

1-1-2015

# The Estate Planner's Income Tax Playbook

Samuel A. Donaldson

*Georgia State University College of Law, [sdonaldson@gsu.edu](mailto:sdonaldson@gsu.edu)*

Follow this and additional works at: [https://readingroom.law.gsu.edu/faculty\\_pub](https://readingroom.law.gsu.edu/faculty_pub)



Part of the [Estates and Trusts Commons](#), [Taxation-Federal Commons](#), and the [Tax Law Commons](#)

---

## Recommended Citation

Samuel A. Donaldson, The Estate Planner's Income Tax Playbook (2015)

This Unpublished Paper is brought to you for free and open access by the Faculty Publications at Reading Room. It has been accepted for inclusion in Faculty Publications By Year by an authorized administrator of Reading Room. For more information, please contact [mbutler@gsu.edu](mailto:mbutler@gsu.edu).

# The Estate Planner's Income Tax Playbook

By  
Samuel A. Donaldson

Professor of Law  
Georgia State University  
Atlanta, Georgia

Senior Counsel  
Perkins Coie LLP  
Seattle, Washington

The American Taxpayer Relief Act of 2012 ("ATRA") made federal income tax planning for high-net worth individuals and their beneficiaries arguably as important (and sometimes, more important) as federal wealth transfer tax planning. These materials address the most common federal income tax issues estate planners face, with an emphasis on planning traps, planning opportunities, and recent developments.

## I. A Look at the Federal Income Tax Landscape for 2015

### A. Individual Income Tax Rates for 2015 (from a format originally prepared by Crowe Horwath):

Taxable Income exceeding		2015 Federal Income Tax Rates for Individuals			
Unmarried	Joint	Ordinary Income	Adjusted Net Cap Gain* & Qualified Dividends	Medicare Surtax on Earned Income**	Medicare Surtax on Net Investment Income
\$0	\$0	10%	0%	2.9%	0%
\$9,225	\$18,450	15%			
\$37,450	\$74,900	25%	15%		
\$90,750	\$151,200	28%			
\$189,300	\$230,450	33%			
AGI over \$200,000***	AGI over \$250,000***			3.8%	3.8%
\$411,500	\$411,500	35%			
\$413,200	\$464,850	39.6%	20%		

\* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).

\*\* Includes the employer contribution of 1.45% (section 3111(b)(6)), individual contribution of 1.45% (section 3101(b)(1)), and additional tax of 0.9% for adjusted gross income over \$200,000 for an unmarried individual and \$250,000 on a joint return (section 3101(b)(2), added by the Patient Protection and Affordable Care Act for years after 2012).

\*\*\* Note too that unmarried individuals with adjusted gross incomes in excess of \$254,200 and joint filers with adjusted gross incomes in excess of \$305,050 are subject to the phase-out of both personal exemptions and itemized deductions.

B. **Observations from the Table**

1. **Income Tax Brackets Largely Unchanged.** ATRA made the 10% rate bracket permanent, along with the reduced brackets of 25%, 28%, and 33% (those were set to revert to 28%, 31%, and 36%, respectively). The 35% bracket continues for individuals, but not for estates and not for trusts. And the 39.6% bracket returns as the maximum marginal tax rate for individuals, estates, and trusts. Curiously, Congress set the top individual rate bracket to start with taxable incomes in excess of \$400,000 (for singles) and \$450,000 (for joint filers), perhaps giving little attention to the fact that the inflation adjustments to the 35% bracket were very close to these figures. As a result, the 35% bracket for unmarried taxpayers is ridiculously thin (it only covers \$1,650 of taxable income in 2014!), reminiscent of the tax brackets used for estates and trusts.
2. **Corporate Tax Rates Unchanged.** ATRA did not change the corporate tax rates under §11. Thus the maximum tax rate on the taxable income of C corporations remains 35%, and even that rate only applies to corporations with over \$18 million in taxable income. For most closely-held C corporations, the 34% rate is the top bracket with which to be concerned.
3. **Don't Forget the 3.8% Surcharge.** The preferential rates for adjusted net capital gain applicable in 2012 (0% for taxpayers in the 10% and 15% brackets; 15% for other taxpayers) continue, but ATRA imposed a new 20% rate applicable to taxpayers in the 39.6% bracket. When one factors in the 3.8% net investment income surcharge under §1411, however, the real tax rate on adjusted net capital gains for these taxpayers is 23.8%. Also, the preferential rates for net capital gain continue to be applied to "qualified dividends," and this too is now "permanent."

C. **Extenders.** In addition to make a number of "permanent" changes to the federal income tax, ATRA contained a number of "extenders" that postponed the sunset of many important rules until the end of 2013. On December 19, 2014, the President signed the Tax Increase Prevention Act of 2014 (the "TIP Act"), which retroactively reinstated most of the provisions that expired at the end of 2013, but only through 2014. Absent action this year, then, several important tax benefits will be unavailable.

1. **Above-the-Line Deduction for Teachers' Classroom Expenses.** For 2014, K through 12 teachers could continue to deduct up to \$250 of unreimbursed expenses in determining adjusted gross income. The expenses must relate to books, equipment, supplies (except for nonathletic supplies used in health or P.E. courses—read "condoms"), or computer equipment and related services or software.

2. **Exclusion for Discharges of Debt on Principal Residence.** In 2007 Congress created a new exclusion for “qualified principal residence indebtedness” (QPRI), defined as up to \$2 million of “acquisition debt” (any debt used to buy, build, or improve a principal residence). A taxpayer need not be insolvent to qualify for this exclusion, but the exclusion will not apply if the debt is discharged on account of services performed for the lender or for any other reason “not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.” The taxpayer’s basis in the principal residence must be reduced (but not below zero) by the amount excluded from gross income under this rule. It was set to expire at the end of 2013 but was continued through 2014.
3. **Deduction of Mortgage Insurance Premiums.** Legislation in 2006 created an itemized deduction for premiums paid or accrued on qualified mortgage insurance. Generally, qualified mortgage insurance is mortgage insurance obtained in connection with acquisition debt on a qualified residence that is provided by the Veterans Administration, the Federal Housing Administration, the Rural Housing Administration, or certain private providers. The deduction was set to expire at the end of 2013 but was extended to include premiums paid or accrued in 2014.
4. **Sales Tax Deduction.** For 2014 only (uh-huh), individuals could continue to elect to deduct either state and local income taxes or state and local general sales taxes. Taxpayers electing to claim their sales taxes may deduct either the actual sales tax paid (as substantiated by all those receipts accumulated in a shoebox) or an amount determined under tables to be prescribed by the Service. The chief beneficiaries of this election are taxpayers living in states without an income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. One suspects Congress will continue to extend this perk.
5. **50% Bonus Depreciation.** Under §168(k), depreciable tangible personal property and computer software acquired and first placed in service in 2014 was eligible for an additional up-front depreciation deduction equal to the 50% of the asset’s adjusted basis after taking into account any §179 election made with respect to the property. The regular depreciation deductions would then be computed based on whatever basis remains after the §179 election and the 50% bonus. This bonus 50% allowance was also available for alternative minimum tax purposes. The 50% bonus does not apply to intangibles amortized under §197 (with the limited exception of computer software), or start-up expenses amortized under §195. The bonus also does not apply to assets with a class life in excess of 20 years.

We have seen this bonus expire before, only to be resuscitated. Perhaps the benefit will continue into 2015.

6. **Expanded Limitations for Contributions of Qualified Conservation Real Property.** Prior to 2006, a contribution of qualified conservation real property to a public charity was treated the same as any other contribution to public charity: to the extent the property was capital gain property in the hands of the donor, the most that could be deducted in any one year was 30% of the taxpayer's contribution base (generally, adjusted gross income) with a carryover of up to five years. Legislation in 2006 permitted the current deduction of such contributions up to 50% of the taxpayer's contribution base, and with a carryover of 15 years. Moreover, the 50% limitation was increased to 100% in the case of "qualified farmers and ranchers" (those whose gross income from farming or ranching business exceeds 50% of their total gross incomes), provided the property is restricted to remain generally available for agriculture or livestock production. These expanded limitations were going to expire but were extended through 2014. Absent extension of the expanded limitations, donations of qualified conservation real property will be less attractive in 2015.
7. **§179 Expensing Election.** The dollar limitation on the §179 expensing election continued at \$500,000 for 2012, 2013, and 2014. (Special thanks to Congress for reinstating the \$500,000 limitation for 2014 on December 19, 2014. Throughout 2014, taxpayers were led to believe the maximum §179 election amount was \$25,000. As with much in life, in this case 'twas better to be lucky than good.) Anyway, as in 2011, the \$500,000 maximum was not reduced until the total amount of §179 property purchased and placed in service during the taxable year exceeds \$2 million. Supposedly, the dollar limitation will drop to \$25,000 in 2015, with a phase-out that begins once the total amount of §179 property purchased and placed in service during the taxable year exceeds \$200,000. We've lived under similar threats for many years, however, and we have yet to see a return to the \$25,000 limitation. No doubt some are banking on another annual renewal of the large expensing limitations.
8. **Above-the-Line Deduction for College Tuition.** The above-the-line deduction for "qualified tuition and related expenses" continued through 2014. The deduction limit remained at \$4,000, and the full deduction is available only to those taxpayers with adjusted gross incomes of \$65,000 or less (or \$130,000 for married taxpayers filing jointly). Individuals with adjusted gross incomes in excess of \$65,000 but not more than \$80,000 (and joint filers with adjusted gross incomes in excess of \$130,000 but not more than \$160,000) could claim a maximum deduction of \$2,000. A

taxpayer still cannot claim both the deduction and the § 25A credits.

9. **Qualified Charitable Distributions from IRAs.** As in past years, individuals age 70½ or older in 2014 could exclude from gross income up to \$100,000 in “qualified charitable distributions” from either a traditional IRA or a Roth IRA. Such distributions are not deductible as charitable contributions, but the exclusion from gross income represents a better result over prior law. Under prior law, the retiree had to include a minimum distribution in gross income but could donate the amount to charity and claim a deduction under §170. The income tax deduction was subject to the overall limitation on itemized deductions, §68, as well as the other limitations applicable to all charitable contributions under §170. In many cases, therefore, the income tax deduction did not offset completely the amount included in gross income even though the entire distribution was paid to charity. The current rule should appeal to those required to take minimum distributions that have sufficient funds from other sources to meet their living needs. A qualified charitable distribution is any distribution from an IRA made by the trustee directly to a public charity (i.e., one described in §170(b)(1)(A)) to the extent such distribution would be includible in gross income if paid to the account holder. The distribution may be made on or after the date the account holder reaches age 70½.
10. **100% Exclusion on Gains from Sales of Section 1202 Stock.** We all know that § 1202(a)(1) generally excludes half of the gain from the sale or exchange of “qualified small business stock” (generally, stock in a domestic C corporation originally issued after August 10, 1993, but only if such stock was acquired by the shareholder either as compensation for services provided to the corporation or in exchange for money or other non-stock property, and only if the corporation is engaged in an active business and has aggregate gross assets of \$50 million or less) held for more than five years. The other half of such gain is subject to a preferential tax rate of 28 percent under §1(h)(1)(F). In effect, then, the entirety of such gain is taxed at a rate of 14 percent (half of the gain is taxed at 28 percent, half of the gain is not taxed at all). But for qualified small business stock acquired in 2013 and 2014, a 100% exclusion applied. This gives §1202 some much-needed bite. Of course, it won’t be until 2019 before taxpayers who purchased stock in 2014 begin to feel the benefit of this increased exclusion.
11. **Stock Basis Adjustments for Charitable Contributions By S Corporations.** When an S corporation contributes property to charity, the corresponding charitable deduction, like all deduction items, passes through to the shareholders. Generally, a shareholder’s basis in S corporation stock is reduced by the amount of deductions passing through, but prior law

provided that an S corporation's charitable contribution will only cause a shareholder's stock basis to be reduced by the shareholder's pro rata share of the adjusted basis of the contributed property. Thus, for example, if an S corporation with two equal shareholders donated to charity real property worth \$100 in which the corporation's basis was \$40, each shareholder could be eligible to claim a \$50 charitable contribution (half of the \$100 value) while only reducing stock basis by \$20 (half of the \$40 basis). ATRA revived this rule and extended it through 2013, and the TIP Act extended it through 2014. This offered a tremendous benefit to S corporation shareholders, especially where the contributed property would have triggered liability for tax under §1374 as built-in gain property. Charitable contributions of such property do not trigger the §1374 tax, and now also have the chance to carry out a fair market value deduction to the shareholders at a cost equal only to the basis of the contributed property.

12. **Five-Year Recognition Period for S Corporation Built-in Gains Tax.** When a C corporation makes an S election, the §1374 tax looms. This corporate-level tax applies to any "net recognized built-in gains" during the "recognition period" (generally, the first ten years following the former C corporation's subchapter S election). For 2009 and 2010, however, the recognition period was shortened to seven years. Then, for 2011 and 2012, the recognition period was shortened to five years. ATRA extended the five-year recognition period through 2013, and the TIP Act extended it through 2014. So if the corporation made its S election effective for 2009, any net recognized built-in gains in 2014 will not be subject to the tax. Curiously, however, any net recognized built-in gains in 2015, the seventh year of S corporation status, would be subject to the tax.

## II. **Flavors of Gain and Loss: Ordinary Income and Loss v. Capital Gain and Loss**

- A. **Flavors of Income and Loss.** Though all people are created equally, not all income is taxed equally. Section 1(h) sets forth a series of preferential tax rates for so-called "net capital gain." Very generally, a taxpayer will be subject to the lower rates of §1(h) on gains from the sale or exchange of "capital assets" held for more than one year. Accordingly, upon any disposition where a taxpayer recognizes gain, one must "characterize" (or "flavor") the gain as either ordinary income or capital gain. Likewise, because capital losses are deductible generally to the extent of capital gains, if a taxpayer recognizes a loss upon the sale or exchange of property, the loss must be characterized as either ordinary loss or capital loss.
- B. **Capital Assets and the Sale or Exchange Requirement.** A capital gain and a capital loss can arise only from the sale or exchange of a capital asset.

1. **Capital Assets.** Section 1221(a) provides that a capital asset is any asset *except* for certain specifically designated items. The statute then lists eight types of assets that are not capital assets. Accordingly, if a taxpayer sells an asset described in any of §1221(a)(1) – (8), the resulting gain or loss is ordinary and not capital gain or loss. Here is a summary of the items specifically listed as *non-capital (or “ordinary”) assets*.
  - a. **Inventory.** An item of the taxpayer’s inventory is not a capital asset.<sup>1</sup> Thus, for example, a guitar sold by a taxpayer in the business of manufacturing, wholesaling, or retailing musical instruments would not be a capital asset.
  - b. **Property Held for Sale to Customers.** Property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s business is not a capital asset.<sup>2</sup>
    - (1) Under this rule, then, a parcel of real estate is not a capital asset in the hands of a taxpayer who normally sells such parcels to customers as part of the taxpayer’s business. But that same parcel of real estate would be a capital asset in the hands of a taxpayer not in the business of selling real estate who held the property for investment purposes.
    - (2) Courts trying to distinguish between real property held for investment purposes (a capital asset) and real property held for sale to customers in the ordinary course of business (not a capital asset) will often examine these factors: (1) the nature and purpose of the acquisition of the property; (2) the length of ownership; (3) the frequency and substantiality of sales; (4) the extent of taxpayer’s efforts in subdividing, developing and advertising the property; (5) whether the taxpayer used a business office or selling agents; and (6) the time and effort habitually spent by the taxpayer in sales.<sup>3</sup>

---

<sup>1</sup> IRC §1221(a)(1).

<sup>2</sup> IRC §1221(a)(1).

<sup>3</sup> See *Byram v. United States*, 705 F.2d 1418 (5<sup>th</sup> Cir. 1983).



- c. **Depreciable Property Used in Business.** Tangible property used in the taxpayer's business that is subject to depreciation deductions is not a capital asset.<sup>4</sup>
- d. **Real Property Used in Business.** Real property used in the taxpayer's business is not a capital asset.<sup>5</sup> Thus, for example, office and factory buildings are not capital assets if the taxpayer uses those buildings in the taxpayer's trade or business.
- e. **Certain Compositions.** Copyrights, literary compositions, musical compositions, artistic compositions, letters, memos, and similar assets are not capital assets in the hands of their creators, those for whom such property was prepared or produced, and those whose basis in such assets are determined in whole or in part with reference to the basis of such property in the hands of the creator or a person for whom such property was prepared or produced.<sup>6</sup>
  - (1) A taxpayer can elect to treat a musical composition or a copyright in a musical work as a capital asset if the taxpayer is the creator of the work, the person for whom the work was created, or a person whose basis in the work is determined with reference to the basis of such property in the hands of its creator or the person for whom it was created.<sup>7</sup>
  - (2) A taxpayer will want to make the election if there is a sale or exchange of the musical work held for more than one year at a gain, since such gain would qualify as long-term capital gain. If the work sells for a loss, however, the taxpayer will not want to make the election because under the general rule of §1221(a)(3) the sale will generate ordinary loss.
- f. **Business Receivables.** Accounts receivable and notes receivable derived in the ordinary course of the taxpayer's business for services rendered or from the sale of inventory property or other

---

<sup>4</sup> IRC §1221(a)(2).

<sup>5</sup> IRC §1221(a)(2).

<sup>6</sup> IRC §1221(a)(3).

<sup>7</sup> IRC §1221(b)(3).

property held for sale to customers are not capital assets.<sup>8</sup> An “account receivable” is any right to payment from the provision of goods or services. Thus, when a lawyer bills a client for legal services performed on the client’s behalf, the lawyer has an account receivable. In the lawyer’s hands, the account receivable is not a capital asset.

- g. **Government Publications.** Any publication of the United States government acquired other than by purchase at the price at which it is offered for sale to the public is not a capital asset in the hands of the person who received such publication from the government or a person whose basis in such publication is determined in whole or in part with reference to the basis of such publication in the hands of the person who received the publication from the government.<sup>9</sup>
- h. **Commodities Derivative Financial Instruments.** Any “commodities derivative financial instrument” is not a capital asset in the hands of a “commodities derivatives dealer” unless the instrument has no connection to the dealer’s business and such instrument is clearly identified as such by the dealer before acquisition.<sup>10</sup> These special terms are defined in §1221(b)(1) and are beyond the scope of these materials.
- i. **Hedging Transactions.** Any “hedging transaction” that is identified as such before it is acquired is not a capital asset.<sup>11</sup> A hedging transaction is any transaction entered into by the taxpayer as part of the taxpayer’s business primarily to manage risks related to price changes and currency fluctuations affecting the taxpayer’s business property.<sup>12</sup>
- j. **Business Supplies.** Supplies regularly used or consumed by the taxpayer in the taxpayer’s business are not capital asset.<sup>13</sup> Thus, for

---

<sup>8</sup> IRC §1221(a)(4).

<sup>9</sup> IRC §1221(a)(5).

<sup>10</sup> IRC §1221(a)(6).

<sup>11</sup> IRC §1221(a)(7).

<sup>12</sup> IRC §1221(b)(2).

<sup>13</sup> IRC §1221(a)(8).

example, a sale of paper, staples, toner cartridges, and pencils used in the taxpayer's business will produce ordinary gain or loss. Likewise, a sale of gasoline by a taxpayer that requires fuel to run the taxpayer's business equipment will give rise to ordinary income or loss.

2. **Construe the List Literally.** Although one can generally conclude that assets held for business use are not capital assets and assets held for investment or personal use are capital assets, one should not construe the list of non-capital assets in §1221(a) with this framework in mind. Instead, courts are instructed to give the terms in §1221(a) their plain meaning and not to consider the broader thematic ties of the items described in the list.<sup>14</sup> In *Arkansas Best Corporation v. Commissioner*, the Court held that stock in a bank held by a holding company was a capital asset because, even though the stock was an essential component of the holding company's business, it was not an asset described in §1221(a).<sup>15</sup>
3. **Rights to Ordinary Income Not Capital Assets.** Footnote 5 of the *Arkansas Best* case preserved a line of cases standing for the proposition that the definition of capital asset "does not include claims or rights to ordinary income." Thus, for example, if a taxpayer sells his or her rights to future rental income from an asset, any resulting gain is ordinary income and not capital gain even though "rights to rental income" is not listed in §1221(a). Courts have consistently applied this doctrine to conclude that the sale of rights to future payments under a state lottery create ordinary income and not capital gain.<sup>16</sup>
4. **Sale or Exchange Required.** In addition, capital gain or loss can arise only from a "sale or exchange," and not any other disposition like a gift or an involuntary conversion of the property. A bilateral transaction involving an exchange of assets is easy to spot, and such an exchange will obviously meet the "sale or exchange" requirement. The other extreme is just as obvious—there is no sale or exchange if a taxpayer abandons a capital asset, if the asset is stolen, or if the asset is gifted to the taxpayer's beneficiary. Certain transactions, while perhaps not technically sales or exchanges, are nonetheless treated as if they are because they are economically equivalent to sale or exchange transactions.

---

<sup>14</sup> *Arkansas Best Corporation v. Commissioner*, 485 U.S. 212 (1988).

<sup>15</sup> *Id.*

<sup>16</sup> See *Davis v. Commissioner*, 119 T.C. 1 (2002).

- a. **Satisfaction of Pecuniary Bequest.** If an estate transfers a capital asset in satisfaction of its obligation to make a pecuniary bequest (a specific dollar amount) to the decedent's beneficiary, the estate is deemed to have "sold" the property because it is the equivalent of selling the property and paying cash to the beneficiary.<sup>17</sup>
  - b. **Personal Casualty Gains.** If a taxpayer receives insurance for the involuntary loss of a personal-use asset by casualty or theft, a "personal casualty gain" results if the amount of insurance received exceeds the taxpayer's adjusted basis in the asset.<sup>18</sup> If a taxpayer's personal casualty gains for the year exceed his or her personal casualty losses for the year, all such gains and losses are deemed to arise from sales or exchanges of capital assets.<sup>19</sup>
- C. **"Long-Term" and "Short-Term" Gains and Losses.** If a taxpayer has a capital gain or loss, one must determine whether the gain or loss is "short-term" or "long-term" in nature. The Code provides a one-year rule for this purpose: capital assets held for one year or less before sale or exchange generate short-term capital gain or loss, while capital assets held for more than one year generate long-term capital gain or loss.
- 1. **Why Holding Period Matters.** This distinction is crucial because only long-term capital gains can be subject to tax at the preferential rates in §1(h). Specifically, a taxpayer seeking to use the preferential tax rates of §1(h) must have a "net capital gain" for the taxable year, meaning an excess of net long-term capital gain over net short-term capital loss. If there is no such excess, the preferential rates of §1(h) will not come into play; any capital gains subject to tax will be treated just like ordinary income. Thus, for example, a taxpayer whose only capital gain for the year is from the sale of a capital asset held for eight months must treat that gain as ordinary income.
  - 2. **Tacked Holding Periods.** In some instances the length of time a taxpayer holds a capital asset (the taxpayer's "holding period") includes the length of time someone else held the property or the length of time the taxpayer held some other property.

---

<sup>17</sup> *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940).

<sup>18</sup> IRC §165(h)(3)(A).

<sup>19</sup> IRC §165(h)(2)(B).

- a. **Carryover Holding Period.** Where a taxpayer exchanges one capital asset (the “old capital asset”) for another (the “new capital asset”), the taxpayer’s holding period in the new capital asset includes the taxpayer’s holding period for the old capital asset if the taxpayer’s basis in the new capital asset is the same (in whole or in part) as the taxpayer’s basis in the old capital asset.<sup>20</sup> This will be the case, for example, in a like-kind exchange of capital assets under §1031, the tax-free transfer of a capital asset to a corporation in exchange for its stock under §351, the tax-free transfer of a capital asset to a partnership in exchange for an interest in the partnership under §721, and the involuntary conversion of a capital asset under §1033.
- b. **Transfer of Another’s Holding Period.** If the taxpayer’s basis in the capital asset is determined with reference to the basis of such property in the hands of its transferor, the taxpayer’s holding period includes the holding period of the transferor.<sup>21</sup> For instance, if the taxpayer received the capital asset by gift from a donor, the taxpayer’s holding period in the capital asset includes the donor’s holding period in the same asset because the taxpayer took the donor’s basis in the capital asset under §1015(a).
- c. **Long-Term Holding Period on Property Acquired from Decedent.** If the taxpayer acquired the capital asset from a decedent and took a stepped-up basis in the asset under §1014, the taxpayer is deemed to have held the asset for more than one year even if the asset is sold within one year of the decedent’s death.<sup>22</sup>

D. **Section 1231 Gains and Losses.** Thus far reference has been limited to two forms of income or loss: ordinary and capital. There is, however, a third, temporary form of income and loss, so-called “§1231 gains and losses.” Although §1221(a)(2) excludes from the definition of capital asset the depreciable property and real property used in a taxpayer’s business, such property may, if held for more than one year, qualify for preferential treatment under §1231.

1. **How It Works.** §1231 is a win-win rule: it states that if a taxpayer’s “§1231 gains” for the year exceed the taxpayer’s “§1231 losses” for the year, all such gains and losses will be treated as long-term capital gains and long-

---

<sup>20</sup> IRC §1223(1).

<sup>21</sup> IRC §1223(2).

<sup>22</sup> IRC §1223(9).

term capital losses. This is good because the net §1231 gain will be taxed at a preferential rate under §1(h). On the other hand, if a taxpayer's §1231 gains for the year do not exceed the taxpayer's §1231 losses for the year, all such gains and losses will be treated as ordinary gains and losses. This too is good because any net §1231 loss will be treated as ordinary loss which can offset all forms of income. In effect, §1231 gain and §1231 loss are the best possible flavors of income and loss because they will always receive the best possible treatment at the end of the year.

2. **Hotchpots and Firepots.** To compute whether a taxpayer has a net §1231 gain or loss for the taxable year, practitioners speak of placing all §1231 gains and losses into a "hotchpot" and then netting the gains against the losses at the end of the year. A special rule provides that certain types of gains and losses will be added to the hotchpot only if there are more gains than losses of those certain types for the year. Practitioners thus speak of a "sub-hotchpot" (or "firepot") for these gains and losses to be placed before deciding whether they are added to the main hotchpot.
3. **Property Used in the Trade or Business.** A §1231 gain or loss typically arises from the sale of involuntary conversion of "property used in the trade or business," a special term of art. An asset qualifies as "property used in the trade or business" if it has each of the following three characteristics: (a) the property must have been used in the taxpayer's business activity; (b) the property must either be depreciable under §167 or be real property; and (c) the taxpayer must have held the property for more than one year.<sup>23</sup> "Property used in the trade or business" also expressly includes certain timber, coal, and iron ore.<sup>24</sup> The term also includes certain cattle, horses, and livestock, but not any poultry.<sup>25</sup> It also includes any unharvested crop on land used in the taxpayer's business if the taxpayer sells both the land and the crop at the same time.<sup>26</sup>

- E. **Depreciation Recapture.** If a taxpayer has §1231 gain or loss from a disposition of an asset that was subject to depreciation, the concept of "depreciation recapture" comes into play.

---

<sup>23</sup> IRC §1231(b)(1).

<sup>24</sup> IRC §1231(b)(2).

<sup>25</sup> IRC §1231(b)(3).

<sup>26</sup> IRC §1231(b)(4).

1. **The Concept.** Depreciation recapture is premised on the theory that it would be a double benefit to a taxpayer to permit depreciation deductions from property used in a trade or business to offset ordinary income and then let gain attributable to depreciation deductions be treated as long-term capital gain. Absent §1245, this could result. A taxpayer, for example, could purchase a piece of equipment for use in the taxpayer's business and depreciate the cost of the equipment over its useful life. These deductions will offset ordinary income. But if the taxpayer then sells the fully-depreciated equipment for any consideration, the taxpayer would have gain that will qualify as §1231 gain because the property will have been held for more than one year. If that is the only item of §1231 gain for the taxable year, the gain will be treated as long-term capital gain and will be subject to tax at a preferential rate.
2. **The Mechanics.** Section 1245 generally provides that in the case of gain from the disposition of tangible property, gain attributable to prior depreciation deductions is characterized as ordinary income unless a specific exception applies. Section 1245 forces the recognition of ordinary income even if another Code provision would otherwise provide for nonrecognition.<sup>27</sup> Nonetheless, if the taxpayer's disposition is described in §1245(b), the general rule of §1245(a) will not apply or will have limited application.
  - a. **Gifts.** Depreciation recapture does not apply to dispositions by gift.<sup>28</sup> Instead, the amount that otherwise would have been recaptured will be saved until there is a non-gift disposition by the donee. At that time the donee will face recapture to the extent there is gain attributable to depreciation that has been allowed to the donee "or to any other person" (i.e., the donor).
  - b. **Bequests.** Depreciation recapture generally does not apply to any transfers at death.<sup>29</sup>
  - c. **Certain Nonrecognition Transactions.** In the case of certain nonrecognition transactions—like those under §§ 351 (transfers to controlled corporations) and 721 (transfers to partnerships)—the amount of depreciation recapture is limited to the amount of any

---

<sup>27</sup> IRC §1245(d).

<sup>28</sup> IRC §1245(b)(1).

<sup>29</sup> IRC §1245(b)(2).

recognized gain to the transferor.<sup>30</sup> In the case of a like-kind exchange under §1031 or an involuntary conversion under §1033, the amount of depreciation recapture is limited to the sum of any recognized gain under those provisions plus the value of any non-§1245 property received by the taxpayer that is not taken into account as part of the taxpayer's recognized gain.<sup>31</sup>

3. **Recapture for Depreciable Real Property.** Depreciation recapture is often a non-issue in the context of depreciable real property (office buildings, rental buildings, and the like). Section 1250 requires recapture only where a taxpayer used a form of accelerated depreciation instead of the traditional "straight-line" method.
  - a. **Dinosaur Provision.** Since 1986, however, taxpayers have been required to depreciate real estate using the straight-line method.<sup>32</sup> Thus, any depreciable real estate placed in service since 1986 will not be subject to depreciation recapture because there is no "additional depreciation" (that is, a depreciation deduction larger than what would be allowed under the straight-line method). Accordingly, §1250 today applies only to buildings that were placed in service before 1986. As time goes by, therefore, §1250 recapture will become increasingly rare.
  - b. **The Flip Side.** Although modern depreciable real property will not be subject to depreciation recapture, Congress has generally provided that any gains from the sale or exchange of depreciable real estate held for more than one year will, to the extent they are treated as long-term capital gains, be subject to a less preferential rate of tax under §1(h): instead of the 20- percent rate normally applicable to such gains, any "unrecaptured §1250 gain" will be taxed at a rate of 25 percent.

#### F. The Preferential Rates for Net Capital Gain

1. **Netting at the End of the Year.** At the end of the year, a taxpayer's long-term capital gains and long-term capital losses for the year are netted against each other. If the taxpayer has more long-term capital gains than long-term capital losses, the taxpayer has a "net long-term capital gain"

---

<sup>30</sup> IRC §1245(b)(3).

<sup>31</sup> IRC §1245(b)(4).

<sup>32</sup> IRC §168(b)(3).



for the year.<sup>33</sup> Likewise, if the taxpayer has more long-term capital losses than long-term capital gains, the taxpayer has a “net long-term capital loss for the year.” Likewise, a taxpayer nets short-term capital gains and short-term capital losses at the end of the year. If the taxpayer has more short-term capital gains than short-term capital losses, the taxpayer has a “net short-term capital gain” for the year.<sup>34</sup> If instead the taxpayer has more short-term capital losses than short-term capital gains, the taxpayer has a “net short-term capital loss” for the year.<sup>35</sup>

2. **Net Capital Gain.** Importantly, if the taxpayer’s “net long-term capital gain” exceeds his or her “net short-term capital loss” for the taxable year, the taxpayer has a “net capital gain.”<sup>36</sup> It is the net capital gain that will be taxed at the preferential tax rates set forth in §1(h). These rates can be summarized generally as follows:

- a. **28% on Collectibles and §1202 Stock.** If the taxpayer’s ordinary income already consumes all of the tax brackets below 28 percent, that portion of the net capital gain attributable to “collectibles gain” and “section 1202 gain” will be taxed at a flat rate of 28 percent.<sup>37</sup> Collectibles gain is the taxable gain from the sale or exchange of a collectible (like a work of art, antique, jewelry, stamp collection, wine collection, or the like) held for more than one year.<sup>38</sup> Section 1202 gain is the taxable gain from the sale or exchange of §1202 stock.<sup>39</sup> In order to be §1202 stock, among other things, such stock must have been held for more than five years.
- b. **25% on Unrecaptured §1250 Gain.** If the taxpayer’s ordinary income already consumes all of the tax brackets below 25 percent, that portion of the net capital gain attributable to prior

---

<sup>33</sup> IRC §1222(7).

<sup>34</sup> IRC §1222(5).

<sup>35</sup> IRC §1222(6).

<sup>36</sup> IRC §1222(11).

<sup>37</sup> IRC §1(h)(1)(F).

<sup>38</sup> IRC §1(h)(5)(A).

<sup>39</sup> IRC §1(h)(7).

depreciation deductions on real estate (office buildings and factory buildings, for example) will be taxed at a flat rate of 25 percent.<sup>40</sup>

- c. **20% on Adjusted Net Capital Gain for Wealthy Taxpayers.** If the taxpayer's ordinary income pushes him or her into the 39.6% bracket, the taxpayer's "adjusted net capital gain" (generally meaning the taxpayer's net capital gain other than the collectibles, §1202 stock, and unreaptured §1250 gain<sup>41</sup>) will be taxed at a flat rate of 20 percent.<sup>42</sup>
  - d. **15% on Adjusted Net Capital Gain for Middle-Income Taxpayers.** If the taxpayer's ordinary income consumes all of the tax brackets below 15 percent but does not push the taxpayer into the highest (39.6%) bracket, the taxpayer's adjusted net capital gain will be taxed at a flat rate of 15 percent.<sup>43</sup>
  - e. **0% on Adjusted Net Capital Gain for Low-Income Taxpayers.** If the taxpayer's ordinary income does not completely consume all of the tax brackets below 15 percent, then the adjusted net capital gain will be taxed at a rate of zero percent until the combined amount of the taxpayer's ordinary income and adjusted net capital gain exceeds the ceiling of the taxpayer's 15-percent tax bracket.<sup>44</sup>
- 3. **Short-Term Capital Gains as Ordinary Income.** If the taxpayer has more capital gains than capital losses but does not have a net capital gain (for example, where the taxpayer has only short-term capital gains and no long-term capital gains), then the excess capital gain will be treated as ordinary income. In other words, no preferential tax rates will apply.
  - 4. **Carryover of Net Capital Loss.** If the taxpayer's capital losses for any taxable year exceed the capital gains for that year, the capital losses for a taxable year are deductible to the extent of the taxpayer's capital gains for the year (long-term and short-term) plus up to \$3,000 of the excess of such losses over such gains.<sup>45</sup> This is often referred to as the "\$3,000 bonus" for

---

<sup>40</sup> IRC §1(h)(1)(E).

<sup>41</sup> See IRC §1(h)(3).

<sup>42</sup> IRC §1(h)(1)(D).

<sup>43</sup> IRC §1(h)(1)(C).

<sup>44</sup> IRC §1(h)(1)(B).

<sup>45</sup> IRC §1211(b).

individuals. If the \$3,000 bonus is not enough to cover the excess capital losses, then the taxpayer has a “net capital loss” for the year.<sup>46</sup> The net capital loss carries over to the next taxable year.<sup>47</sup> Carryovers can continue for the life of the taxpayer, but they die with the taxpayer.

### III. Income Tax Treatment of Lifetime and Testamentary Gifts

- A. **Exclusion from Gross Income.** The exclusion in §102(a) for gifts and bequests is one of the centerpieces of the Internal Revenue Code. The exclusion has been justified on the grounds of administrative convenience, that it softens the burden imposed on transferors by federal estate and gift taxes, and that it encourages generosity and wealth transfers. None of these justifications has been universally embraced, however. In any case, §102(a) ensures that donees do not have to include the value of gifted or inherited property in gross income. Gifts of income, however, are not eligible for the exclusion, as §102(b) makes clear. In addition, §102(c) declares that an employee can never receive a “gift” from an employer. As a result, any property transferred to an employee will likely be treated as compensation income unless a different exclusion provision applies.
1. **Test for a “Gift.”** To qualify as a “gift” the transferor must exhibit “detached and disinterested generosity” in making the transfer to the recipient “out of affection, respect, admiration, charity or like impulses.”<sup>48</sup> If the motive of the transferor was to compensate the taxpayer for services rendered, the taxpayer has received compensation income.<sup>49</sup>
  2. **Income on Gifted Property Not Excluded.** Note that any subsequent income earned on the gifted property is not excluded from gross income under §102(a).<sup>50</sup>
  3. **Gifts of Income Not Excluded.** Similarly, the gift of an income interest in property or a trust does not exclude the amounts received under the income interest.<sup>51</sup>

---

<sup>46</sup> IRC §1222(10).

<sup>47</sup> IRC §1212(b)(1).

<sup>48</sup> *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

<sup>49</sup> IRC §61(a)(1).

<sup>50</sup> IRC §102(b)(1).

<sup>51</sup> IRC §102(b)(2).

EXAMPLES:

- (1) Dad gives Starbucks stock to Son out of detached and disinterested generosity. Son may exclude the fair market value of the Starbucks stock from gross income.
- (2) Same as (1), except that following transfer, Son receives a cash dividend on the Starbucks stock. Son must include the cash dividend in gross income.
- (3) Dad transfers Starbucks stock to a trust that pays income to Son for life with the remainder payable to Son's estate. As the Starbucks stock generates dividends, the trustee pays them to Son. Son must include the dividends in gross income in the year(s) they are received from the trustee.

B. **Donee's Basis in Gift Property.** A taxpayer acquiring property by inter vivos gift generally takes the donor's basis in the gifted property.<sup>52</sup> If, at the time of the gift, the fair market value of the property was less than the donor's basis in the property, then the taxpayer's basis in the property is equal to such fair market value *but only for purposes of computing the amount of any realized loss*. Consequently, most estate planners shy away from recommending gifts of loss property; it is often better for the donor to sell the loss property, claim the resulting loss, and then give the sale proceeds to the beneficiary.

1. **Increase for Gift Tax Paid.** If the donor pays federal gift taxes as a result of the gift, the taxpayer is permitted to add a portion of such gift tax paid to the taxpayer's basis in the property.<sup>53</sup> The addition to basis can be expressed in formula form as follows:

$$\left( \frac{\text{value of gift minus donor's basis @ time of gift}}{\text{value of gift}} \right) \times (\text{gift tax paid}) = \text{addition to basis}$$

2. **Part-Gift, Part-Sale.** If the taxpayer acquired the property in a part-gift, part-sale transaction (the taxpayer purchased the property for less than its value at the time of the purchase and the reason for the discount was because of the seller's detached and disinterested generosity), then the taxpayer's basis in the property is either the amount paid for the property or the seller's basis in the property, whichever is greater.<sup>54</sup>

---

<sup>52</sup> IRC §1015(a).

<sup>53</sup> IRC §1015(d)(1), (6).

<sup>54</sup> Reg. §1.1015-4.

**EXAMPLES:**

(1) Mom gives Costco stock to Daughter. At the time of the gift, the stock is worth \$10,000 and Mom's adjusted basis in the shares is \$3,000. Daughter takes Mom's basis in the shares. Thus, if Daughter sells the stock two years later for \$14,000, Daughter will recognize \$11,000 of long-term capital gain from the sale.

(2) Same as (1), except that Mom's basis in the shares at the time of the gift is \$12,000. For purposes of determining gain, Daughter's basis in the stock is \$12,000; but for purposes of determining loss, Daughter's basis in the stock is \$10,000, the stock's fair market value at the time of the gift. If Daughter sells the stock two years later for \$14,000, Daughter will recognize \$2,000 of long-term capital gain from the sale. Alternatively, if Daughter sells the stock two years later for \$4,000, Daughter will recognize a \$6,000 long-term capital loss from the sale. Finally, if Daughter sells the stock two years later for \$11,000, Daughter recognizes neither gain nor loss—the transaction is without tax consequence.

(3) Same as (1), except that Mom pays \$4,000 in federal gift tax as a result of the gift to Daughter. Daughter's basis in the stock is \$5,800 (\$3,000 basis from Mom plus \$2,800, which is 70% of the gift tax paid by Mom). Thus, on the Daughter's sale of the stock two years later for \$14,000, Daughter will recognize \$8,200 of long-term capital gain.

(4) Same as (1), except that Mom sold the stock to Daughter for \$8,000. Mom charged Daughter only \$8,000 for \$10,000 worth of stock out of detached and disinterested generosity. This is therefore a part-gift, part-sale. Mom will recognize \$5,000 of capital gain (the \$8,000 paid by daughter exceeds Mom's \$3,000 adjusted basis in the stock) and Daughter's basis in the shares will be \$8,000, since the amount she paid exceeds Mom's stock basis.

(5) Same as (4), except that Mom sold the stock to Daughter for \$1,000. Mom cannot recognize a loss (see Reg. §1.1001-1(e) and §267) and Daughter's basis in the shares will be \$3,000, since Mom's stock basis is greater than the consideration paid by Daughter.

C. **Basis in Property Acquired from a Decedent.** If the property passed to the taxpayer from a decedent, the taxpayer's basis in the property is its fair market value at the date of the decedent's death.<sup>55</sup> This is often referred to as a "stepped-up" basis, but that phrase is somewhat misleading because sometimes the value of property at a decedent's death is less than the decedent's basis.

1. **What it Means to Take from a Decedent.** Property is considered to have passed from a decedent if it meets any of the conditions set forth in §1014(b). These include: acquiring the property by bequest, devise, or inheritance; receiving the property from a revocable living trust created by

---

<sup>55</sup> IRC §1014(a)(1).

the decedent during the decedent's lifetime; acquiring the property through the decedent's exercise of a testamentary power of appointment; and any property included in the decedent's gross estate for federal estate tax purposes.

2. **Community Property and the Step-Up.** Surviving spouses in community property states enjoy a nice bonus: not only does the decedent's one-half share of community property get a stepped-up basis but so too does the surviving spouse's one-half share.<sup>56</sup>

- D. **Tax Alchemy.** A gift is useful when the property will be sold and the gain on a sale would be ordinary income to the donor but capital gain to the donee. The benefit will depend upon the differential between the maximum rates applicable to ordinary income and to capital gains. (Of course, the gift tax consequences of the transfer must be taken into account in deciding whether to make the gift.)

**EXAMPLE:** Donor (who is married and involved in real estate development and sales) gave his adult son and daughter-in-law a parcel of undeveloped real property that had an adjusted basis in Donor's hands of \$1,000 and a value of \$56,000. The entire gift to the son and the daughter-in-law is sheltered by the available annual exclusions if the gift is split between Donor and Donor's spouse. While Donor's basis in the property (\$1,000) and Donor's holding period carries over to the donees (see §§1015(a) and §1223(2)), the characterization ordinarily does not. Thus the real property will be a capital asset in the hands of the donees even though the property would have generated ordinary income in Donor's hands. One caveat: if the sale was prearranged by Donor, the donees may be treated as Donor's agents and the gain may be taxed to Donor as ordinary income.<sup>57</sup>

#### IV. Gain on the Sale of a Principal Residence

- A. **The Good(?) Old Days.** Prior to 1997, the applicable rules upon the sale of a taxpayer's home were substantially more complicated. In those days, taxpayers could avoid recognizing gain from the sale of a home as long as they acquired a new residence within two years of the sale. The catch was that the taxpayer's basis in the new home had to reflect the unrecognized gain from the sale of the old home. In addition, a special rule gave taxpayers age 55 or over a one-time exclusion of up to \$125,000 of gain from the sale of a residence. This added benefit helped taxpayers who sought to "buy down" to a less expensive home once their children had grown and left home. Under the prior regime, then, taxpayers who did not buy new homes that were at least as expensive as their old homes had to

---

<sup>56</sup> IRC §1014(b)(6).

<sup>57</sup> See *Salvatore v. Commissioner*, 434 F.2d 600 (2d Cir. 1970).

recognize at least a portion of their realized gains unless they qualified for the one-time exclusion for taxpayers who reached age 55.

B. **Summary of the Current Rules.** The current regime is much simpler. For one thing, everything is contained in a single Code section, §121, instead of two Code sections. Moreover, we no longer care what a taxpayer does with the sale proceeds, and we no longer force deferral of unrecognized gains into the basis of any subsequently acquired residence. Only taxpayers with extraordinary gains and those who flunk the statutory requirements of §121 will face taxation of gains from home sales.

1. **\$250,000 Exclusion.** A taxpayer may exclude up to \$250,000 of realized gain from the sale or exchange of the taxpayers' principal residence. The taxpayer need not be living in the home at the time of the sale; §121(a) only requires that the taxpayer have owned and used the property as his or her personal residence "for periods aggregating 2 years or more" during the five-year period prior to the date of sale. Practitioners often refer to the §121(a) requirements as the "ownership test" and the "use test." Even where a taxpayer meets the ownership test and the use test, however, the §121 exclusion is not available if the taxpayer has made prior use of the exclusion within the two-year period ending on the date of sale.
2. **\$500,000 Exclusion.** Married couples filing joint returns can exclude up to \$500,000 of realized gain provided these three requirements are met (if any of these requirements is not met, §121(b)(2)(B) provides that the maximum amount excludible is the sum of the maximum amounts each spouse could exclude separately if they were unmarried):
  - a. **Either Owns.** At least one of the spouses must meet the ownership test.<sup>58</sup>
  - b. **Both Use.** Both spouses must meet the use test.<sup>59</sup>
  - c. **Neither Ineligible.** Neither spouse can be ineligible for the exclusion because of a prior use of the §121(a) exclusion within the two years prior to the current sale.<sup>60</sup>

---

<sup>58</sup> IRC §121(b)(2)(A)(i).

<sup>59</sup> IRC §121(b)(2)(A)(ii).

<sup>60</sup> IRC §121(b)(2)(A)(iii).

3. **Reduced Exclusion.** If a taxpayer cannot meet all of the requirements for the §121(a) exclusion, a “reduced exclusion” under §121(c) will still apply as long as the sale is due to a change in place of employment, health, or “unforeseen circumstances,” generally defined as events outside the control of the taxpayer that were not reasonably foreseeable upon acquisition of the property.
- C. **Ownership Test.** To qualify for the full exclusion limitation, a taxpayer must have owned the residence for a total period of two years (730 days) in the five-year period (1,825 days) prior to the date of the sale. §121(a). The 730 days of ownership need not be consecutive; as long as the taxpayer owned the property for a total of 730 days in the 1,825 days prior to the sale, the ownership test is met.
1. **Imputing Ownership of Spouse or Ex-Spouse.** If the taxpayer received the property in a transaction described in §1041 (transactions between spouses and transactions between former spouses that are incident to divorce, see Part VIII below), then the taxpayer’s ownership period includes all of the days the transferor (the spouse or former spouse) owned the property.<sup>61</sup>
  2. **Property Acquired from a Decedent.** When a decedent’s estate sells the decedent’s residence, the estate may claim the period of the decedent’s ownership and use even though the estate is generally a separate taxable entity.<sup>62</sup> Likewise, a sale of a decedent’s home by a trust that was a “qualified revocable trust” before the decedent’s death can qualify for the §121(a) exclusion and the decedent’s ownership and use will be attributed to the trust.<sup>63</sup>
- D. **Use Test.** A taxpayer must also have used the residence as his or her principal residence for a total period of two years (730 days) in the 5-year period (1,825 days) prior to the date of the sale.
1. **Consecutive Days Not Required.** Again, there is no requirement that the taxpayer use the property as his or her personal residence for at least 730 consecutive days; nonconcurrent periods of use within the five-year pre-sale period are aggregated to determine whether the use test is met.<sup>64</sup>

---

<sup>61</sup> IRC §121(d)(3)(A).

<sup>62</sup> IRC §121(d)(11)(A).

<sup>63</sup> IRC §121(d)(11)(C).

<sup>64</sup> See Reg. §1.121-1(c)(1).



2. **Principal Residence.** If the taxpayer uses more than one home during the year, determining whether the home that is sold is the taxpayer's "principal" residence depends on all the facts and circumstances. Generally, the taxpayer's principal residence is the one he or she uses a majority of the time during a taxable year.<sup>65</sup> But other factors count too, including the principal place of abode of the taxpayer's family members, the address listed on the taxpayer's tax returns, and the address used for bills and other correspondence.
  3. **Short Temporary Absences.** The taxpayer is deemed to continue using a residence during "short temporary absences" like vacations or other seasonal absences.<sup>66</sup> An example in the regulations, however, indicates that a college professor is not deemed to be using his residence during his one-year abroad on a sabbatical leave.<sup>67</sup>
  4. **Use by Former Spouse Pursuant to Divorce Decree.** A taxpayer is treated as using a home he or she owns during such times that the taxpayer's spouse or former spouse is granted use of the property under a divorce or separation instrument.<sup>68</sup>
  5. **Use During Periods of Care Away from Home.** A taxpayer may be deemed to continue using a property as his or her principal residence during periods when he or she in fact resides in a licensed care facility.<sup>69</sup> To qualify for this special rule, the taxpayer must be physically or mentally incapable of self-care and must have in fact used the property as his or her principal residence for at least 365 days during the 1,825 days prior to the property's sale.
- E. **Once-Every-Two-Years Test.** There's one more requirement (in addition to the ownership test and the use test) to qualify for the full exclusion. The taxpayer must not have made prior use of the §121 exclusion within the two-year period (730 days) prior to the date of the sale.<sup>70</sup>

---

<sup>65</sup> Reg. §1.121-1(a)(2).

<sup>66</sup> Reg. §1.121-1(c)(2)(i).

<sup>67</sup> See Reg. §1.121-1(c)(4), Example 4.

<sup>68</sup> IRC §121(d)(3)(B).

<sup>69</sup> IRC §121(d)(7).

<sup>70</sup> IRC §121(b)(3)(A).

- F. **No Exclusion for Depreciation** – Did the taxpayer claim depreciation deductions with respect to the property anytime after May 6, 1997? If yes, then the §121(a) exclusion does not apply to the extent of that prior depreciation (i.e., the amount of prior depreciation deductions must be included in gross income).<sup>71</sup> This rule will usually apply where the taxpayer used part of the property as a home office and claimed depreciation deductions with respect to that part of the property.
- G. **Reduced Exclusion.** If a taxpayer fails to meet any of the elements for the §121(a) exclusion, a reduced exclusion limitation will apply provided the taxpayer's sale of the home is due to change in place of employment, health, or unforeseen circumstances.<sup>72</sup> If none of these situations applies, then the taxpayer's realized gain on the sale of the residence will be recognized unless another exclusion or nonrecognition provision applies.
1. **Unforeseen Circumstances.** The Code does not define this term, but the regulations provide that a sale is due to 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."<sup>73</sup> The regulations also list a number of specific events that qualify automatically as unforeseen circumstances, including disasters, death, divorce, and multiple births from the same pregnancy.<sup>74</sup> The same regulation indicates that a preference for a new home or changed financial circumstances will not qualify as an unforeseen circumstance.
  2. **Reduced Exclusion Limit May Shelter All Gain.** If the reduced exclusion limitation exceeds the taxpayer's realized gain from the sale of the residence, the entire gain is excluded. The reduction, in other words, applies to the applicable limitation on the exclusion and not the exclusion itself.
  3. **Computing the Reduced Exclusion Limitation.** The amount of the reduced exclusion limitation may be determined by the following formula:<sup>75</sup>

---

<sup>71</sup> IRC §121(d)(6).

<sup>72</sup> IRC §121(c)(2).

<sup>73</sup> Reg. §1.121-3(e)(1).

<sup>74</sup> Reg. §1.121-3(e)(2).

<sup>75</sup> See IRC §121(c)(1).

[Lesser of: (i) actual ownership and use; <u>or</u> (ii) period since prior sale]		applicable		reduced exclusion
-----	x	exclusion	=	limitation
2 years		limit		

In this formula, “actual ownership and use” refers to the total number of days during the five-year period prior to the sale during which the taxpayer “owned and used” the property as his or her principal residence. The “period since prior sale” refers to the number of days between the most recent prior sale by the taxpayer to which the §121(a) exclusion applied and the date of the sale at issue. The “applicable exclusion limit” is either \$250,000 or \$500,000, depending on the exclusion limit that would have applied had the taxpayer satisfied the requirements for the full exclusion.

- H. **No Exclusion Where Title Held by Credit Shelter Trust.** A trust does not reside anywhere; accordingly, a trust cannot claim the §121 exclusion. For this reason, estate planners are loathe to place a personal residence into a credit shelter trust, especially where the decedent’s surviving spouse will continue to reside in the home. To preserve the exclusion, planners generally prefer that the decedent’s interest in the principal residence pass outright to the surviving spouse (or to the spouse’s revocable living trust).

## V. The Kiddie Tax

- A. **The Value of “Income-Splitting.”** Inter vivos gifts can be appealing for income tax purposes, too. “Income-splitting” within the family is popular, though its importance varies according to the other income of the parties and the progressivity of the income tax rate schedule. The total family income tax burden may be reduced somewhat if income-producing assets are distributed among several family members rather than being concentrated in the hands of one or both parents. Shifting income to others within the family is also helpful in mitigating the impact of the 3.8% surcharge under §1411. The surcharge is applied against the taxpayer’s net investment income or the amount by which modified adjusted gross income exceeds the threshold amount, whichever is less. To the extent, then, that a taxpayer can shift net investment income to another family member—one with an adjusted gross income well below the threshold for §1411 liability—less surcharge will be paid.
- B. **Kiddie Tax Mechanics.** The potential income tax savings of transferring income-producing property to children are reduced by the §1(g) “Kiddie Tax.” Section 1(g) provides that the net unearned income of a child under age 19 (or, if the child is a

full-time student, under age 24) is computed at the marginal rate of the child's parent if the child has at least one parent living at the end of the year, does not file a joint return, and does not have earned income in excess of one-half of the amount of his or her support. For this purpose, net unearned income generally means unearned income in excess of an amount equal to twice the standard deduction under §63(c)(5).

1. **Beware the Election.** A parent of a child under 19 (or a full-time student under 24) may elect to report the net unearned income of the child directly on his or her return by making an election under §1(g)(7). The election may be beneficial neither donor nor donee faces liability for the 3.8% surcharge, as it makes for fewer returns to be prepared. But where the parent is subject to the surcharge and the child is not, the parent will not want to make the election to the extent the child's net unearned income will constitute net investment income to the parent. There is currently no mechanism by which a parent's liability for the 3.8% surcharge is imputed to a child's net unearned income where the child files his or her own return.
2. **Minimizing the Kiddie Tax Bite.** In order to avoid having the unearned income of a person under 19 (or a full-time student under 24) taxed to his or her parent, the minor's property may be invested in forms that produce little or no current taxable income (*e.g.*, insurance policies) or ones that defer the recognition of income (*e.g.*, Series EE bonds). Importantly, the income of a trust is subject to the Kiddie Tax only to the extent it must be paid to the beneficiary or is distributed to him or her.

## VI. Installment Sales

*Note: Most of the material in this Part VI is adapted from John R. Price and Samuel A. Donaldson, PRICE ON CONTEMPORARY ESTATE PLANNING (2015 edition: Wolters Kluwer).*

- A. **Generally.** The income tax rules applicable to installment sales are intended to allow the gain on the sale of real property or a casual sale of personal property to be reported as payments are received. Gain on an installment sale is reported on the installment method unless the transferor makes a timely election not to use that method.<sup>76</sup> Further, an installment sale of depreciable real or personal property will result in recapture of depreciation in the year of sale, with other gain reported under the installment method.<sup>77</sup> A taxpayer might elect not to use the

---

<sup>76</sup> IRC §453(d).

<sup>77</sup> IRC §453(i).

method where he or she has current losses that would offset the gain on the sale. The method does not affect the character of gain as capital gain or ordinary income. It also does not affect the way in which losses are reported—the installment method is totally inapplicable to losses.

- B. **Eligibility for Installment Method.** In general, the installment method applies to any disposition of property where one or more payments will be received in future years.<sup>78</sup> It is unavailable with respect to sales of stock or securities that are traded on an established securities market.<sup>79</sup> Also, installment sales treatment does not apply to a sale of depreciable property between the taxpayer and a controlled (more than 50-percent owned) entity, or two controlled entities.<sup>80</sup> By reason of §1239 the gain recognized on a sale of depreciable property to a controlled corporation is ordinary income. Similarly, the gain on the sale of a noncapital asset to a controlled partnership is treated as ordinary income.<sup>81</sup>
- C. **Installment Method Mechanics.** Under the installment method, the gain recognized for a tax year is “that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.”<sup>82</sup> Sometimes that proportion is called the “gross profit ratio,” which can also be expressed as a percentage. For purposes of the ratio, gross profit is calculated by reducing the gross selling price by the transferor's adjusted basis and the expenses of sale. For example, if property having a basis of \$10,000 is sold for \$50,000, the transferor's gross profit is \$40,000. The total contract price is the amount the transferor will ultimately receive as a result of the sale, including cash, notes, and other property received, but not encumbrances on the property except to the extent they exceed the transferor's adjusted basis. Except where the property is sold subject to an encumbrance, the total contract price is essentially the sale price of the property.<sup>83</sup> The selling price does not include interest, whether stated or unstated, or original issue discount.<sup>84</sup>

---

<sup>78</sup> IRC §453(b)(1).

<sup>79</sup> IRC §453(k)(2).

<sup>80</sup> IRC §§453(g)(1); 1239(b).

<sup>81</sup> IRC §707(b)(2).

<sup>82</sup> IRC §453(c).

<sup>83</sup> Reg. §15A.453-1(b)(2)(iii).

<sup>84</sup> Reg. §15A.453-1(b)(2)(ii).

**EXAMPLE:** *T* sold property to *X* that had a basis of \$50,000, subject to a \$20,000 mortgage. The purchase price was \$100,000, of which \$10,000 was paid in the year of sale and the balance of \$70,000 was due in equal annual installments with a reasonable rate of interest over the following 7 years. *X* gave *T* a nonnegotiable promissory note for the balance. For purposes of the installment sale rules, *T*'s gross profit was \$50,000 (the \$100,000 selling price less *T*'s basis of \$50,000). The total contract price is \$80,000, which is the total amount *T* will receive disregarding the mortgage that is within the amount of *T*'s basis. Accordingly, 62.5% of each payment ( $\$50,000 \div \$80,000$ ) must be recognized as gain. In addition, *T* must report the interest element of each payment. A purchaser such as *X* is ordinarily not entitled to deduct any portion of the payments made to the seller. Unless the property falls within one of the exceptions to §163(h) the interest payments by *X* will be personal interest expense, which is nondeductible.

1. **Payments Received.** In general, gain is recognized only as payments are received by the seller, or when the obligation is sold, exchanged, or otherwise disposed of by him or her. For the purposes of the installment sale rules, the word “payment” has a broad and somewhat undefined meaning. The planner must be alert to the circumstances under which the seller may be treated as having received payment without having actually received any cash or other property.
2. **Payment by Note.** The receipt of an evidence of indebtedness of the purchaser is not ordinarily treated as payment.<sup>85</sup> However, the receipt of an obligation that is payable on demand does constitute payment.<sup>86</sup> The receipt of a readily traceable obligation issued by a corporation or government or political subdivision thereof is also treated as payment.<sup>87</sup> Assignment of the installment obligation as collateral security on a loan substantially equal to the amount of the installment obligation is also a disposition.<sup>88</sup>
3. **Security Interests and Escrow Accounts.** The seller’s retention of a security interest in the property does not constitute a payment or otherwise jeopardize the application of the installment sale method. However, funds deposited in an escrow account for future distribution to the transferor are considered to be a payment unless there is a substantial restriction, other than the passage of time, upon the transferor's right to receive the sale

---

<sup>85</sup> IRC §453(f)(3).

<sup>86</sup> IRC §453(f)(4)(A).

<sup>87</sup> IRC §453(f)(4)(B).

<sup>88</sup> *Rev. Rul. 65-185.*

proceeds.<sup>89</sup> Thus, “the substitution of the escrow deposit for the deed of trust as collateral for the installment sale obligation represents payment of the remaining unpaid balance of the installment obligation.”<sup>90</sup> In order to qualify as a substantial restriction upon the transferor's right to the proceeds, the provision “must serve a bona fide purpose of the purchaser, that is, a real and definite restriction placed on the seller or a specific economic benefit conferred on the purchaser.”

4. **Property Subject to Debt.** Where an existing mortgage is assumed by the purchaser, the mortgage is treated as a payment received by the seller only to the extent it exceeds the seller's basis after adjustment for selling expenses.<sup>91</sup> That treatment is consistent with the recognition of gain when the owner makes a gift of property that is subject to encumbrances in excess of its basis.

D. **Inter Vivos Disposition of Installment Obligation.** Gain or loss is usually recognized whenever the seller sells, exchanges, or otherwise disposes of the installment obligation.<sup>92</sup> However, transfers to spouses are excepted from this rule.<sup>93</sup> Also, the transfer of an obligation to the trustee of a grantor trust is not a disposition.<sup>94</sup> Accordingly, the installment sale rules should not deter the holder of an installment obligation from creating a revocable trust.

1. **Cancellation as Disposition.** For estate planning purposes, perhaps the most important rule is one that treats the cancellation of an installment obligation as a taxable disposition.<sup>95</sup> When a note is cancelled or otherwise becomes unenforceable, the seller is treated as having received the full face amount of the obligation where the obligor is a related person.<sup>96</sup> In effect, §453B(f) reverses the questionable conclusion of *Miller v. Usry*,<sup>97</sup>

---

<sup>89</sup> Rev. Rul. 73-451.

<sup>90</sup> Rev. Rul. 77-294, amplified by Rev. Rul. 79-91.

<sup>91</sup> Reg. §15A.453-1(b)(3)(i).

<sup>92</sup> IRC §453B.

<sup>93</sup> IRC §§453B(g); 1041.

<sup>94</sup> Rev. Rul. 74-613.

<sup>95</sup> IRC §453B(f).

<sup>96</sup> IRC §453B(f)(2).

<sup>97</sup> 160 F. Supp. 368 (W.D.La. 1958).

that a father's forgiveness of his son's installment note did not constitute a disposition of the note for income tax purposes. If the obligor is not a related party, gain or loss is limited to the difference between the seller's basis and the fair market value of the obligation.<sup>98</sup>

2. **Related Party Rules.** For purposes of §453, the term “related person” means one whose stock would be attributed to the original transferor under §318(a), excluding paragraph (4), or a person who bears a relationship described in §267(b) to the person disposing of the property.<sup>99</sup> Accordingly, the term includes spouses, siblings, ancestors and lineal descendants, as well as many trusts, partnerships, and corporations in which the transferor has a direct or indirect interest. For example, the trustee of a trust would be treated as a related party if any of the enumerated relatives of the original transferor is a beneficiary.

**EXAMPLE:** *T* sold Blackacre, which had a basis of \$10,000, to *X* for \$100,000, represented by an interest-bearing note on which no principal payments were due until 5 years following the sale. *T* gave the note to *X* before any principal payments had been made. If *X* is a related party, *T* will recognize a gain of \$90,000 in the year the note becomes unenforceable by reason of the gift. If *X* is not a related party, *T* will recognize gain in an amount equal to the excess of the fair market value of the note over his or her basis in it.

- E. **Dispositions at Death.** In general, the rules regarding the inter vivos disposition of an installment obligation do not apply to the transmission of an installment obligation at death.<sup>100</sup> Instead, the unreported gain attributable to an installment obligation is treated as an item of income in respect of a decedent.<sup>101</sup> As such, the gain component is barred by §1014(c) from acquiring a new basis by reason of the holder's death. For that reason the person who receives an installment obligation from a decedent is taxed on payments in the same manner the decedent would have been.<sup>102</sup> However, for income tax purposes, the seller's successor is allowed a deduction for the portion of the federal and state death taxes paid by the seller's estate with respect to the unreported gain.<sup>103</sup> Where an installment obligation is

---

<sup>98</sup> IRC §453B(a), (f)(1).

<sup>99</sup> IRC §453(f)(1).

<sup>100</sup> IRC §453B(c).

<sup>101</sup> IRC §691(a)(4).

<sup>102</sup> IRC §691(a)(1)(B).

<sup>103</sup> IRC §691(c).



transferred by a trust to a remainder beneficiary by reason of the life tenant's death, the transfer is a disposition, which triggers gain to the distributing trust.<sup>104</sup>

**EXAMPLE:** *T* bequeathed an installment note of an unrelated party to a child, *C*. The note had a value in *T*'s estate equal to its face amount, \$20,000, of which \$10,000 was attributable to the unreported long-term capital gain. *T*'s estate paid \$4,000 in estate tax with respect to the unreported gain. If *C* receives payment of the entire amount due on the note in one year, \$20,000, *C* must include the full \$10,000 gain in gross income. However, *C* is entitled to a \$4,000 deduction for the estate tax paid with respect to the gain. Thus, only \$6,000 of the gain is ultimately subject to tax.

1. **Distribution to Obligor.** The rules cannot be avoided by bequeathing the obligation to the obligor or providing in the seller's will for cancellation of the obligation. Any cancellation of the obligation or its transmission to the obligor triggers the recognition of gain "by the estate of the decedent (or, if held by a person other than the decedent before the death of the decedent, by such person)."<sup>105</sup> Because of this rule it is particularly important to plan carefully for the transmission of the installment obligation of family members. For example, the obligation might be bequeathed to the obligor's children or to a trust for their benefit instead of being left to the obligor. Even where the obligations will pass to the obligors, the tax cost can be reduced by canceling or distributing them during a year in which the estate either has capital losses or other deductions to offset the gain or has little or no other income.

**EXAMPLE:** *T* sold capital gain property to a related party, *P*, in exchange for *P*'s note that was payable at the end of 10 years. *T* died prior to the payment of the note, which *T* bequeathed to *P*. Under §691(a), the bequest of the note to *P*, a related obligor, requires *T*'s estate to recognize all of the unreported gain on the sale. The same result would follow if the obligation were cancelled by *T*'s will. Of course, no gain would be recognized by *T*'s estate if the note were bequeathed to a person other than the obligor.

2. **Self-Cancelling Installment Notes.** Although a self-canceling installment note may work for estate tax purposes (*i.e.*, nothing is included in the seller's gross estate), the cancellation triggers recognition of the unrealized gain.<sup>106</sup> In *Estate of Frane v. Commissioner*,<sup>107</sup> the Tax Court held that for

---

<sup>104</sup> Private Letter Ruling 8317050.

<sup>105</sup> IRC §691(a)(5); Private Letter Ruling 9108027 (testamentary forgiveness of balance of installment note causes recognition of income by decedent's estate).

<sup>106</sup> Rev. Rul. 86-72.

<sup>107</sup> 98 T.C. 341 (1992), *rev'd*, 988 F.2d567 (8th Cir. 1993).

purposes of §453B the death of the obligee of a self-canceling installment note was a cancellation that constituted a taxable disposition by the decedent. As a result, because the decedent and the obligors were related, “gain was recognized equal in amount to the excess of the face amount of the obligations over basis ‘at the time of’ the transaction—the date of the decedent’s death.”<sup>108</sup> Because the gain was properly reportable by the decedent, under §691(a)(1) it was not income in respect of a decedent reportable by his estate. Interestingly, “[o]n its federal estate tax return, the estate disclosed the promissory notes in question, but did not include any balance due in respect thereof in decedent’s gross estate. Respondent audited the estate tax return and issued a closing letter without making any adjustments to decedent’s gross estate with respect to any balance due under the promissory notes.”<sup>109</sup> On appeal, the Eighth Circuit held that under §691(a)(5)(A)(iii) the gain was recognizable by the estate and not the decedent.<sup>110</sup>

- F. **Imputed Interest and Original Issue Discount.** Alas estate planners cannot ignore the imputed interest rules of §483 and the original issue discount (OID) rules of §§1272-1275. In general, these rules are designed to prevent the parties from converting into a capital gain the portion of deferred payments that would otherwise constitute interest by increasing the purchase price and reducing or eliminating any provision for payment of interest. Thus, a seller cannot treat the full amount of deferred payments as the proceeds of sale and none of it as interest, and a seller usually cannot defer interest if the OID rules apply. Section 1274 defines debt instruments to which the OID rules apply. These include, generally, debt instruments that are not publicly traded that are issued in exchange for property where there are payments due more than six months after the date of sale or exchange and there is unstated or deferred interest. Unstated interest occurs when the stated interest rate falls below the “test rate” (the “applicable federal rate” or “AFR”) at or about the time of the contract for sale.
1. **Exempt Transactions.** Luckily, the complex rules of §§1272-1275 do not apply to many common intrafamily transactions. The following transfers are specifically exempted by §1274(c)(3) and are, therefore, subject to §483: (1) sales of farms for \$1 million or less by individuals, estates, testamentary trusts, and certain corporations and partnerships, (2) sales of a principal residence by an individual, (3) sales involving \$250,000 or less

---

<sup>108</sup> 98 T.C. at 353.

<sup>109</sup> 98 T.C. at 345.

<sup>110</sup> *Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993).

in total payments (principal and interest), (4) sales of patents for a royalty, and (5) qualified sales of land to a family member as defined in §483(e).

2. **Applicable Federal Rate.** Under §1274A, the test and imputation rate to be applied to qualified debt instruments for purposes of §§483 and 1274 is the lesser of the AFR or 9 percent compounded semiannually. A qualified debt instrument is one given in exchange for the sale of property other than new §38 property, the principal amount of which does not exceed \$2.8 million (adjusted for inflation since 1989). §1274A(b). For sales at prices in excess of \$2.8 million and all sales of §38 property the test rate is equal to the AFR.

*Duration of Debt Obligation*

Not over 3 years

Between 3 and 9 years

Over 9 years

*Applicable Federal Rate*

Short-term rate

Mid-term rate

Long-term rate

- G. **Resale by Related Persons.** Prior to the enactment of the Installment Sales Revision Act of 1980 the installment sale was often used to transfer appreciated property to a family member or to the trustee of a trust established by the transferor, who would promptly sell the property for its full market value. In most cases, neither the original transferor nor the related buyer was required to recognize any gain at the time of the resale. If the resale did not involve a payment to the original seller, the resale usually did not require him or her to recognize any gain. The related seller usually had no gain on the resale because his or her basis in the property was fixed by the installment sale. In effect, the installment sale technique allowed a family group to realize the gain without subjecting it to current taxation. Today, however, §453(e) provides that the disposition of the property by a related purchaser triggers recognition of gain by the original transferor. In general, recognition is not triggered if the resale of property occurs more than two years after the installment sale. Where the resale rule applies, gain is recognized by the original transferor only to the extent the amount realized on the resale exceeds the total payments made on the original transaction. To that extent the gain flows through and is taxed to the original transferor as if the original transferor received the proceeds of the resale. If the original transferor is required to recognize gain because of a resale, any later payments received by him or her are not taxed until they equal the amount realized from the resale that triggered the acceleration of gain.<sup>111</sup>

1. **Related Party Rules.** As before, related persons include spouses, brothers and sisters, ancestors and lineal descendants, as well as many trusts,

---

<sup>111</sup> IRC §453(e)(5).

partnerships, and corporations in which the transferor has a direct or indirect interest.

2. **Transactions Treated as Resales.** In general, the resale rule applies to any voluntary disposition made by the related party unless the disposition did not have the avoidance of federal income tax as one of its principal purposes.<sup>112</sup> Thus, the recognition of gain by the original transferor normally will be accelerated if the resale violates the basic rules. However, an exception insulates a corporation's sale of stock that it had purchased in an installment sale.<sup>113</sup> Also, a disposition following the death of the original transferor or the related party is not treated as a resale.<sup>114</sup> In this connection the Senate Report states that the death exception applies "after the death of either spouse when the spouses hold their interest in the installment obligation or the purchased property as community property or as equal undivided joint interests."<sup>115</sup>

**EXAMPLE:** *T* sold land with a basis of \$20,000 and a fair market value of \$100,000 to his son, *S*, in exchange for a \$100,000 nonnegotiable promissory note that provided for 6% interest, compounded semiannually. Under the note, no principal payments were due for 10 years. *S* sold the land for \$100,000 cash immediately after he received it from *T*. Under the resale rule *T* must recognize the full \$80,000 gain in the year in which *S*, a related party, sold the land. *S* realized no gain on the sale because his cost basis in the land was \$100,000. Any subsequent payments received by *T* are tax-free since all of the gain has been taxed to him already under the resale rule. If the second sale had occurred more than 2 years after the original transfer, *T* would not have been required to recognize any gain on the resale.

## VII. Like-Kind Exchanges

- A. **Background.** A "like-kind exchange" is any transaction where the properties exchanged have the same nature or character. Most like-kind exchanges involve real property, but it is also possible to have a like-kind exchange of tangible personal property (a passenger car for another passenger car) or even intangible property (a copyright in a song for a copyright in a different song).

1. **Policy.** The principal justification for nonrecognition in a like-kind exchange is that the taxpayer has not changed the substantive nature of his or her

---

<sup>112</sup> IRC §453(e)(7).

<sup>113</sup> IRC §453(e)(6)(A).

<sup>114</sup> IRC §453(e)(6)(C).

<sup>115</sup> S. Rep. No. 1000, 96th Cong., 2d Sess. 16 (1980).

investment; instead, only the exact form of the investment has changed. For instance, if a landlord swaps one apartment building for another apartment building, one can justify nonrecognition on the grounds that the landlord remains invested in rental real estate after the exchange. As long as any gain or loss from the old property is carried over into the new property, there is no serious harm in letting the landlord change the form of his or her investment. When one considers the breadth of §1031(a), however, some of this justification is lost. A taxpayer can, for example, swap an acre of farmland for a metropolitan apartment building and qualify for nonrecognition under §1031(a).

2. **Limited Gain Recognition.** §1031(a)(1) provides that if a taxpayer exchanges property held for business or investment purposes solely for property “of like kind” that will be held for business or investment purposes, no gain or loss is recognized. If a taxpayer receives both like-kind property and other property in the exchange (cash or property not of like kind), §1031(b) states that the taxpayer must recognize gain (but not loss) to the extent of the value of the other property.

#### B. Eligibility for Nonrecognition

1. **Old Property Held for Business or Investment.** The property surrendered by the taxpayer in the exchange must have held for use in a business or investment activity.
  - a. **Personal-Use Property Ineligible.** Property held by the taxpayer for personal use is not eligible for §1031 treatment. This includes the taxpayer’s residence, personal automobile, and personal effects like a television.
  - b. **Disqualified Assets.** Certain assets are expressly excluded from §1031 treatment even if the taxpayer held them for business or investment uses. These include inventory items held for sale to customers, marketable securities, promissory notes, and partnership interests.<sup>116</sup>
2. **Exchange for Like-Kind Property.** The property acquired in the exchange must be of “like-kind” with the property surrendered.
  - a. **Same Nature or Character.** The Code contains no guidance as to whether an exchange involves property of like kind. The regulations

---

<sup>116</sup> The complete list is set forth at IRC §1031(a)(2).

provide that the term “like kind” refers to “the nature or character of the property and not to its grade or quality.” Thus, for example, improved real property and unimproved real property are of like kind because they share the same nature or character (they are both interests in land) even though they have different grades or qualities.

- b. **Real Property.** Nearly every exchange of real property for other real property will qualify. The regulations state that “[t]he fact that any real estate involved is improved or unimproved is not material, for that facts relates only to the grade or quality of the property and not its kind or class.”<sup>117</sup> Thus, an exchange of unimproved land for improved land is a like-kind exchange.<sup>118</sup>
  - c. **Personal Property.** Exchanges of personal property (anything other than land, whether tangible or intangible) are subject to more restrictive rules.<sup>119</sup> Generally, *depreciable* personal property will be considered like-kind to other depreciable personal property that has the same “General Asset Class” used in assigning class lives for purposes of depreciation. For *intangible* property (and personal property not subject to depreciation), the more general test of “nature or character” applies.
3. **New Property Held for Business or Investment.** The like-kind property received in the exchange must be held by the taxpayer for use in a business or investment activity.
- a. **No Need to Use in Same Activity.** Just as the property exchanged must have been held for use in a business or investment activity, the property acquired must be so held by the taxpayer. There is no requirement, however, that the taxpayer use the new property in the *same* activity in which the taxpayer used the old property. For example, a taxpayer can swap land used in his or her business for rental real estate that will be held for investment purposes. The only restriction is that the new property cannot be held for personal use.

---

<sup>117</sup> Reg. §1.1031(a)-1(b).

<sup>118</sup> See Reg. §1.1031(a)-1(c)(2).

<sup>119</sup> See Reg. §1.1031(a)-2.

- b. **No Guidance on How Long New Property Must be Held.** Presumably, a taxpayer ultimately intending to use the acquired property for personal purposes may not simply hold the property for business or investment purposes for only a brief time; however, there is no firm guidance on this point. This should rarely be an issue, however; if the recipient intends to sell the new property right away, why bother with the like-kind exchange in the first place?
- 4. **No Additional Consideration Received.** To get full nonrecognition, the taxpayer must receive no consideration in addition to the like-kind property.
  - a. **Recognize Gain to the Extent of Boot.** If the taxpayer receives cash or some other property (referred to as “boot”) in addition to the like-kind property, §1031(a)(1) does not apply. Instead, §1031(b) applies and the taxpayer recognizes gain to the extent of the value of the boot received.
    - (i) **If Realized Gain Exceeds Amount of Boot.** Section 1031(b) provides that the realized gain to the taxpayer “shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property (received).” Thus, the amount of gain recognized is limited to the amount of boot received.
    - (ii) **If Amount of Boot Exceeds Realized Gain.** If the realized gain is less than the amount of boot received, the entire realized gain is recognized but nothing more.
  - b. **No Loss Recognized.** If the taxpayer realizes a loss on the exchange and receives boot in addition to the like-kind property, no loss is recognized. §1031(c).
  - c. **Debt Relief Treated as Boot.** If the old property is encumbered by debt, remember that the amount realized includes the amount of the debt no matter whether the debt is recourse or nonrecourse and no matter whether the other party formally assumes the debt or merely takes the property subject to the debt. In addition, the last sentence of §1031(d) treats such debt relief as money received by the taxpayer. Thus, where the taxpayer transfers property that secures a debt, the taxpayer is deemed to receive cash equal to the amount of the debt relief, meaning the taxpayer receives boot.

- C. **Basis in Property Received.** A taxpayer's basis in property received in a like-kind exchange is computed under the formula provided in the first sentence of §1031(d):

$\begin{array}{r} \text{Basis in Old Property} \\ \text{Minus Money Received} \\ \text{Plus Recognized Gain} \\ \text{Minus Recognized Loss} \\ \hline \text{Basis in New Property} \end{array}$
--

1. **Basis in Old Property.** This refers to the taxpayer's adjusted basis in the property surrendered in the exchange. A taxpayer's original cost basis in the old property may be adjusted upward due to improvements and downward due to depreciation deductions.
2. **Money Received.** This refers to any cash the taxpayer received in the exchange.
  - a. **Debt Relief Treated as Money Received.** The last sentence of §1031(d) treats debt relief as money received by the taxpayer "for purposes of this section," meaning §1031. Thus any debt relief should be treated as "money received" for purposes of computing the basis of the new property received.
  - b. **Taking on Extra Debt.** If the taxpayer takes the new property subject to a different liability, and if the amount of that liability exceeds the amount of the liability attached to the taxpayer's old property, then there is no net debt relief to the taxpayer. Accordingly, the taxpayer in such a situation is not deemed to receive any cash under §1031(d).<sup>120</sup> The other party to the exchange, of course, will be deemed to receive cash because that party necessarily has been relieved of more debt than he or she is assuming in the transaction.
3. **Basis Where Taxpayer Gets Boot and Like-Kind Property.** Where the taxpayer receives boot in addition to the like-kind property, the basis computed under the formula in the first sentence of §1031(d) must be apportioned between the like-kind property and the boot.

---

<sup>120</sup> See Reg. §1.1031(d)-2, Example (2).



- a. **Boot Gets Fair Market Value Basis.** The second sentence of §1031(d) provides that any non-cash boot receives a basis equal to the fair market value of such property.
- b. **Remaining Basis Goes to Like-Kind Property.** Any basis remaining after assigning a fair market value basis to the boot becomes the basis in the like-kind property received. (Notice that the taxpayer's basis will always preserve the amount of unrecognized gain or loss. You can always check to make sure the computed basis is correct by computing the consequences of a hypothetical sale of the new property for fair market value immediately after the exchange. The amount of any realized gain or loss should equal the amount of gain or loss that was not recognized because of the application of §1031.)

## VIII. Marital Property Transfers

- A. **Property Transfers Between Spouses.** In *United States v. Davis*,<sup>121</sup> the Court held that a taxpayer had to recognize gain upon the transfer of stock to his spouse pursuant to a separation agreement. The moral of the case is that the transfer of appreciated property in satisfaction of a legal obligation is a realization event for federal income tax purposes. Congress understood the moral, perhaps, but it clearly felt the specific result in *Davis* was wrong. So it enacted §1041 to overrule *Davis* in the context of spousal transfers. Under §1041(a), no gain or loss is recognized on a transfer of property to a spouse. The transferee spouse is deemed to receive the property by gift, §1041(b)(1), meaning he or she does not have gross income.<sup>122</sup> In addition, the transferee spouse takes a basis in the property equal to the transferor spouse's adjusted basis in the property at the time of the transfer.<sup>123</sup> Just like other nonrecognition transactions, §1041(b) preserves the gain or loss in the hands of the recipient spouse by giving the recipient spouse a basis in the transferred property equal to the transferor spouse's basis.
- B. **Property Transfers Between Former Spouses.** The nonrecognition rule also applies to transfer between former spouses if they are "incident to a divorce." §1041(c)(1) automatically deems all transfers within one year of the divorce to be "incident to the divorce," and §1041(c)(2) includes all transfers "related to the cessation of the marriage" as being incident to the divorce.

---

<sup>121</sup> 370 U.S. 65 (1962).

<sup>122</sup> IRC §102(a).

<sup>123</sup> IRC §1041(b)(2).

1. **Transfer to Former Spouse Within One Year of Divorce.** If the transfer between former spouses occurs within one year after the date on which the marriage ceased, the transfer is “incident to the divorce,” §1041(c)(1), meaning the gain or loss is not recognized, provided that the former spouse is a United States citizen or resident.<sup>124</sup> The former spouse is deemed to receive the property by gift,<sup>125</sup> meaning he or she does not have gross income.<sup>126</sup> In addition, the former spouse takes a basis in the property equal to the transferor’s adjusted basis in the property at the time of the transfer.<sup>127</sup>
2. **Transfer to Former Spouse Within Six Years of Divorce and Pursuant to Instrument.** If the transfer between former spouses is pursuant to a divorce or separation instrument and occurs within six years after the date on which the marriage ceased, then the transfer is “related to the cessation of the marriage,”<sup>128</sup> It is therefore “incident to the divorce,”<sup>129</sup> meaning the gain or loss is not recognized as long as the former spouse is a United States citizen or resident.<sup>130</sup> The former spouse is deemed to receive the property by gift,<sup>131</sup> meaning he or she does not have gross income.<sup>132</sup> In addition, the former spouse takes a basis in the property equal to the transferor’s adjusted basis in the property at the time of the transfer.<sup>133</sup>
3. **Transfer to Former Spouse to Effect Division of Marital Property.** If the transfer between former spouses was made to effect the division of property owned by the former spouses at the time the marriage ceased, then the transfer may be “related to the cessation of the marriage” if the

---

<sup>124</sup> IRC §1041(a)(1), (d).

<sup>125</sup> IRC §1041(b)(1).

<sup>126</sup> IRC §102(a).

<sup>127</sup> IRC §1041(b)(2).

<sup>128</sup> Reg. §1.1041-1T(b), Q&A 7.

<sup>129</sup> IRC §1041(c)(2).

<sup>130</sup> IRC §1041(a)(1), (d).

<sup>131</sup> IRC §1041(b)(1).

<sup>132</sup> IRC §102(a).

<sup>133</sup> IRC §1041(b)(2).

parties can show that it was burdensome to comply with the one- and six-year periods described above.<sup>134</sup> If successful, the transfer will be considered “incident to the divorce,”<sup>135</sup> meaning the gain or loss is not recognized as long as the former spouse is a United States citizen or resident.<sup>136</sup> The former spouse is deemed to receive the property by gift,<sup>137</sup> meaning he or she does not have gross income.<sup>138</sup> In addition, the former spouse takes a basis in the property equal to the transferor’s adjusted basis in the property at the time of the transfer.<sup>139</sup>

4. **Transfer to Third Party Pursuant to Spouse’s Written Request.** A transfer to a third party either pursuant to the written request of the transferor’s spouse or former spouse or pursuant to a divorce or separation instrument can qualify for the §1041 exclusion because it will be deemed to be a transfer to the spouse or former spouse.<sup>140</sup> Thus, any realized gain or loss to the transferor is not recognized if the other elements of §1041 are met. If §1041 applies, the transferee is deemed to have received the property by gift,<sup>141</sup> meaning he or she does not have gross income.<sup>142</sup> In addition, the transferee takes a basis in the property equal to the transferor’s adjusted basis in the property at the time of the transfer.<sup>143</sup> The transferee is then deemed to have transferred the property to the third party, the tax consequences of which will depend on the facts surrounding such transfer.<sup>144</sup>

---

<sup>134</sup> Reg. §1.1041-1T(b), Q&A 7.

<sup>135</sup> IRC §1041(c)(2).

<sup>136</sup> IRC §1041(a)(1), (d).

<sup>137</sup> IRC §1041(b)(1).

<sup>138</sup> IRC §102(a).

<sup>139</sup> IRC §1041(b)(2).

<sup>140</sup> Reg. §1.1041-1T(c), Q&A 9.

<sup>141</sup> IRC §1041(b)(1).

<sup>142</sup> IRC §102(a).

<sup>143</sup> IRC §1041(b)(2).

<sup>144</sup> Reg. §1.1041-1T(c), Q&A 9.

C. **Alimony.** Cash payments that qualify as “alimony” are included in the recipient’s gross income under §71(a) and are deductible by the payor under §215.

1. **Alimony Defined.** For purposes of this rule, §71(b)(1) defines “alimony” as a payment in cash that meets these three requirements: (i) the payment is received by (or on behalf of) the taxpayer under a divorce or separation instrument (specially defined in §71(b)(2)) that does not designate the payment as non-alimony; (ii) if the taxpayer and the payor are legally separated, they are not members of the same household at the time of payment; and (iii) the payor has no liability to continue making payments or any substitute for payments after the taxpayer’s death.
2. **Child Support.** Payments for child support are not considered to be payments of alimony.<sup>145</sup> Therefore, such amounts are not included in gross income. To the extent the amount of any cash payment to the taxpayer will be reduced upon the occurrence of a contingency related to a child, such amount will be considered child support and not alimony.<sup>146</sup> If the taxpayer receives a payment for alimony and child support that is less than the amount required to be received under the divorce or separation instrument, the taxpayer is deemed to receive all of the required child support before receiving any portion of the alimony.<sup>147</sup>
3. **Watch Out for Alimony Recapture.** If the amount of alimony received by the taxpayer in the first two years of alimony payments substantially exceeds the payments received in later years, the taxpayer receiving the payments may have a deduction under §71(f) for the “excess front-loading” of payments in the first two years. Here are formulas for determining whether this “alimony recapture” applies and, if so, the amount of the taxpayer’s deduction:

**STEP ONE:** Compute the excess payments for the second calendar year in which alimony payments are made.

- |  |          |
|--|----------|
| 1. Alimony in the second post-separation year: | 1. _____ |
| 2. Alimony in third post-separation year:      | 2. _____ |
| 3. Add \$15,000 to line 2:                     | 3. _____ |
| 4. Subtract line 3 from line 1:                | 4. _____ |

<sup>145</sup> IRC §71(c)(1).

<sup>146</sup> IRC §71(c)(2).

<sup>147</sup> IRC §71(c)(3).

*The amount in line 4 is the excess payment for the second post-separation year; the taxpayer receiving the alimony can deduct this amount in the third post-separation year.*

**STEP TWO:** Compute the excess payments for the first calendar year in which alimony payments are made.

- |  |           |
|--|-----------|
| 5. Alimony in the first post-separation year:          | 5. _____  |
| 6. Enter the amount in line 1 here:                    | 6. _____  |
| 7. Enter the amount in line 4 here:                    | 7. _____  |
| 8. Subtract line 7 from line 6:                        | 8. _____  |
| 9. Enter the amount in line 2 here:                    | 9. _____  |
| 10. Enter the average of the amounts in lines 8 and 9: | 10. _____ |
| 11. Add \$15,000 to line 10:                           | 11. _____ |
| 12. Subtract line 11 from line 5:                      | 12. _____ |

*The amount in line 12 is the excess payment for the first post-separation year; the taxpayer receiving the alimony can deduct this amount in the third post-separation year.*

## **IX. Income Taxation of Life Insurance**

*Note: Most of the material in this Part IX is adapted from John R. Price and Samuel A. Donaldson, PRICE ON CONTEMPORARY ESTATE PLANNING (2015 edition: Wolters Kluwer).*

- A. **Receipt of Life Insurance Proceeds.** In general, amounts received under a life insurance contract by reason of the death of the insured are not included in the recipient's gross income.<sup>148</sup> The exclusion is available whether the payment is made to the estate of the insured or to another beneficiary. Likewise, it is available whether the payment is made directly to an individual or in trust. Importantly, the exclusion is not dependent upon the proceeds being subject to the estate tax. Thus, the proceeds are excluded from the beneficiary's gross income whether or not they are included in the gross estate of the insured.

**EXAMPLE:** Wife's life was insured under a policy owned by Husband. The policy designated Child as beneficiary. The policy provided for the payment of an additional amount equal to the face amount of the policy if the insured dies as the result of accidental injuries. Wife died in an automobile accident and C received both the face amount of the policy plus the additional benefit. Although none of the insurance was included in Wife's gross estate, the proceeds paid to Child are excluded from Child's gross income.

1. **Deferred Payments.** The general exclusion extends only to the amount payable as a death benefit at the time of the insured's death. It does not

<sup>148</sup> IRC §101(a)(1).

apply to interest paid because of a delay in payment of the death benefit.<sup>149</sup> Instead, the additional amounts are taxed as income to the recipient.

- a. **Interest-Only Option.** Most policies permit the insured or the beneficiary to elect to have the proceeds paid in a lump sum or under one or more settlement options, usually either the “interest-only” option or the “installment” option. Under the interest-only option, the beneficiary receives only interest on the proceeds at a guaranteed rate until the principal amount is withdrawn or paid out. The beneficiary is taxed on the interest as it is paid.<sup>150</sup>
- b. **Installment Option.** The installment option usually provides for payment of a fixed amount either for a specified period (*e.g.*, \$2,500 per month for ten years) or for the life of the beneficiary with a certain number of payments guaranteed. In this case, the principal portion of each payment is not included in the beneficiary's income.<sup>151</sup> The principal component of each payment is determined by prorating the amount held by the insurer with respect to the beneficiary over the period for which payments will be made.

**EXAMPLE:** The proceeds of a \$100,000 policy on the life of Daughter are payable to Mother in ten annual installments of \$12,500 each. Under the basic rule of §101(d), \$10,000 of each payment is excludable from Mother's income ( $\$100,000 \div 10 = \$10,000$ ). The other \$2,500 of each payment is taxable as interest.

2. **The Transfer for Value Rule.** The proceeds of a policy that is transferred for value are generally includible in the recipient's income except to the extent of the consideration paid plus premiums and other amounts subsequently paid by the recipient.<sup>152</sup> This limitation on the availability of the general exclusion was apparently intended to discourage trafficking in life insurance policies for profit. A provision with such a broad sweep is probably not necessary to achieve the desired purpose—a questionable object of the income tax law in any event. As it is, the transfer for value rule acts as a trap for the unwary and unsophisticated.

---

<sup>149</sup> IRC §101(c), (d).

<sup>150</sup> IRC §101(c).

<sup>151</sup> IRC §101(d).

<sup>152</sup> IRC §101(a)(2).

- a. **Exception for Carryover Basis Transfers.** The transfer for value rule does not apply when the transferee's basis in the policy for the purpose of determining gain or loss is determined in whole or in part by reference to the basis of the policy in the hands of the transferor.<sup>153</sup> This shelters all transfers that have a gift element; thus, a transfer that is a part gift-part sale is within the exception.<sup>154</sup> The exception also applies where a policy is transferred from one corporation to another in a tax-free reorganization, as a result of which the transferor's basis in the policy carries over to the transferee.<sup>155</sup> Importantly, the transfer for value rule would not apply to policies transferred between spouses or between ex-spouses where incident to the divorce.<sup>156</sup>

- (1) **Transfer to Grantor Trust.** A life insurance policy can be transferred for consideration to a trust owned by the grantor for federal income tax purposes without triggering the transfer for value rule. In *Rev. Rul. 2007-13*, the Service held that a grantor who is treated as the owner of a trust that owns a life insurance contract on the life of the grantor is treated as the owner of the insurance contract for purposes of the transfer for value rule of §101(a)(2). In the ruling, the grantor creates two trusts, cleverly titled TR1 and TR2. TR2 later transfers a policy on the life of the grantor to TR1 in exchange for cash. TR1 is a grantor trust, meaning the grantor is the deemed owner of the trust's assets for income tax purposes. The Service ruled that if TR2 is also a grantor trust, there is no transfer for value, because the grantor is the deemed owner of both trusts. Consistent with the rationale of *Rev. Rul. 85-13*, the Service concluded that a transaction between two grantor trusts is disregarded, because it is, in substance, a sale of the policy by the grantor to the grantor. The Service also ruled that if TR2 is not a grantor trust, then the transaction will not be disregarded, but the transaction will be excepted from the transfer for

---

<sup>153</sup> IRC §101(a)(2)(A).

<sup>154</sup> *Rev. Rul. 69-187*.

<sup>155</sup> Reg. §1.101-1(b)(5), Example 4.

<sup>156</sup> IRC §1041.

value rule, because it is treated as a transfer to the grantor, the insured.

- (2) **Planning Techniques with Grantor Trusts.** The ruling indirectly endorses a couple of common planning techniques. If a policy sits in a grantor trust the terms of which no longer meet the needs of the insured's family, the grantor might create a new grantor trust containing more appropriate provisions, fund the new trust with cash, and have the new grantor trust purchase the policy from the old grantor trust. The ruling confirms that such a transfer would not trigger the transfer for value rule. Furthermore, if the insured currently owns the policy outright and wishes to transfer it to a trust without subjecting the transfer to the three-year rule of §2035, the owner-insured might sell the policy to a trust in which the owner-insured is the deemed owner for income tax purposes. Not only is the transfer immune from the transfer for value rule (as the ruling confirms), but because §2035(d) precludes application of the three-year rule where the owner-insured transfers the policy for its fair market value, the policy is removed from the owner-insured's gross estate even if the owner-insured dies immediately after the sale.<sup>157</sup>

- b. **Exception for Transfers to Insured, Insured's Partner, Insured Partnership, or Insured's Corporation,** The transfer for value rule also does not apply when the transfer was made to the insured, a partner of the insured, a partnership of which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.<sup>158</sup> This is particularly important in planning business transactions. In *Private Letter Ruling 9701026*, the Service ruled that the transfer of a policy to a partner of the insured in connection with the creation and funding of a new buy-sell agreement was within the exception. Beware, however: the superficial breadth of this exception is misleading—it does not protect a wide variety of fairly common transfers, among them:

---

<sup>157</sup> See *Private Letter Ruling 9413045*.

<sup>158</sup> IRC §101(a)(2)(B).



- (1) One shareholder transfers a policy insuring his life to another shareholder in exchange for a similar policy on that shareholder's life (or for other consideration).<sup>159</sup>
- (2) An employee or director of a corporation who is not a shareholder or officer transfers a policy on his or her life to the corporation in exchange for cash or other valuable consideration.
- (3) A corporation sells a policy insuring the life of an employee to the employee's spouse for a cash payment.<sup>160</sup>

**B. Payment of Premiums.**

1. **Personal Policies.** Premiums paid on personal (*i.e.*, nonbusiness) insurance are generally not deductible for income tax purposes. To begin with, premiums paid by a taxpayer on policies insuring the premium payor's life are considered to be nondeductible personal expenses.<sup>161</sup> Premium payments made on policies insuring the lives of family members are also subject to that rule. In addition, premiums on policies insuring the life of another person are not deductible if the proceeds would be excluded from the premium payor's gross income under §101(a).<sup>162</sup> Further, §264 bars all corporations from deducting any premiums paid on life insurance of which the corporation is directly or indirectly owned by a beneficiary.
  - a. **Premium Payments Deductible as Alimony.** A deduction is allowed under §215 for premium payments that constitute income to a spouse or former spouse of the insured under §71. In order to obtain the deduction, the policy must generally have been assigned to the former spouse in connection with a legal separation, dissolution of marriage, or decree of separate maintenance. The mere designation of the former spouse as beneficiary is not sufficient.
  - b. **Premium Payments as Charitable Contributions.** Subject to the percentage limitations of §170 (discussed in Part X below), a

---

<sup>159</sup> See *Private Letter Ruling 7734048*.

<sup>160</sup> *Estate of Rath v. United States*, 608 F.2d 254 (6th Cir. 1979).

<sup>161</sup> Reg. §1.262-1(b)(1).

<sup>162</sup> IRC §265(a)(1); *Jones v. Commissioner*, 231 F.2d 655 (3d Cir. 1956).

charitable deduction is allowed for premiums paid on a policy that is owned by a charity or a charitable trust. When an income tax charitable deduction is sought the planner should not rely upon the mere irrevocable designation of the charity as beneficiary. Instead, the policy should be irrevocably assigned to the charity, which itself qualifies for the charitable deduction. Note that a charitable deduction is allowable only if the charity has an insurable interest in the donor's life, so it will be entitled to receive the proceeds when the donor dies.

2. **Business Policies.** Under §162, an employer may deduct the premiums paid on life insurance policies on the lives of its officers and employees. The premiums are deductible business expenses if (1) the payments are in the nature of additional compensation, (2) the total amount of compensation paid to an officer or employee is not unreasonable,<sup>163</sup> and (3) the employer is not directly or indirectly the beneficiary.<sup>164</sup> No deduction is allowed for the payment of premiums on policies insuring lives of shareholders. Such payments constitute dividend distributions rather than the payment of compensation for services. In such cases, the amount of the dividends is includible in the shareholder's income. Also, no deduction is allowed if the employer is entitled to receive any of the proceeds of a policy under a split-dollar plan or otherwise.<sup>165</sup>

- C. **Policy Loans.** Under most cash value life insurance policies, the owner may borrow up to the cash surrender value of the policy on the sole security of the policy. Although the payment to the owner is called a loan, there is no personal liability to repay it. The Tax Court commented on this feature of life insurance policies in *J. Simpson Dean v. Commissioner*:<sup>166</sup>

Insurance policy loans are unique because the borrower assumes no personal liability to repay the principal or to pay interest on the amount borrowed. Such loans are based on the reserve value of the insurance policies involved. If either the principal or the interest is not repaid, it is merely deducted from the reserve value of the policy. Since the insurance company “never advances more than it already is absolutely bound for under the policy, it has no interest in creating personal liability.”

---

<sup>163</sup> IRC §162(a).

<sup>164</sup> IRC §264(a)(1). See *Rev. Rul. 56-400*.

<sup>165</sup> IRC §264(a)(1); *Rev. Rul. 66-203*.

<sup>166</sup> 35 T.C. 1083, 1085 (1961), *nonacq.*, 1973-2 C.B. 4.

In *Williams v. Union Central Life Insurance Co.*,<sup>167</sup> the Supreme Court said, “While the advance is called a 'loan' and interest is computed in settling the account, 'the item never could be sued for,' and in substance 'is a payment, not a loan.'”

1. **No Income to Borrower.** Despite the Supreme Court’s view, a policy loan made with respect to most policies is generally not treated as a distribution for income tax purposes. Accordingly, in the case of most policies, taking out a loan does not have any income tax consequences for the borrower. Failure to repay the loan, of course, will have income tax consequences.
2. **Deductibility of Interest Payments on Policy Loans.** The income tax deduction for interest paid on personal loans, such as policy loans, was completely eliminated in 1991.<sup>168</sup> In addition, no deduction is allowable with respect to interest paid on an indebtedness in excess of \$50,000 related to policies purchased after June 20, 1986 that insure the life of anyone who is an officer, employee, or person who is financially interested in the taxpayer's trade or business.<sup>169</sup> However, the preexisting rules regarding the deductibility of interest on policy loans remains of some significance. For example, the old rules apply to loans of \$50,000 or less with respect to business-related insurance.

#### D. **Income Tax Basis in Insurance Policies**

1. **Cash Value Policies.** For the purpose of determining gain or loss on the sale of a cash value policy owned by the insured or a person with an insurable or economic interest in the life of the insured, the basis of the policy is the amount of premiums and other consideration paid reduced by the cost of insurance (COI) protection provided. Unless otherwise determinable, COI of a cash value policy is presumed to be the amount by which the net premiums paid exceed the cash surrender value of the policy (including the amount of any outstanding loans). No loss is recognized if the amount received is less than the net premiums and other consideration paid. The basis of a cash value policy owned by an investor who has no insurable or economic interest in the life of the insured is determined without a reduction for COI during the period the policy was owned by the investor.

---

<sup>167</sup> 291 U.S. 170, 179 (1934),

<sup>168</sup> IRC §163(h)(2).

<sup>169</sup> IRC §264(a)(4).

2. **Term Policies.** The basis of a term policy with no cash surrender value owned by the insured or a person with an insurable or economic interest in the life of the insured is the amount of net premiums paid less COI. Again, the basis of a term policy owned by an investor is determined without regard to COI for the period a policy is owned by an investor.<sup>170</sup>

**E. Surrender or Sale of Insurance Policy**

1. **Surrender.** When a life insurance policy is surrendered the amount received (other than as an annuity) is included in gross income to the extent it exceeds the investment in the contract.<sup>171</sup> The “investment in the contract” is the total of premiums and other consideration paid less all amounts previously received under the contract that were not included in gross income.<sup>172</sup> (Presumably, the amount of any policy loans that were outstanding against the policy would be treated as part of the consideration received.) The ruling characterizes the gain as ordinary income and not capital gain, because the surrender of a policy does not constitute a “sale or exchange.” No deduction is allowed if the owner surrenders a policy and receives less than the net amount of premiums and other consideration paid.<sup>173</sup>
2. **Sale.** The seller realizes gain when a life insurance policy is sold for more than its adjusted basis.<sup>174</sup> If a policy is sold for less than its adjusted basis, the courts have thus far not allowed a deduction. As indicated above, the adjusted basis of an insured owner or person with an insurable or economic interest in the life of the insured is the amount of premiums and other consideration paid less COI provided prior to the sale. Again, unless otherwise indicated, COI is the amount by which the net premiums paid exceed the cash surrender value of the policy. The gain is ordinary income to the extent the cash surrender value of the policy exceeds premiums and other consideration paid (the “inside build up”); any additional gain is capital gain. Again, the adjusted basis of an investor is determined without regard to COI for the period the investor owned the policy.

---

<sup>170</sup> *Rev. Rul. 2009-14.*

<sup>171</sup> IRC §72(e).

<sup>172</sup> *Rev. Rul. 2009-13.*

<sup>173</sup> *London Shoe Co. v. Commissioner*, 80 F.2d 230 (2d Cir. 1935), *cert. denied*, 298 U.S. 663 (1936); *Standard Brewing Co.*, 6 B.T.A. 980 (1927).

<sup>174</sup> *Rev. Rul. 2009-13.*

## **X. Income Tax Deduction for Charitable Contributions**

- A. **The Incentive to Do Good.** Perhaps it is a sad reflection of our society, but Congress provides the deduction in §170 to encourage us to do what we might not do otherwise: give to charity. There are strict limits on the charitable contribution deduction, however. First, only gifts to certain charitable organizations will qualify for the deduction. A handout given to street peddler will not be deductible. Second, the transfer must be a “gift” and not a bargained-for exchange. So when you give \$100 to National Public Radio and receive a \$10 mug as a token of the charity’s appreciation, the amount of the deduction is limited to the \$90 gift portion. Third, in the case of charitable contributions of property there are several situations where the deduction will be limited to the donor’s basis in the contributed property. And finally, there is an overall cap on the total amount of charitable contributions a taxpayer may claim in any single year. The cap is always a function of the taxpayer’s adjusted gross income, but the exact cap depends on the type of property contributed and the nature of the recipient organization.
- B. **Qualified Recipients.** To secure a deduction under §170, a taxpayer must transfer cash or property to an organization described in §170(c).
- C. **No Quid Pro Quo.** If the taxpayer receives or expects to receive property or services from the charity in exchange for the cash or property transferred, then no deduction is allowed unless (and only to the extent that) the value of the cash or property transferred to the charity exceeds the value of the property or services received from the charity.<sup>175</sup> If the taxpayer receives full consideration for an amount transferred to charity, there is no deduction because there has been no charitable contribution.<sup>176</sup>
- D. **Deduction Amount.** How much of the contribution the taxpayer may deduct depends on the type of property contributed to the charity. The following table explains the amount of the deduction:

---

<sup>175</sup> Reg. §1.170A-1(h)(2)(i).

<sup>176</sup> *Hernandez v. Commissioner*, 490 U.S. 680 (1989).

Type of Contribution	Deduction Amount
<b>Cash</b>	Amount of cash contributed
<b>Loss property</b> (basis exceeds value)	Value of property [Reg. §1.170A-1(c)(1)]
<b>Ordinary income property</b> (value exceeds basis, but it's not a capital asset)	Basis of property [§170(e)(1)(A)]
<b>Short-term capital gain property</b> (value exceeds basis in capital asset held for not more than one year)	Basis of property [§170(e)(1)(A)]
<b>Long-term capital gain real property</b> (value exceeds basis in real property that is a capital asset and held more than one year)	Value of property [Reg. §1.170A-1(c)(1)], but basis of property if contributed to private foundation [§170(e)(1)(B)(ii)]
<b>Long-term capital gain intellectual property</b> (value exceeds basis in certain intellectual property that is a capital asset and held for more than one year)	Basis of property [§170(e)(1)(B)(iii)]
<b>Other intangible long-term capital gain property</b> (value exceeds basis in an intangible capital asset and held for more than one year)	Value of property [Reg. §1.170A-1(c)(1)], but basis of property if contributed to private foundation [§170(e)(1)(B)(ii)] unless it's "qualified appreciated stock" [§170(e)(5)]
<b>Long-term capital gain related tangible property</b> (value exceeds basis in a tangible capital asset held more than one year and related to the charity's purpose)	Value of property [Reg. §1.170A-1(c)(1)], but basis of property if contributed to private foundation [§170(e)(1)(B)(ii)]
<b>Long-term capital gain unrelated tangible property</b> (value exceeds basis in a tangible capital asset held more than one year and unrelated to charity's purpose)	Basis of property [§170(e)(1)(B)(i)]

- E. **Annual Deduction Limitation and Carryover.** The gross deduction amount may not be entirely deductible in the year of contribution. Generally, a taxpayer cannot claim total charitable contributions in excess of 50 percent of the taxpayer's "contribution base." The taxpayer's contribution base, generally, is his or her adjusted gross income (the only difference is that any net operating loss carryback to the year at issue is ignored in computing the contribution base).<sup>177</sup> In some cases, a more limited ceiling on the total amount deductible for any one taxable year applies. Use the table below to determine the maximum amount a taxpayer can deduct in the year of contribution. Note that any amount not deductible in the year of contribution generally carries over for up to five succeeding taxable years.<sup>178</sup>

<sup>177</sup> IRC §170(b)(1)(F).

<sup>178</sup> IRC §170(d)(1).

Type of Contribution	% Limit if Contributed to Public Charity [listed in 170(b)(1)(A)]	% Limit if Contributed to Private Charity [not listed in 170(b)(1)(A)]
<b>Cash</b>	50% of adjusted gross income [§170(b)(1)(A)]	30% of adjusted gross income [§170(b)(1)(B)]
<b>Loss property</b> (basis exceeds value)	50% of adjusted gross income [§170(b)(1)(A)]	30% of adjusted gross income [§170(b)(1)(B)]
<b>Ordinary income property</b> (value exceeds basis, but it's not a capital asset)	50% of adjusted gross income [§170(b)(1)(A)]	30% of adjusted gross income [§170(b)(1)(B)]
<b>Short-term capital gain property</b> (value exceeds basis in capital asset held for not more than one year)	50% of adjusted gross income [§170(b)(1)(A)]	20% of adjusted gross income [§170(b)(1)(D)(i)]
<b>Long-term capital gain real property</b> (value exceeds basis in real property that is a capital asset and held > one year)	30% of adjusted gross income [§170(b)(1)(C)(i)]	20% of adjusted gross income [§170(b)(1)(D)(i)]
<b>Long-term capital gain intellectual property</b> (value exceeds basis in certain intellectual property that's a capital asset & held > one year)	50% of adjusted gross income [§170(b)(1)(A)]	20% of adjusted gross income [§170(b)(1)(D)(i)]
<b>Other intangible long-term capital gain property</b> (value exceeds basis in an intangible capital asset and held > one year)	30% of adjusted gross income [§170(b)(1)(C)(i)]	20% of adjusted gross income [§170(b)(1)(D)(i)]
<b>Long-term capital gain related tangible property</b> (value exceeds basis in a tangible capital asset held > one year & related to charity's purpose)	30% of adjusted gross income [§170(b)(1)(C)(i)], but 50% of adjusted gross income if to a private foundation [§170(b)(1)(A)]	20% of adjusted gross income [§170(b)(1)(D)(i)]
<b>Long-term capital gain unrelated tangible property</b> (value exceeds basis in a tangible capital asset held > one year & unrelated to charity's purpose)	50% of adjusted gross income [§170(b)(1)(A)]	20% of adjusted gross income [§170(b)(1)(D)(i)]

## XI. Planning for Closely-Held Businesses – General Observations

- A. A Note on Scope.** We now turn to a consideration of the basic business tax issues most relevant to the closely-held enterprise that's already operating as a going concern. Here we are not concerned with the "choice of entity" question facing entrepreneurs at the inception of the business. There are many other excellent, comprehensive resources to assist planners at the inception of the business.<sup>179</sup>

<sup>179</sup> See, e.g., Dwight Drake, *BUSINESS PLANNING: CLOSELY HELD ENTERPRISES* (3d ed. 2011); Richard A. Shaw and Thomas J. Nichols, *Choice of Entity in Light of Recent and Proposed Tax Changes*, 68 NEW YORK UNIVERSITY ANNUAL INSTITUTE ON

Instead, these materials offer a brief overview of the basic income tax mechanics of each entity form and a discussion of several particular estate planning strategies available (and the particular pitfalls present) depending on the entity that walks through the door with the client. We are not concerned here with whether the client should do business as a corporation or partnership; rather, we are concerned with what to do once the business has already been operating for some time and has proven successful. The answers to that question often depend on the form in which the business operates. These materials do not address strategies applicable to all closely-held business interests. The installment payment of federal estate tax attributable to closely-held business interests under IRC §6166, for example, is not covered in these materials because this benefit applies to C corporations, S corporations, and partnerships. Instead, these materials focus on techniques that are unique to certain of the entity forms.

- B. The Internal Revenue Code Sees Only Three Entities.** A client's business will almost always come in one of seven forms: (1) a sole proprietorship; (2) a general partnership; (3) a limited partnership; (4) a limited liability partnership; (5) a limited liability company; (6) an S corporation; and (7) a C corporation. For federal tax purposes, however, there are only three types of business entities. The first form described above (sole proprietorship) is simply disregarded for federal tax purposes, so all items of income and deduction attributable to the business are added to the owner's other items of income and deduction on his or her (or their) Form 1040.

The next three forms (general partnership, limited partnership, limited liability partnership) are treated as partnerships for federal tax purposes, meaning they will subject to the marvelous complexities of Subchapter K. Any of these three forms are welcome to elect corporation status, but that is rarely done for domestic entities.

The fifth form, the limited liability company, will be treated as a sole proprietorship for federal tax purposes if it has only one owner; if it has multiple owners it will be treated as a partnership unless the owners elect to have the entity taxed as a corporation.

The last two forms, the corporations, have no choice. From a federal tax perspective, they are corporations and nothing else. Of course, an S corporation is a pass-through entity, meaning that the entity will generally not be liable for payment of federal income tax. The items of income, gain, loss, deduction, and credit of an S corporation are attributed to its shareholders in proportion to their ownership interests as if they derived such items themselves (though the

---

FEDERAL TAXATION, Ch. 13 (2010); Richard A. Mann, Michael O'Sullivan, Larry Robbins, and Barry S. Roberts, *Starting from Scratch: A Lawyer's Guide to Representing a Start-Up Company*, 56 ARK. L. REV. 773 (2004).



character of any given item is determined at the entity level). Subsequent distributions of after-tax earnings from the S corporation are not again subject to tax as dividends. This is the major distinction between S corporations and C corporations. C corporations are separate taxable entities. Their taxable incomes are subject to a different progressive rate table, and distributions of after-tax earnings and profits are gross income to the recipient shareholders. Under current law, this “double tax” is mitigated to some extent because dividends received from domestic corporations and certain foreign corporations are taxed at the same rate as net capital gains (*i.e.*, at zero percent, 15 percent, or 20 percent, though the latter two rates will be 3.8 percent higher where the IRC §1411 surcharge on net investment income applies). This preferential rate for “qualified dividend income” applies to dividends on common and preferred shares from both closely-held and publicly-traded corporations.

## **XII. C Corporations**

### **A. The Basic Mechanics**

- 1. Formation.** From a tax perspective, forming a corporation is one of life’s easier tasks. Generally, a taxpayer will not have to recognize gain on the transfer of property to a corporation solely in exchange for shares of the corporation’s stock.<sup>180</sup> Taxpayers will have to recognize any realized gain, however, if: (1) they receive property from the corporation in addition to the corporation’s stock;<sup>181</sup> (2) they do not own at least 80 percent of the corporation’s stock;<sup>182</sup> (3) they contribute services (rather than property) to the corporation;<sup>183</sup> or (4) the amount of any indebtedness secured by the contributed property exceeds the taxpayer’s adjusted basis in such property at the time of contribution.<sup>184</sup>

If a taxpayer enjoys non-recognition upon contribution, the basis of the shares received from the corporation is equal to the aggregate adjusted

---

<sup>180</sup> IRC §351(a).

<sup>181</sup> IRC §351(b).

<sup>182</sup> IRC §351(a). For purposes of this rule, all contemporaneous capital contributions are aggregated. Thus, for example, if Abbott and Costello each contribute a capital asset to a newly-formed corporation in exchange for 50 percent of the corporation’s stock, neither will recognize the realized gain from the transaction because their transfers will be aggregated.

<sup>183</sup> IRC §351(d).

<sup>184</sup> IRC §357(c).

bases of the property transferred.<sup>185</sup> Likewise, the corporation's basis in the contributed property is the same basis the contributing shareholder had in the property.<sup>186</sup> If a taxpayer recognizes gain from the capital contribution, the taxpayer's basis in the acquired stock (and the corporation's basis in the contributed property) is generally its fair market value.

2. **Operation.** The C corporation is a separate taxable entity. It completes a Form 1120 to report its taxable income and pays tax at graduated rates ranging from 15 – 35 percent.<sup>187</sup> C corporations are also subject to the alternative minimum tax (AMT), and may even be subject to additional “penalty taxes” where the corporate form is abused. These penalty taxes are discussed later in these materials.
3. **Distributions.** The signature feature of subchapter C is the double tax on corporate earnings. A corporate distribution will be included in the shareholder's gross income (though subject to a maximum tax rate of 23.8 percent<sup>188</sup>) to the extent the distribution represents the “earnings and profits” of the corporation.<sup>189</sup> Additional amounts in excess of the corporation's earnings and profits are presumed to be a return of the shareholder's contributed capital.<sup>190</sup> Consequently, the additional amounts received are tax-free to the extent of the shareholder's stock basis. If the shareholder's stock basis is used up and additional amounts still remain, the excess will be taxed as capital gain.<sup>191</sup> If the corporation distributes property, the shareholder takes a fair market value basis in the property.<sup>192</sup>

---

<sup>185</sup> IRC §358.

<sup>186</sup> IRC §362(a).

<sup>187</sup> IRC §11. Little attention has been given to the fact that while the American Taxpayer Relief Act of 2012 increased individual income tax rates for taxpayers with the highest incomes, corporate tax rates under IRC §11 were unchanged. This may be because the disparity between the maximum individual tax rate (39.6 percent) and the maximum corporate tax rate (35 percent) is not worth much ado.

<sup>188</sup> See IRC §51(h)(11); 1411.

<sup>189</sup> IRC §§301(c)(1); 316(a).

<sup>190</sup> IRC §301(c)(2).

<sup>191</sup> IRC §301(c)(3).

<sup>192</sup> IRC §301(d).

If distributions of cash or property trigger the double tax, should distributions of the corporation's own stock also be taxable to the shareholder? In *Eisner v. Macomber*,<sup>193</sup> the Supreme Court held that pro rata stock distributions were not taxable to the shareholders. Taxpayers then pushed the envelope: they created elaborate classes of stock that could be converted into cash or property or the corporation's common stock at the demand of a shareholder. The Service objected to these elaborate classes of stock as disguised dividend distributions, and some courts agreed. Congress has since cleared the air through a general rule proclaiming that stock distributions are tax-free.<sup>194</sup> That general rule is subject to a number of exceptions,<sup>195</sup> but most proportionate stock distributions remain tax-free. If a shareholder receives stock tax-free, the shareholder must allocate his or her basis in the old shares among the old and new shares.<sup>196</sup>

4. **Liquidation.** "Liquidation" refers to the death or dissolution of the business entity. Under most state statutes, the assets of the entity are sold and the proceeds are used to pay off the entity's creditors. Any remaining proceeds are distributed proportionately to the owners. Instead of selling assets, liquidating entities may distribute assets to creditors and owners.

Unlike formation, liquidation is rarely painless from a tax perspective. Since a double tax has not been imposed on such assets (or, in the case of a sale, the proceeds), liquidating distributions to shareholders are taxable.<sup>197</sup> Similarly, the corporation recognizes gain and loss upon a liquidating distribution.<sup>198</sup> If a subsidiary corporation liquidates, there is a potential for a triple tax: once to the liquidating subsidiary, again to the parent corporation upon its liquidation, and finally to the shareholders of the parent corporation. To mitigate the adverse consequences attendant with these general rules, most subsidiary corporations may liquidate on a tax-free basis.<sup>199</sup>

---

<sup>193</sup> 252 U.S. 189 (1920).

<sup>194</sup> IRC §305(a).

<sup>195</sup> See IRC §305(b).

<sup>196</sup> IRC §307(a).

<sup>197</sup> IRC §331.

<sup>198</sup> IRC §336.

<sup>199</sup> IRC §332.

## B. Planning Opportunities with C Corporations

1. **Reduced Rate on Gain from Sale of Qualified Small Business Stock.** IRC §1202(a)(1) generally excludes half of the gain from the sale or exchange of qualified small business stock held for more than five years.<sup>200</sup> The other half of such gain is subject to a preferential tax rate of 28 percent.<sup>201</sup> In effect, then, the entirety of such gain is taxed at a rate of 14 percent (half of the gain is taxed at 28 percent, half of the gain is not taxed at all). Under the American Recovery and Reinvestment Act of 2009, the exclusion increased to 75 percent of the gain from the sale or exchange of qualified small business stock acquired after February 17, 2009, and before January 1, 2011.<sup>202</sup> Where the special 75 percent exclusion applies, then, the effective rate of tax on the entire gain is only seven percent. The Creating Small Business Jobs Act of 2010, however, went one step further: qualified small business stock acquired from September 28, 2010, through December 31, 2010, was eligible for a 100-percent exclusion. The Tax Relief and Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended the 100-percent exclusion for stock acquired through 2012, and the American Taxpayer Relief Act of 2012 further extended the 100-percent exclusion to stock acquired in 2013. It was extended again through 2014 by the Tax Increase Prevention Act of 2014.

Only C corporation stock can claim this benefit. Specifically, “qualified small business stock” is any stock in a domestic C corporation originally issued after August 10, 1993, but only if such stock was acquired by the shareholder either as compensation for services provided to the corporation or in exchange for money or other non-stock property, and only if the corporation is a qualified small business.<sup>203</sup> A “qualified small business” is one with aggregate gross assets of \$50 million or less at all times after August 10, 1993, and before the time immediately after the date of issuance.<sup>204</sup>

---

<sup>200</sup> Under IRC §57(a)(7), however, seven percent of the excluded gain is an item of tax preference for purposes of the alternative minimum tax.

<sup>201</sup> IRC §§1(h)(1)(E); 1(h)(4); 1(h)(7).

<sup>202</sup> IRC §1202(a)(3).

<sup>203</sup> IRC §1202(c)(1).

<sup>204</sup> IRC §1202(d)(1). “Aggregate gross assets” is measured as the sum of cash plus the adjusted bases of all corporate assets (assuming that the basis of all contributed property is equal to its fair market value as of the date of contribution). IRC §1202(d)(2).

In addition to these requirements, the corporation must meet an “active business requirement” during substantially all of the shareholder’s holding period in order for IRC §1202 to apply.<sup>205</sup> This requires that at least 80 percent of the value of the corporation’s assets be used in the active conduct of a trade or business engaged in any activity other than: (1) professional services in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or other business in which the principal asset is the reputation or skill of one or more of its employees; (2) banking, insurance, financing, leasing, investing, or similar business; (3) farming; (4) extraction or production of natural resources eligible for percentage depletion; or (5) operation of hotels, motels, restaurants, or similar businesses.<sup>206</sup>

Depending on the applicable percentage exclusion (based on when the stock was acquired), the benefit of IRC §1202 exclusion may be significant. If IRC §1202 does not apply but the client holds the stock for more than one year, the gain will be long-term capital gain subject to a preferential tax rate generally ranging from 15 to 23.8 percent. In case of IRC §1202 stock acquired before February 17, 2009, the cost of losing the 14 percent rate applicable to IRC §1202 stock may be only one percent of the gain. To the extent a client can save much more than this additional tax amount by making a subchapter S election or otherwise operating the business in a more profitable or tax-savvy manner that sacrifices the IRC §1202 exclusion, a planner should not be afraid to recommend such action. Of course, where the new seven percent (or zero percent) preferential tax rate applies, the comparative benefit of IRC §1202 is stronger; depending on the amount of gain at issue, foregoing pass-through taxation or similar strategies might be desirable.

2. **Like-Kind Exchange of Qualified Small Business Stock,** One less heralded benefit of owning IRC §1202 stock is the ability to engage in a tax-deferred like-kind exchange under IRC §1045(a). As long as the selling shareholder purchases stock in another qualified small business within 60 days of the sale, he or she can elect to defer all non-recapture gain from the sale (provided the new stock costs at least as much as the amount realized from the sale of the old stock). The shareholder’s basis in the new small business stock is reduced by the amount of gain deferred by the election.<sup>207</sup>

---

<sup>205</sup> IRC §1202(c)(2)(A).

<sup>206</sup> IRC §1202(e).

<sup>207</sup> IRC §1045(b)(3).

- 3. Ever Thought of an S Election?** If the C corporation qualifies as a small business corporation under IRC §1361(b), its shareholders may elect S corporation status<sup>208</sup> to ameliorate the impact of the double tax on C corporation earnings. The S election usually causes no immediate tax consequences to the corporation or the shareholders,<sup>209</sup> although built-in gains on assets held by the C corporation at the time of its conversion to an S corporation may have to be recognized by the S corporation.<sup>210</sup> This is better than a conversion from C corporation to partnership because that requires a deemed liquidation of the corporation, a taxable event to the corporation and the shareholders.<sup>211</sup>

The S election may have other benefits beyond avoiding the double tax. If the C corporation is unable to use the cash method of accounting,<sup>212</sup> conversion to S corporation status will permit the entity to use the cash method.<sup>213</sup> If the C corporation is currently paying or may soon face liability for the personal holding company penalty tax in IRC §541,<sup>214</sup> conversion to S corporation status will eliminate the penalty tax.<sup>215</sup>

- 4. Other Chances to Minimize Double Taxation.** Most C corporations can lessen the impact of the double tax by transferring earnings and profits

---

<sup>208</sup> IRC §1362(a).

<sup>209</sup> But see IRC §1363(d) and discussion *infra*.

<sup>210</sup> IRC §1374.

<sup>211</sup> IRC §§ 331(a); 336(a).

<sup>212</sup> A C corporation generally cannot use the cash method unless: (1) it is engaged in farming; (2) substantially all of its activities consists of the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or (3) its average annual gross receipts for the three prior taxable years does not exceed \$5 million. IRC §448(b).

<sup>213</sup> That is, unless the S corporation is a “tax shelter.” IRC §448(a). A tax shelter is any “syndicate” within the meaning of IRC §1256(e)(3)(B) or a “tax shelter” as defined in IRC §6662(d)(2)(C)(iii) (yes, a “tax shelter” means “a syndicate or a tax shelter”). IRC §§448(d)(3); 461(i)(3).

<sup>214</sup> A C corporation is a personal holding company if: (1) at least 60 percent of its “adjusted ordinary gross income” for the taxable year is “personal holding company income,” and (2) at any time during the last half of the taxable year not more than five individuals own (directly or indirectly) more than 50 percent in value of the corporation’s stock. IRC §542(a). Personal holding company income includes dividends, interest, royalties, annuities, rents, compensation for the use of corporate property by shareholders, and income from estates and trusts. IRC §543(a).

<sup>215</sup> IRC §1363(a).

into deductible payments of compensation, rent, or interest. While this is helpful to the corporation, it is worse for the shareholders, for these disguised distributions are ordinary income potentially subject to tax at rates far in excess of the preferential rate applicable to qualified dividend income.<sup>216</sup> One might expect that the competing interests of corporations and their shareholders might offset each other to the point that the Service might not care whether payments from corporations to shareholders are characterized as nondeductible (but tax-preferred) dividends or deductible (but fully taxable) forms of ordinary income. But these strategies are still effective in reducing the total tax bite to corporation and shareholder.

Consider the following example: A owns all of the stock in *Corp*, a C corporation. *Corp* has taxable income in Year One of \$100. Assuming *Corp* is taxed at the highest rate applicable to C corporations (35 percent), *Corp* will pay \$35 in tax on this income, leaving \$65 of after-tax earnings. If *Corp* distributes the \$65 as a dividend to A in Year Two, *Corp* gets no deduction, but A will pay tax of only \$13 on the dividend (20 percent), leaving A with \$52 after tax.<sup>217</sup> If *Corp* makes no distribution but pays A a \$65 salary in Year Two, *Corp* would get a \$65 deduction for Year Two (saving *Corp* taxes of \$22.75) but A would have to pay tax of \$22.75 on the compensation (assuming A is in the 35 percent bracket), leaving A with \$42.25 after tax. This is a worse result for A than the dividend distribution (treating the amount received from *Corp* as compensation reduces the after-tax amount by nearly \$10) but a much better result for *Corp* (the compensation deduction saves \$22.75 in tax). If A and *Corp* act in concert, they should collectively prefer the result of the salary payment instead of the dividend distribution because the benefit of the deduction to *Corp* exceeds the burden to A.<sup>218</sup>

**5. Redemptions to Pay “Death Taxes.”** If the estate tax value of the decedent’s stock in a corporation (C or S) comprises more than 35 percent of the decedent’s adjusted gross estate,<sup>219</sup> IRC §303(a) treats the

---

<sup>216</sup> IRC §1(h)(11).

<sup>217</sup> This example uses a 20 percent rate for the qualified dividend income even though the applicable rate is probably either 18.8 percent or 23.8 percent. But 20 percent made for easier math. Sue me.

<sup>218</sup> It should be noted that compensation paid to A will be subject to employment taxes, which increases the total tax burden to both A and *Corp*. Even if employment taxes are figured in, however, there likely remains a preference for paying the after-tax earnings as compensation because of the deduction to the corporation.

<sup>219</sup> IRC §303(b)(2). “Adjusted gross estate” is not a term used in IRC §303; it is my own shorthand for the base used by IRC §303(b)(2), namely the value of the gross estate less the amounts deductible under IRC §§2053 (administrative expenses) and 2054 (casualty losses during administration).

redemption of an estate's interest in a closely-held corporation as a sale of the stock (even if the transaction would otherwise be treated as a distribution with respect to the stock under IRC §302) to the extent the redemption proceeds do not exceed the sum of all estate, inheritance, legacy, and succession taxes imposed by reason of death plus funeral and administrative expenses deductible under IRC §2053. The redemption must occur within the estate tax return's assessment period to qualify for this benefit.<sup>220</sup>

## C. Planning Challenges with C Corporations

1. **Penalties on Excessive Retained Earnings.** Congress worries that the shareholders of a closely-held corporation prefer for the corporation to accumulate and retain its net earnings instead of paying dividends. Distributions of after-tax earnings are taxable to the shareholders. But if the corporation retains its after-tax earnings, the value of the corporation's stock increases without current taxation to the shareholders. The shareholders can thus defer the double tax on their shares of after-tax earnings until they either sell the stock (at an inflated price because of the retained surplus) or liquidate the corporation (at which point the retained earnings would finally be distributed). To thwart this deferral strategy, IRC §§531-537 impose an "accumulated earnings tax," a surtax levied on retained earnings in excess of the reasonable needs of the business where such retention has the purpose of avoiding income tax to the shareholders.

Prior to 2003, dividends were taxed at a higher rate than net capital gain. In those days, shareholders had even more incentive to keep after-tax earnings inside the corporation and then sell the stock at an inflated price because of the retained earnings. Absent the accumulated earnings tax, the shareholders could achieve tax alchemy by converting ordinary income into net capital gain. Now that most dividend distributions are taxed at the same rate as net capital gains, part of the incentive to avoid dividend distributions is lost. But the accumulated earnings tax remains. Sure, shareholders would still benefit from deferral of the double tax if the accumulated earnings tax did not exist, but deferral alone is hardly a grave sin.

A corporation's accumulated earnings tax is equal to 15 percent of its "accumulated taxable income."<sup>221</sup> The accumulated taxable income figure

---

<sup>220</sup> IRC §303(b)(1).

<sup>221</sup> IRC §531.



roughly represents the corporation's undistributed taxable income (computed with some adjustments) in excess of amounts retained for the reasonable needs of the business.<sup>222</sup> Accumulations of \$250,000 or less are deemed to be retained for the reasonable needs of the business (in the case of a personal service corporation, the threshold is reduced to \$150,000).<sup>223</sup> So if a corporation's retained earnings are within this threshold, there is no accumulated earnings tax exposure.

The tax is not self-assessed; rather it is a penalty imposed by the Internal Revenue Service. The Service initiates the issue by sending a notice to the corporation that all or part of a proposed notice of deficiency includes the accumulated earnings tax. At that point, the burden of proof shifts to the corporation to prove it is not liable for the tax.<sup>224</sup>

In reviewing the financial statements for a client's corporation, the planner should consider whether the corporation is vulnerable to the accumulated earnings tax. Annual retained earnings in excess of the applicable threshold described above should be a red flag. If there is exposure, the planner should consider any of a number of possible solutions, including: (1) paying higher salaries to the owners in order to reduce retained earnings in a deductible way; (2) documenting the corporation's long-term capital-intensive plans that require accumulation of after-tax earnings; and (3) making a subchapter S election, if possible.

2. **The Corporate Alternative Minimum Tax.** Like individuals, C corporations are subject to the alternative minimum tax (AMT). Proper calculation of the corporate AMT is easy, assuming you did well on the "games" section of the LSAT where you are told of six monkeys playing chess and you have to figure out who played against whom in each game.<sup>225</sup> The key to calculating a corporation's AMT liability is to determine its "alternative minimum taxable income" (AMTI). The starting point, no surprise, is the corporation's regular taxable income. Certain adjustments to that figure are made under IRC §§56 and 58. For example, a corporation must

---

<sup>222</sup> IRC §535(a). Note that the tax is imposed only with respect to the corporation's earnings in a single taxable year. Those earnings are not again subject to tax in later years as they continue to be retained.

<sup>223</sup> IRC §535(c)(2). A "personal service corporation" is one engaged in any of the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, where the owners provide the services.

<sup>224</sup> IRC §534.

<sup>225</sup> This was on the LSAT I took in the 1980s. I kept looking for the answer, "Monkeys don't play chess." Without realizing it, I was displaying the qualities of a tax attorney.

recompute certain depreciation deductions by using the straight-line method of IRC §168(g)(2) rather than the usual accelerated cost recovery system allowed for regular tax purposes.<sup>226</sup> The taxable income figure is then further adjusted by the so-called "preference items" in IRC §57. For example, a corporation must increase taxable income by the amount of tax-exempt interest received on private activity bonds.<sup>227</sup>

The final major adjustment to taxable income is the "adjusted current earnings" (ACE) adjustment provided in IRC §§56(c)(1) and (g). The purpose of this adjustment is to reflect the corporation's true earnings for the taxable year. Once all adjustments have been made, a "tentative minimum tax" is computed by computing 20 percent of the corporation's AMTI as exceeds the exemption amount (\$40,000).<sup>228</sup> AMT liability arises to the extent this tentative minimum tax liability exceeds the corporation's regular tax liability.

The corporate AMT is only a concern of very large corporations. Certain "small" C corporations are wholly exempt from the AMT. A C corporation with average annual gross receipts of \$7.5 million or less for all three-year periods beginning after 1993 and ending before the current year is considered a "small" corporation and, as such, is deemed to have a tentative minimum tax liability of zero.<sup>229</sup> For the corporation's first three-year period (or portion of a period), the limit is \$5 million instead of \$7.5 million.

Logically, most corporations subject to the AMT try to avoid it whenever possible. After all, the tax significantly increases the corporation's compliance and recordkeeping burdens, what with different depreciation schedules, different foreign tax credit carryovers, different net operating loss carryovers, and the like. But while AMT liability in any given taxable year means extra tax liability for the corporation, the corporation can actually reduce its *total* tax liability by *incurring* or increasing an AMT liability for the year.

---

<sup>226</sup> IRC §56(a)(1)(A)(i).

<sup>227</sup> IRC §57(a)(5)(A). For regular tax purposes, such interest is excluded from gross income under IRC §103.

<sup>228</sup> IRC §55(d)(2). The \$40,000 exemption amount is reduced by 25 percent of the amount by which AMTI exceeds \$150,000. IRC §55(d)(3).

<sup>229</sup> IRC §55(e).

For example, suppose that a corporation anticipates having a taxable income of \$20 million and an AMTI of \$40 million. The corporation's regular tax liability for the year would be \$7 million. Its tentative minimum tax for the year would be \$8 million (20 percent of AMTI). Concerned that it would have to pay an AMT of \$1 million (the excess of tentative minimum tax over regular tax liability), the corporation decides to accelerate some income into the current year. Thus the corporation quickly enters into a contract and ships goods to a customer at the end of the taxable year. The customer agreed to pay \$5 million to the corporation for the goods. Under the accrual method of accounting, the corporation would recognize the income in the current taxable year. As a result of the last-minute income item, the corporation's taxable income increases to \$25 million (assuming it incurs no deductible expenses as a result of the sale). Its regular tax liability under IRC §11(b) therefore increases to \$8.75 million. The corporation's AMTI would also increase, reaching a total of \$45 million. The corporation's tentative minimum tax would therefore be \$9 million. The sale has therefore decreased the corporation's AMT liability to \$250,000 (the excess of the new tentative minimum tax over the new regular tax liability figure). But the corporation is *worse* off than before. Without the sale, the corporation's total tax burden is \$8 million (\$7 million of regular tax and \$1 million of AMT). But with the sale, the corporation pays total tax of \$9 million (\$8.75 million of regular tax plus \$250,000 of AMT). The corporation is better off having a higher AMT. This example shows that a corporation facing AMT liability should not try to accelerate income or defer deductions solely with a focus of reducing AMT exposure.

3. **Funding the Buy-Sell Agreement.** Shareholders of a closely-held C corporation may prefer that the corporation redeem the shares of a retiring or deceased shareholder (a "redemption agreement"), as opposed to having the surviving shareholders to purchase the shares directly (a "cross-purchase agreement"). Using entity funds to purchase the stock offers centralized funding (together with increased certainty of funding, for it is easier to monitor the reserves of the corporation than to continually police the saving habits of the other shareholders). In addition, where insurance will be used to fund the purchase, the C corporation needs fewer pre-tax dollars to fund premium payments to the extent the corporation is in a lower tax bracket than the shareholders.

But a redemption agreement carries some risks when the business operates as a C corporation. *First*, payments to the retiring shareholder may be treated as dividends, and while the preferential tax rate applicable to qualified dividend income helps it does not substitute for the lack of stock basis that could be used to reduce the tax bite. *Second*, to the extent there is net buildup in the value of life insurance contracts funding the C

corporation's payment obligation, there is increased risk of alternative minimum tax.<sup>230</sup> *Third*, if the C corporation uses a sinking fund or similar reserve to save up for a future redemption, there is additional risk that the Service will assert liability for accumulated earnings tax.<sup>231</sup> *Finally*, corporate-owned life insurance is an asset of the corporation that, in turn, drives up the estate tax value of the corporation's stock when a shareholder dies.<sup>232</sup> Together these risks may not outweigh the benefits of centralized funding, but they should be factored in to the decision of whether to use a redemption agreement.

### XIII. S Corporations

#### A. The Basic Mechanics

1. **Formation.** Unless a specific provision in subchapter S applies, the rules applicable to C corporations also apply to S corporations.<sup>233</sup> Because subchapter S is silent as to incorporation issues, the rules previously described for C corporations apply to S corporations. The only wrinkles upon formation of an S corporation pertain to the *eligibility* requirements to be an S corporation and the *timing* rules applicable to the subchapter S election.

- a. **Eligibility Rules.** Not every corporation can elect to be treated as an S corporation. There are limits as to the number and types of shareholders that a corporation may have, although these limits are easily circumvented in most cases. There is also a limit as to the corporation's capital structure, a limit intended to ensure that the pass-thru of tax items remains relatively easy to administer.

As a threshold matter, **only domestic corporations** can elect to be treated as S corporations.<sup>234</sup> A domestic corporation is any corporation organized in the United States or under the law of the United States or any particular state.<sup>235</sup> A corporation organized in

---

<sup>230</sup> IRC §56(g)(4)(B)(ii).

<sup>231</sup> While the corporation should be successful in proving that an accumulation of earnings to fund a redemption agreement is a reasonable business need, the corporation still faces the hassle of having to make this showing.

<sup>232</sup> See Treas. Reg. §§20.2031-2(f); 20.2042-1(c)(6).

<sup>233</sup> IRC §1371.

<sup>234</sup> IRC §1361(b)(1).

<sup>235</sup> IRC §7701(a)(4).

both the United States and a foreign country qualifies as a domestic corporation.<sup>236</sup>

An S corporation can have **no more than 100 shareholders**. (From 1997 through 2004, there was a 75-shareholder limit.) With some exceptions, every person holding stock in an S corporation counts toward the 100-shareholder limitation.<sup>237</sup> Spouses and their estates are treated as one shareholder for purposes of applying the limitation,<sup>238</sup> regardless whether the spouses own shares jointly or separately or solely by operation of community property laws. Furthermore, all “members of a family” are treated as one shareholder for purposes of the 100-shareholder limitation.<sup>239</sup> Members of a family are the common ancestor, the lineal descendants of the common ancestor (up to a maximum of six (!) generations), and the current *and former* spouses of the lineal descendants or the common ancestor.<sup>240</sup> This effectively eviscerates the 100-shareholder limitation.

Very generally, subchapter S welcomes most individual shareholders (and their estates<sup>241</sup>) but exhibits hostility toward entity shareholders. A discussion of **trusts as shareholders** of S corporation stock appears later in these materials.

Most individuals are eligible S corporation shareholders.<sup>242</sup> A corporation cannot make an S election if it has a **nonresident alien**

---

<sup>236</sup> Treas. Reg. §301.7701-5(a). See also PLR 9512001 (corporation organized in United States and in foreign country is eligible to make S election and will not be treated as having two classes of stock).

<sup>237</sup> Rev. Rul. 59-187, 1959-1 C.B. 224.

<sup>238</sup> IRC §1361(c)(1).

<sup>239</sup> IRC §1361(c)(1)(A)(ii).

<sup>240</sup> IRC §1361(c)(1)(B). The determination of whether there is more than six generations separating the common ancestor from the youngest generation of shareholders is made on the latest of: (1) the date the S election is made; (2) the first date on which the common ancestor or a lineal descendant (or spouse) owns stock in the S corporation; and (3) October 22, 2004 (the date of enactment for the American Jobs Creation Act of 2004). *Id.*

<sup>241</sup> IRC §1361(b)(1)(B). There is no limitation as to how long an estate may hold S corporation stock. This is not the case for testamentary trusts, which, as discussed *infra*, must distribute S corporation stock or otherwise qualify as a permissible S corporation shareholder within two years.

<sup>242</sup> In Revenue Ruling 2004-50, 2004-1 C.B. 977, the Service ruled that a federally recognized Indian tribal government is not an eligible S corporation shareholder, meaning that the corporation in which the tribe owns

shareholder,<sup>243</sup> and if a nonresident alien individual becomes a shareholder in an S corporation, the corporation will lose its S election<sup>244</sup> and will generally be precluded from re-electing S status for five years.<sup>245</sup> A nonresident alien individual is an individual that is neither a citizen of the United States nor a resident of the United States.<sup>246</sup>

An individual is a resident of the United States if he or she meets either the “green card test” or the “substantial presence test.” Both of these tests are objective; the intent of the individual and other such subjective measures (like domicile) are irrelevant. An individual meets the green card test if he or she is a lawful permanent resident of the United States at any time during the calendar year.<sup>247</sup> An individual meets the substantial presence test if he or she is present in the United States on at least 31 days of the current year and at least 183 total days of the current and two preceding calendar years.<sup>248</sup> Presence, for these purposes, is determined using a composite, weighted measure of the days of physical presence over a three-year period. All days in the current calendar year are added to one-third of the days in the first preceding calendar year and to one-sixth of the days in the second preceding calendar year.

If a current S corporation (or a C corporation or a partnership whose owners wish to make an S election) wants to pass shares to a nonresident alien individual, the S corporation and the nonresident alien should form a partnership or other pass-thru entity for federal income tax purposes. This preserves the S

---

shares cannot make a subchapter S election. The Service noted that only individuals and certain estate and trusts can hold S corporation shares under IRC §1361(b)(1). Since the Indian tribe is exempt from taxation under established authorities, and because the tribe is not subject to federal income tax as an individual under IRC §1, the Service determined that the tribe was not an “individual” for purposes of qualifying the corporation for election to subchapter S status.

<sup>243</sup> IRC §1361(b)(1)(C).

<sup>244</sup> IRC §1362(d)(2)(A).

<sup>245</sup> IRC §1362(g).

<sup>246</sup> IRC §7701(b)(1)(B).

<sup>247</sup> IRC §7701(b)(1)(A)(i).

<sup>248</sup> IRC §§7701(b)(1)(A)(ii); 7701(b)(3)(A).

election while permitting the nonresident to participate in the profits and losses of the enterprise.<sup>249</sup> For example, suppose that Adam and Beth each own 10 shares in an S Corporation. Evita, a nonresident alien individual, wants to join Adam and Beth as an equal stakeholder, and both of the existing owners want Evita involved in the business. To protect the corporation's S election, the corporation and Evita form a limited liability company to be taxed as a partnership for United States income tax purposes. The corporation contributes all of its business assets to the LLC in exchange for two-thirds of the membership interests in the LLC, while Evita makes proportionate contributions of cash and/or property in exchange for a one-third interest in the LLC. The LLC's operating agreement provides that all tax items shall be allocated according to the membership interests, meaning the S corporation is taxed on two-thirds of the LLC's taxable income and that Evita is taxed on one-third of the LLC's taxable income. The share allocable to the S corporation passes through in equal shares to Adam and Beth. This structure should accomplish the objectives of Adam, Beth, and Evita without sacrificing the S election. Of course, if the LLC distributes some of the assets contributed by Evita to the S corporation (or if the LLC distributes some of the assets contributed by the S corporation to Evita) within seven years of their transfer to the LLC, the parties may have to recognize gain under the disguised sale rules in subchapter K.<sup>250</sup>

Planners in community property states need to pay special attention to the nonresident alien prohibition. If an employee of an S corporation is married to a nonresident alien, the non-employee spouse may have a community property interest in any shares acquired by the employee as compensation. This would terminate the S election. Even if the shareholder-employee holds the S corporation shares as separate property, it may be possible for the non-employee spouse to acquire a community property interest in the shares to the extent the employee-shareholder otherwise receives inadequate compensation for the services he or she performs on behalf of the corporation.<sup>251</sup>

---

<sup>249</sup> See Michael Schlesinger, *S CORPORATIONS: TAX PLANNING AND ANALYSIS 12* (CCH 2000). Schlesinger notes that this structure would survive scrutiny under the partnership anti-abuse rules in Regulation §1.701-2 because the S corporation's shareholders are taxed on their shares of the S corporation's income while the nonresident alien is taxed on his or her share of the partnership's profits.

<sup>250</sup> See IRC §§ 704(c)(1)(B); 707; 737.

<sup>251</sup> See William C. Staley, *S Corporations and Estate Planning*, at 6 (Glendale Estate Planning Council, Nov. 15,

Corporations, partnerships, limited liability companies, and other **business entities are not eligible to be shareholders** of S corporation stock.<sup>252</sup> Disregarded entities (such as single-member limited liability companies) are permissible shareholders if their owners are eligible S corporation shareholders. The Service will often ignore transitory ownership of S corporation stock by a partnership in the process of converting to an S corporation, even though there is no Code or regulation authority to forgive momentary ownership by an ineligible entity.<sup>253</sup> Since 1998, organizations described in IRC §401(a) or IRC §501(c)(3) that are exempt from tax under IRC §501(a) can be S corporation shareholders.<sup>254</sup> Translation? Employee stock ownership plans (ESOPs) and certain charitable organizations can hold S corporation stock. For eligible exempt organizations other than ESOPs, tax items from the S corporation pass through as unrelated business taxable income (UBTI).<sup>255</sup>

An S corporation can only have **one class of stock**.<sup>256</sup> For this purpose, differences in voting rights among shares of common stock are disregarded.<sup>257</sup> Estate planners like to see S corporations with voting and nonvoting shares, because nonvoting shares in a closely-held business make ideal assets for gifts and other wealth transfers from a discount planning perspective. An S corporation has a single class of stock if all shares have equal rights to distributions and liquidation proceeds.<sup>258</sup> Whether all shares have equal economic rights is determined with reference to what the regulations call the corporation's "governing provisions."<sup>259</sup> These

---

2005).

<sup>252</sup> IRC §1361(b)(1)(B).

<sup>253</sup> See, e.g., PLRs 200237014, 200237011, 9010042, and 8934020.

<sup>254</sup> IRC §1361(c)(6).

<sup>255</sup> IRC §512(e).

<sup>256</sup> IRC §1361(b)(1)(D).

<sup>257</sup> IRC §1361(c)(4).

<sup>258</sup> Treas. Reg. §1.1361-1(l)(1).

<sup>259</sup> Treas. Reg. §1.1361-1(l)(2)(i).



include the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements related to distributions and liquidation.

- b. Election.** All shareholders must consent to make a subchapter S election.<sup>260</sup> An election is effective for the taxable year following the year of election, except that an election made in the first two and a half months of a taxable year is effective as of the first day of the taxable year.<sup>261</sup> The Service will consider requests for relief from the effects of a late election. Unless a special situation applies, however, the corporation usually must request relief through a private letter ruling that will require payment of a user fee.<sup>262</sup> The Service has identified a number of special situations:

- *A partnership, LLC, or other noncorporate eligible entity failed to timely file the Form 2553 and has not elected to be treated as a corporation.* If the entity can show reasonable cause for its failure to timely file the S corporation election (and the entity classification election on Form 8832), then requests for relief made within six months after the due date for the tax return for the first year the entity intended to be an S corporation will be honored and the entity will be given additional time to make the required elections.<sup>263</sup>

- *A corporation failed to timely file the Form 2553 but has reasonable cause for its failure to do so.* Requests for relief made within two years of the original due date for the S election will be considered by the Service provided either: (1) the corporation has not yet filed a return for the first year in which the election was intended and the request for relief comes within six months of the due date for that return; or (2) the corporation did file a return for the first year in which the election was intended and all of the shareholders have reported consistently with an S election on all of their affected returns for the year(s) in which the election was intended.<sup>264</sup>

---

<sup>260</sup> IRC §1362(a).

<sup>261</sup> IRC §1362(b).

<sup>262</sup> See Rev. Proc. 2014-1, 2014-1 I.R.B. 1.

<sup>263</sup> Rev. Proc. 2004-48, 2004-1 C.B. 172.

<sup>264</sup> Rev. Proc. 2003-43, 2003-1 C.B. 998.

- *The corporation filed a Form 1120S and, within six months, the Service did not notify the corporation or any shareholder of any problem with S corporation status.* If the shareholders reported their income consistent with S corporation status for the year(s) in which the S election was intended, then the corporation qualifies for automatic relief.<sup>265</sup>

2. **Operation.** In general, an S corporation will not pay income tax, since items of income, gain, loss, deduction, and credit pass through to the shareholders on a “per share” or “pro rata” basis.<sup>266</sup> Thus, if an S corporation has two equal shareholders, each must include one-half of the corporation’s tax items on his or her own individual income tax return. The ultimate treatment of a tax item (as capital gain or ordinary income, for example) will depend upon the particular shareholder; consequently, some items pass through separately, while others are “netted” at the corporate level before passing through to the shareholders.

At the close of each taxable year, an S corporation shareholder’s stock basis is adjusted to reflect both the shareholder’s pro rata share of the S corporation’s pass-through items and any distributions made during the year.<sup>267</sup> The adjustments to basis occur in this order:<sup>268</sup> (1) increase stock basis by the shareholder’s share of income items; then (2) decrease stock basis by the amount of nontaxable distributions; then (3) decrease stock basis by the shareholder’s share of noncapitalized, nondeductible expenses;<sup>269</sup> then finally (4) decrease stock basis by the shareholder’s share of loss and deduction items.

3. **Distributions.** The tax treatment of distributions from S corporations depends upon whether the S corporation has accumulated earnings and

---

<sup>265</sup> Rev. Proc. 97-48, 1997-2 C.B. 521. To claim the relief, a completed Form 2553 must be filed with the words “FILED PURSUANT TO REV. PROC. 97-48” printed at the top of the Form.

<sup>266</sup> IRC §1366.

<sup>267</sup> IRC §1367(a).

<sup>268</sup> Treas. Reg. §1.1367-1(f).

<sup>269</sup> Examples of noncapital, nondeductible expenses include illegal bribes, fines, penalties, expenses related to tax-exempt income, disallowed losses under IRC §267, and the disallowed portion of meal and entertainment expenses under IRC §274.

profits. Only C corporations can have “earnings and profits.”<sup>270</sup> Corporations that have always been S corporations do not have accumulated earnings and profits.

Distributions from “pure” S corporations (those that have never been C corporations) are tax-free to the extent of the shareholder’s stock basis.<sup>271</sup> Any distributions in excess of a shareholder’s basis is treated as gain from the sale or exchange of property (i.e., as long-term capital gain if the stock has been held for more than one year, or short-term capital gain if the stock has been held for one year or less).<sup>272</sup> Whether a shareholder has sufficient stock basis to absorb a distribution is tested at the end of the year, after all items of income and other increases to basis occur, but before any reductions to stock basis due to losses, deductions, and nondeductible expenses.<sup>273</sup> This ordering rule maximizes the chances that any particular distribution will be tax-free. If an S corporation distributes appreciated property instead of cash, the distribution triggers gain to the corporation.<sup>274</sup> Like any gain, it passes through pro rata to the shareholders, with resulting increases to stock basis.

If an S corporation has accumulated earnings and profits, the distribution rules are slightly more complicated. A three-tier regime applies to such distributions. *First*, that portion of the distribution not in excess of the corporation’s “accumulated adjustments account” (“AAA”) is taxed under the rules applicable to distributions from S corporations without earnings and profits (i.e., tax-free to the extent of stock basis, with any excess treated as capital gain).<sup>275</sup> *Second*, the remainder of the distribution is treated as a dividend to the extent of the corporation’s accumulated earnings and profits.<sup>276</sup> *Third*, if the distribution exceeds accumulated

---

<sup>270</sup> IRC §312.

<sup>271</sup> IRC §1368(b)(1).

<sup>272</sup> IRC §1368(b)(2).

<sup>273</sup> Treas. Reg. §1.1367-1(f).

<sup>274</sup> IRC §§1371(a); 311(b).

<sup>275</sup> IRC §1368(c)(1). If an S corporation makes more than one distribution during the taxable year, and if the total amount of such distributions exceeds the positive balance in the corporation’s AAA, the AAA is allocated proportionately to all of the distributions. Treas. Reg. §1.1368-2(b).

<sup>276</sup> IRC §1368(c)(2).

earnings and profits, the balance is treated under the rules applicable to distributions from S corporations without earnings and profits.<sup>277</sup>

The AAA is an entity-level account that begins at zero when the corporation's S election takes effect.<sup>278</sup> It is then adjusted upward and downward, generally by the same items that adjust a shareholder's basis under IRC §1367.<sup>279</sup> There are some differences, however, between the adjustments to the AAA and the adjustments to stock basis. For one thing, the AAA can go below zero.<sup>280</sup> And, importantly, no adjustment is made to the AAA for tax-exempt income or for expenses related to tax-exempt income.<sup>281</sup> Also, taxes paid by the corporation for years attributable to the corporation's period as a C corporation can adjust stock basis but such amounts do not affect the AAA.<sup>282</sup> As these exceptions suggest, AAA is generally a reflection of the S corporation's items of income and deduction of tax consequence that have been passed through to the shareholders (in other words, perhaps, the corporation's previously taxed income).

Redemptions carry out a ratable share of the corporation's AAA if the redemption is treated as a sale or exchange under either IRC §302(a) or IRC §303(a).<sup>283</sup> If the corporation makes both regular distributions and redemption distributions in the same taxable year, the AAA is adjusted first for ordinary distributions and then for any redemption distributions.<sup>284</sup>

Shareholders seeking to avoid the complexity of IRC §1368(c) may consider distributing the entire amount of the corporation's accumulated earnings and profits. This "purging" distribution permits future distributions to be tested under the simpler regime of IRC §1368(b). There are two ways to

---

<sup>277</sup> IRC §1368(c)(3).

<sup>278</sup> Treas. Reg. §1.1368-2(a)(1).

<sup>279</sup> IRC §1368(e)(1)(A); Treas. Reg. §§1.1368-2(a)(2), -2(a)(3).

<sup>280</sup> IRC §1368(e)(1)(A).

<sup>281</sup> *Id.* Thus, for example, death benefits received by an S corporation generally do not affect AAA even though the corporation has an increase in cash because the death benefits are excluded from gross income under IRC §101(a). Likewise, premium payments on life insurance policies should not affect AAA if the corporation will receive the death benefits on a tax-free basis.

<sup>282</sup> *Id.*

<sup>283</sup> Treas. Reg. §1.1368-2(d)(1)(i).

<sup>284</sup> Treas. Reg. §1.1368-2(d)(1)(ii).

make a purging distribution. First, the corporation can elect to treat any distributions as coming first from accumulated earnings and profits and then from the AAA.<sup>285</sup> In effect, this election swaps the first two tiers of the three-tier regime. The practical effect of this election is that distributions are includible as dividends to the extent of earnings and profits and *then* tax-free to the extent of stock basis. If one expects the preferential rates for qualified dividend income to expire in the near future, the election might be beneficial to the distributee-shareholders in the long term. At the same time, the election can be beneficial to the other shareholders.

The second way to make a purging distribution is for the corporation to elect a deemed dividend distribution. Under this approach, the corporation makes no actual distributions but the shareholders are taxed as though the corporation made a pro rata distribution of its accumulated earnings and profits at a time when its AAA is zero, followed by the shareholders' contribution of those same dollars back to the corporation, all on the last day of the taxable year.<sup>286</sup> This alternative keeps capital within the corporation's hands but may leave the shareholders without the dollars required to pay the tax associated with the deemed dividend.

4. **Liquidation.** The rules applicable to C corporation liquidations apply to S corporation liquidations. Thus, the corporation realizes gain and loss upon the distribution of assets to shareholders, and such gains and losses pass through to the shareholders like other income and deduction items. These gains and losses affect a shareholder's stock basis like other pass-through items.

## B. Planning Opportunities for S Corporations.

1. **Leverage the Purchase of Additional Shares.** Normally, interest paid on debt incurred to purchase investment property ("investment interest") is deductible by the borrower only to the extent of his or her "net investment income."<sup>287</sup> This limitation does not apply to interest paid on debt incurred to purchase stock in an S corporation or a partnership. Instead, such interest is deemed to be paid on debt incurred to purchase the pass-through entity's inside assets.<sup>288</sup> Accordingly, if all of the entity's assets

---

<sup>285</sup> Treas. Reg. §§1.1368-1(f)(1)(i); 1.1368-1(f)(2)(i).

<sup>286</sup> Treas. Reg. §§1.1368-1(f)(1)(ii); 1.1368-1(f)(3).

<sup>287</sup> IRC §163(d)(1).

<sup>288</sup> Reg. §1.163-8T.

are used in the conduct of a trade or business, the interest paid on debt incurred to buy stock in the S corporation or partnership will be considered business interest. That's good news because business interest is not subject to the same limitation applicable to investment interest (in other words, business interest is deductible without regard to the currently taxable income generated by the entity's business).<sup>289</sup> So if the client is thinking about purchasing additional shares (or if the client wants to help another to purchase the client's shares in the S corporation), this benefit is worth keeping in mind when running the numbers.

## **2. The Employment Tax Loophole for Sole-Shareholder S Corporations.**

While all of the operating profits of a disregarded single-member LLC or sole proprietorship are subject to employment taxes, only the salary paid to the sole shareholder of an S corporation is considered "wages" subject to employment taxes.<sup>290</sup> Operating income of an S corporation not distributed in the form of salary is not self-employment income.<sup>291</sup> As a result, sole shareholders of S corporations have an incentive to receive no salary from their S corporations and take all of their incomes in the form of distributions.

Of course, if an S corporation pays no salary to its sole shareholder-employee, the Service may recharacterize some portion of the corporation's distributions as wages for employment tax purposes.<sup>292</sup> Still,

---

<sup>289</sup> IRC §§163(a); 163(h)(2)(A).

<sup>290</sup> Rev. Rul. 73-361, 1971-2 C.B. 331.

<sup>291</sup> Rev. Rul. 59-221, 1959-1 C.B. 225. See also IRS Publication 533.

<sup>292</sup> Rev. Rul. 74-44, 1974-1 C.B. 287. There are many cases in which the Service has been successful in converting a portion of S corporation distributions into wages for purposes of employment taxes. See, e.g., *Mike J. Graham Trucking, Inc. v. Commissioner*, T.C. Memo 2003-49, aff'd in unpublished opinion (3d Cir. 2004); *Veterinary Surgical Consultants v. Commissioner*, 117 T.C. 141 (2001), aff'd in unpublished opinion (3d Cir. 2004). The taxpayers in both *Graham Trucking* and *VSC* argued that distributions from S corporations could not be treated as compensation because §530 of the Revenue Act of 1978 states that employment taxes do not apply if the S corporation has never treated the shareholder-employee as an employee for any period and if all filed returns are consistent with this assumption. The taxpayers conveniently forgot the language in §530 that says that employment tax relief does not apply if the corporation "had no reasonable basis for not treating such individual as an employee." The courts in both cases held that there was no precedent for treating the shareholder-employees as contractors or non-employees within their respective industries, and there were no audits of the corporations that upheld such treatment by the corporations. Accordingly, there was no basis for the corporations not to treat the taxpayers as employees, so some portion of the corporations' distributions must be treated as wages. See James A. Fellows and John F. Jewell, *S Corporations and Salary Payments to Shareholders: A Major Issue for the IRS*, 2006 THE CPA J. 46 (May 2006) (available at <http://www.nysscpa.org/cpajournal/2006/506/essentials/p46.htm>.)

it appears the Service is not exercising its recharacterization power as much as it could: nearly a decade ago, a report of the Treasury Inspector General for Tax Administration claimed that some 36,000 sole shareholder-employees received no salaries from their S corporations.<sup>293</sup> The same report indicated that the percentage of S corporation profits paid to their sole shareholder-employees dropped from 47.1 percent in 1994 to 41.5 percent in 2001. To the extent sole proprietors and owners of disregarded entities have 100 percent of the business profits subject to employment taxes, there remains an advantage to keeping salaries modest and maximizing distributions from an S corporation.

The question becomes how much salary to pay to the sole shareholder-employee of an S corporation. The cautious approach is for the S corporation to pay its shareholder-employee the same salary that he or she would require if the shareholder-employee were only an employee of the entity.<sup>294</sup> More aggressive clients may prefer the lemming approach: keep salaries to about 41 – 47 percent of the S corporation's net profits so as to be consistent with other S corporations, even if a non-shareholder-employee would insist upon a higher salary from the corporation.

3. **Shift Built-in Gains to Your Low-Bracket (or Idiot) Co-Owners.** When a shareholder contributes property with a value in excess of its adjusted basis to an S corporation, the corporation generally takes the contributing shareholder's basis in the property.<sup>295</sup> When the S corporation subsequently sells the appreciated property, the gain from the sale, like any gain, is apportioned proportionately among the shareholders. The built-in gain is not allocated automatically to the contributing shareholder, which is not the case for a partnership.<sup>296</sup> This provides contributing partners with an opportunity to shift gain to other, lower-bracket taxpayers without having to worry about the assignment of income doctrine.

---

<sup>293</sup> Statement of J. Russell George, Inspector General, Treasury Inspector General for Tax Administration before the Senate Finance Committee (May 25, 2005), available at [http://www.treas.gov/tigta/congress/congress\\_05252005.htm](http://www.treas.gov/tigta/congress/congress_05252005.htm). See also Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (2005) at 426 (estimating that treating all net income from partnerships and S corporations as self-employment income could increase revenues by \$57.4 billion over the nine-year period from 2006 to 2014); Tony Nitti, *S Corporation Shareholder Compensation: How Much is Enough?*, AICPA THE TAX ADVISER (August 1, 2011).

<sup>294</sup> See Richard B. Robinson, *Tax Audit Issues for S Corporations*, in 41<sup>ST</sup> ANNUAL SOUTHERN FEDERAL TAX INSTITUTE MATERIALS at J-3 (2006).

<sup>295</sup> IRC §362(a).

<sup>296</sup> IRC §704(c)(1)(A). See discussion *infra* on partnerships.

For example, suppose *A* and *B* form an S corporation when *A* contributes inventory worth \$100,000 (in which *A*'s basis is \$10,000) and *B* contributes \$100,000 cash. *A* and *B* are given equal shares in the corporation's single class of stock. If the corporation sells the inventory for \$100,000 to an unrelated party, the corporation's \$90,000 gain (ordinary income if the property is inventory in the hands of the corporation) will be allocated equally among *A* and *B*. Notice that \$45,000 of the gain attributable to the period during which *A* held Blackacre is effectively shifted to *B*. If *B* is related to *A* and is in a lower tax bracket than *A*, this could be a beneficial result. Of course, *B* may not see it that way, so an "opportunity" for *A* is a "challenge" for *B*.

4. **Manufacturing Basis to Claim Net Losses.** An S corporation shareholder may deduct his or her proportionate share of the corporation's losses to the extent of the shareholder's stock basis and any basis in debt owed by the corporation to the shareholder.<sup>297</sup> Losses in excess of these basis limitations are carried forward to subsequent taxable years,<sup>298</sup> but time value of money considerations suggest we should do what we can to give the shareholder enough basis in the year the loss passes through to the shareholder.

If a client's share of an S corporation loss exceeds the client's stock basis and debt basis, the planner should explore techniques to give the client sufficient basis to claim the loss currently. A simple solution is for the client to make a loan or capital contribution to the S corporation, but the client may not have the dollars immediately available or may want to get basis now but pay later. It is not enough for the client to contribute a promise to pay to the corporation; there is no basis credit for the client's own note until actual payments are made on the note. But if the corporation has another shareholder, the client could consider giving a note to the other shareholder in exchange for some or all of the other shareholder's stock. Paying for stock with a note gives the client immediate stock basis that can be used to claim the loss flowing from the S corporation, while deferring the actual out-of-pocket cost to the client.<sup>299</sup>

---

<sup>297</sup> IRC §1366(d)(1).

<sup>298</sup> IRC §1366(d)(2).

<sup>299</sup> See Jeanne E. Sullivan, *Structure and Techniques for S Corporations for 2007 and Beyond*, 31<sup>ST</sup> ANNUAL AMERICAN INSTITUTE ON FEDERAL TAXATION, Outline 11 (2007) at 61.



## C. Planning Challenges with S Corporations

1. **Beware the Interests Given to Employees.** If an employee of an S corporation owns more than two percent of the corporation's outstanding stock (or more than two percent of the total combined voting power of the corporation's stock) on any day of the taxable year, the employee is no longer eligible to receive "employee fringe benefits" on a tax-free basis.<sup>300</sup> If the majority shareholder seeks to reward key employees with stock, it might have the unintended consequence of forfeiting some of these important benefits.

Examples of benefits not excludable by so-called "2-percent shareholders" are: (1) the cost of accident and health insurance plans under IRC §§105 and 106; (2) meals and lodging furnished on the business premises for the convenience of the employer under IRC §119; (3) the cost of group-term life insurance coverage under IRC § 79; and (4) cafeteria plans under IRC §125. When a 2-percent shareholder receives one of these taxable fringe benefits, it is to be treated as additional compensation subject to Federal withholding and employment taxes.<sup>301</sup> That means the S corporation likely gets a deduction for the extra compensation, and this deduction will pass through to the shareholders *pro rata* like any other deduction item.

Not all fringe benefits excluded from the gross incomes of employees are lost; benefits that remain excludable include: (1) dependent care assistance under IRC §129;<sup>302</sup> (2) educational assistance programs under IRC §127;<sup>303</sup> and (3) several of the fringe benefits listed in IRC §132,

---

<sup>300</sup> IRC §1372(a); Reg. §1.707-1(c). To be more precise, IRC §1372(a) states that so-called "2-percent shareholders" of an S corporation are to be treated as partners in a partnership for purposes of applying Code provisions related to employee fringe benefits. Regulation §1.707-1(c) treats fringe benefits paid to employee-partners as "guaranteed payments" because they are paid without regard to the partnership's income for services rendered. The same regulation states that a partner who receives guaranteed payments is not, by virtue of the payments, regarded as an employee of the partnership. Accordingly, the value of a fringe benefit "is not excludible from the partner's gross income under the general fringe benefit rules (except to the extent the Code provision allowing exclusion of a fringe benefit specifically provides that it applies to partners) because the benefit is treated as a distributive share of partnership income ... for purposes of all Code sections other than sections 61(a) and 162(a), and a partner is treated as self-employed to the extent of his or her distributive share of income." Rev. Rul. 91-26, 1991-1 C.B. 184. See also Albert B. Ellentuck, *S Corporation's Treatment of Employee-Shareholder Fringe Benefits*, THE TAX ADVISER (May 2003).

<sup>301</sup> Rev. Rul. 91-26, 1991-1 C.B. 184.

<sup>302</sup> IRC §129(e)(3) provides that the exclusion is available to self-employed individuals as well as employees. Because partners in a partnership and 2-percent shareholders in an S corporation are deemed to be self-employed, as discussed *supra*, the exclusion is available to partners and 2-percent shareholders in an S corporation.

<sup>303</sup> IRC §127(c)(2).

including no-additional-cost services, qualified employee discounts, de minimis fringes, working condition fringes, and on-premises athletic facilities.<sup>304</sup>

2. **Getting Basis Credit for Entity Debt.** As mentioned above, S corporation shareholders need basis (either stock basis or debt basis) in order to claim their shares of the corporation's net losses. While partners in a partnership are entitled to basis credit for their shares of the partnership's debts, the same is not true for shareholders of an S corporation. It is not sufficient for a shareholder to guarantee the S corporation's debt in order to give the shareholder basis credit for the debt.<sup>305</sup> The preferred approach is for the lender to make the loan to the shareholder who then loans those proceeds to the S corporation. By structuring the loan arrangement in this fashion, the shareholder makes a loan to the corporation, which expressly entitles the shareholder to basis credit.<sup>306</sup> It is worth noting that to the extent the shareholder incurs personal liability in order to have the loan structured in such a way as to give the shareholder basis credit for the debt, the shareholder bears a genuine risk that a direct loan to the corporation would not present. But since many loan arrangements with closely-held S corporations require personal guarantees from the shareholders already, structuring the loan to pass through the shareholder may not affect the shareholder's liability for repayment.
3. **Debt as a Second Class of Stock.** Speaking of debt, planners have to tread carefully here. Shareholder loans to an S corporation may be recharacterized as equity, which would give the S corporation an impermissible second class of stock. A loan to an S corporation will be treated as stock if the transaction constitutes equity under general

---

<sup>304</sup> Reg. §§1.132-1(b)(1); 1.132-1(b)(2)(ii); 1.132-1(b)(3); 1.132-1(b)(4).

<sup>305</sup> If the shareholder makes an actual payment on the guarantee, he or she gets basis credit for the amount paid.

<sup>306</sup> As long as proper formalities are observed and the shareholder in fact assumes liability for servicing the debt, the refinancing of an entity debt into a shareholder debt can give the shareholder debt basis. See *Miller v. Commissioner*, T.C. Memo. 2006-125 (restructuring of corporation's line of credit under which shareholder assumed the debt gave shareholder basis credit to the extent of the shareholder's liability). As the *Miller* court observed, "The same result as a 'back to back' loan is reached where a shareholder substitutes his own note for the note of his S corporation on which he was a guarantor, thereby becoming the sole obligor on the new indebtedness. In such 'note substitution' scenarios, so long as the S corporation's indebtedness to the third-party lender is extinguished, so that the shareholder becomes the sole obligor to the lender, the shareholder's assumption of what was formerly the S corporation's legal burden serves as a constructive furnishing of funds to the S corporation for which the S corporation becomes indebted to repay to the shareholder."

principles of federal tax law or if the principal purpose of the transaction is to circumvent the single-class-of-stock or eligible-shareholder rules.<sup>307</sup> To be safe, all loan arrangements from shareholders to S corporations should come within one of the three safe harbors outlined in the regulations: (1) short-term unwritten advances that never exceed \$10,000 in the aggregate;<sup>308</sup> (2) debts owed solely to the shareholders and in proportion to their stock holdings;<sup>309</sup> and (3) “straight debt.” Straight debt is a written, unconditional obligation to pay a sum certain (on demand or on a specified due date) held by a United States citizen or resident, an estate, or an eligible trust shareholder and which does not provide for contingent interest (that is, interest computed or payable that is contingent on corporate profits, the borrower’s discretion, the payment of dividends, or similar factors) and is not convertible to into stock.<sup>310</sup>

The debt-as-second-class-of-stock problem can arise in situations planners may not expect. For example, if an S corporation redeems a portion of the shares of a retiring or deceased shareholder, the applicable buy-sell agreement usually permits the S corporation to pay the purchase price in installments. If the buy-sell agreement requires the S corporation to pay interest on the deferred payments, the obligation may create a second class of stock unless it qualifies under straight debt safe harbor. Planners should review the provisions of a buy-sell agreement involving S corporation stock to make sure this situation does not arise by accident.

- 4. The Perils of Former C Corporations.** If an S corporation used to be a C corporation, the planner has to proceed carefully. Three separate Code provisions come into play for former C corporations, although the last two are more significant because they continue to haunt the former C corporation for quite a while following the subchapter S election.

*The first provision* is IRC §1363(d), which forces a corporation using the LIFO method of inventory valuation to recapture as gross income the excess of the FIFO value of its inventory over the LIFO value of its inventory at the close of the corporation’s last taxable year as a C corporation. The recapture amount is treated as gross income in such last taxable year, but the increase in tax caused by this recapture is payable in four equal annual

---

<sup>307</sup> Treas. Reg. §1.1361-1(l)(4)(ii)(A).

<sup>308</sup> Treas. Reg. §1.1361-1(l)(4)(ii)(B)(1).

<sup>309</sup> Treas. Reg. §1.1361-1(l)(4)(ii)(B)(2).

<sup>310</sup> Treas. Reg. §1.1361-1(l)(5)(i). My English teacher would have a fit about that sentence, but it’s all there.

installments without interest. Unless the planner is helping the business to elect S corporation status, the planner will likely not have to address this issue.

*The second provision* is IRC §1374, proof that the S election does not provide a perfect conduit for former C corporations. This provision imposes a tax on the disposition of “built-in gains.” It is the S corporation that is liable for payment of this tax. The basic theme behind the IRC §1374 tax on built-in gains is that gains and losses attributable to taxable years prior to the S election should be taxed as though the corporation were still subject to subchapter C. For example, suppose that X Corporation purchased raw land for \$100 three years ago. Today, the land is worth \$500, and the corporation wants to sell the land to an unrelated purchaser. If X sells the land, X will be taxed on the \$400 gain. If X then distributes the after-tax proceeds of the sale to its shareholders (as a dividend), the after-tax profit will be taxed again. The shareholders of X thus have an incentive to make the S election prior to the sale. If X makes an S election prior to the sale, the \$400 gain will pass to the shareholders under IRC §1366, and subsequent distribution of the proceeds will be tax-free under IRC §1368. In effect, the election allows X to convert two levels of tax into one level of tax. Congress reacted to this situation by enacting IRC §1374. Now, when the gain occurs during years in which the corporation was subject to two layers of tax, it is appropriate to tax that gain twice even though the entity is currently a valid S corporation.

The IRC §1374 tax applies to any “net recognized built-in gains” during each of the first several years following the former C corporation’s subchapter S election (known as the “recognition period”).<sup>311</sup> The tax is computed by applying the highest rate under IRC §11 (now 35 percent) to the net recognized built-in gain for the taxable year or, if less, the corporation’s taxable income for the taxable year.<sup>312</sup> The cumulative amount of net recognized built-in gains during the recognition period cannot exceed the corporation’s “net unrealized built-in gain” as of the date of the S election.<sup>313</sup> Note that the tax applies to any disposition that

---

<sup>311</sup> See IRC §1374(d) for definitions of key terms. Legislation in 2009 shortened the recognition period to seven years for 2009 and 2010 only. IRC §1374(d)(7)(B). Under the Creating Small Business Jobs Act of 2010, the recognition period for taxable years beginning in 2011 only was shortened to five years, and the American Taxpayer Relief Act of 2012 extended the five-year recognition period through 2013. So if the corporation made its S election effective for 2008, for example, any net recognized built-in gains in 2013 were not subject to the tax. Curiously, however, any net recognized built-in gains in 2014, the seventh year of S corporation status, are subject to the tax.

<sup>312</sup> IRC §§1374(b)(1); 1374(d)(2)(A).

<sup>313</sup> IRC §1374(c)(2).

results in a recognized built-in gain, whether in the form of a sale or a distribution to the shareholders.<sup>314</sup>

The tax imposed under IRC §1374 passes through to the S corporation's shareholders as a loss with the same character as the corresponding gain giving rise to the tax.<sup>315</sup> This lessens the impact of the double tax to some extent.

There are several ways to avoid or lessen the burden of the IRC §1374 tax. Perhaps the most common solution is to wait out the recognition period: the tax does not apply to dispositions of built-in gain property that occur in or after the eleventh year of the S election.<sup>316</sup> The tax can be deferred if the corporation effects a like-kind exchange of the built-in gain property under IRC §1031, although the IRC §1374 taint is preserved in the asset(s) received in the like-kind exchange.<sup>317</sup> Regulations provide that if an S corporation acquires some asset before or during the recognition period with a principal purpose of reducing or eliminating the IRC §1374 tax (because the asset will generate a loss, deduction, or credit that can be used to reduce the corporation's taxable income below the amount of net recognized built-in gain), such loss, deduction or credit shall be ignored for purposes of computing the IRC §1374 tax.<sup>318</sup> Finally, one could consider a charitable contribution of the built-in gain property. The S corporation does not recognize gain upon making the gift to charity (so the IRC §1374 tax cannot apply), and the deduction flows through to the shareholders. The shareholders reduce their stock bases by their shares of the corporation's adjusted basis in the contributed property,<sup>319</sup> which insures that the lurking gain is not later taxed upon sale of the shares or liquidation of the corporation.

---

<sup>314</sup> IRC §§311(b); 1374(d)(3).

<sup>315</sup> IRC §1366(f)(2).

<sup>316</sup> But see *supra* Note 132 regarding different recognition periods in effect for 2009, 2010, and 2011.

<sup>317</sup> IRC §1374(d)(6).

<sup>318</sup> Treas. Reg. §1.1374-9.

<sup>319</sup> IRC §1367(a). First introduced in 2006, this rule has thrice expired and thrice resuscitated. Most recently it expired at the end of 2013. As of now, contributions in 2014 and later will require shareholders to reduce their stock bases by the amount of the deduction, which in many cases will be the fair market value of the contributed property. See IRC §170(e). Although there is still no gain to the corporation (and, thus, no IRC §1374 tax exposure), the extra reduction in stock basis effectively preserves such gain at the shareholder level.

*The third provision* is IRC §1375, which imposes a penalty tax at the entity level when two conditions exist: (1) an S corporation has “accumulated earnings and profits” (which by definition only applies if the S corporation was formerly a C corporation), and (2) the S corporation’s “passive investment income” exceeds 25 percent of its total gross receipts. If the IRC §1375 tax is imposed for three consecutive years, the corporation will face the “death penalty”: its S election is terminated and the corporation will revert to C corporation status.<sup>320</sup>

Why the concern with the amount of passive income generated by a corporation? One treatise explains the policy of these rules as follows:

These statutory measures restrict attempts to use S corporations as incorporated pocketbooks for their shareholders by investing the corporations’ retained earnings in marketable securities and other passive investments of a type that the shareholders would have purchased had the earnings been paid out as dividends. This ploy is particularly likely to happen when the C corporation has liquidated its business assets. The passive-investment-income limitation can also be viewed as a rough-and-ready offset to the fact that a C corporation can be converted to S status without subjecting its accumulated earnings to tax at the shareholder level as if the earnings were distributed in a quasi-liquidation.<sup>321</sup>

Basically, Congress wants to limit the benefits of subchapter S to corporations engaged in active businesses.

The mechanics of the IRC §1375 tax are relatively simple. The corporation’s “excess net passive income” is multiplied by the highest rate of tax under IRC §11 (still 35 percent).<sup>322</sup> Excess net passive income is computed under the formula on the next page.

---

<sup>320</sup> IRC §1362(d)(3).

<sup>321</sup> Boris I. Bittker & James S. Eustice, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (7<sup>th</sup> student ed. 2000) at 6-19.

<sup>322</sup> IRC §1375(a).

$$\frac{(\text{PII}) - (25\% \text{ of GR})}{(\text{PII})} \times (\text{NPI}) = \text{Excess Net Passive Income}$$

PII = **passive investment income** (royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of securities)<sup>323</sup>

GR = **gross receipts** (the total amount received or accrued under the corporation's accounting method)<sup>324</sup>

NPI = **net passive income** (passive investment income less those deduction directly connected with the production of passive investment income other than net operating loss carryovers and dividends-received deductions)<sup>325</sup>

The corporate-level taxes are coordinated because built-in gains and losses are taken out of the definition of passive investment income.<sup>326</sup> Instead of passing through as a loss, the amount of IRC §1375 tax serves to reduce the amount of each item of passive investment income passing through to the shareholders.<sup>327</sup>

There are some planning suggestions for minimizing exposure to the IRC §1375 tax. If the corporation had relatively little earnings and profits at the time of the S election, it may be advisable to distribute the subchapter C earnings and profits to the shareholders, especially since those earnings will be taxed at preferential tax rates to the shareholders in the hopes of avoiding a 35 percent tax imposed on the corporation.<sup>328</sup> Once the subchapter C earnings and profits are gone, the IRC §1375 tax (and the risk of the death penalty under IRC §1362(d)(3)) cannot apply. Alternatively, the shareholders can try their very best to manage gross receipts so that the amount of passive income does not cross the 25 percent threshold.

<sup>323</sup> IRC §§1362(d)(3)(C)(i); 1375(b)(3).

<sup>324</sup> Treas. Reg. §1.1362-2(c)(4)(i).

<sup>325</sup> IRC §1375(b)(2).

<sup>326</sup> IRC §1375(b)(4).

<sup>327</sup> IRC §1366(f)(3).

<sup>328</sup> IRC §1368(e)(3) permits the shareholders to declare that distributions come first from subchapter C earnings and profits and then from subchapter S earnings (the accumulated adjustments account), although the default distribution rules apply the opposite assumption.

5. **Beware Trusts Holding S Corporation Stock.** Only certain domestic trusts qualify as S corporation shareholders. If S corporation falls into the hands of an “ineligible” shareholder, the S election is lost and the corporation becomes a C corporation unable to elect S corporation status for five years unless it successfully obtains discretionary relief from an inadvertent termination of the S election. Although many trusts qualify as eligible shareholders of S corporation stock, some common trust arrangements do not qualify. For instance, a charitable remainder trust is not an eligible shareholder of S corporation stock. Planners should therefore not advise clients to fund charitable remainder trusts with S corporation stock because doing so would sacrifice the S election.

Generally there are five kinds of trusts that qualify as S corporation shareholders.

The first is the **qualified subchapter S trust**, or QSST.<sup>329</sup> A QSST is a domestic trust<sup>330</sup> that has only one income beneficiary during that beneficiary’s life (unless each beneficiary has a separate share of the trust<sup>331</sup>) who is a United States citizen or resident.<sup>332</sup> The trust instrument must require that all income be distributed currently (or such income must in fact be paid at least annually to the current income beneficiary). A QSST may permit distributions of principal only to the current income beneficiary during his or her life. No one else may be entitled to distributions of income or principal during the trust term, and no payments can be made from the trust that discharge someone else’s obligation to support the current income beneficiary. The trust instrument must provide that the current income beneficiary’s income interest terminates at his or her death or, if earlier, upon expiration of a fixed term. If a QSST terminates during the current income beneficiary’s life, all assets must be distributed to him or her.

---

<sup>329</sup> IRC §1361(d).

<sup>330</sup> See IRC §§7701(a)(30)(E); 7701(a)(31)(B). Under these rules, a trust is a domestic trust only if: (a) a court within the United States has primary supervision over the administration of the trust, and (b) one or more United States fiduciaries control all substantial decisions of the trust. The regulations give some examples of the “substantial decisions” related to a trust that a fiduciary may have. Treas. Reg. §301.7701-7(d)(1)(ii). These include, among others: (1) whether and when to make distributions of income and principal; (2) the amount of distributions; (3) whether a receipt is allocated to income or principal; (4) the selection of a beneficiary; and (5) whether to appoint a successor trustee to succeed another trustee that is unable or willing to serve or continue to serve.

<sup>331</sup> See IRC §663(c).

<sup>332</sup> Spouses are treated as one current income beneficiary if they file jointly and each is a United States citizen or resident.



To become a QSST, the current income beneficiary must make a QSST election.<sup>333</sup> In the case of a trust owning shares in a C corporation that becomes an S corporation, the QSST election is made on Part III of the Form 2553, Election by a Small Business Corporation. If the corporation's S election is already in effect when the trust receives the shares, the QSST election is made by signing and filing a statement with the service center where the corporation files its income tax return.<sup>334</sup> The current income beneficiary reports all S corporation items attributable to the stock held by the QSST on his or her personal tax return.<sup>335</sup> For purposes of the 100-shareholder limitation, the current income beneficiary is treated as the shareholder of the stock.<sup>336</sup>

The second is the **electing small business trust**, or ESBT.<sup>337</sup> A trust can qualify as an ESBT if it has only individuals, estates, and/or qualified exempt organizations<sup>338</sup> as present, remainder, or reversionary beneficiaries.<sup>339</sup> A trust cannot qualify as an ESBT if any person has acquired an interest in the trust by purchase.<sup>340</sup> In addition, each "potential current beneficiary"<sup>341</sup> of the trust must be an eligible

---

<sup>333</sup> If the corporation loses its S election solely because the current income beneficiary of an otherwise valid QSST fails to make a QSST election, the S election may be preserved if a QSST election is filed within two years of its original due date. See Rev. Proc. 2003-43, 2003-1 C.B. 998.

<sup>334</sup> Treas. Reg. §1.1361-1(j)(6)(ii). The statement must: contain the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation; identify the election as one made under IRC §1361(d)(2); specify the date on which the election is to become effective (cannot be more than 2 months and 15 days before the date the election is filed); specify the date(s) on which stock was transferred to the trust; and provide all information required to prove that the trust meets the requirements of a QSST.

<sup>335</sup> If the trust sells the S corporation stock, gain or loss is recognized by the trust (although the sale is considered to have been made by the current income beneficiary for purposes of the at-risk rules in IRC §465 and the passive loss rules in IRC §469). See IRC §1361(d)(1)(C).

<sup>336</sup> IRC §1361(c)(2)(B)(i).

<sup>337</sup> See IRC §1361(e).

<sup>338</sup> Any organization described in IRC §170(c)(2) – (5) is a qualified exempt organization, as is any IRC §170(c)(1) organization that holds a contingent interest and is not a potential current beneficiary.

<sup>339</sup> A person who may take under the exercise of a power of appointment is not considered a beneficiary of the trust for this purpose unless such power is actually exercised in that person's favor.

<sup>340</sup> A purchase includes any transaction in which the basis of the acquired property is its cost. IRC §1361(e)(1)(C).

<sup>341</sup> A potential current beneficiary is one entitled to (or who may currently) receive distributions of income or principal from the trust. IRC §1361(e)(2).

shareholder of S corporation stock if the trust is to qualify as an ESBT. The trust cannot be a charitable remainder trust or otherwise exempt from federal income tax.

An eligible trust becomes an ESBT when the trustee(s) with authority to legally bind the trust sign and file an election statement with the service center where the corporation files its income tax return.<sup>342</sup> While the requirements for an ESBT are easier to meet than the requirements for a QSST, the price for ease lies in the taxation of the trust's income. The trust itself must pay a flat tax of 39.6 percent<sup>343</sup> on the trust's taxable income attributable to the S corporation items,<sup>344</sup> the exemption amount for alternative minimum tax purposes is reduced to zero, and no capital loss carryovers are permitted.<sup>345</sup> For purposes of the 100-shareholder limitation, each potential current beneficiary is counted as a shareholder.<sup>346</sup>

In computing an ESBT's income attributable to the S corporation, the only items taken into account are: (1) the trust's shares of the S corporation's item of income, gain, loss, deduction, and credit; (2) gain or loss from the trust's sale of the S corporation stock; (3) state or local income taxes and administrative expenses allocable to the S corporation stock; and (4) interest paid or accrued on debt used to acquire stock in the S corporation.<sup>347</sup>

---

<sup>342</sup> Treas. Reg. §1.1361-1(m)(2)(i). The statement must include: the name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the corporation; a statement that an ESBT election pursuant to IRC §1361(e)(3) is being made; the date when the trust first owned stock in the corporation; the date the election is to take effect (cannot be more than 2 months and 15 days before the date the election is filed); and representations that the trust meets all of the requirements of an ESBT and that all potential current beneficiaries are eligible shareholders of S corporation stock.

<sup>343</sup> Formally, the tax rate is equal to the highest rate applicable to trusts and estates under IRC §1(e). IRC §641(c)(2)(A).

<sup>344</sup> The trust continues to pay tax at the slightly progressive rates of IRC §1(e) on income attributable to other assets.

<sup>345</sup> IRC §641(c).

<sup>346</sup> IRC §1361(c)(2)(B)(v). During any period that there is no potential current beneficiary of an ESBT, the trust itself is treated as the shareholder for purposes of applying the 100-shareholder limitation.

<sup>347</sup> IRC §641(c)(2)(C).

The third kind of trust eligible to be an S corporation shareholder is a good, old-fashioned **grantor trust**.<sup>348</sup> A grantor trust is any trust that is deemed to be owned by the grantor or another person under any of IRC §§671-678.<sup>349</sup> A grantor trust is effectively disregarded for federal income tax purposes because all of the trust's tax items are reported by the deemed owner. Accordingly, if the deemed owner is an eligible shareholder of S corporation stock, transfers of S corporation stock to a grantor trust will not jeopardize the company's S election. For purposes of the 100-shareholder limitation, the deemed owner is counted as the shareholder.<sup>350</sup>

The fourth kind of eligible trust is a **former grantor trust**.<sup>351</sup> As its name implies, a former grantor trust is a trust that was a grantor trust (with a United States citizen or resident as the deemed owner) immediately before the deemed owner's death and that continues after such death. Although the trust is no longer a grantor trust because of the deemed owner's demise, the trust itself remains an eligible S corporation shareholder regardless of its dispositive scheme until the day before the second anniversary of the deemed owners death.<sup>352</sup> After such time, the trust will need to qualify as a QSST, ESBT, or grantor trust if the S election is to continue. The estate of the deemed owner is counted as the shareholder for purposes of the 100-shareholder limitation.

The final kind of eligible trust is a **testamentary trust**. All testamentary trusts are permitted S corporation shareholders for a two-year period beginning on the date the stock is transferred to the trust.<sup>353</sup> After such time, the trust will need to qualify as a QSST, ESBT, or grantor trust if the S election is to continue. During the two-year grace period, the trust itself

---

<sup>348</sup> IRC §1361(c)(2)(A)(i).

<sup>349</sup> For more on the use of grantor trusts in estate planning, see (ahem) Samuel A. Donaldson, *Understanding Grantor Trusts*, in 40 HECKERLING INSTITUTE ON ESTATE PLANNING 2-1 (Tina Portuando ed., 2006).

<sup>350</sup> IRC §1361(c)(2)(B)(i). This is true even where the trust contains *Crummey* powers that give the beneficiaries a power to withdraw some or all of the amounts contributed to the trust so that a gift of S corporation stock to the trust qualifies for the federal gift tax annual exclusion. See, e.g., PLR 200732010 (grantor trust with *Crummey* powers is an eligible shareholder of S corporation stock because the grantor's ownership of the trust under IRC §674 trumped the beneficiaries' ownership of the trust under IRC §678(a).

<sup>351</sup> IRC §1361(c)(2)(A)(ii).

<sup>352</sup> If no one is the deemed owner of the trust, the trust itself pays the tax on the items of income, gain, loss, deduction, and credit attributable to its share of the S corporation's stock.

<sup>353</sup> IRC §1361(c)(2)(A)(iii).

pays the tax on the items of income, gain, loss, deduction, and credit attributable to its share of the S corporation's stock if no one is the deemed owner of the trust. The testator is treated as the shareholder for purposes of applying the 100-shareholder limitation.

#### XIV. Partnerships

##### A. The Basic Mechanics

1. **Formation.** Like a corporation, formation of a partnership is also a painless event. A partner will not recognize gain or loss upon a transfer to the partnership in exchange for an interest unless the contribution consists of services.<sup>354</sup> Note that a partner does not need to be an 80-percent owner to achieve non-recognition, as does the shareholder of a corporation. To preserve any gain or loss not recognized, the partner's basis in the partnership interest equals the sum of the bases of the properties transferred to the partnership in exchange for the interest.<sup>355</sup> The partnership also takes a carry-over basis in the property received from the partner.<sup>356</sup>
2. **Operation.** The tax items of a partnership pass through to the partners.<sup>357</sup> Unlike an S corporation, however, the partners of a partnership are generally free to allocate these tax items among the partners as they wish, so long as these allocations have "substantial economic effect."<sup>358</sup> Thus, equal partners in a partnership may agree to allocate all losses to one partner and all tax-exempt income to the other partner, so long as the allocations have "substantial economic effect." The flexible tax allocations make the partnership a more attractive business vehicle to most business owners.

Allocations have "economic effect" if the partnership agreement requires, for the full term of the partnership, that: (1) capital accounts be created and maintained in the manner set forth in the regulations;<sup>359</sup> (2) liquidating

---

<sup>354</sup> IRC §721.

<sup>355</sup> IRC §722.

<sup>356</sup> IRC §723.

<sup>357</sup> IRC §§701; 702.

<sup>358</sup> IRC §704(b).

<sup>359</sup> See Treas. Reg. §1.704-1(b)(2)(iv).

distributions be made in accordance with the partners' positive capital account balances,<sup>360</sup> and (3) any partner with a deficit balance in his or her capital account following liquidation of the partnership be unconditionally obligated to restore the amount of the deficit.<sup>361</sup> If the partnership agreement complies with the first two requirements but does not comply with the third requirement, the allocation can still have economic effect under an alternate test.<sup>362</sup> Assuming the economic effect test is met, an allocation will be respected if it is **substantial**. While various standards for substantiality are provided in the regulations—a general rule as well as a rule for shifting and transitory allocations—the focus is whether the allocation will affect substantially the dollar amounts to be received by the partners from the partnership.<sup>363</sup>

3. **Distributions.** As you would expect, distributions from a partnership are generally tax-free since the partners have already taken the partnership's tax items into account on their own income tax returns. No gain is recognized upon a distribution to a partner except to the extent the amount of cash distributed exceeds the partner's outside basis immediately before the distribution.<sup>364</sup> No gain or loss is recognized by the partnership.<sup>365</sup> If a partner receives cash or property regardless of the partnership's profitability, however, the distribution may constitute a "guaranteed payment" that will be treated as compensation income.<sup>366</sup> Further discussion of the partnership distribution rules appears later in these materials.
4. **Liquidation.** The basis of property (other than money) distributed to a partner in liquidation of the partner's interest in the partnership is an amount equal to the partner's basis in the partnership interest reduced by

---

<sup>360</sup> A partner's capital account balance is the amount he or she would be entitled to receive upon liquidation of the partnership. A capital account is increased by the net value of any contributed cash or property and the partner's share of partnership income items. It is decreased by the value of any distributions to the partner and the partner's share of partnership loss and deduction items.

<sup>361</sup> Treas. Reg. §1.704-1(b)(2)(ii)(b).

<sup>362</sup> See Treas. Reg. §1.704-1(b)(2)(ii)(d).

<sup>363</sup> See Treas. Reg. §1.704-1(b)(2)(iii).

<sup>364</sup> IRC §731(a)(1).

<sup>365</sup> IRC §731(b).

<sup>366</sup> IRC §707.

any money distributed in the same transaction.<sup>367</sup> Liquidation of a partner's interest is defined as the termination of the partner's entire interest in the partnership by means of a distribution or series of distributions.<sup>368</sup> Loss is not recognized by a partner upon a distribution *except* that loss *is* recognized on a distribution in liquidation of a partner's interest where no property other than cash, unrealized receivables, and inventory items are received by the partner.<sup>369</sup> The amount of the loss (which is considered to be loss from the sale or exchange of the partnership interest) is equal to the excess of the partner's basis in the partnership interest over the sum of the cash distributed to the partner and the adjusted basis of the distributed property under IRC §732.

## **B. Planning Opportunities with Partnerships**

- 1. The IRC §754 Election and the Adjustment to Inside Basis.** If the partnership makes an election under IRC §754, the partnership's basis in its assets ("inside basis") will be adjusted, but only with respect to the transferee partner. Specifically, the entity will increase its inside basis by the excess of the transferee partner's outside basis (freshly stepped-up under IRC §1014, remember) over his or her share of the partnership's inside basis. Alternatively, if the transferee partner's outside basis was stepped-down under IRC §1014, the entity will reduce its inside basis by the excess of the transferee partner's share of inside basis over his or her outside basis. This adjustment to inside basis affects not just the allocation of gain and loss to the transferee partner upon a disposition of a partnership asset. It determines the partner's share of inside basis for purposes of depreciation deductions and distributions, as well.

Notice that if the estate planner succeeds in claiming a significant valuation discount for the value of the partnership interest included in the deceased partner's gross estate, there is an adverse effect on the adjustment to inside basis (though usually not to such an extent that the valuation discounts have no net value). To illustrate, suppose Mom dies holding a five percent general partner interest and a 20 percent limited partner interest in a partnership. The partnership's assets have a combined liquidation value of \$1,000,000 and an aggregate inside basis of \$200,000. Mom's estate values the five percent general partner interest at \$40,000 (assuming a 20 percent blended valuation discount against the \$50,000

---

<sup>367</sup> IRC §732(b).

<sup>368</sup> See IRC §761(d).

<sup>369</sup> IRC §731(a)(2).

liquidation value attributable to the general partner interest) and it values the 20 percent limited partner interest at \$120,000 (assuming a 40 percent blended valuation discount against the \$200,000 liquidation value attributable to the limited partner interest). Both interests pass to Son. Son's aggregate outside basis is \$160,000, the sum of the date-of-death values of the general and limited partner interests included in Mom's gross estate. If the partnership has a valid IRC §754 election in effect, the \$50,000 of aggregate inside basis (that portion of the inside basis attributable to Mom's interests) is increased to \$160,000, *not* to its \$250,000 liquidation value. Thus, while the IRC §754 election eliminates the disparity between inside and outside bases with respect to Son, the election does not completely eliminate the inherent gain attributable to the interests now held by Son; if the partnership sells all of its assets, \$90,000 of gain will be allocable to Son. Of course, this beats the \$200,000 gain that would have been allocable to Son had no IRC §754 election been made. And the estate tax savings from an aggregate \$90,000 discount likely exceeds the income tax burden from \$90,000 of extra gain. But it shows that the higher the discount, the less beneficial the IRC §754 election becomes to the decedent's successor in interest.

Note that if the deceased partner's surviving spouse is also a partner in the partnership, and if the spouses owned their interests as community property, the surviving spouse's interest in the partnership also triggers an adjustment to inside basis if the IRC §754 election is in effect.

2. **S Corporation Election.** Unincorporated domestic entities (like partnerships) can elect to be treated as corporations for federal tax purposes.<sup>370</sup> Any such organization that elects status as a corporation can also elect to be taxed as an S corporation.<sup>371</sup> To the extent a partnership wants to avail itself of the benefits of S corporation status, the partners can simply make this two-step election to achieve the desired status.

The key obstacle, of course, is that an electing unincorporated entity must meet the eligibility requirements of an S corporation in order for the S election to become effective. The entity, for example, cannot have more than 100 owners<sup>372</sup> and no owner may be a nonresident alien individual.<sup>373</sup>

---

<sup>370</sup> Treas. Reg. §301.7701-3.

<sup>371</sup> See, e.g., Priv. Ltr. Rul. 199942017.

<sup>372</sup> IRC §1361(b)(1)(A).

<sup>373</sup> IRC §1361(b)(1)(C).

These are easy enough to spot, but the “single-class-of-stock” requirement for S corporations<sup>374</sup> can be harder to police. The Service will not issue rulings as to whether a limited partnership qualifies as a small business corporation eligible to elect S corporation status.<sup>375</sup> No doubt this is because the varying rights and obligations of general and limited partners may well constitute a second class of stock.<sup>376</sup> We know that a limited partnership agreement does not create a second class of stock as long as distributions to the partners are to be made in accordance with the partners’ respective cumulative interests.<sup>377</sup> But if the partnership agreement requires distributions in accordance with positive capital account balances and such capital accounts are not in proportion to the partners’ percentage interests, the partnership likely has more than one class of stock, making the S election unavailable.<sup>378</sup> Disproportionate operating distributions from the partnership should not create a second class of stock provided the entity makes corrective distributions to make distributions proportionate.<sup>379</sup>

3. **Allocating Items in the Year of a Partner’s Death.** Upon the death of a partner, IRC §706(c)(2)(A) provides that the taxable year of the partnership closes with respect to the deceased partner. The deceased partner’s final income tax return includes all pass-through items for the short taxable year ending at death, either through an interim closing of the books or through a *pro rata* allocation based on the number of days in each

---

<sup>374</sup> IRC §1361(b)(1)(D).

<sup>375</sup> Rev. Proc. 2011-3, 2011-1 I.R.B. 111, §5.11.

<sup>376</sup> See Rev. Proc. 99-51, 1999-2 C.B. 760.

<sup>377</sup> See, e.g., Priv. Ltr. Ruls. 200326023, 200326024, and 200326025. In the last of these private rulings, the shareholders of an S corporation (S1) formed a limited liability partnership (LLP) that made a double-election to be treated as an S corporation. The shareholders then contributed their S1 stock to LLP and S1 elected to be treated as a qualified subchapter S subsidiary corporation (or “Q-Sub”). LLP then created a wholly-owned limited liability company (LLC) that is disregarded for federal tax purposes as an unincorporated organization with only one owner. LLP transferred some of its S1 stock to LLC. Because LLC is disregarded, S1’s Q-Sub election is not lost. S1 then converted to a limited partnership, with LLC as the general partner and LLP as the limited partner. As a limited partnership, S1 made a triple-election (electing to be a corporation, an S corporation, and a Q-Sub). At the end of the day, then, the shareholders owned all of the interests in LLP (an S corporation for tax purposes) which in turn held all of the limited partner interests (and, through a disregarded entity, all of the general partner interests) in a limited partnership (a Q-Sub for tax purposes). The Service approved this transaction in the ruling.

<sup>378</sup> See Richard B. Robinson, *Tax Audit Issues for S Corporations*, in 41<sup>ST</sup> ANNUAL SOUTHERN FEDERAL TAX INSTITUTE MATERIALS at J-7 (2006).

<sup>379</sup> See, e.g., Priv. Ltr. Rul. 200524020.



period.<sup>380</sup> For example, suppose A, B, and C are equal general and limited partners in a partnership. A dies on July 1, Year One. The partnership's income for Year One consists of two gains: a \$900 gain in March and a \$300 gain in November. If the partnership makes an election to close its books on July 1, the proportionate shares of the partners would be as follows:

<u>Partner</u>	<u>March Gain Share</u>	<u>November Gain Share</u>
A	\$300	zero
B	\$300	\$150
C	\$300	\$150

If, on the other hand, the partnership does not close its books, the proportionate shares of the partners for Year One would be as follows:

<u>Partner</u>	<u>March Gain Share</u>	<u>November Gain Share</u>
A	\$150	\$50
B	\$375	\$125
C	\$375	\$125

In this example, B and C are inclined to close the books, for their proportionate shares under a closing of the books (\$450) is less than their shares if no such election is made (\$500). Of course, if the November gain were larger than the March gain, the incentive would be the opposite. The point is that the fiduciary and the surviving partners should work together to determine which approach is better.<sup>381</sup>

## C. Planning Challenges Presented by Partnerships

- The Estate Planning Drawbacks of Special Allocations.** Partners are generally free to allocate the income, gain, loss, deduction, and credit items of the partnership among themselves however they may agree, subject to the constraint in IRC §704(b) that such allocations have "substantial economic effect." Detailed regulations give guidance for ensuring that allocations meet this amorphous standard. The regulations provide two safe harbors under which an allocation will be deemed to have "economic effect."<sup>382</sup> Both safe harbors require the partnership to

<sup>380</sup> Treas. Reg. § 1.706-1(c)(2)(ii).

<sup>381</sup> The same is generally true of S corporations. IRC §1377(a), presumes that S corporation items will be allocated *pro rata* on a daily basis unless the surviving shareholders agree to an interim closing of the books.

<sup>382</sup> Treas. Reg. § 1.704-1(b)(2)(ii). The first safe harbor applies where the partnership agreement requires: (1) the determination and maintenance of capital accounts in accordance with specific rules provided elsewhere in the regulations; (2) that liquidating distributions be made in accordance with the positive capital account balances of

maintain capital accounts using specific accounting rules set forth in the regulations.<sup>383</sup> In some cases, compliance with these accounting rules proves to be difficult (i.e., expensive).

Special allocations of partnership income and deduction items are common in partnerships that conduct an active trade or business in which the partners participate. From an estate planning perspective, however, they may pose two problems. First, the use of special allocations might run afoul of IRC §2701. Section 2701 values certain retained interests in a partnership at zero for purposes of valuing subordinate equity interests transferred to certain family members. If all interests in a partnership have identical distribution and liquidation rights, IRC §2701 does not apply. Accordingly, estate planners usually advise the partners to make sure all income and deduction allocations are made according to the partners' interests in the partnership, regardless of whether such interests have voting or management rights. Differences in voting and management rights (as well as differences in liability for entity debts) do not by themselves create subordinate equity interests, so creating voting and nonvoting partnership interests does not trigger application of IRC §2701's zero-value rule.<sup>384</sup>

Second, where the planner intends to have a partner give some portion of his or her partnership interest to a donee, the planner must be cognizant of IRC §704(e)(2). It states that where there has been a gift of a limited partner interest in a partnership, the recipient's distributive share of the partnership's income is limited in two ways. *First*, the donor must be adequately compensated for any services rendered to the FLP. In other words, the donor cannot perform services at no charge for the partnership and pass along the savings to the recipient. For example, suppose Parent gives Child a 40 percent limited partner interest in a partnership, retaining a ten percent general partner interest and a 50 percent limited partner interest. The partnership's taxable income for the year is \$100,000. In that

---

the partners; and (3) that any partner with a deficit balance in his or her capital account at liquidation be required to restore the deficit balance to the partnership within a stated period. Treas. Reg. § 1.704-1(b)(2)(ii)(b). The second safe harbor applies where the partnership agreement requires: (1) both of the first two conditions of the first safe harbor (maintenance of capital accounts according to specific rules and liquidating distributions according to positive capital account balances); (2) the operation of a "qualified income offset" provision; and (3) that no allocation to a partner may cause or increase a deficit balance to that partner's capital account in an amount greater than the amount that partner is obligated to restore upon liquidation of the entity. Treas. Reg. § 1.704-1(b)(2)(ii)(d).

<sup>383</sup> Treas. Reg. § 1.704-1(b)(2)(iv).

<sup>384</sup> Treas. Reg. § 25.2701-1(c)(3).

same year, Parent performed services for the partnership valued at \$40,000. An allocation of \$40,000 of the \$100,000 taxable income to Child would violate IRC §704(e)(2) because it does not consider the services performed by Parent. Instead, the \$40,000 in services should be treated as compensation to Parent, leaving \$60,000 to be allocated according to the partners' interests in the partnership. In sum, Parent would be allocated income totaling \$76,000 (\$40,000 for Parent's services plus 60 percent of the partnership's remaining \$60,000 income, or \$36,000), while Child would be allocated \$24,000 of income (40 percent of the partnership's \$60,000 income after services).

*Second*, if the recipient's interest was funded with donated capital, the donor and the recipient must be allocated income in proportion to the donated capital. In effect, the maximum income allocable to a recipient partner is the income allocable to the recipient partner's interest in partnership capital. Thus, if Mom and Dad form a partnership with contributed capital and gift a 20 percent limited partner interest to Child, Child must report 20 percent of the partnership's income attributable to the contributed capital. Combining the two rules under IRC §704(e)(2), the regulations state that family partnership income must be distributed proportionate to capital interests after distributing reasonable compensation to the donor for services rendered to the partnership.<sup>385</sup>

If the partnership is a holding company (one not actively conducting a trade or business), it is rare to see special income or deduction allocations. Given the risks described above, it might be better *not* to follow the capital account rules in the regulations, provided the partnership agreement requires all allocations to be in accordance with the partners' interests in the partnership. Remember: failure to fall within one of the two safe harbors for economic effect means only that the Service can reallocate items if it determines that an allocation was not made in accordance with the partners' interests in the partnership. It does not mean that all allocations are *per se* invalid.

2. **Distributions within Seven Years of Capital Contributions.** Normally, property distributions from a partnership are tax-free.<sup>386</sup> But if the partnership liquidates within seven years of a partner's contribution of

---

<sup>385</sup> Treas. Reg. § 1.704-1(e)(3).

<sup>386</sup> IRC §731(a). Cash distributions from a partnership are taxable to the extent the cash distributed exceeds the recipient partner's basis in the partnership interest immediately prior to the distribution. IRC §731(a)(1).

property to the partnership, two Code provisions can convert a tax-free liquidation into a taxable one.<sup>387</sup>

First, IRC §704(c)(1)(B) provides that if property distributed to one partner was contributed to the partnership by another partner within seven years of the distribution, and if that property had built-in gain or loss at the time of contribution, then the contributing partner must recognize the built-in gain or loss at the time of the distribution. For example, suppose that *A* and *B* formed a partnership in Year One when *A* contributed farmland worth \$500,000 and with an adjusted basis of \$300,000 in exchange for a five percent general partner interest and a 45 percent limited partner interest, and *B* contributed cash in the amount of \$500,000 for a 50 percent limited partner interest. In Year Five, the partnership distributed the farmland to *B*. Assuming the value of the land has not changed since contribution, *A* must recognize *A*'s \$200,000 built-in gain from the farmland in Year Five.

Recognition of the built-in gain is avoided if the property is distributed back to the contributing partner. For this purpose, any assignee or successor to the contributing partner's interest is treated as the contributing partner to the extent of the built-in gain allocable to the assignee-successor's interest.<sup>388</sup> Thus, in the example above, if in Year Four *A* gave *A*'s general and limited partner interest to *C*, and if in Year Five the partnership distributed the farmland to *C*, neither *A* nor *C* recognizes gain from this distribution under IRC §704(c)(1)(B) since *C* was *A*'s successor in interest.

Second, IRC §737 generally provides that if a partner contributes appreciated property to the partnership and, within seven years of such contribution, receives a distribution of non-cash property, the contributing partner must recognize the IRC §704(c) built-in gain (or, if less, the excess of the distributed property's value over the partner's outside basis immediately prior to the distribution minus any cash received in the same distribution). To illustrate, return to the original example involving *A* and *B* and the formation of their partnership in Year One. Suppose the partnership used the cash contributed by *B* to acquire a small parcel of vacant land in the suburbs. In Year Five, the partnership distributed the suburban land to *A*. Assuming the value of the contributed properties has

---

<sup>387</sup> For more on the federal income tax aspects of liquidating a partnership formed for estate planning purposes, see Samuel A. Donaldson, *Super-Recognition and the Return-to-Sender Exception: The Federal Income Tax Problems of Liquidating the Family Limited Partnership*, 35 CAP. U. L. REV. 15 (2006). Yes, it's a shameless plug, but *someone* has to cite my works.

<sup>388</sup> Treas. Reg. § 1.704-4(d)(2).

not changed since contribution, A must recognize the \$200,000 built-in gain from the farmland in Year Five. As was the case with IRC §704(c)(1)(B), an assignee-successor to a contributing partner's interest is treated as a contributing partner for purposes of IRC §737's general rule.<sup>389</sup> Thus, if A gifted A's general and limited partner interests to C in Year Four and the partnership distributed the suburban land to C in Year Five, C "steps into A's shoes" and must recognize in Year Five the \$200,000 built-in gain from A's contribution of the farmland in Year One.

On its face, § 737 would apply if the contributing partner received back from the partnership the appreciated property originally contributed to the partnership. Regulations recognize that because such a "return-to-sender" distribution is not taxable under IRC §704(c)(1)(B), IRC §737 does not apply if the contributing partner receives the property he or she originally contributed to the partnership.<sup>390</sup> Oddly, however, there is no rule providing that an assignee-successor to the contributing partner's interest likewise qualifies for this exception. It is therefore possible that an assignee-successor must recognize gain under IRC §737 upon receipt of property originally contributed to the partnership by the assignee-successor's predecessor in interest—even though the receipt of the contributed property by the same party is expressly *not* subject to IRC §704(c)(1)(B).<sup>391</sup>

The moral of the story here is to postpone any distributions of IRC §704(c) property until the partnership has held such property for seven years, as IRC §§704(c)(1)(B) and 737 only apply to distributions made within seven years of contribution.

- 3. Distributions of Marketable Securities Treated as Cash Distributions.** Under IRC §731(a)(1), no gain is generally recognized upon a distribution from a partnership except to the extent that any cash received in the distribution exceeds the recipient partner's outside basis immediately prior to the distribution. For purposes of this rule, however, IRC §731(c) provides that marketable securities are treated as cash (valued at fair market value as of the date of distribution). That, of course, creates the risk that a distribution of marketable securities will be a taxable event to

---

<sup>389</sup> Treas. Reg. § 1.737-1(c)(2)(iii).

<sup>390</sup> Treas. Reg. § 1.737-2(d)(1).

<sup>391</sup> For a contrary view, see Ellen K. Harrison and Brian M. Blum, *Another View: Responding to Richard Robinson's 'Don't Nothing Last Forever'—Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 313, 315 (2003).

the recipient partner. For example, assume *A* and *B* formed a partnership when *A* contributed a collectible with a value of \$100,000 and a basis of \$20,000 and *B* contributed \$100,000 cash. The partnership used \$50,000 of the cash to purchase Microsoft stock. The partnership then distributed the Microsoft stock to *A*. Under IRC §731(c), the stock distribution is treated as a cash distribution in the amount of \$50,000, the value of the Microsoft shares distributed. *A* must recognize a gain of \$30,000 because the amount of deemed cash distributed exceeds *A*'s \$20,000 outside basis.

By its terms, IRC §731(c) does not apply if: (a) the marketable securities received by the partner were those contributed by the same partner; (b) subject to some limitations, the marketable securities distributed were acquired by the partnership in a nonrecognition transaction;<sup>392</sup> (c) the distributed securities were not marketable when first acquired by the partnership and did not become marketable for at least six months;<sup>393</sup> or (d) the partnership is an “investment partnership” and is making a distribution to an “eligible partner.”

This last exception requires elaboration. A partnership will qualify as an investment partnership if it has never been engaged in a trade or business and 90 percent or more of its assets, measured by value, have always consisted of portfolio assets.<sup>394</sup> And an eligible partner is any partner that contributed nothing but such portfolio assets to the partnership.<sup>395</sup>

Now let's return to the first exception: marketable securities will not be treated as cash for purposes of IRC §731 if they are distributed to the same partner that contributed them to the partnership. This is consistent with the “return-to-sender” exceptions under IRC §§704(c)(1)(B) and 737 described above. But here, as with IRC §737, there is no rule extending the exception to a distribution of marketable securities to an assignee-

---

<sup>392</sup> Treas. Reg. § 1.731-2(d)(1)(ii). The total cash and marketable securities acquired by the partnership in the nonrecognition transaction must be less than 20 percent of the value of the assets transferred by the partnership in such transaction. Also, the distribution of the marketable securities must occur within five years of the partnership's acquisition of the securities (or, if later, within five years of the date when the securities became marketable).

<sup>393</sup> Treas. Reg. § 1.731-2(d)(1)(iii). Also, the partnership must be distributing the securities within five years of the date upon which they became marketable. Moreover, the issuer of the securities must not have issued any marketable securities prior to the time the partnership first acquired the distributed securities. Isn't this fun?

<sup>394</sup> Treas. Reg. § 1.731-2(c)(3)(i).

<sup>395</sup> Treas. Reg. § 1.731-2(e)(2)(i).

successor to the contributing partner's partnership interest.<sup>396</sup> In other words, those who receive a partnership interest by gift may have to recognize gain upon a distribution of marketable securities from the partnership even if those securities were contributed to the partnership by the donor. And the application of this rule does not expire after seven years.

One solution is to effect a proportionate distribution of any marketable securities. By doing so, one makes better use of the limitation in IRC §731(c)(3)(B), which reduces the amount of the deemed cash distribution by the recipient partner's share of gain on the distributed securities. For example, suppose that in Year One, *A*, *B*, and *C* formed a partnership when *A* contributed stock in Starbucks Corporation worth \$900,000 (in which *A* had a basis of \$720,000) in exchange for a four percent general partner interest and an 86 percent limited partner interest, while *B* and *C* contributed their undivided, one-half interests in a parcel of raw land worth a total of \$100,000 (in which each had a basis of \$20,000) in exchange for a ten percent limited partner interest (five percent held by *B* and five percent held by *C*). *A* died in Year Ten, leaving *A*'s general and limited partner interests in equal shares to *B* and *C*. At the date of *A*'s death, the Starbucks stock is worth \$1.5 million, and the raw land is worth \$500,000. *A*'s estate claims a 50 percent combined discount on the value of the partnership interests passing to *B* and *C*, reporting a combined value of \$900,000 on *A*'s federal estate tax return (90 percent interest in a total liquidation value of \$2 million, less 50 percent). Each beneficiary's aggregate outside basis in FLP is now \$470,000 (\$450,000 attributable to the 90 percent interest from *A* that was stepped-up under IRC §1014 plus \$20,000 attributable to the ten percent interest acquired through their contribution).

If the partnership in this example distributes the Starbucks stock in equal shares to *B* and *C*, each is deemed to receive a cash distribution of only \$360,000 (not \$750,000), because the \$390,000 gain that would be allocated to each child from partnership's sale of the stock reduces the deemed cash distribution pursuant to IRC §731(c)(3)(B).<sup>397</sup> This deemed distribution is not taxable to either *B* or *C* because each has an outside basis in excess of the deemed distribution amount. The distribution will

---

<sup>396</sup> Regulation § 1.731-2(d)(1) states, in relevant part that "section 731(c) and this section do not apply to the distribution of a marketable security if-(i) the security was contributed to the partnership by the distributee partner...." No mention is made of a successor in interest here.

<sup>397</sup> For convenience, this example assumes no IRC §754 election is in place.

reduce each of *B*'s and *C*'s outside basis to \$110,000 (\$470,000 minus \$360,000 deemed cash).<sup>398</sup>

If, instead, the partnership distributes the raw land plus \$500,000 of the Starbucks stock to *B* (\$1 million total) and the remaining \$1 million of Starbucks stock to *C*, the result changes. *C* is deemed to receive a cash distribution of \$610,000 (not \$1 million), because the \$390,000 gain that would be allocated to *C* from the partnership's sale of the stock reduced the deemed cash distribution under IRC §731(c)(3)(B). Because *C*'s outside basis immediately prior to the distribution is \$470,000, *C* must recognize \$140,000 of gain thanks to the deemed cash distribution. The disproportionate distribution of the Starbucks stock to *C* in this case forced the recognition of gain that would not have occurred in a proportionate distribution of the stock.<sup>399</sup>

The IRC §731(c)(3)(B) gain limitation is handy where the partnership distributes marketable securities with a low inside basis. Partners should therefore be reluctant to distribute freshly-purchased marketable securities with an inside basis (nearly) equal to their value. Likewise, marketable securities that have recently declined in value are less attractive candidates for distribution to donee-partners.

While a proportionate distribution of marketable securities may be helpful in avoiding IRC §731(c), it presents problems outside of the tax realm. Beneficiaries are often reluctant to hold assets as tenants in common (proof that the minority interest discount and, to a greater extent, the marketability discount are quite real). If so, then perhaps the best solution to the IRC §731(c) problem lies back in the exceptions: where possible, a partnership holding a substantial amount of marketable securities should own only portfolio assets at all times and care should be taken to make sure each partner is an "eligible partner." One *bad* solution would be to reallocate the partnership's gain to the distribute partner in an effort to maximize use of the IRC §731(c)(3)(B) gain limitation. Regulations give the

---

<sup>398</sup> Note that IRC §704(c)(1)(B) does not apply in this example because the distribution occurs after the seven-year period during which IRC §704(c)(1)(B) is alive.

<sup>399</sup> Notice here that the IRC §754 election might be detrimental to the successors in interest. An increase in inside basis lessens the benefit of the IRC §731(c)(3)(B) reduction for the distributee's distributive share of gain on the property. If the partnership would realize no gain if it sold the distributed property, there is no reduction in the amount of the deemed cash distribution. Thus, while the IRC §754 election is generally beneficial in the context of IRC §§704(c)(1)(B) and 737, it can be disadvantageous for purposes of IRC §731(c).



Service the power to disregard a blatant attempt to avoid IRC §731(c)(1) through a change in partnership allocations.<sup>400</sup>

4. **Sales of Partnership Interests Can Yield Ordinary Income.** Subchapter K uses a hybrid aggregate-entity approach for the sale of an interest in a partnership. Generally, the sale gives rise to capital gain or loss because the selling partner is disposing of a capital asset.<sup>401</sup> But the portion of the gain or loss allocable to “unrealized receivables” or “inventory items” will be treated as ordinary income or loss.<sup>402</sup> This rule applies no matter whether the partner sells all or part of the partner’s interest.

**Unrealized receivables** are any rights to payments for goods or services that have not previously been included in the partnership’s gross income. The term also includes any gain attributable to assets the sale of which would give rise to ordinary income.<sup>403</sup> **Inventory items** are any assets that are neither capital assets nor IRC §1231 assets.<sup>404</sup> Accordingly, “inventory” means not only inventory but also supplies used in the partnership’s business, hedging transactions, and everyone’s favorite: government publications.

For example, suppose *A* owns a one-third interest in the *ABC* Partnership, a cash method partnership that develops real estate. *ABC* both constructs buildings for sale to customers and holds real estate for rental purposes. On January 1, *A* sells her partnership interest to *D* for \$180,000 cash. *ABC*’s balance sheet at the time of the sale is as follows:

<u>Asset</u>	<u>Basis</u>	<u>Value</u>	<u>Capital</u>	<u>Basis</u>	<u>Value</u>
Cash	\$ 45,000	\$ 45,000	<i>A</i>	\$110,000	\$180,000
Accounts Receivable	\$ 0	\$ 60,000	<i>B</i>	\$110,000	\$180,000
Building for sale	\$150,000	\$180,000	<i>C</i>	<u>\$110,000</u>	<u>\$180,000</u>
Building for rent	\$135,000	\$240,000			
Goodwill	<u>\$ 0</u>	<u>\$ 15,000</u>			
	\$330,000	\$540,000		\$330,000	\$540,000

---

<sup>400</sup> Treas. Reg. § 1.731-2(h)(1).

<sup>401</sup> IRC §741.

<sup>402</sup> IRC §751(a).

<sup>403</sup> IRC §751(c).

<sup>404</sup> IRC §751(d).

A's realized gain from the sale is \$70,000. To determine the character of this gain, we must pretend ABC sold A's share of all partnership assets for fair market value.<sup>405</sup> The accounts receivable are "unrealized receivables" under IRC §751(c), and A's share of the \$60,000 partnership gain from a sale of the receivables is \$20,000. In addition, the building held for sale is an inventory item of the partnership under IRC §751(d), and A's share of the \$30,000 gain to the partnership is \$10,000. Accordingly, A must recognize \$30,000 of ordinary income from the sale of her partnership interest (\$20,000 from the receivables and \$10,000 from the building for sale).<sup>406</sup> The remaining \$40,000 of A's \$70,000 realized gain may be long-term capital gain, provided A held her partnership interest for more than one year.

5. **No Tax-Free Mergers with Corporations.** Only corporations can participate in tax-free reorganizations with other corporations. A merger between a partnership and a corporation is treated as a taxable exchange. If the partners anticipate selling their business to a corporation and wish to participate in a tax-free reorganization transaction, they may be tempted to "check the box" so that the partnership is taxed as a corporation. But if the partners make the election only shortly before engaging in the reorganization, there is a high risk that the transaction will not qualify for nonrecognition. This risk arises under the common law step transaction doctrine, where a proposed reorganization planned prior to the formation of a target corporation can be deemed a taxable exchange because there is no other business purpose for the corporation and because the transaction is, in substance, a taxable exchange.<sup>407</sup>

There is no magic amount of time after electing corporate status that a former partnership should wait before the reorganization occurs. Instead, the principal focus should be on making sure there is some separate business purpose for converting the partnership to a corporation beyond qualifying the exchange for nonrecognition.<sup>408</sup> If the partners anticipate that the business might be acquired by a corporation, it is a good idea to create a corporation well in advance of discussions with a particular buyer.

---

<sup>405</sup> Treas. Reg. §1.751-1(a)(2).

<sup>406</sup> The building held for rent is not IRC §751(a) property because it is not held for sale to customers. The property qualifies as IRC §1231 property under IRC §1231(b), so it is not an "inventory item" of the partnership.

<sup>407</sup> *West Coast Marketing Corp. v. Commissioner*, 46 TC 32 (1966).

<sup>408</sup> See Robert R. Keatinge, *Tax Considerations in Choice of Business Entity*, 31<sup>ST</sup> ANNUAL AMERICAN INSTITUTE ON FEDERAL TAXATION, Outline 9, at 71 (2007).

The partners can then move the business assets from the partnership to the corporation as discussions become serious. There is authority to suggest that funding a shell corporation followed shortly by the shell's acquisition by another corporation can qualify as a tax-free reorganization.<sup>409</sup>

It is important to note that no such risk exists where the partners wish to take the business public instead of selling it to an acquiring corporation. A last-minute conversion or incorporation of the business on the eve of a public offering does not disqualify the conversion from nonrecognition.<sup>410</sup>

6. **The Built-in Gain Problem Under IRC §704(c).** If a partner contributes “built-in gain property” to the partnership, subchapter K and corresponding regulations insure that the contributing partner’s built-in gain cannot be shifted to another partner. Built-in gain property is property which, on the date of contribution to the partnership, has a fair market value greater than its tax basis.<sup>411</sup> When the partnership disposes of the built-in gain property, the built-in gain *must* be allocated to the contributing partner.<sup>412</sup>

---

<sup>409</sup> *Weikel v. Commissioner*, T.C. Memo. 1986-58. *Weikel* has been criticized by other courts. See *Long Term Capital Holdings v. U.S.*, 330 F. Supp. 2d 122 (D. Conn. 2004); *Associated Wholesale Grocers v. U.S.*, 927 F.2d 1517 (10<sup>th</sup> Cir. 1990). Both of these cases observe that courts can still apply the step transaction doctrine to transactions even where the business purpose for the entity is established.

<sup>410</sup> This is because the conversion qualifies for nonrecognition under IRC §351, which does not have a continuity of interest requirement that applies to reorganizations under IRC §368(a).

<sup>411</sup> IRC §704(c)(1)(A); Treas. Reg. §1.704-4.

<sup>412</sup> IRC §704(c)(1)(A).