s assets was 5.95%. Using this rate, the appraiser determined that CCC’s capital gain tax would be incurred over a 16.8-year period. He then divided the $51 million capital gain tax liability by 16 years to arrive at the average capital gain tax liability that would be incurred each year, and discounted this liability to present value using the average annual rate of return for large cap stocks, the type held by CCC.

The Tax Court said that a hypothetical buyer of CCC is investing in a securities mix, much like a mutual fund, and would be unable to liquidate the underlying securities. In addition, there was no intention among the trusts or family members to liquidate CCC. The Court adopted the IRS expert’s methodology and figures, resulting in an 11.2% reduction in value for built-in capital gain tax liability. The Court then allowed a 10% discount for lack of control and a 15% lack of marketability discount.
D. Johnson v. Commissioner, 95 A.F.T.R.2d 2005-2638 (5th Cir. 2005), aff'g 87 T.C.M. (CCH) 971 (2004). The Fifth Circuit affirmed the Tax Court's holding that H. Dee Johnson had to offset NOLs from a bad debt with cancellation of debt income from a bankruptcy discharge, even though the cancellation of debt did not count as taxable income pursuant to Section 108(a).

When Johnson entered bankruptcy in 1991, he took $153,000 in debts payable to him and transferred the same to the bankruptcy estate. The debts soon became worthless, resulting in an operating loss of $153,000. He also transferred two properties to the estate, one encumbered with a $262,128 mortgage balance, and the other with $128,572 still owed. Both properties were mortgaged to Citicorp Mortgage, Inc. (CMI). CMI obtained relief from the automatic stay and foreclosed on its mortgages. It sold the two properties for a combined $193,200, leaving an unrecovered deficiency of $197,500. CMI did not file proofs of claims against the bankruptcy estate for this amount.

A few months later, the bankruptcy court granted Johnson a discharge, which released him from all dischargeable debts. In 1995 the bankruptcy court accepted a final report showing that the estate had used liquidation proceeds to cover most of the debt, and left $4,916 of the allowed debts discharged and unpaid. In 1994 and 1995 Johnson deducted the full amount of his NOLs from his income taxes.

The Court held that Johnson must offset the bad debt with the unrecovered deficiency from CMI. Although debt forgiveness is excluded from gross income under Section 108(a), it must still be used to offset the NOLs under Section 108(b). It was of no consequence that CMI did not file a proof of claim. According to Bankruptcy Code Section 727, because the CMI debts arose before Johnson received the order of relief, they were discharged by the order. Consequently, the discharge met the requirements of occurring in a Title 11 case pursuant to Section 108(d)(2), thereby triggering Sections 108(a) and 108(b).

The Court added that CMI had liens on the property, and did not need to file a proof of claim to protect those liens. Although failure to file a proof of claim prevents a creditor from collecting from the estate, the creditor may still enforce security interests in estate property subject to a lien. CMI did so by foreclosing on the properties. Because CMI failed to file a proof of claim, it forfeited the right to pursue the unreserved deficiency. Because this occurred before the order of relief, this amount was subsequently discharged by the order.

E. Strangi v. Comm'r, 96 A.F.T.R. 2d 2005-5048 (5th Cir. 2005), aff'g Estate of Strangi v. Comm'r, T.C. Memo 2003-145. The Fifth Circuit affirmed the Tax Court's application of Section 2036(a)(1) in requiring a decedent's estate to include assets transferred to a family limited partnership immediately before the decedent's death. This marks the second time the Fifth Circuit has ruled on Strangi, which is one of the most widely cited family limited partnership cases.

Albert Strangi (as represented under a power of attorney by his son-in-law, Robert Gulig) contributed about $10 million of assets, representing 98% of his total wealth, to a newly formed family limited partnership ("SFLP") in exchange for a 99% limited partner interest. About 75%
of the assets Strangi transferred to SFLP were marketable securities or other liquid assets. The balance consisted of limited partnership interests and real estate, including Strangi’s personal residence.

Strangi also contributed $50,000 to Stranco, Inc., the 1% corporate general partner, in exchange for a 47% interest in that entity. Strangi’s four children contributed just over $50,000 for an aggregate 53% interest in Stranco. A 0.25% stock interest in Stranco was shortly thereafter given to a charity.

At the time of these transfers, Strangi was terminally ill. He died approximately two months after the transfers were completed. Prior to his death, Stranco made two distributions from SFLP to Strangi, in the aggregate amount of $14,000, “to meet his needs and expenses”. After Strangi’s death, his estate received distributions of over $3 million from SFLP to pay estate taxes, funeral and administration expenses. At the same time, Stranco received distributions proportionate to its 1% interest in SFLP.

The first time Strangi appeared before the Tax Court, the Tax Court held that the family limited partnership created by Strangi was valid under state law and had to be recognized for Federal estate tax purposes. The Tax Court also held that restrictions in the partnership’s buy-sell agreement that affected the estate tax valuation of the partnership would not be disregarded under Section 2703(a) and that Strangi’s initial transfer of assets to the partnership was not a taxable gift. The IRS argued during trial, but did not raise in its brief, that the assets Strangi transferred to SFLP should be brought back into his estate under Section 2036, but the Tax Court held the argument was raised too late. The Fifth Circuit concluded the Tax Court should have considered the Section 2036 argument and remanded the case. On remand, the Tax Court concluded the non-discounted value of the assets transferred to the SFLP should be included in Strangi’s estate under both 2036(a)(1) and 2036(a)(2).

Section 2036(a)(1) includes previously transferred assets in an individual’s gross estate if he or she retained the possession or enjoyment of the property, or the right to the income therefrom. If the individual retains the right, either alone or in conjunction with any other person, to designate the persons who will possess or enjoy the property of the income therefrom, the transferred property is included in the individual’s estate under Section 2036(a)(2). If, however, the transfer of assets is a bona fide sale for an adequate and full consideration, Section 2036 does not apply.

In upholding the Tax Court’s decision, the Fifth Circuit concluded that Strangi and the other shareholders of Stranco had an implicit agreement that allowed Strangi to retain the enjoyment of his property after the transfer to SFLP. The partnership made distributions to Strangi to pay his expenses during life and to pay his estate expenses at death. In addition, Strangi continued to live in his residence after it was transferred to the partnership, and payment of rent was deferred until after Strangi’s death. In the eyes of the Fifth Circuit, these facts evidenced the implied agreement. The Fifth Circuit found that, because Section 2036(a)(1) applied, it was not necessary to address Section 2036(a)(2).
The Fifth Circuit next addressed the bona fide sale exception to Section 2036. The IRS conceded that the “full and adequate consideration” prong of the exception was met because Strangi received an interest in the partnership proportionate to the assets he transferred to it, and the partnership formalities were followed. The Appeals Court stated that, in order to pass the “bona fide sale” prong of the exception, there must be a substantial business or other non-tax purpose for contributing the assets to the partnership. The estate proffered five different non-tax rationales for the creation of SFLP, and both the Tax Court and the Fifth Circuit (stressing that it was using a clearly erroneous standard) rejected each rationale as implausible. Therefore, the bona fide sale exception did not apply, and the full value of the $10 million in assets transferred to SFLP were included in Strangi’s estate.

F. Teruya Brothers Ltd. v. Comm’r, 124 T.C. No. 4 (Feb. 9, 2005). Teruya Brothers Ltd. (“Teruya”) owned 62.5% of the common shares of Times Super Market Ltd. (“Times”). Teruya engaged in separate exchanges of two of its properties (“Property 1” and “Property 2”), as follows. Teruya entered into “exchange agreements” with a qualified intermediary (“QI”), whereby QI agreed to complete the exchange of Property 1 and Property 2 for like-kind replacement properties pursuant to Internal Revenue Code Section 1031. Pursuant to its agreement with QI, Teruya transferred its interests in Property 1 and Property 2 to QI, and QI then sold them to unrelated third parties. QI applied the proceeds from the sale of Property 1 and Property 2, as well as additional cash from Teruya, to purchase like-kind replacement properties for Teruya from Times, a related party.

The Court held that the transactions were structured to avoid the purposes of Section 1031(f) governing like-kind exchanges between related parties. The transactions were the economic equivalent of direct exchanges of the properties between Teruya and Times, followed by Times’ sales of the properties to unrelated third parties. The interposition of a qualified intermediary in these transactions does not change the result. Consequently, the Court disqualified the exchanges from like-kind exchange treatment under Section 1031(f).