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Keynote Speaker
Roger A. McEowen

Current Issues in Federal Estate and Gift; Extracting Assets from Old C Corporations - Traps and Opportunities; Other Odds and Ends

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About the Speakers

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Roger A. McEowen is the Professor of Agricultural Law and Taxation at Washburn University School of Law in Topeka, Kansas. He also teaches in the Agricultural Economics Department at Kansas St. University where he also provides Extension programming in agricultural law and taxation.

From 1991-1993, McEowen was in the full-time practice of law with Kelley, Scritsmier and Byrne in North Platte, Nebraska. From 1993-2004, he was an associate professor of agricultural law and extension specialist in agricultural law and policy at Kansas State. From mid-2004 through 2015, McEowen was the Leonard Dolezal Professor in Agricultural Law at Iowa State University in Ames, Iowa, where he was also the Director of the ISU Center for Agricultural Law and Taxation (CALT), which he founded.

He has published scholarly articles in various legal and tax journals, and is the author of *Principles of Agricultural Law*, an 850-page textbook/casebook that is updated twice annually, and a second 300-page book on agricultural law. His *Agricultural Law and Taxation Blog* contains over 100 detailed and fully annotated articles annually and is the most widely read agricultural law and taxation blog online. In mid-2017, Prof. McEowen's new book, *Agricultural Law in a Nutshell*, was published by West Academic Publishing Co. McEowen also authors the monthly publication, "Kansas Farm and Estate Law." In addition, he has co-authored Bureau of National Affairs (BNA) Tax Management Portfolios on the federal estate tax family-owned business deduction and the reporting of farm income, and is the lead author of a BNA portfolio concerning the income taxation of cooperatives. He is also the Editor of the Iowa Bar Tax Manual, and *Estate Planning for Farmers and Ranchers* and *Family Business Organizations*, both Thomson-Reuters/West publications.

Prof. McEowen conducts approximately 80-100 seminars annually across the United States for farmers, agricultural business professionals, lawyers, and other tax professionals. He also conducts two radio programs each airing twice monthly heard across the Midwest and on the worldwide web. In addition, his two-minute radio program, "*The Agricultural Law and Tax Report*," is heard each weekday by over 2 million listeners on farm radio stations from NY to CA as well as SiriusXM 147. He also can be seen as a weekly guest on RFD-TV where he discusses various agricultural law and tax topics with the RFD-TV hosts.

He received a B.S. with distinction from Purdue University in Management in 1986, an M.S. in Agricultural Economics from Iowa State University in 1990, and a J.D. from the Drake University School of Law in 1991.

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CURRENT DEVELOPMENTS IN ESTATE AND GIFT TAXATION

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I. GROSS ESTATE CALCULATIONS & DEDUCTIONS

A. **Revenue Reconciliation Act of 2017**. The tax reform bill ("RRA 2017") enacted in December of 2017 retained the basic provisions of the American Taxpayer Relief Act ("ATRA 2013") which has been in place since January 1, 2013, but increased the federal estate tax, gift tax and GST tax exemption equivalents. The change to the exemption equivalent provisions sunsets on December 31, 2025. After that time, the exemptions will revert to the inflation-adjusted amounts put in place under ATRA 2013. ATRA 2013 does NOT include a sunset provision, so the basic provisions of ATRA 2013 remain in effect until further action by Congress.

RRA 2017 retains the inflation adjustments to the applicable exclusion amounts under current law, but for taxable years after December 31, 2017, the adjustments are made based on the somewhat less generous Chained Consumer Price Index for All Urban Consumers (C-CPI-U). The C-CPI-U differs from the Consumer Price Index for All Urban Customers (CPI-U) because it attempts to account for individuals' ability to alter consumption patterns in response to price changes. The changes to inflation indexing do not sunset after 2025.

1. **Exemptions & Rates.** The applicable exemption equivalents and rates, as well as the present interest annual exclusion are as follows:

   a. For Decedents dying in 2023, the estate tax exemption equivalent is $12,920,000 and the applicable tax rate on amounts over the exemption is 40%. For years after 2023, the exemption equivalent is indexed to inflation, and will be $13,610,000 for 2024.

   b. For gifts completed in 2023, the lifetime gift tax exemption amount is $12,920,000 with a tax of 40% on gifts in excess of the exemption amount. For years after 2023, the exemption equivalent is indexed to inflation, and will be $13,610,000 for 2024.

   c. For 2023, the GST exemption is $12,920,000 and is indexed to inflation in future years. It will be $13,610,000 for 2024.

d. For 2023, the present interest annual exclusion maximum that can be used to offset taxable gifts is $17,000. It is indexed for inflation and will be $18,000 for 2024. The maximum exclusion for gifts to a noncitizen spouse is $175,000 and will be $185,000 in 2024.

e. The amount for determining the 2% portion of I.R.C. §6166 estate tax deferral is $1,750,000 and will be $1,850,000 for 2024.

f. The maximum reduction in value via an I.R.C. §2032A election is $1,310,000 and will be $1,390,000 for deaths in 2024.

2. **Basis**. RRA 2017 retains a full step-up in basis for assets included in the Decedent's gross estate that do not constitute income in respect of a decedent. For estates below the applicable exemption, this provides an incentive to retain assets in the estate until death to obtain the step-up for beneficiaries. This is particularly true for assets likely to be sold upon death.

3. **Portability**. RRA 2017 retains the portability rules. A spouse may, under certain circumstances, use the unused estate tax exemption equivalent of his or her deceased spouse. Portability operates as follows:

a. When the first spouse dies, an election is made by filing a federal estate tax return (Form 706) to establish the amount of the unused portion of the deceased spouse's exemption equivalent.

> **NOTE:** To make the election, a return is required to be filed even if the deceased spouse's Estate would not otherwise be required to file a federal estate tax return (because it is under the then current exemption equivalent). There is a schedule on the return to calculate the amount of exemption available to the surviving spouse. There is a box to check if the estate decides not to elect portability. On a return filed only for portability purposes, the portability regulations provide that good faith estimated values may be used for property qualifying for the marital or charitable deduction. The estimated values are then plugged into a range of dollar values and included on the return. To establish basis for purposes of a future sale of the assets, it may still be necessary to have evidence of actual value.

b. When the surviving spouse dies, the Estate of the surviving spouse is entitled to an exemption equal to the surviving spouse's remaining exemption plus the unused exemption amount from the first spouse. In addition, the surviving spouse can use the deceased spouse's "excess exemption" to fund lifetime gifts. The unused exemption

amount is a fixed number and is NOT adjusted annually for inflation.

c. The exemption is only portable between a Decedent and his or her "last deceased spouse" who died after December 31, 2010. A surviving spouse who remarries may lose the opportunity to use the unused credit of the first spouse if his or her second spouse also predeceases.

d. Portability does not apply to the exemption for generation skipping transfer tax.

B. **Clawback Regulations**. Treas. Reg. § 20.2010-1, 20.2010-2, 20.2010-3. RRA 2017 amended IRC § 2010(g) to direct Treasury to prescribe the regulations necessary to implement the purposes of the section with respect to differences between the estate and gift tax exclusion amount in effect at date of death and at the time gifts are made by the Decedent.

In November 2019, the Service issued final regulations. Under the final regulations, the Estate of a Decedent who passes away after 2025 is entitled to claim the greater of the then current estate tax exemption equivalent or the amount of the exemption equivalent used in connection with gifts made prior to 2026. The regulations include the following example: A, an individual who never married, made gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $11.8 million in basic exclusion amount allowable on the dates of the gifts. A dies after 2025 and the basic exclusion amount on A's date of death is $6.8 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million basic exclusion amount used to determine those credits) exceeds the credit based on the $6.8 million basic exclusion amount applicable on the decedent's date of death, under paragraph (c)(1) of this section, the credit to be applied for purposes of computing the estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on the post-1976 gifts made by

The examples also clarify that a deceased spouse's unused exemption claimed with regard to a spouse who dies before 2026 is not reduced as a result of the sunsetting of the law.

On April 26, 2022, the Service released additional proposed regulations dealing with clawback issues. The new proposed rules seek to clarify whether gifts made during life but treated as transfers at death should benefit from the anti-clawback rule. Examples of these types of transactions are transfers to a grantor retained annuity trust or a qualified personal residence trust where the retained interest causes estate inclusion upon the death of the grantor. The proposed regulations generally provide that the anti-clawback protections will NOT apply to these

transfers. Examples of completed transfers that may nonetheless be included in the gross estate are transfers included under Sections 2035 (certain gifts within 3 years of death), 2036 (retained interests), 2037 (certain transfers at death), 2038 (revocable transfers), 2042 (certain life insurance proceeds), 2701 (freeze partnerships), and 2702 (GRATs, GRUTs, GRITs, and QPRTs).

C. **New Procedure/Fee for Estate Tax Closing Letter**. T.D. 9957. In final regulations released on September 28, 2021, the Service established a new $67 user fee for authorized persons who wish to request the issuance of IRS Letter 627 (estate closing letter). The Service issues estate tax closing letters upon request of an authorized person only after an estate tax return has been accepted by the Service as filed, after an adjustment to which the estate has agreed, or after an adjustment in the deceased spousal unused exclusion (DSUE) amount. In view of the resource constraints and purpose of issuing estate tax closing letters as a convenience to authorized persons, the Service has identified the provision of estate tax closing letters as an appropriate service for a user fee to recover the costs that the government incurs in providing such letters. The procedure for requesting the estate tax closing letter and paying the user fee utilizes https://www.pay.gov.

D. **Basis Consistency & Reporting Rules**. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 included provisions enacting a basis consistency rule. Under the rule, which is effective for property with respect to which an estate tax return is filed after July 31, 2015, the basis of property for income tax reporting purposes cannot exceed the final value determined for federal estate tax purposes or, if there was no final determination, the value listed on the statement provided by the Estate under new Section 1035(a). Under this section, the executor of an estate for which a federal estate tax return is filed must provide to the Service and to the person receiving the property a statement identifying the value of each interest in property reported on the return and such other information the Service may require. The required form for the statement is IRS Form 8971 and is generally due to be delivered within 30 days after the filing of the estate tax return. The temporary and proposed rules were issued on March 2, 2016. Final regulations at Treas. Reg. §1.6035-2 providing additional guidance were issued on December 1, 2016. The notice requirement does NOT apply to returns filed solely for portability purposes.

> **NOTE:** In February 2021, the Service requested comments on the Form 8971 with a deadline of April 19, 2021. ACTEC and others submitted comments requesting a number of clarifications. So far, no changes have occurred, and no additional guidance has been issued.

E. **IRS Updates and Extends Simplified Procedure to Extend Time to Elect Portability**.
Rev. Proc. 2022-32, 2022-30 IRB 101

The Service has extended the time period for using the simplified method to obtain an extension to elect portability on an estate tax return. Under the revenue procedure, a personal representative must file a complete and properly prepared federal estate tax return (Form 706) by the *fifth anniversary* of the decedent's death. The executor must state at the top of the form that the return is "FILED PURSUANT TO REV. PROC. 2022-32 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)." This relief is available only if: (a) the decedent was survived by a spouse; (b) the decedent died after December 31, 2010; (c) the decedent was a citizen or resident of the United States on the date of death; (d) the executor is not otherwise required to file an estate tax return because the gross estate is less than the filing threshold under §6018(a); and (e) the executor did not file a timely estate tax return. This procedure cannot be used for estates above the filing threshold, even if no tax is due because of the marital or charitable deduction. A return filed in accordance with this procedure is deemed to be timely filed for purposes of electing portability, and the Decedent's unused exemption amount is available to the surviving spouse with respect to all transfers made after the date of death, even if they were made before the return was filed under this procedure. Even beyond the deadlines set forth in the revenue procedure, it is possible to obtain an extension, but a private letter ruling is required, and the Service has been fairly liberal in granting such requests. In PLR 202046006, for instance, the Service allowed a late filing to make a portability election when the estate tax return was not timely filed, and a portability election was not made "for various reasons" which were not described in any detail in the letter ruling. *See also* PLR 202216008, PLR 202133002. Rev. Proc. 2022-32 is effective July 8, 2022.

F. **Cases and Rulings.**

1. **Tax Court Considers Intergenerational Split Dollar**.
Estate of Morrissette v. Commissioner, T.C. Memo 2021-60

An intergenerational split dollar agreement is intended to allow a grantor to make large premium payments on life insurance policies benefiting the grantor's children while limiting the transfer tax consequences. A grantor establishes an irrevocable trust to purchase life insurance on the lives of the grantor's children and then makes premium payments to the trust pursuant to the trust's agreement to repay the grantor (when the insured passes away) the greater of the total premiums paid or the cash surrender value of the policies. Since repayment is likely to occur long after the grantor's death, the repayment obligation can be substantially discounted in the grantor's estate. In this case, the Decedent established three irrevocable trusts, one for each of her sons. Each irrevocable trust for a son owned two life insurance policies on the lives of the other two sons. The premiums on all the life insurance policies (approximately $30 million total) were paid by the Decedent's revocable trust based on a split dollar life insurance agreement which provided that upon the death of a son, the revocable trust would receive a portion of the death benefits equal to the greater

of the cash value of the policy or the sum of all the premiums paid. Upon the Decedent's death, the Estate valued the Decedent's rights under the split dollar arrangement at just under $7.5 million after taking into account the long time period between the Decedent's date of death and the likely time of payment under the split dollar agreement. The Service argued that the entire premium payment or cash value amount should be included in the Decedent's estate under Section 2036, Section 2038, or Section 2703.

The Tax Court determined that none of these provisions applied to the arrangement which was a bona fide transaction supported by a legitimate non-tax purpose. However, the Tax Court determined that the Estate had significantly undervalued the value of the Decedent's retained rights under the split dollar arrangement. It directed the parties to revalue the retained rights using parameters provided by the Court and determine that the application of penalties was appropriate. It was not reasonable, in the Court's view, for the Estate to convert a $30 million premium value into a $7.5 million value for reporting purposes.

2. **Cash-Surrender Value of Intergenerational Split Dollar Policies Excluded from Gross Estate**.
Estate of Levine v. Commissioner, 158 T.C. No. 2 (2022)

The Decedent's revocable trust paid premiums on life insurance policies taken out on the Decedent's daughter and son-in-law that were held by an irrevocable life insurance trust. Decedent's revocable trust had the right to be repaid for those premiums when the Decedent's daughter and son-in-law died at some time in the future. Decedent's gift tax return reported only $2,644 as a gift out of more than $6.2 million in premiums paid. Upon the Decedent's death, the Decedent's Estate valued the Decedent's right to repayment in the future at $2,282,105. The Service argued that the value of the asset in the Decedent's Estate was the cash surrender value of the policies or $6,153,478. To get to this value, the Service argued that the Decedent retained the right to income or the right to designate who would possess the income under Section 2036, retained the power to alter amend or revoke enjoyment of the gift, or that the restrictions in the split-dollar agreement were restrictions that should be disregarded under Section 2703. DECISION: The Tax Court agreed with the Estate. It determined that the property transferred was cash and that no rights were retained with regard to the transferred cash.

> **Note:** Importantly, the court stated, "we see here a carefully drafted arrangement that expressly gives the power to terminate *only* to the Insurance Trust. It gave Levine herself no unilateral power to terminate the policies and no language like that in the arrangement at issue in *Estate of Cahill* or *Morrissette II* that gave her that right acting in conjunction with the Insurance Trust. By requiring *both* parties'

> approval, the arrangements that we analyzed in *Morrissette II* and *Estate of Cahill* necessarily *required* each decedent's approval to terminate the arrangement. The opposite is true here, where only the Insurance Trust could terminate the arrangement. Without any contractual right to terminate the policies, we can't say that Levine had any sort of possession or rights to their cash-surrender values. If the contest between the Estate and the Commissioner were confined to the tiltyard defined by the transactional documents, we would have to conclude that sections 2036(a) and 2038 do not tell us to include the polices' cash surrender values in the Estate's gross value."

3. **Value of Checks Written Before Death but Paid After Death Included in Gross Estate**.
Estate of Demuth v. Commissioner, T.C. Memo. 2022-72

Prior to Decedent's death, Decedent's son (acting under a power of attorney), wrote 11 annual exclusion gift checks to relatives of the Decedent. Only one check was paid by the bank prior to death. The other checks were paid after death. The Decedent's estate did not include any of the checks on the Decedent's federal estate tax return. The Service argued that the value of all the unpaid checks should be included in the estate.

The Tax Court agreed with the Service. Since the Decedent could have placed a stop-payment on the checks up until the time of death, the transfers were still revocable. The Tax Court did, however, hold the Service to a concession it had made agreeing that 3 of the checks should not be included even though this concession was inconsistent with applicable Pennsylvania law.

4. **Cashier's Check Included in Gross Estate**.
United States v. Allison, 587 F. Supp. 3d 1015 (E.D. Cal. 2022)

Shortly before his death, the Decedent had a cashier's check prepared to pay a relative's child support. The state agency rejected the check and after his death, the Decedent's estate issued another check. The Decedent also paid a settlement stemming from a lawsuit to determine ownership of real property Decedent owned. The Service argued that the child support check was included in the Decedent's gross estate since delivery and acceptance did not occur until after death. The Service also argued that the settlement check was not deductible from Decedent's gross estate since it determined a portion of the gross estate and did not qualify as a claim against the estate.

The court agreed with the Service and included both checks in the Decedent's gross estate.

5. **Farm Transferred to Partnership Shortly Before Death Included in Gross Estate**.
Estate of Moore v. Commissioner, T.C. Memo 2020-40 (2020)

In late 2004, the Decedent was diagnosed with significant health issues. Shortly thereafter, the Decedent established a series of trusts and a limited partnership and contributed his farm into the partnership. Limited partnership interests were sold to an irrevocable trust based on a 53% discount. Soon after the partnership received the farm, Decedent sold farmland without input from the rest of the family. The partnership paid 80% of the $320,000 attorney fee for the estate plans and the Decedent paid 20% out of his revocable trust. Decedent also had the partnership distribute $500,000 checks to each of his children, but in the form of a promissory note to be paid back with interest. However, the children testified the attorney told them the amounts did not need to be repaid and no efforts were made to collect on the notes. Finally, the partnership paid the Decedent $2 million to cover expensed related to the sale of farmland and to cover the Decedent's income tax resulting from the sale of farmland. The Decedent died in March 2005 and the Estate filed a federal estate tax return based on all these transactions.

The Service claimed that the entire value of the partnership was included in the Decedent's estate and denied various deductions. The Tax Court agreed with the Service, finding an implied agreement under Section 2036 that the Decedent retained access to all the assets and found no legitimate business purpose for the limited partnership. The Court also walked through a detailed analysis of how Section 2043(a) applied to determine the final amounts included.

> **Note:** The Tax Court's opinion was affirmed on appeal. *Estate of Moore v. Comr., No. 20-73013, 2021 U.S. App. LEXIS 33111 (9th Cir. Nov. 8, 2021).* The donations to the charitable trust were not required by the trust documents. The assets were partnership assets and the partnership agreement stated that no partner owned an interest in the partnership assets. Therefore, the trustee was not required to make the donation.

6. **Charitable and Marital Deduction Denied for Discretionary Transfer**.
CCA 202233014 (Jul. 12, 2022)

The Decedent's estate created a charitable remainder unitrust ("CRUT"). The CRUT provided for 5% unitrust payments. The Trustee was required to distribute 25% of the unitrust amount to the Decedent's surviving spouse. The remaining 75% was to be distributed either to charity or to the spouse in the Trustee's discretion. In Chief Counsel Advice, the Service determined that the estate could not claim a charitable deduction for the 75% unitrust interest because the transfer to charity was not ascertainable or severable

from the spouse's charitable interest. The Service also determined that the estate was not entitled to a marital deduction because the spouse's interest in the 75% cannot be established on the Decedent's date of death.

7. **Marital Deduction Allowed; Marital Status Confirmed**.
Estate of Grossman v. Commissioner, T.C. Memo 2021-65

The Decedent married First Wife in a Jewish ceremony in New York in 1955. Years later, the Decedent unilaterally obtained a "quickie divorce" in Mexico and married Second Wife in a civil ceremony. In 1974, First Wife challenged the validity of the Mexico divorce and obtained a declaratory judgment holding that the second marriage was null and void because the Decedent was still married to First Wife. In 1986, the Decedent's marriage to First Wife was dissolved by a rabbinical court. In 1987, the Decedent married Third Wife in a Jewish ceremony in Israel. When the Decedent passed away in 2014, he left the bulk of his $85 million estate to Third Wife and his Estate claimed a marital deduction. The Service disallowed the marital deduction on the basis that the Decedent's divorce from First Wife in a rabbinical court was not valid, so the Decedent was still married to First Wife, not Third Wife. Both the Estate and the Service filed motions for partial summary judgment.

The Tax Court looked to the place of celebration rule and focused on the third wedding ceremony in Israel. Under New York law, the marriage to third wife would be respected if it was a valid marriage under Israeli law. The Tax Court found sufficient evidence that the third marriage performed in Israel was valid. The Court denied the Service's motion for partial summary judgment and granted the Estate's motion for partial summary judgment.

8. **Proposed Regulations Address Estate Tax Deductions**.
Prop. Reg. § 20.2053-1 to 20.2053-4

On June 28, 2022, the Service released proposed regulations addressing various details regarding deductions for claims and administrative expenses. The regulations are proposed to apply to estate of decedents dying on or after the adoption of the rules as final regulations. The regulations address the following:

First, the regulations apply present value concepts to claims and expenses paid or to be paid after a three-year grace period following the Decedent's date of death. Only the discounted value of such claims and expenses will be allowed as detailed in a written appraisal document.

Second, the regulations provide additional guidance and limitations on the deductibility of interest on loans incurred to pay estate tax. Under the regulations, interest will be deductible for estate tax purposes only if: (a) the interest arises from an instrument that constitutes indebtedness under federal tax law; (b) the

interest and expense must be "bona fide" in nature based on all the facts and circumstances; and (c) the loan and loan terms must be actually and necessarily incurred in the administration of the estate and must be "essential" to the property settlement of the estate. The regulations appear to be focused on limiting the use of so-called *Graegin* loans and include a list of 11 factors to be considered in determining whether the loan arrangement is legitimate and essential. These factors include the interest rate and loan terms, whether the lender is a family member, whether the payment schedule extends beyond that reasonably necessary, whether there are practical alternatives to a loan, whether the estate illiquidity results from actions of the estate or the decedent, whether the lender is a beneficiary.

Third, the regulations address the deductibility of claims based on the Decedent's personal guaranty. The regulations allow a deduction only when the underlying agreement is "bona fide" (bargained for at arm's length). A safe harbor provided for a guaranty for debt of an entity in which the decedent had an interest if certain criteria are met.

Fourth, the proposed regulations modify the rules regarding the provision of a "written appraisal document" to support the value of certain claims deducted before they are paid.

9. **Service Grants Extension to Make QTIP Election**.
PLR 202244007 (Aug. 10, 2022)

The Estate's accountant inadvertently failed to report the trust property as QTIP property on a timely filed federal estate tax return. The Service determined that the requirements of Treas. Reg. §301.9100-3 were met and granted an extension to make the QTIP election on a supplemental federal estate tax return. *See also PLR 202238008 (Jun. 29, 2022).*

10. **Court Allows Late Special Use Valuation Election**.
U.S. v. Parks, No. 21-cv-12676, 2022 U.S. Dist. LEXIS 210055 (E.D. Mich. Nov. 18, 2022)

The Decedent passed away in 2003. The Estate requested a 6-month extension to file the federal estate tax return. Despite not receiving any additional extensions, the Estate finally filed a federal estate tax return over five years later in 2010. On the late-filed return, the Estate claimed special use valuation. On audit, the Service disallowed the election claiming the election was not timely made.

The court allowed the election based on the language of Temp. Reg. § 22.0 and IRS guidance indicating the election can be made on a late return as long as it is the first return filed. *See also* PLR 201908018 (Oct. 13, 2018) (allowing a late

special use valuation election under the requirements of Treas. Reg. §301.9100-3.

11. **Charitable Deduction for Stock Disallowed due to Failure of Appraisal.** ***Estate of Hoensheid v. Commissioner, T.C. Memo 2023-34***

Taxpayer, now deceased, had been a one-third owner of a family-held corporation. After he and his brothers had all either retired or had announced a plan to retire, the shareholders opted to sell the company. In early 2015, they retained a financial adviser – a sell-side investment banking firm -- to help them manage the sale, which involved a fee of 1 percent of the proceeds up to their target price of $80 million and thereafter 5 percent of the sales proceeds above $80 million. Their agreement did not include any mention of appraisal or valuation services.

By April 1, the firm had received a letter of intent from a private equity firm to acquire the company for $92 million. Soon thereafter, Taxpayers began discussions with Fidelity to establish a donor-advised fund to hold the proceeds of some of the stock, aided by their long-time tax and estate planning attorneys. In order to avoid realization of income, Taxpayers were advised that they needed to have a completed gift of the stock before there was a definitive agreement to purchase it. However, Taxpayers responded that they wanted to "wait as long as possible to pull the trigger" on the donation, as if they parted with the shares and the deal to sell the company did not go through, they would be left with a smaller share percentage than the other brothers who owned stock in the company.

Due diligence on the part of the prospective purchaser continued. As the size of the company required Hart-Scott-Rodino notification, the purchaser complied by submitting an affidavit on May 22 representing that it had a "good faith intention of completing the transaction." However, Taxpayer had not yet completed any agreement with Fidelity at this time.

On June 1, Fidelity emailed a "letter of understanding" that Taxpayers signed, which outlined general terms and conditions for a donation. However, Taxpayers did not specify the number of shares and they also refused to execute a shareholder consent allowing any transfer, stating that "I do not want to transfer the stock until we are 99 percent sure we are closing."

On June 15, the company had its shareholder meeting at which Taxpayer and his two brothers approved the sale of the company's stock. Taxpayer's brothers also approved Taxpayer's proposal to transfer some of the stock to Fidelity to fund the charitable gift. Such approval was apparently necessary due to a buy-sell agreement among them. However, the consent did not specify a number of shares, leaving that to be filled in by Taxpayer. A board meeting followed at which the board also approved Taxpayer's request to transfer a portion of his shares to

Fidelity. Taxpayer prepared a stock transfer certificate but held it in his desk until July 9 or 10, 2015.

On July 1, the purchaser (who was aware of the pending charitable gift) circulated a draft stock purchase agreement for both Taxpayer and Fidelity. On July 6, the purchaser formed a new corporation for the purpose of the acquisition, and it informed the parties the next day that they intended to sweep cash to distribute it to the sellers. However, they still did not have a giving account set up with Fidelity, no transfer of shares, and no executed agreement from Fidelity to participate in the sale.

On the eve of final closing, after further negotiations and actions in furtherance of the acquisition agreement, Fidelity asked for a stock certificate. Counsel for Taxpayers emailed a certificate, signed but undated, indicating that 1380.4 shares – valued at $3 million – were owned by Fidelity. The purchaser requested a shareholder list, which counsel provided showing that 1380 shares had been issued to Fidelity. On July 14, the purchaser sent a revised minority stock purchase agreement to Fidelity, which showed the shares had been transferred as of July 10.

However, the company issued a dividend to the brothers – then still shareholders – on July 14, which totaled over $4 million and represented the cash balance in the company coffers prior to the sale. Fidelity did not participate in this dividend for the shares it supposedly owned. On July 15, the deal closed and shareholders received the proceeds of the sale, which included cash, stock, and a promissory note. Fidelity received $2.9 million in cash. After closing, the brothers – but not Fidelity – received additional amounts comprised of excess working capital from the company as well as a company tax refund.

Fidelity sent a letter confirming the donation of the stock as of June 11, 2015, which provided that it had exclusive control over the stock and that no goods or services were provided in exchange for the contribution. However, there was no appraisal. The investment bank was "playing dumb" about providing an appraisal, and Taxpayer's advisor tried to "light a fire" to get their attention, to no avail.

When it came time to report the gift on their return, Taxpayers reported a noncash charitable deduction of $3.2 million. The return included an appraisal report from Brian Dragon, who worked for the selling investment bank. The appraisal included a brief biography that did not include any representation of experience or qualifications. The appraisal supported a value in excess of the proceeds received after the sale, but it neither provided the empirical basis for its conclusions, the date of the contribution, nor the fact that it was prepared for federal income tax purposes.

Taxpayer's 2015 return was audited, and the IRS disallowed the charitable deduction and imposed an accuracy penalty. The Tax Court upheld the disallowance of the deduction, but it overturned the penalty assessment in this case.

First, applying Michigan law (the law of the domicile of the donors), the court found that a completed gift requires (1) donor intent; (2) actual or constructive delivery; and (3) donor acceptance. On the intent element, the court found no proof of donative intent until July 9, when the Taxpayers finally settled on the number of shares to be given. There was no basis to find constructive delivery while Taxpayer held the stock certificate in his desk, thereby maintaining dominion and control over the stock. Further, transfer to his agent did not necessarily complete a gift, as the Taxpayer did not prove that the agent was still not subject to his instructions, thus permitting recall of the shares. Nor was there a showing of a transfer of the shares on the corporate books prior to July 10. The shareholder list printed on July 13 shows an entry for Fidelity, but that was not prepared by the corporation, but instead by Taxpayer's counsel. The court finally settled on July 13 as the date of delivery, which corresponded to the date Taxpayer's counsel emailed a PDF of the certificate showing a transfer and indicating the number of shares transferred.

Fidelity opened up a giving account for Taxpayers on July 10, but there was no evidence showing acceptance of the shares until July 13, after they had received the stock certificate. Taxpayers did not produce any correspondence on or about that time showing Fidelity's understanding that the gift had occurred prior to this date. When coupled with other evidence, the court inferred receipt did not occur prior to that time.

At that time, there was a reasonable probability of income from the sale. Under the assignment of income doctrine, Taxpayers were in constructive receipt of those proceeds and thus could not avoid capital gain income from the sale of the shares. Taxpayers' attempt to rely on *Dickinson, TC Memo 2020-128,* which the court characterized as a "nonprecedential decision", was unavailing. In that case, a stock redemption would occur after the gift of the stock, a condition which the court found would not be satisfied until after the gift was completed, thus allowing the form of the transaction as a gift of stock to be respected. However, in this case, the gift did not occur until the sale was virtually certain to occur – the Taxpayers wanted it that way.

Although the court found that the IRS had not proven that Fidelity had an obligation to sell the shares at the time the gift had been completed, this was not dispositive. Instead, the court looked at other actions taken by the buyer and sellers that made the transaction "virtually certain" to occur. This included cash payments of employee bonuses totaling over $ 6 million before closing, as well as the dividend payment based on the cash left in the corporate coffers. Shareholders would not have made these payments – which could not be clawed back unless they believed closing was virtually certain to occur. There were no significant unresolved contingencies, and the fact that shareholder approval was a foregone conclusion in this case did not provide any basis for uncertainty on this deal, which involved a substantial premium over the target price.

The court cautioned that this should not signal a "bright line for donors to stop short of in structuring charitable contributions before a stock sale." Unfortunately for Taxpayers, their own tax counsel had advised "any tax lawyer worth [her] fees would not have recommended that a donor make a gift of appreciated stock" so close to the closing of a sale.

Having failed to escape the assignment of income doctrine, Taxpayers nevertheless claimed a charitable deduction. The Service challenged both the contemporaneous written acknowledgement requirement as well as the qualified appraisal requirement in this case. The Tax Court upheld the contemporaneous written acknowledgement requirement, stating that describing the gift as stock would suffice for this purpose. However, it found the appraisal lacking. The court outlined no fewer than eight aspects of the appraisal that failed to meet the requirements in the regulations.

Taxpayers could not rely on substantial compliance in this case, where entire categories of information were omitted. Moreover, the failure to identify the correct date for the valuation was particularly problematic, as the June 11 date stated for valuation was off by a month. During that month, significant events occurred affecting valuation, including approval of the transaction and a $6 million bonus payment to employees.

Taxpayers also could not rely on reasonable cause in this case. Taxpayers, rather than their counsel, had apparently identified Mr. Dagon as the person to perform the appraisal, after they rejected a national accounting firm's offer to perform it. Taxpayers chose Dagon because they would avoid an additional fee – which turned out to be costly. Their self-serving testimony that they relied on their tax counsel, who reviewed the appraisal after it was complete – did not provide credible evidence that they had relied upon her professional judgment. Moreover, even Taxpayer should have known that he had not transferred the shares on June 11, as the appraisal report stated. That issues would also prevent good faith reliance upon counsel, even if it had otherwise been proven.

Taxpayers were able to avoid penalties, however, as the IRS conceded penalties on the matter of the charitable deduction. As the IRS asserted a new underpayment penalty for the failure to report capital gains income from the shares that were donated, it had the burden of proof regarding that new penalty, which it failed to do. In this case, the matter of the anticipatory assignment of income was not so clear cut that Taxpayers could be held to account for otherwise relying on their counsel, even if that advise proved incorrect.

> **Observation:** Not only was the charitable deduction lost, but there was also income from the sale. A cash contribution following the sale would have been a much better deal.

12. **No Charitable Deduction for Gift from CRAT – Botched Reformation.**
Estate of Block v. Comr., T.C. Memo. 2023-30

Before her death, the decedent created a revocable trust and executed a will in which she left her remaining estate to the trust. One of the trust's provisions created a sub-trust that was intended to meet the requirements of a CRAT as defined in I.R.C. §664.

The sub-trust became effective on death, with the annuity to be paid to the decedent's sister and then to the sister's husband, if he should survive her. Upon the death of the later to die of the sister or the sister's husband, the remainder of the sub-trust was to be paid to a public charity eligible for the estate tax charitable deduction pursuant to I.R.C. §2055. The provisions of the sub-trust stated that the decedent's sister was to be paid an annual amount equal to the greater of: (1) all net income or (2) $50,000. The sub-trust provisions further stated that the trust was irrevocable but that the trustees could amend it for the sole purpose of making sure the sub-trust met the requirements of I.R.C. §664. However, the trustees could not change the annuity period, the annuity amount, or the charity.

On Form 706, the estate claimed a charitable deduction for the remainder interest in the sub-trust going to the charity. The IRS disallowed the deduction on the basis that the sub-trust failed to satisfy the requirements of a CRAT because the annuity amount was not a specified amount, but the greater of all net income or $50,000. The trustees then amended the sub-trust to provide that the annuity amount was fixed at $50,000 effective as of the date of death. The IRS still disallowed the deduction. The Tax Court agreed.

The Tax Court noted that the initial sub-trust provisions did not meet the requirements of a CRAT because the annuity amount was not limited to a specific dollar amount. The court further determined that the judicial reformation provisions in I.R.C. §2055 also did not apply because: (1) the amendment to the sub-trust was executed sometime beyond the 90-day qualified reformation window; and (2) the amendment was not the result of a judicial proceeding.

13. **No Charitable Deduction for Distribution from CRUT.**
CCA 202233014 (Aug. 19, 2022)

The decedent created a testamentary charitable remainder unitrust (CRUT) in which his surviving spouse and a charity were named beneficiaries. The trustee was required to distribute 25% of the unitrust payment to his surviving spouse, and the remaining 75% of the unitrust payment was to be distributed between the surviving spouse and the charity at the trustee's discretion. The unitrust payments were to be paid for the life of the surviving spouse, and, upon her death, the remainder interest was to be distributed to the charity. The issue was whether the 75% portion of the unitrust payment qualified for the estate tax marital or charitable deduction.

The IRS determined that the remainder interest in the CRUT going to the charity qualified for the estate tax charitable deduction under I.R.C. §2055(e)(2)(A) because the CRUT was valid under I.R.C. §664. However, it also determined that the unitrust interest that could be distributed to the charity did not qualify for the estate tax charitable deduction because it was not in the form of a fixed unitrust amount and no part of the unitrust was ascertainable or severable from the spouse's noncharitable interest under I.R.C. §2055(e)(2)(B).

Regarding the 25% of the unitrust interest designated exclusively for the surviving spouse, the OCC determined that the value of the unitrust interest qualified for the estate tax marital deduction because, under I.R.C. §2056(b)(8), the surviving spouse was the only noncharitable beneficiary of the CRUT. However, the IRS determined that the 75% of the unitrust interest of which the trustee of the CRUT had the power to distribute between the surviving spouse and the charity did not qualify for the estate tax marital deduction because the interest passing to the spouse was not ascertainable and, therefore, not treated as passing to the spouse under I.R.C. §2056(a).

14. **Distribution of Assets to a New Trust Did Not Cause Trust to Lose Exempt Status for GST Tax Purposes.**

I.R.S. Priv. Ltr. Rul. 202301001 (Jan. 6, 2023)

Here, the Internal Revenue Service (IRS) addressed whether the distribution of assets from Trust A to Trust B, which had several different provisions than Trust A, would cause the trusts to lose their exempt status for generation-skipping transfer (GST) tax purposes.

According to the ruling, on Date 1, a date prior to September 25, 1985, a grantor established and funded Trust A, an irrevocable trust for the benefit of his descendants: a son, a daughter, the spouses of the son and daughter, and the issue of the son and daughter. Trust A was to terminate after the deaths of the grantor and the grantor's spouse, son, and daughter upon the latest to occur of (1) the youngest issue of the grantor living on Date 1 attaining the age of x, or (2) the expiration of a y-year period after the death of the grantor and or grantor's spouse, son, or daughter. Upon termination, all of the property was to be distributed in equal shares per stirpes to the issue of the grantor. Trust A was not to continue for more than twenty-one years after the death of the survivor of certain named beneficiaries who were alive on Date 1. At the end of this period, the entire trust was to be paid over and distributed as provided in the trust document.

At the time of the request for the Private Letter Ruling, the grantor and the grantor's spouse were both deceased. The court accepted jurisdiction over the administration of Trust A and issued an order changing the administration of Trust A to another state and changing the trustee of Trust A to a trust company. The trust company appointed all of the principal and accumulated income of Trust A to a new trust,

Trust B. Trust B differed in some respects from Trust A: instead of providing an outright distribution of assets to the beneficiaries, Trust B provided that, after the termination of Trust B, the balance of the trust estate would be allocated and distributed to separate trusts to the living descendants of the grantor, per stirpes, as described in Article 4 of Trust B. Under Article 4 of Trust B, the beneficiary of each Article 4 trust would be the sole lifetime beneficiary of their trust and would be granted a testamentary general power of appointment over the principal of the trust. Trust B also modified provisions relating to the administration of trust, allowing the future appointment of (1) a distribution committee with the authority to make discretionary distribution decisions, (2) an investment committee with authority limited to investment and administrative decisions, and (3) a trust protector.

The court authorized the appointment of principal and income from Trust A to Trust B, contingent upon the receipt of a favorable Private Letter Ruling on the following issues: (1) The proposed transfer of Trust A assets to a successor trust, Trust B, and the modifications caused by the distribution to Trust B, would not cause the loss of the exempt status from the GST tax under I.R.C. § 2601; and (2) whether, as a result of a beneficiary's testamentary power to appoint in Article 4.2 of Trust B with respect to the property of that beneficiary's Article 4 trust, the property subject to the power would be includible in that beneficiary's gross estate under I.R.C. § 2041.

> **Backgound.** I.R.C. § 2601 imposes a tax on every GST, which is defined in I.R.C. § 2611 as a taxable distribution, a taxable termination, and a direct skip. Treas. Reg. § 26.2601-1(b)(1)(i) addresses when a modification of a trust that is exempt from the GST tax will not cause the trust to lose its exempt status. It provides that the distribution of trust principal from an exempt trust to a new trust will not lead to a loss of exempt status if it does not shift a beneficial interest in the trust to a beneficiary who occupies a lower generation or extend the time for vesting of any beneficial interest beyond the period provided for in the original trust. To determine if there has been a shift of a beneficial interest to a lower generation, the IRS must measure the effect of the instrument on the date of the modification against the effect of the instrument in existence immediately before the modification. A modification that indirectly increases the amount transferred by lowering administrative costs or income taxes will not constitute a shift in the beneficial interest in the trust.

The IRS noted that Trust A and Trust B had identical income and principal distribution terms, the same time of termination, and the same class of remainder beneficiaries. Trust A and Trust B differed in that Article 4 of Trust B provided for the trust estate to be allocated and distributed in separate trusts to the living descendants of the grantor per stirpes after the termination of Trust B, and that the beneficiary of each separate trust would be the sole lifetime beneficiary of the

separate trust and granted a testamentary general power of appointment over the principal of the trust.

The IRS stated that the grant of a testamentary general power of appointment to a sole lifetime beneficiary of a trust is deemed to be functionally equivalent to a grant of outright ownership. Therefore, the grant of the power of appointment would cause each separate trust to be includible in the gross estate of the beneficiary at their death under I.R.C. § 2041(a)(2). In addition, the grant of the power would cause each beneficiary to be treated as the transferor of their separate Article 4 trust for GST tax purposes under I.R.C. § 2652(a)(1).

Treas. Reg. § 26.2601-1(b)(4)(i)(D)(2) provides that modifications that are administrative in nature that only indirectly increase the amount transferred are not considered to shift a beneficial interest in the trust. The IRS determined that Trust B's administrative provisions would not cause the distribution of principal from Trust A to Trust B to amount to a shift of a beneficial interest to a lower generation beneficiary or extend the time for vesting of any beneficial interest beyond the period provided for in the original trust. Therefore, the distribution of assets from Trust A to Trust B would not cause either trust to lose its exempt status for GST tax purposes.

> **Observation:** A Private Letter Ruling has no precedential value and cannot be relied on by other taxpayers. However, this ruling suggests that, at least in cases involving similar facts, this strategy will not affect the GST tax-exempt nature of two trusts when trust assets are distributed from one trust to another if the two trusts (1) have identical income and principal distribution terms, dates of termination, and classes of remainder beneficiaries, and (2) provide for the creation of separate trusts for each beneficiary that include a power of appointment that would cause each beneficiary to be treated as the transferor of their separate trust for GST tax purposes.

15. **No Administrative Expense Deduction for Estate.**
Estate of Kalikow v. Comr., T.C. Memo. 2023-21

Years after the decedent's death his wife died. His will created a QTIP trust for her that included a requirement to pay her all income. QTIP status was elected on his estate tax return under I.R.C. §2056(b)(7). Most of the assets in the trusts were interests in a family limited partnership (FLP) that owned rental real estate. She was entitled to income distributions from the trust for life, and on her death, the assets remaining in the QTIP trust were to be divided and paid to trusts for each of the couple's two children with the residue of her estate going to charity.

More than three years after her death, one of her grandchildren petitioned the court to compel the QTIP trustees for an accounting of the trust. Based on the accounting,

it was asserted that she was underpaid income to the extent of almost $17 million. Ultimately, a settlement was reached in which the QTIP trust agreed to pay her estate about $6.5 million of undistributed income and about $2.7 million in fees. The QTIP value was set at $55 million. The two remaining issues were: (1) whether the value of the trust assets included in the gross estate pursuant I.R.C. §2044 should be reduced by the agreed-on undistributed income amount, and (2) whether the estate is entitled to deduct any part of the agreed-on settlement payment as administration expenses pursuant to I.R.C. §2053.

The court determined that the QTIP's settlement payment didn't support a deduction for administrative expenses by the estate under I.R.C. §2053. In calculating the value of her gross estate, the value of the QTIP couldn't be reduced by the settlement. The fair market value of the QTIP assets had to be included in her gross estate at the time of death under I.R.C. §2044. The court held that there was no basis for the trust's liability to affect the date-of-death value of the FLP interests.

There was also a valuation dispute concerning the value of the FLP interests. The estate reported the 98.5% of FLP interests value at about $42 million, and the IRS argued it was worth about $105 million. The parties settled at $54 million.

> **Comment:** The accountant for the family was both a co-trustee on the QTIP trust and executor of the wife's estate, and his accounting firm received substantial fees for services. The accountant in his role as executor argued for positions to increase the size of the estate. That position would have increased the bequests to charity under her will but reduced what the children received under the QTIP following her death. A significant question is whether these overlaps in roles were beneficial to the family.

II. GIFTS AND VALUATION

A. **Court Follows Formula Clause to Increase Final Valuation After Allowed FLP Discounts**.

Nelson v. Comr., T.C. Memo 2020-81

The Taxpayer transferred a 27% interest in a family holding company, which owned eight subsidiaries, one of which was a real estate holding company, to an FLP. Shortly after the formation of the FLP, the Taxpayer gifted and sold FLP interests to the trust for the benefit of her husband and daughters. The gift was structured as an assignment of FLP interests with a fair market value of $2.096 million as of December 31, 2008 "as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment." The Service disagreed with the results of the appraisal and argued the result of the clause was actually a higher gift which triggered a gift tax deficiency.

The Tax Court determined that the valuation formula was valid, but since it did not refer to a final determination for federal gift tax purposes, the amount determined by the appraiser was the amount transferred, even if the Service later disagreed with the appraisal amount. The Tax Court then reviewed the valuation. In valuing the FLP's interest in the holding company, the Court allowed a 15% lack of control discount and a 30% discount for lack of marketability. In valuing the FLP interest, the Court allowed 5% lack of control discount and a 28% lack of marketability discount. The overall result was the value of the gift was increased by approximately $4.5 million.

B. **Transfer of LLC Interests Was Indirect Gift**.
Smaldino v. Comr., T.C. Memo 2021-127 (2021)

The Taxpayer transferred certain business properties to an LLC and later transferred 8% of the LLC to an irrevocable trust for his children and grandchildren. Thereafter, the Taxpayer transferred 41% of the LLC to the Taxpayer's spouse. The assignment making the transfer to the spouse was signed "effective as of April 14, 2013", but there was evidence that it was not actually signed until August of 2013. Also, in August of 2013, the spouse signed assignment transferring 41% of the LLC to the irrevocable trust "effective as of April 15, 2013." The spouse testified that she had made a commitment to transfer the LLC interests to the trust when she received them. The Service argued that the substance of the transaction was a gift from the Taxpayer to the irrevocable trust and assessed a gift tax deficiency.

The Tax Court agreed with the Service and assessed tax. The Tax Court did allow some valuation discounts in determining the value of the gift.

C. **Discounts For Gifts of Fractional Interests in Land Survive Motion for Summary Judgment**.
Buck v. United States, 563 F. Supp. 3d 8 (D. Conn. 2021)

The Taxpayer purchased timberland worth over $82 million. Over the next few years, the Taxpayer gifted a 48% fractional interest in the land to each of his sons and retained a 4% undivided interest. In valuing the gift, the Taxpayer claimed a 55% discount, claiming that each 48% interest was worth just over $18 million. The denied the discount and assessed a gift tax deficiency. The Taxpayer sued in district court and the Service moved for summary judgment claiming that no discount should be available for a fractional interest in land unless the Taxpayer held the interest in fractional form before the gift.

The district court denied the Service's motion and allowed the case to proceed, finding that some level of discount could be applied. Gifts should be valued at the time of the gift, not before or after they are made. Valuation for gift tax purposes differs from valuation for estate tax purposes.

D. **Life Insurance Proceeds Included in Value of Deceased Owner's Shares**. ***Connelly v. United States, No. 4:19-cv-01410-SRC, 2021 U.S. Dist. LEXIS 179745 (E.D. Mo. Sept. 21, 2021)***

The Decedent was the president and CEO and majority shareholder in a closely held business owned with the Decedent's brother. The business owned life insurance on each brother's life. When the Decedent died, the business received $3.5 million in life insurance proceeds. Upon the Decedent's death, a stockholder agreement gave the surviving brother the first option to purchase the shares, which he did not exercise. Upon the brother's failure to exercise the option, the Company and the Decedent's estate entered into an agreement whereby the estate received $3 million, and the Decedent's son received a three-year option to buy company stock from the surviving brother. The Service argued that the agreement was not a bona fide agreement but rather a device to transfer wealth within the family. It valued the business at $6.86 million for estate tax purposes after including the value of the life insurance.

The District Court agreed with the Service and denied the Estate's claim for a refund of estate tax paid. In *Blount*, the 11th Circuit determined that the redemption obligation of the business offset the value of the life insurance proceeds so that there was no increase in value. The Missouri District Court rejected this argument and found it was appropriate to include the life insurance proceeds in the overall value. The overall approach did not pass muster as a bona fide agreement to redeem the stock for fair value.

> **Note:** On further review the trial court's decision was affirmed. *Connelly v. United States Department of Treasury, 70 F.4th 412 (8th Cir. Jun. 2, 2023).*

E. **Bad Valuation Discount Planning Costs Family Millions.**
Estate of Warne v. Comr., T.C. Memo. 2021-17

A married couple started investing in real estate in the 1970s, continuing to acquire properties during their remaining lifetimes. They transferred ownership of the properties to five separate LLCs. The LLCs also held various leased fee interests associated with the properties. In 1981, they created a Family Trust with the wife named as trustee. The Family Trust became the majority interest holder of the five LLCs. The husband died in 1999 and the wife in 2014 with the Family Trust included in her estate. In late 2012, the wife gifted fractional interests in the LLCs to her sons and granddaughters. When she died, the Family Trust owned majority interests in each of the five LLCs. Remainder interests were transferred to the wife's children and grandchildren as well as a sub-trust of the family trust. She also left 75 percent of her interest in an LLC that the Family Trust owned 100 percent of to the family charitable foundation. The remaining 25 percent was left to a church. Her estate valued the LLCs by applying discounts for lack of control

and lack of marketability. The estate also claimed a charitable deduction for the full 100 percent value of the LLC interests donated to charity which matched the value of that LLC that was included in the decedent's gross estate. The IRS challenged the amount of the discounts and also reduced the charitable deduction because of the split donation of the LLC interests between the foundation and the church. On the valuation of the LLC interests, the Tax Court noted that the LLC operating agreements gave much control to the holder of the majority interest, including the power to unilaterally dissolve the LLC and appoint and remove managers. The Tax Court was inclined to allow no discounts, but the parties had stipulated that some discount for lack of control applied. Hence, the Tax Court determined that a lack of control discount of four percent should apply. The court also allowed a five percent discount for lack of marketability. On the charitable donations, the Tax Court noted that the proper valuation focused on what the charities received. Because each charity received only a fractional interest in the LLC, the Tax Court reasoned that a discount should apply. The Tax Court accepted the parties' stipulated discount of 27.385 percent for the 25 percent LLC interest donated to the church and a four percent discount for the 75 percent LLC interest donated to the charitable foundation. The effect of the discounts reduced the total charitable contribution by more than $2.5 million.

F. **QTIP Trust Commutation Resulted in Gifts.**
C.C.A. 202118008 (Feb. 1, 2021)

The Decedent established a QTIP Trust for the Decedent's spouse with the remainder interest to pass to the Decedent's children. The spouse and children agreed to a commutation of the QTIP Trust whereby each beneficiary would receive the actuarial value of their respective interests. In addition, the children agreed that all of their interest should be transferred outright to the spouse. The Service determined that the transaction resulted in a gift of the remainder interest from the spouse to the children followed by a gift of the remainder interest back to the spouse. The Service determined that these gifts do not offset.

G. **GRAT Invalidated Due to Misplaced Reliance on Appraisal**.
C.C.A. 202152018 (Oct. 4, 2021)

The Taxpayer transferred stock to a grantor retained annuity trust. The stock was valued based on a 7-month-old valuation. After the valuation was prepared, but before the transfer was made, the Taxpayer entertained a number of tender offers which valued the stock significantly higher. Less than a year after the transfer, a transaction took place at three times the initial valuation. The IRS advised that the merger discussions in process at the time of the transfer should have been taken into account in establishing the value of the GRAT transfer.

H. **Division of Trust by Gift Approved.**
PLR 202116001 (Jul. 9, 2020)

The decedent established a QTIP Trust for the spouse. The spouse proposed to divide the trust into two trusts. One trust would continue as a QTIP Trust. The other would continue as a trust for the benefit of Decedent's children (the Children's Trust) and the spouse would have no interest in the trust. The Service determined that there were no gift tax consequences with regard to the continuing QTIP Trust. The creation of the Children's Trust was treated as a gift by the spouse equal to the value of the assets allocated to the modified trust.

I. **Court Considers Tax Affecting of S Corporation Stock.**
Estate of Cecil, T.C. Memo. 2023-24

This case involved an S corporation that was the long-time company that owns and operates the Biltmore Estate in Ashville, North Carolina. The S corporation offers tours of the house and gardens and operates hotels, restaurants, retail stores and various outdoor activities. In 2010, Mr. and Mrs. Cecil transferred voting and nonvoting stock to their children and grandchildren. The IRS later determined a $26 million combined gift tax deficiency in 2014 and the donees challenged it. The issue involved the valuation of the S corporation for purposes of valuing the gifted stock. All of the experts used a "tax-affected" approach to valuing the S corporation to arrive at a C corporation-equivalent value. The IRS disagreed with this approach when using a discounted cash flow (DCF) method. Under the DCF valuation method, the S corporation's earnings are projected and then discounted to present value using a discount rate derived from empirical studies of publicly traded shares of C corporations. As a result, the discount rate reflects corporate income taxes and shareholder-level dividend and capital gain taxes. In other cases, experts have used the DCF method and applied an entity-level corporate tax rate to the projected earnings of the S corporation being valued. However, the experts have not then made adjustments for the S corporation shareholder's avoidance of dividend and capital gain taxes. The Tax Court allowed "tax-affecting" to value the S corporation, but for the fact that all of the experts agreed to its use. In addition, the Tax Court accepted a 20 percent discount for lack of control and a comparable discount for lack of marketability.

J. **Estate Transfers were Gifts.**
Estate of Spizzirri v. Comr., T.C. Memo. 2023-25

The decedent engaged in consecutive polygamy during his life and had four children from the first of his four marriages and had three stepchildren as the result of his fourth marriage. Before his fourth marriage, the decedent and his wife-to-be entered into a prenuptial agreement, which was modified several times during their marriage. Among other provisions, the prenuptial agreement, as modified, provided

that the decedent's will would include payments to the surviving spouse and a bequest of $1 million to each of the stepchildren.

Although the decedent's fourth marriage was never dissolved, he and his wife were estranged for several years before his death as a result of his various relationships with other women that resulted in two illegitimate children. The decedent made large payments to a number of these women as well as to various other family members, but he never reported them as gifts or issued a Form 1099-MISC, *Miscellaneous Income*, to the recipients.

The decedent's will had been executed before his fourth marriage and did not contain the provisions he agreed to in the prenuptial agreement regarding payments to his surviving spouse and her children. The will generally provided that the decedent's estate would go to his children from his first marriage. There were three codicils to this will, all of which specified the rights of his two bastard sons and one that provided for the payment of the mortgage on, and transfer of his interest in, a condominium he had purchased with one of his courtesans.

During probate, the decedent's surviving spouse filed claims seeking enforcement of the prenuptial agreement, which were ultimately settled. The surviving spouse's children also filed claims seeking to enforce the prenuptial agreement regarding the $1 million bequest to each of them. The estate ultimately paid these bequests and sent the Forms 1099-MISC reporting these payments.

After the claims were settled, the estate filed an estate tax return. Among other reported items, the return reported no adjusted taxable gifts, even though the decedent had made payments to various persons in excess of the gift tax annual exclusion. The return also reported the payments to the surviving spouse's children as claims against the estate that reduced the decedent's taxable estate. Additionally, the estate claimed as administrative expenses the cost of repairs to property of the estate.

The IRS issued a notice of deficiency that increased adjusted taxable gifts from zero to nearly $200,000, disallowed the deductions for the payments to the surviving spouse's children, and disallowed administrative expenses for repairs to one of the estate's properties.

The Tax Court determined that the estate had failed to meet its burden of proof that the transfers were not gifts. The estate argued that the transfers were payments for care and companionship services during the last years of the decedent's life. The court noted that the decedent made the transfers by checks that contained no indication that they were meant as compensation. In addition, the decedent failed to issue any Forms 1099 or W-2 related to these payments, nor did he report them on his personal income tax returns. The Tax Court also noted that witness testimony failed to establish that the transfers were anything other than gifts.

The Tax Court also noted that the payments to the surviving spouse's children would only provide a deduction for the estate if they were bonafide and contracted for "adequate and full consideration in money or money's worth" and not be predicated solely on the fact that the claim is enforceable under state law. Based on these requirements, the Tax Court determined that the claims were not bonafide but were of a donative character, finding that payments to the surviving spouse's children did not stem from an agreement for the performance of services — they were essentially bequests not contracted for adequate and full consideration in money or money's worth.

Regarding the administrative expenses for repairs to the house, the Tax Court noted that Treas. Reg. §20.2053-3(a) limits deductible administrative expenses to those that are actually and necessarily incurred in the administration of the decedent's estate. The Tax Court noted that the appraisal report for the house, on which the house's claimed FMV was based, stated that the decks on the house that were repaired "may need to be replaced" and that the estate did not provide any corroboration that their replacement was necessary for a sale or to maintain the FMV claimed on its return. Thus, the court determined that the costs paid for the repairs were not deductible expenditures necessary for the house's preservation and care but rather were nondeductible expenditures for improvements to it.

K. Taxpayer Loses Most Claims on Variable Prepaid Forward Contract. *Estate of McKelvey v. Commissioner, 161 T.C. No. 9 (2023)*

This case is on remand from the Second Circuit, which had reversed the Tax Court's prior decision in favor of the Taxpayer. See *Estate of McKelvey v. Commissioner, 906 F.3d 26 (2d Cir. 2018), revn'g. and rem'g., 148 T.C. 312 (2017).* The Tax Court upheld the IRS position on the theory approved by the Second Circuit.

The taxpayer had been the founder of Monster Worldwide, Inc., which owned monster.com, a successful employment website. He died on November 27, 2008, just after the transactions relevant to this case.

On September 11, 2007, Taxpayer entered into a "variable prepaid forward contract" (VPFC) with Bank of America covering stock he owned in Monster. At this time, Monster stock was trading at $33.47. Under the contract terms, Taxpayer received an up-front cash prepayment (over $50M) secured by a pledge of the shares for security, in exchange for a promise to deliver up to 1.76 million shares (or a cash equivalent) over ten subsequent settlement dates in September 2008. The number of Monster shares he was obligated to deliver depended on the closing price for Monster shares on each of the settlement dates. If the closing price was less than or equal to $30.46 per share, one tenth of the total covered shares would be delivered. Thus, Bank of America bore some risk of loss if the stock price declined. If the stock price closed between $30.46 and $40.58, the number of shares would be reduced, thus sharing some of the appreciation between Bank of America and

Taxpayer. If the closing price was greater than $40.58, then the number of shares would be further reduced. At any time, Taxpayer could also elect to pay cash instead of deliver stock.

On July 24, 2008, when the Monster stock was trading at $18.24, Taxpayer paid the Bank nearly $3.5 million to extend the VPFC settlement dates until corresponding periods in 2010. After Taxpayer died, his estate settled the contract with Bank of America by delivering the full number of 1.76 million shares. This early settlement was apparently permitted under the terms of the contract.

Taxpayer had also engaged in a similar VPFC with Morgan Stanley, which covered 4.762 million shares. The prepayment amount was $142 million, and the settlement dates were the same as the Bank of America deal, although the prices were slightly different. Taxpayer also paid consideration to extend the Morgan Stanley VPFC in 2008. It was also settled early in 2009, after Taxpayer's death and in advance of the extended settlement dates.

Taxpayer's return for 2008 did not report the extension of the VPFC's as triggering the realization of any taxable gain. The IRS issued a notice of deficiency in 2014, determining that Taxpayer had over $200 million in capital gains from the transactions.

The Second Circuit had previously ruled that the extension of the contracts resulted in an exchange of derivative obligations. In effect, the old contract was exchanged for a new one. The IRS had argued that this exchange caused a termination, which would trigger a short-term capital gain recognition under IRC § 1234A, but the Second Circuit remanded to the Tax Court to assess this claim.

The Tax Court looked to case law and rulings addressing the treatment of option contracts. The Second Circuit had explicitly ruled that the contracts here were not debt instruments, thereby ruling out law otherwise relevant to the modification of debt. Each option contract has its own holding period, which exists independently from the underlying asset. Based on the Second Circuit holding that an exchange had occurred, the Tax Court determined that there had been a disposition of the original agreement, as the obligations under that agreement had terminated. Although entering a VPFC is not a taxable event, termination and replacement can give rise to the application of section 1234A, which requires that gain or loss from cancellation, lapse, expiration, or other termination of rights or obligations concerning a capital asset in the taxpayer's hands to be treated as gain or loss from the sale of a capital asset.

Here, the Monster shares were capital assets. The VPFC included obligations to deliver shares, which terminated under the agreement. Since Taxpayer terminated the VPFC within one year (i.e., by replacing them), this termination triggered short-term capital gain. But Taxpayer argued that the open transaction doctrine should

apply, leaving the determination of the amount of that gain until the replacement VPFCs terminated at settlement. Prior to that time, Taxpayer argued that the amount of the gain or loss is indeterminate.

The Tax Court rejected Taxpayer's argument, concluding that the options here could be valued. Unlike examples from case law cited by Taxpayer, the options in this case had changed significantly in value at the time they negotiated a replacement, as the Monster stock had fallen below the minimum contract price. The open transaction doctrine applies when it is impossible to determine the value of either asset exchanged. Here, Taxpayer gave cash and a future promise in exchange for the new VPFCs. Those new VPFCs could not yet be valued, and the Taxpayer could settle those with either cash or shares, whichever was more advantageous to him. But the gain on termination involved the original VPFCs, which did not require the court to value the new VPFCS.

Here, IRC §1001(a) requires realization of gain from the sale or other disposition of property based on the excess of the amount realized over adjusted basis. However, the Second Circuit had ruled that the exchange here involved obligations, not property rights. Nevertheless, the Tax Court refused to create a gap in the Code's coverage for this transaction. Even if the derivative held by Taxpayer was not technically property, it would be treated as subject to section 1001(a), as the underlying shares that gave value to the derivatives were property.

The amount realized here was less than the amount determined by the IRS, which was based on the total contract value received as a prepayment. However, Taxpayer had to pay for the continuing obligation, which was deducted from the total. Moreover, Taxpayer had to perform his remaining obligations, which the court used expert testimony to value at a total of $110 million. Thus, Taxpayer only realized $71.6 million in short-term capital gains under this theory.

> **Observation:** Options transactions are confusing. The idea is interesting - giving a dying Taxpayer access to cash without triggering gain recognition or even incurring a loan. But if they are not property, what are they? And what happened down the road when the Taxpayer who had the obligation died? Could the value of the derivative be adjusted under section 1014? If not, then what happens later when the Taxpayer's estate settles his obligations by transferring property? Presumably, the stock basis held by the estate increases to FMV at Taxpayer's death, which precludes realization of gain on the stock. But does the estate hold a second asset – the option contract – which potentially holds a second form of gain under the same rationale that applied during Taxpayer's life? Something does not seem right about all of this.

III. RETIREMENT PLANS

A. **Secure Act Changes Retirement Plan Rules**. The SECURE Act made a number of changes to retirement plan provisions. The Act pushes back the age for required minimum distributions from 70½ to 72 for those who are not 70½ by the end of 2019. The Act allows 529 plan accounts to be used for qualified student loan repayments (up to $10,000 annually) and allows penalty-free withdrawals of $5,000 from 401(k) accounts to defray the costs of having or adopting a child. Finally, the Act changes the distribution rules to eliminate the stretch for non-spouse beneficiaries. Unless the beneficiary qualifies for an exemption, non-spouse beneficiaries are now required to withdraw inherited plan balances within ten years. The ten-year rule is not applicable in the following situations: (a) A person who is not more than 10 years younger than the plan participant must withdraw the required minimum distributions based on his or her life expectancy; (b) A minor child of the plan participant who is the beneficiary (in trust or otherwise) of a separate share of the plan, can withdraw based on the child's life expectancy until the child reaches the age of majority, which varies from state to state but is usually 18 or 21, or, if still in school, up to age 26, then ten-year rule applies, and the entire remaining plan balance must be withdrawn by the end of the next 10 years; (c) A disabled person or chronically ill person can with withdraw based on life expectancy.

On February 23, 2022, the Service issued proposed regulations providing more detail on required distributions during the 10-year period. Under the regulations, if the decedent died on or after the decedent's required beginning date, the beneficiary is required to take required minimum distributions (based on the beneficiary's life expectancy) during the 10-year period and must withdraw the entire balance by December 31 of the tenth year. If the decedent died prior to the decedent's required beginning date, there are no annual distribution requirements, but the entire balance must be withdrawn by December 31 of the tenth year. The proposed regulations also restate and simplify the provisions dealing with trusts as beneficiaries of retirement plan assets.

NOTE: Most believed the distributions required by the regulations would take effect after the regulations become final. However, on October 7, 2022, the Service issued Notice 2022-53 indicating that penalties would not be imposed on missed distributions in 2021 or 2022. The Notice takes the position that the distributions are required (or at least will be required) to be taken even though the regulations are not yet final.

NOTE: The Secure Act 2.0 delays the RMD beginning date to age 73 by 2022, to age 74 by 2029, and to age 75 by 2032. It would also make it easier to purchase annuities inside retirement plans.

B. SECURE 2.0 Act Allows Certain Special Needs Trusts to Name Charity as Beneficiary While Preserving Stretch Distributions for Disabled or Chronically Ill Beneficiary

Consolidated Appropriations Act, 2023, Pub. L. 117-328, 136 Stat. 4459

The 2019 SECURE Act replaced the stretch distribution scheme for inherited retirement accounts with a ten-year payout rule for most non-spouse beneficiaries following the death of the plan participant. However, under the SECURE Act, preservation of the stretch distribution is possible for eligible designated beneficiaries, including special needs beneficiaries. An applicable multi-beneficiary trust (AMBT) is an accumulation trust for multiple beneficiaries, one or more of whom is disabled or chronically ill as defined by the SECURE Act. AMBTs may be either type I or type II. Type I AMBTs provide that, immediately upon the death of the plan participant, the trust divides into separate trusts for each beneficiary (and one of the separate trusts can be a type II trust). Type II AMBTs allow for multiple beneficiaries, but all of them must be disabled or chronically ill until after the death of the final disabled or chronically ill beneficiary.

Generally, when naming a trust as the beneficiary of a retirement asset, the ability to stretch distributions relies on having only living persons as countable beneficiaries. If a charity (which is not a living person) is named as one of the countable beneficiaries of the trust, the trust will not qualify for stretch distributions.

The SECURE 2.0 Act, changes the AMBT rules to allow a qualified charity to be named as a remainder beneficiary of the AMBT while still allowing stretch payments from the retirement account to the AMBT over the life expectancy of the disabled or chronically ill beneficiary—provided certain other requirements are met. For example, no one other than the disabled or chronically ill beneficiary can benefit during their lifetime; the charitable beneficiary therefore can only be a remainder beneficiary after the death of the last surviving disabled or chronically ill beneficiary. The charity must also be a qualified charity under Internal Revenue Code (I.R.C.) § 408(d)(8), so if a donor-advised fund (which is not a qualified charity under § 408(d)(8)) is named as a remainder beneficiary of the trust, stretch distributions are not allowed.

If the trust is not designed appropriately and stretch distributions are not allowed, distributions must be made to disabled or chronically ill beneficiaries over a much shorter period: depending upon when the retirement account owner died, distributions must be made according to the five-year rule or the remaining life expectancy of the retirement account owner. The SECURE 2.0 Act fix only applies starting in 2023; it is not applicable where the owner of the retirement account died after the SECURE Act's effective date and before the enactment of the SECURE 2.0 Act.

Observation: It is possible to name a charitable remainder beneficiary of an AMBT without jeopardizing the stretch distribution for special needs beneficiaries, provided certain requirements are met. The changes made by the SECURE 2.0 Act will benefit those who are charitably inclined, providing them with additional flexibility while preserving the tax savings for special needs beneficiaries of AMBTs.

C. American Eagle Coins Must be Held by Custodian.
McNulty v. Comr., 157 T.C. No. 10 (2021)

The petitioner set up a self-directed IRA via a single-member LLC that would be used to hold IRA funds through the purchase of membership interests. She instructed the IRA custodian to have the LLC buy gold and silver American Eagle coins. But, according to the custodian's website, an LLC owned by an IRA could invest in the coins and the IRA owner could hold the coins at their home without tax consequences or penalties so long as the coins were titled in an LLC. Based on the website information, the petitioner instructed the coins be transferred directly to her at her home for storage there in a safe. The petitioner funded the IRA by transferring funds from an annuity and an employer-sponsored Sec. 401(k) profit-sharing plan. She did not report either transfer as taxable. She then used the funds to buy membership interests in the LLC via the IRA. The IRA purchased membership interests on three occasions in 2015 and 2016, and each time the petitioner instructed the custodian to transfer the purchase price of the membership interests from the IRA to the LLC's bank account. In turn, the petitioner, as the LLC's manager, had the LLC use the funds to buy American Eagle coins from an authorized coin dealer. The funds to buy the coins were transferred from the LLC's bank account to the dealer's account. The dealer invoices listed the LLC as the buyer, but the shipping label was addressed to the petitioner individually or along with her IRA. The coins were shipped to the petitioner where she stored them in a safe at her home. The dealer provided annual valuations for the gold coins, but not for the silver coins. The IRA trustee valued the IRA via a year-end IRA asset valuation provided by the petitioner, but the valuations omitted the LLC bank account balance and the value of the silver coins. The custodian filed Form 5498 with IRS for 2015 and 2016 reporting the IRA's fair market value of $349,856 and $388,247 respectively. A CPA prepared the tax returns, but was not consulted on the self-directed IRA and was not informed concerning how the coins were being held. Upon audit, the IRS determined that the petitioner received taxable distributions in both 2015 and 2016, and assessed an accuracy-related penalty for both years. The IRS took the position that the coins were actually held under the petitioner's control rather than the LLC – she was the LLC manager and had physical possession of the coins that were purchased with IRA funds. As such, a qualified custodian or trustee was not responsible for the management and disposition of the property in the self-directed IRA as required by Treas. Reg. §1.408-2(e). A custodian is required to maintain custody of the IRA assets,

maintain the required records, and process transactions that involve IRA assets. I.R.C. §408(h) and (i) and Treas. Reg. §1.408-2(e)(4) and (5)(i)(2). The Tax Court agreed with the IRS, finding that the petitioner had complete and unfettered control over the coins and could use them in any manner she wished.

The Tax Court determined that the existence of the LLC was irrelevant because it was being treated taxwise as a disregarded entity, even though the Tax Court also said this didn't matter because the petitioner had complete control over the coins in any event. Thus, she had received taxable distributions that should have been included in her gross income. The Tax Court also determined that the exemption contained in I.R.C. §408(m)(3) allowing coins and bullion to be held in an IRA did not negate the requirement of physical possession by a trustee as a condition of the IRA owning coins and bullion. The Tax Court also determined that the petitioner had violated I.R.C. §408(a)(5) barring commingling of IRA assets (the storing of the coins in a safe with non-IRA assets) with other property except in a common trust fund or common investment fund. Simply labeling the coins as having been purchased with IRA funds was not enough and, in any event, she had physical possession and control over the coins. The Tax Court upheld the accuracy-related penalties because even though a CPA prepared the returns, the petitioner did not seek advice from the CPA and never disclosed the facts regarding where the IRA's assets were being held. The website was where the petitioner got her "research" leading her to conclude that the structure was acceptable. The website was not an unbiased source of information.

D. **Estate Allowed to Divide IRA for Beneficiaries**.
Priv. Ltr. Rul. 202039002 (Jun. 25, 2020)

The decedent's IRA was payable to his Estate. The executor proposed to distribute the IRA by trustee-to-trustee transfers one-third each into three transferee IRAs to be set up in the name of the deceased IRA owner for the benefit of each beneficiary. The Service determined that (a) transfers of one-third interests in a decedent's Individual Retirement Account to three transferee IRAs will not constitute taxable distributions to the beneficiaries, nor rollovers, because each of the transferee IRAs is to be set up and maintained in the name of the deceased IRA owner for the benefit of a beneficiary, and (b) any amounts of such transferred assets distributed to a beneficiary will not be included in decedent's estate's gross income nor reported as such by the custodian of the transferee IRAs.

E. **Spousal Rollover Allowed for IRA Payable to Trust**.
Priv. Ltr. Rul. 202227005 (Apr. 14, 2022)

The decedent's IRAs were payable to the decedent's revocable trust. The decedent's spouse was the sole Trustee and the sole beneficiary of the revocable trust. The Service determined that the spouse was entitled to rollover the IRAs into an IRA in the surviving spouse's name. *See also P.L.R. 202214008 (*allowing

spousal rollover for IRA payable to estate of which spouse was sole beneficiary and executrix).

F. **Spousal Rollover Allowed for Roth IRA Payable to Trust**.
Priv. Ltr. Rul. 202136004 (Jun. 14, 2021)

The decedent and the decedent's spouse created a joint trust agreement and named the trust as the beneficiary of the decedent's IRA. The decedent's spouse was the sole trustee and sole beneficiary of the Trust. The Service determined that the spouse was entitled to roll over the Decedent's IRA into an IRA in the surviving spouse's name.

G. **IRA Divided into Separate Trusts for Children**.
Priv. Ltr. Rul. 202140011 (Jul. 12, 2021)

The decedent had his own IRA and owned an inherited IRA from his brother. Both IRAs named the decedent's trust as beneficiary. Under the terms of the trust, the trust was divided into separate shares for each of the decedent's three children. The IRS allowed the IRAs to be transferred in a "trustee to trustee" transfer into individual IRAs titled "IRA of decedent fbo (name of child)." This ruling permitted the interests of the three children to be separated.

H. **IRA Distribution of In-Kind Partnership Interest Followed by Liquidation and Recontribution of Cash Proceeds not Eligible for Rollover Treatment.** ***Estate of Caan v. Commissioner, 161 T.C. No. 6 (2023)***

The decedent relied on professional advisors to handle his business, legal, and financial affairs. During 2015, the decedent had two IRA accounts at UBS. One had ETFs, cash, and similar securities. Another had a partnership interest in a hedge fund that was not publicly traded. That account required the IRA custodian to provide a report of the fair market value of "alternative assets" as of December 31 each year. The decedent was subject to a custodial agreement that reflected this requirement, and he was responsible to provide UBS with that information so that they could fulfill their duties as custodian. After he failed to provide that information, UBS refused to continue serving as custodian. It sent a letter informing him that it was distributing his interest in the partnership, and it issued Form 1099-R, which used the fair market value at the prior year ($1.9 million), which was the latest information it had on hand.

Complicating matters, before the letter had been sent, the decedent's financial advisor moved from UBS and began a similar role at Merrill Lynch. He had convinced the decedent to transfer both of the IRA accounts to Merrill Lynch. However, the hedge fund interest was ineligible for transfer through the Automated Customer Account Transfer Service (ACATS), so he had directed UBS to liquidate the interest and then transfer the proceeds to an IRA at Merrill Lynch. That did not

happen, however, until almost a year after UBS notified the decedent that it was distributing his partnership interest.

The decedent reported the distribution of the hedge fund interest, but he claimed it was nontaxable. The IRS issued a notice of deficiency for about $780K, along with accuracy penalties of $156K. A tax court petition followed. The decedent died during the proceedings, leaving them to be carried on by his estate.

The Tax Court held that UBS had distributed the hedge fund interest in 2015, and that it was taxable because a rollover had not been completed within 60 days. A letter from UBS had correctly advised the decedent that he had 60 days following the distribution to contribute it to another IRA account. The decedent had a custodial account, not a trust, in which the custodian's duty was only to hold the assets and not to make investment decisions. When UBS distributed the partnership interest, the decedent became the holder. He could execute a rollover, but only if he contributed the same property to another IRA. He did not do so on a timely basis. The decedent argued that UBS' distribution violated California trust law, but the court rejected this claim as it was not a trustee, but a custodian. Moreover, the court found UBS went above and beyond to attempt to accommodate the decedent.

After the distribution, the decedent had requested a rollover before the end of the 60 day period. But the rollover was not done in a manner that satisfied the applicable tax rules. First, the partnership interest was not contributed in kind; it was liquidated. Cash transferred to the IRA was not a valid rollover, as the in-kind property he received had been changed in this case. A rollover requires the same money or property to be transferred; that did not happen. The court focused on requirements in section 408, applicable here, which did not permit the same flexibility in other types of qualified plains that might hold in-kind property.

However, the IRS agreed that the 2013 value used for Form 1099-R was overstated. It instead agreed that the ending capital account balance for 2015 was the closed approximation to the fair market value. This also matched the liquidation value received by the estate.

The decedent's advisors had also requested another form of relief: a letter ruling request to obtain a waiver of the 60 day period based on "equity or good conscience". The IRS denied that request. At issue here was whether the Tax Court could review that denial. Based on past precedents involving section 402 determinations, the Tax Court agreed that it had jurisdiction to review a waiver under section 408, which used similar language. However, the appropriate standard for review was abuse of discretion. The Tax Court found no abuse here, as by liquidating the partnership interest after distribution, it could no longer meet the rollover requirement. This was not something the IRS could waive.

Observation: This case shows the careful path that must be followed in the case of an in-kind distribution where a rollover is desired. The decedent did not get good help from his advisors.

IV. MISCELLANEOUS

A. **Income Tax Rates for Trusts and Estates**. RRA 2017 modifies the income tax rates for trusts and estates, though they remain quite compacted. The income tax rates for trusts and estates for taxable years beginning in 2023 (& 2024) are:

Not over $2,900 ($3,100)	10%
$2,900 but not over $10,550 (over $3,100 to $11,150)	24%
$10,550 but not over $14,450 (over $11,150 to $15,200)	35%
Over $14,450 (over %15,200)	37%

The dollar amounts for bracket thresholds are adjusted for inflation and then rounded to the next lowest multiple of $100 in future years. The indexing will use the Chained Consumer Price Index for All Urban Consumers (C-CPI-U), rather than the Consumer Price Index for All Urban Consumers (CPI-U).

B. **Summary Judgment Denied in Malpractice Case**.
Wellin v. Farace, No. 20-1120, 2021 U.S. App. LEXIS 34665 (4th Cir. Nov. 22, 2021).

With the assistance of an attorney, the decedent established a family limited partnership (FLP) and later sold a controlling interest in the FLP to an intentionally defective grantor trust over which the decedent's children were trustees. Before the decedent's death, the decedent's children caused the FLP assets to be sold, resulting in a large income tax liability to the decedent, who died shortly after the sale. The decedent's estate claimed the attorney failed to property advise him of the risks and potential tax liability associated with the transaction. The attorney asserted that the claims were barred by the applicable statute of limitations based on the decedent's (and the decedent's wife's) complaints and inquiries regarding the transaction. The district court granted summary judgment in favor of the attorney.

The appellate court reversed, concluding that material issues of fact remained regarding *when* the alleged malpractice was discovered or discoverable.

C. **Pass-Through Businesses Owned by an Estate or Trust**. RRA 2017 provides that, for taxable years beginning after December 31, 2017, and before January 1, 2026, an individual taxpayer generally may deduct 20% of qualified business income from a partnership, S corporation, or sole proprietorship. Section 199A makes estates and trusts eligible for the deduction for such pass-through income. The final regulations provide some guidance on how the deduction applies to estates and trusts. Treas. Regulation § 1.199A-6(d)(2) confirms that the grantor of a grantor trust is entitled to the deduction and provides rules on calculating qualified business income at the estate/trust level and allocating it to the beneficiaries. Treas. Regulation § 1.643(f)-1 provides that multiple trusts by the same grantor will be combined for 199A purposes if the trusts are established for tax avoidance purposes.

D. **Reliance on Attorney Not Reasonable Cause for Late Filing**.
Andrews v. United States, 153 Fed. Cl. 665 (2021).

The Estate sought a refund of late filing and late payment penalties related to the Estate's federal estate tax return. The Estate argued that it reasonably relied upon an attorney to timely seek an extension of the deadline for filing the return and making payment. The Court of Federal Claims upheld the penalties, holding that it requires no special training or effort to ascertain a deadline and make sure it is met.

E. **Lack of Information May Constitute Reasonable Cause for Late Filing**.
Leighton v. United States, 155 Fed. Cl. 543 (2021).

The decedent's estate failed to timely file a federal estate tax return because it mistakenly believed that the value of the gross estate was under the filing threshold. Later, the executor determined that substantial gifts had been made during the Decedent's lifetime which used up a significant portion of the available estate tax exemption and meant that a return was required, and that tax was due. After paying the tax, interest and penalties, the estate sued for a refund claiming that the executor reasonably relied upon the information available in determining not to file. The Service moved to dismiss. The Court of Federal Claims denied the motion to dismiss, finding that it was possible that the underlying facts constituted reasonable cause and that a trial was necessary to make that determination.

F. **John Doe Summons to Law Firm Upheld**.
Taylor Lohmeyer Law Firm PLLC v. United States, 957 F.3d 505 (5th Cir. 2020), cert. den., 142 S. Ct. 87 (2021)

A law firm client was audited by the Service and agreed to pay about $4 million in tax. The audit involved assignment of income to foreign accounts pursuant to a tax structure put together with the assistance of the law firm. The Service issued a "John Doe summons" to the law firm to disclose the names of all clients over a 23-year

period who had used the law firm's services to acquire, establish, maintain, operate or control any foreign account or any foreign legal entity. The law firm argued the information was protected by attorney-client privilege. The appellate court upheld the validity of the summons finding that the law firm's clients' identities were not "connected inextricably with a privileged communication" and therefore were not privileged. The U.S. Supreme Court decline to hear the case.

G. S Election Must Be Revoked to be a C Corporation.
Chan v. Comr., T.C. Memo. 2021-136

The petitioners operated a restaurant via their S corporation. They failed to file tax returns for two years and didn't report the business income on their personal returns. The IRS audited, reconstructed their income using the bank deposits method and disallowed all expenses. The petitioners claimed that they operated the restaurant via a C corporation. The IRS rejected that claim, noting that the petitioners had not affirmatively revoked the S election. The Tax Court upheld the IRS position with respect to the petitioners' type of entity. However, the Tax Court determined that material facts existed concerning other issues and gave the petitioners a chance to demonstrate the expenses associated with the business.

H. **Shareholders Liable for Corporate Tax under "Midco" Transaction.**
Sloan v. Comr., T.C. Memo. 2022-6, on rem. from, 896 F.3d 1083 (9th Cir. 2018), rev'g., T.C. Memo. 2016-115, cert. den., 139 S. Ct. 1348 (2019)

The petitioners were transferees of C corporate assets via a "Midco" transaction. Under a Midco transaction, an intermediary company is affiliated with a promoter. The intermediary company is typically a shell company that is often organized offshore that buy the shares of a target company. The cash of the petitioner's C corporation (target corporation) flowed through the intermediary to the selling shareholders. After acquiring the target's embedded tax liability, the shell company engaged in a transaction purporting to offset the target's realized gains and eliminate the corporate-level tax. The promoter and the target's shareholders then agreed to split the dollar value of the corporate tax that had purportedly been avoided with the promoter keeping as its fee a negotiated percentage of the avoided tax amount. The target's shareholders kept the balance of the avoided corporate tax as a premium above the target's true net asset value (i.e., assets net of accrued tax liability). After the transaction there were no assets left in the target corporation and the IRS issued notices of liability to the petitioners as transferees. In the original Tax Court case, the Tax Court ruled that the petitioners were not liable as transferees on the theory that they and their advisers did not have actual or constructive knowledge of the results of the transaction. On appeal, the appellate court reversed, concluding that the petitioners were at the very least on constructive notice that the entire scheme had no purpose other than tax avoidance. The appellate court also concluded the transfer was a constructively fraudulent transfer under Arizona law. The U.S.

Supreme Court declined to hear the case. On remand, the Tax Court entered a decision consistent with the IRS' computations. Those computations included accuracy-related penalties and IRS recovery of pre-notice interest.

I. **Deduction for Full Amount of C Corporate Shareholder Compensation Not Deductible.**
Clary Hood, Inc. v. Comr., T.C. Memo. 2022-15, aff'd. in part, vac'd. in part and remanded, 69 F.4th 168 (4th Cir. May 31, 2023)

A married couple were the sole shareholders of the petitioner, a corporation engaged in the construction business that excavated, graded and prepared land for development. The petitioner's growth was irregular from 2000 on. The principal took a relatively modest salary between 2000 and 2012 but took a big increase in the years 2013 to 2016, ostensibly to compensate for earlier years. The company had an outside consulting firm perform an analysis to determine what the principal's compensation should be. While the IRS conceded that the CEO had been underpaid, the IRS challenged the amount in 2015 and 2016 as excessive. The Tax Court examined the usual factors considered in such a case including the employee's qualifications; the nature, extent, and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with gross income and net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; and the salary policy of the taxpayer as to all employees.

The Tax Court denied a deduction for the full amount of the compensation. In addition, the IRS assessed an accuracy-related penalty for both years. The taxpayer was able to show that he relied in good faith on the advice of the accounting firm and the Tax Court did not sustain the penalty. However, for the second year the taxpayer could not substantiate its reliance on the outside adviser.

On appeal, the appellate court affirmed the Tax Court's denial of deductions stemming from $10 million in total bonuses paid to the CEO, concluding that they were more like non-deductible dividends based on the multi-factor approach required by the Treasury Regulations. However, the appellate court vacated the $282,000 penalty for 2016 because the petitioner had relied on a professional's advice in paying out the bonus for that year that was based on a "consistent methodology."

J. **FBAR Penalties Are Not Fines Subject to Discharge Upon the Death of Account Holder.**
United States v. Gaynor; No. 2:21-cv-00382-JLB_KCD, 2023 U.S. Dist. LEXIS 157733 (M.D. Fla. Sept. 6, 2023)

The court granted the Government's motion for partial summary judgment holding that the penalties imposed for willfully failing to comply with FBAR filings on

foreign accounts do not abate upon the Taxpayer's passing. Although the taxpayer's counsel conceded that every district court considering this issue has ruled that the penalties survive the taxpayer's death, the matter had not yet been considered by any Circuits, including the Eleventh Circuit to which an appeal would lie.

Although there was some controversy remaining over the balances in the accounts, the penalties assessed totaled over $20 million. The court observed that higher penalties could have been assessed based on evidence concerning balances, leaving this matter to be decided at trial along with the matter of willfulness. The court looked to other Eleventh Circuit precedents examining whether a statute is penal (which abates upon death) or remedial (which does not abate). Agreeing with another district court, which stated that "the FBAR penalty is primarily remedial with incidental penal effects", the court ruled that the penalties could be imposed on the decedent taxpayer's estate. It observed that treating FBAR penalties as fines would grant an inappropriate windfall to decedents.

> **Comment:** The court rejected an Eighth Amendment excessive fines claim here not based on precedent, but instead on the fact that the final penalty amount had not yet been determined, thus making the matter unripe for consideration. Other courts have rejected Eighth Amendment challenges as legally insufficient.

K. **Whistleblower Award Denied for IRS Refusal to Take Action to Collect Taxes.** ***Raffaelli v. Commissioner, T.C. Memo 2023-79***

The petitioner submitted Form 211 to the IRS Whistleblower Office seeking a reward based on a taxpayer's failure to report a $350,000 taxable gift to his daughter. The petitioner discovered the information about the putative gift in connection with civil litigation against the daughter.

The IRS classifier in the Estate and Gift Operating Division rejected the claim. Although no gift tax return had been filed, the classifier recommended no award. First, the classifier noted that the amount of the proceeds in dispute would not exceed $2 million, the threshold for nondiscretionary awards. Second, the classifier believed that the putative gift was likely a loan. No documents showing a bank statement or gift letter had been provided. The classifier recommended not to forward this to examination, and the IRS Whistleblower Office agreed, sending a final decision of rejection to the petitioner.

At the Tax Court, the IRS moved to dismiss for lack of jurisdiction. Based D.C. Circuit Court of Appeals opinion in *Li v. Comr., 22 F.4th 1014 (D.C. Cir. 2022),* to which an appeal would lie, the Tax Court dismissed the case. The classifier's decision not to proceed on the information did not constitute an award "determination" that would give rise to a reviewable decision in the Tax Court under I.R.C. §7623(b)(4). The Tax Court noted that an award determination only

arises when the IRS "proceeds with any administrative or judicial action," which did not occur here. The Tax Court dismissed the case. *Raffaelli v. Comr., No. 11004-20W, 2023 U.S. Tax Ct. LEXIS 2892 (U.S. Tax Ct. Jun. 23, 2023).*

> **Observation:** Those representing clients in nontax cases may need to consider potential tax consequences that could be triggered by documents produced in discovery, lest they buy more trouble with the IRS from disclosure. For another case denying jurisdiction on the basis that the WBO failed act on information, see *Katakis v. Commissioner, T.C. Memo 2023-112.*

L. **No Basis Increase for Assets in an IDGT.**
Rev. Rul. 2023-2, 2023-16 IRB 658

An estate planning technique that is largely restricted in usage to higher wealth individuals is that of an intentionally defective grantor trust (IDGT). With an IDGT, the grantor sells assets to a grantor trust, and the trust pays for the assets by issuing a note to the grantor. There is no gain because the seller (grantor) is treated as still owning the assets. Because the note bears a fixed rate of interest that freezes the value of the assets in the grantor's estate over time an enormous amount of property can be leveraged out of the estate. Under IRC Sec. 7872, if credit is extended to a family member or to a trust for the benefit of a family member, the note should bear the Applicable Federal Rate (AFR).

A significant question has involved the issue of whether the trust assets receive a fair market value basis at the time of the grantor's death. Rev. Rul. 85-13, says that a grantor trust is ignored for income tax purposes, but not for estate tax purposes. As a result, the assets transferred to the trust are not included the transferor's estate. As for basis, in the typical IDGT transaction the basis of the assets in the grantor's hands is lower than what the basis in the assets will be at death. The trust takes the grantor's (low) basis. It doesn't matter what the grantor sells the assets to the IDGT for. It's a gift not a sale.

In early 2023, the IRS took the position that there is no step-up in basis because the property wasn't a bequest, devise or inheritance from the decedent and didn't fall within one of the six other types of property listed in I.R.C. §1014(b) that qualify for a basis adjustment at death.

M. **Co-Trustees and Beneficiaries Liable for Unpaid Estate Tax.**
United States v. Paulson, 68 F. 4th 528 (9th Cir. 2023)

The decedent died in 2000 with an estate valued at nearly $200 million, with most of his assets placed in a living trust. But years later more than $10 million in estate taxes, interest, and penalties remained unpaid. The Government sued several of the decedent's heirs, alleging that they controlled the trust, as trustees, or received estate property, as transferees or beneficiaries, and were therefore personally liable

for the estate taxes under I.R.C. §6324(a)(2) as well as under the state (CA) Probate Code.

The trial court ruled for the heirs holding that they were not liable for unpaid estate tax under I.R.C. §6324(a)(2). However, the trial court ruled for the Government on its claims under the state Probate Code.

The appellate court reversed, because the heirs/beneficiaries were withing the categories of persons listed in I.R.C. §6324(a) when they had or received estate property, and the statutory timeframe for collection from third parties had not expired.

N. **Frivolous Return Penalties Applied to Trustee.**
Stanojevich v. Commissioner, 160 T.C. No. 7 (2023)

In a Collection Due Process proceeding, the IRS sought summary judgment against a trustee who filed frivolous tax returns on behalf of the trust for 2009-2012. The trustee sought relief on the ground that the $5000/return penalties imposed upon him under I.R.C. § 6702 relate to filings he made on behalf of another taxpayer - the trust. The trustee had claimed that the trust had paid taxes equal to the amount of reported income, and he had further prepared false Form 1099s to show the payment of those taxes. He sought a refund for the trust, but instead got nothing but penalties for frivolous returns under section 6702.

The Tax Court had jurisdiction not only to review the procedural aspects of the lien filed against him, but also the underlying penalties that support his liability as there was no opportunity to review a notice of deficiency in the Tax Court. Here, the taxpayer was found to have raised his challenge to the penalties at the Collection Due Process proceeding at Appeals, which made him eligible to raise it here. The court upheld the penalties, finding not only frivolous behavior but also that *fiduciaries are not exempted from those penalties*.

> **Observation:** Trustees are required to file returns, and they must fulfill their duties to the government as well as to their beneficiaries. Just in case anyone thought otherwise, the Tax Court issued this as a full Tax Court Opinion and not as a memorandum opinion.

V. ESTATE/TRANSFER TAX PROPOSALS

Over the past two years, there have been numerous proposals to make changes to the estate and gift tax system. Here is a summary of the items that have been previously proposed:

A. **STEP Act**. A group of five Democratic Senators introduced the STEP Act (the "Act"). The Act would tax transfers of appreciated property at death or by lifetime gift. In essence, the transfer would be treated as a sale and capital gains tax would

be due on the difference between the fair market value of the transferred property and its income tax basis. A few exclusions would apply. Lifetime transfers to an individual other than a spouse would be taxable after the first $100,000 of cumulative gain involved in transfers made by the donor. Transfers upon death to a person other than a spouse would be taxable after the first $1,000,000 of cumulative gain, taking into account the portion of the $100,000 exclusion used during lifetime. The balance of the gain would be taxable.

For example, if an individual dies holding stock worth $4 million that was originally purchased for $2 million, there would be $2 million of built-in gain. The first $1 million of gain would be excluded, but the remaining $1 million of gain would be taxed as capital gain.

Under the Act, there would be exemptions for transfers to spouses and for transfers to charities, charitable trusts, qualified disability trusts, and cemetery trusts. In addition, for a personal residence, there would be a separate gain exclusion of up to $250,000 ($500,000 for a married couple). Transfers from qualified retirement accounts would not be subject to the transfer tax. For certain transfers of business assets (including farms and certain farm assets) the Act would allow tax payments over a 15-year period. The first 5 years would be interest only followed by 10 equal payments for the remaining 10 years.

The Act would also require all non-grantor trusts to report and pay capital gains tax on all their appreciated assets every 21 years. All trusts created before 2005 would automatically report built-in gain in 2026. Additionally, trusts with more than $1 million of assets or more than $20,000 of gross income would be required to provide a balance sheet, income statement, and a list of all trustees, grantors, and beneficiaries to the IRS.

B. **For the 99.5% Act**. Senator Bernie Sanders introduced the "For the 99.5% Act" (the "Act"). This Act would significantly reduce the exemption amounts. The estate tax exemption would be reduced from $11.7 million to $3.5 million, and the lifetime gift tax exemption would be reduced from $11.7 million to $1 million. Instead of a flat 40% estate and gift tax rate, there would be a progressive rate system as follows:

- 45% for estates between $3.5 and $10 million
- 50% for estates between $10 and $50 million
- 55% for estates between $50 million and $1 billion
- 65% for estates over $1 billion.

The Act would allow farmers to use special use valuation rules to lower the value of their farmland by up to $3 million for estate tax purposes. Currently, donors can make gifts worth up to $15,000 to any one person in any calendar year and it is does not count against the lifetime gift exemption. Under the Act, this general rule would

continue however the following transfers would be limited to $10,000 per year to any one individual and $20,000 total per year:

- Transfers to a trust
- Transfers of any pass-through entity
- Transfers of an interest subject to prohibitions on sale
- Any transfer that cannot immediately be liquidated

The Act would also substantially limit the use of a number of estate planning tools:

- The use of valuation discounting would be limited or eliminated in a number of areas, including valuation of passive or investment-type assets held in pass-through entities and valuation of family-owned entities.
- Assets held in an intentionally defective grantor trust created after the effective date of the Act or contributed after the effective date would be included in the grantor's estate for federal estate tax purposes.
- Grantor Retained Annuity Trusts would be required to include a gift element upon funding and would have to have a minimum term of 10 years.
- Dynasty trusts would be subject to estate tax every 50 years.

C. **House Ways and Means Committee Proposal**: In September 2021, the House Ways and Means Committee released their proposed changes (the "Proposal"). Under the Proposal, the estate and gift tax exemption would revert to $5 million (indexed for inflation) in 2022 rather than 2026. In addition, the Proposal eliminates the favorable tax status of Intentionally Defective Grantor Trusts, limits the use of Grantor Retained Annuity Trusts, and restricts the use of valuation discounts on transfers of nonbusiness assets. On the positive side, the Proposal does include some changes which would expand the availability of special use valuation for real estate used in farming or a family business. The Proposal would prohibit annual contributions to retirements plans if a taxpayer's total retirement plan balances exceed $10 million. In addition, taxpayers with retirement plan balances in excess of $10 million would be required to take accelerated required distributions to reduce the balance to $10 million. The Proposal would also eliminate so-called "back door" Roth conversions where a taxpayer makes a taxable contribution to a traditional IRA and then converts to a Roth. The Proposal also further restricts the use of IRA funds for investments in which the IRA owner has an interest.

D. **2021 IRS Estate Tax Data.**

IRS data released in November 2022 reports the following for federal estate tax returns filed in 2021:

6,158 returns were filed.

2,584 returns were filed with a tax due

Of the 2,584 taxable returns:

648 showed estates valued under $10 million

1,020 showed estates valued from $10 million to $20 million

636 showed estates valued from $20 million to $50 million

265 showed estates valued at more than $50 million

The taxable returns reported $18.4 billion in tax paid.

Based on annual revenues of the U.S. government of around $4 trillion, federal estate tax accounts for less than one half of one percent of federal revenues.

E. **U.S. Treasury Greenbook Fiscal Year 2024 Revenue Proposals. https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf.**

There are several proposals in the Greenbook that are meant to help alleviate some of the complications that have arisen in estate and trust tax matters and simplify the process.

Required Reporting on Trust Value

One proposal would require reporting the estimated total value of a trust's money and property (otherwise known as *assets*) and other information about trusts to the IRS on an annual basis. Currently, most domestic trusts must file an annual income tax return. However, trusts do not have to report the nature or value of the trust's accounts and property. Because of this, the IRS claims that it has no statistical data on the nature or magnitude of wealth held in domestic trusts. This lack of statistical data has made it difficult for the administration "to develop administrative and legal structures capable of effectively implementing appropriate tax policies and evaluating compliance with applicable statutes and regulations." This in turn further hampers the administration's "efforts to design tax policies intended to increase the equity and progressivity of the tax system." The proposal would require certain trusts to report certain information to the IRS on an annual basis to facilitate the analysis of tax data, the development of tax policies, and the administration of the tax system.

The Treasury state that the information could be reported on an annual income tax return or other form, as determined by the Secretary, and would include the name, address, and taxpayer identification number of each trustee and trust grantor, and general information about the nature and estimated total value of the trust's accounts and property. Also, each trust (regardless of value or income) would be required to report the inclusion ratio of the trust at the time of any trust distribution

to a non-skip person, as well as information about trust modifications or transactions with other trusts that occurred that year.

> **Note:** The proposal would apply for taxable years ending after the date of enactment. It is anticipated that increased reporting would require increased participation by attorneys and trustees in the preparation of fiduciary income tax returns.

Require Defined Value Formula Clause Be Based on Variable Without IRS Involvement

This proposal requires that a defined value formula clause be based on a variable not requiring IRS involvement. Many taxpayers like to use gifts, bequests, or disclaimers as part of a particular tax strategy. To achieve this result, sometimes a defined value formula clause is necessary to determine how much money or property should be transferred. A defined value clause is the amount transferred based on a value as determined for tax purposes and using a formula based on IRS enforcement activities. After losing a number of court decisions upholding taxpayer use of formula clauses for hard-to-value assets, the Treasury has found the defined value formula poses a number of challenges as it currently exists because it potentially allows a donor to escape the gift tax consequences of undervaluing transferred property; makes examination of the gift tax return and litigation by the IRS cost-ineffective; and requires the reallocation of transferred property among donees long after the date of the gift. The Treasury also believes that "defined value formula clauses that depend on the value of an asset as finally determined for Federal transfer tax purposes create a situation where the respective property rights of the various donees are being determined in a tax valuation process in which those donees have no ability to participate or intervene." To address these concerns, the proposal provides "that if a gift or bequest uses a defined value formula clause to determine value based on the result of involvement of the IRS, then the value of such gift or bequest will be deemed to be the value as reported on the corresponding gift or estate tax return."

Transfers made by gift or occurring upon a death after December 31, 2023, would be subject to this proposal.

Eliminating Present Interest Requirement for Annual Gifts

The Treasury also proposes to eliminate the requirement that gifts must be of a present interest to qualify for the gift tax annual exclusion. Currently, the annual per-donee gift tax exclusion is available only for gifts of a present interest. Under the proposal, gifts would no longer have to be of a present interest to qualify for the gift tax annual exclusion. "Instead, the proposal would define a new category of transfers (without regard to the existence of any withdrawal rights) and would impose an annual limit of $50,000 per donor, indexed for inflation after 2024, on

the gift giver's transfers of property within this new category that would qualify for the gift tax annual exclusion.

The proposal would be effective for gifts made after December 31, 2023.

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SECTION J

CORPORATIONS/PARTNERSHIPS

CONVERSION FROM "C" CORPORATION TO "S" CORPORATION (FARM EXAMPLE)

FACTS: Your clients are the majority shareholders of a cash basis "C" corporation (current retained earnings = $236,000) who have reached retirement age. They have no on-farm heirs to take over the farming operation and anticipate the corporation, which includes low basis farmland, will be liquidated at their deaths. Following retirement, they wish to rent all corporate farmland on a cash rental basis to simplify their involvement.

According to their current wills, at the death of the first spouse, a portion of the corporate stock will transfer to a by-pass trust which will meet qualified subchapter "S" trust (QSST) eligibility. The trust provides for the remainder of trust assets to pass equally to your clients' children upon the death of the surviving spouse.

The following is intended to provide some insight into the various tax related problems involved with a conversion from a "C" corporation to a "S" corporation, followed by liquidation of the corporation or passage of the assets to family members, considering the above fact pattern. It is not intended to be a complete recitation of tax law. Alternative courses of action are discussed which could provide significant tax savings; however, the unwinding of a "C" corporation is usually complicated, time-consuming and fraught with pitfalls for the unwary.

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PROBLEM -- EVENTUAL LIQUIDATION OF CORPORATION/BUILT-IN GAINS (IRC §1374)

The 1986 Tax Reform Act substantially changed corporate tax law in the area of corporate liquidations. Generally, the liquidation of a "C" corporation will result in double taxation (corporate and shareholder level) as a result of appreciation in value of corporate assets from the inception of the corporation through the date of liquidation.

RECOMMENDATION -- "S" CORPORATION ELECTION (BUILT-IN GAIN RULE): The corporation should consider electing "S" corporate status (if 100 shareholders or less) to lock in and limit the total amount of gain that would be realized upon a corporate liquidation. The election of "S" corporate status will freeze the corporate built-in gain at a level that will not exceed the difference between the cost basis in the farm real estate/improvements and the fair market value as of the effective date of the "S" election. **Following this election, the corporation and shareholders could avoid double taxation (corporate and shareholder level) on any additional appreciation in the fair market value of farm real estate/improvements. As an additional benefit, if the corporation continued its corporate existence for a period of five (5) years following the "S" corporate election, the corporation and its shareholders could avoid double taxation (corporate and shareholder levels) on the appreciation in value of farm real estate/improvements arising under the built-in gain rule.**

CAUTION - BUILT-IN GAIN ON LIQUIDATION OF GRAIN/EQUIPMENT: Built-in gain will be created if the corporation has zero basis grain and/or farm equipment and machinery on hand at the time of the conversion from "C" corporate status to "S" corporate status because these assets will be, or are likely to be, liquidated within the 5-year built-in-gain recognition period. Consider liquidating grain inventories and any farm equipment/machinery likely to be sold within the next 5 years prior to a conversion. Otherwise, the corporation may incur gain at the C corporate rate (currently a flat 21 percent) when these assets are sold.

APPRAISAL OF ASSETS TO DETERMINE NET UNREALIZED BUILT-IN GAIN AT DATE OF "S" CORPORATION CONVERSION: Following an "S" election, the corporation and its shareholders bear the burden of determining what appreciation in fair market

value occurred on subject assets. An appraisal of all corporate assets (farm real estate/improvements, etc.) should be **completed at the "S" corporation conversion date** so that measurement issues with IRS will be avoided if assets are liquidated during the 5-year built-in gain recognition period.

NOTE – TIMING OF CONVERSION: For farm corporations, it is usually best to consider an "S" corporation election after harvest and before planting to avoid any growing crop issues. However, growing crops which will ultimately be sold as inventory during the 5-year recognition period should not constitute separate assets on the conversion date; and, thus, should not be subject to the IRC §1374 built-in gain rules. See: Rev. Rul. 2001-50 (which dealt with timber, coal & iron ore sales during the built-in gain recognition period).

PERMANENT 5-YEAR RECOGNITION PERIOD: The PATH Act of 2015 permanently changed the built-in gain recognition period from 10 years to 5 years. Thus, for tax years beginning after 2014, and for assets held by the "S" corporation as of the beginning of its first tax year, **the recognition period is now the 5-year period beginning with the first day of the first tax year for which the corporation was an "S" corporation.** IRC §1374(d)(7). See discussion regarding prior temporary reductions in the original 10-year built-in gain recognition period below.

TAXATION OF BUILT-IN GAINS: A corporate level tax is imposed by IRC §1374 on any net recognized built-in gain occurring in any taxable year during the 5-year recognition period. The built-in gain tax is **in addition to regular taxation** that would occur upon sale of the asset. As denoted above, the tax is equal to the C corporate rate of 21 percent.

The built-in gains tax applies to any asset carried over from "C" corporate status that is disposed of within the 5-year recognition period. The built-in gain for each asset liquidated is limited to its net unrealized gain (FMV - adjusted tax basis) as measured on the date on which the "S" election takes effect. Any built-in gains tax liability is treated as a reduction in the "S" corporation's taxable income for the year of recognition. IRC §1366(f)(2) & IRC Reg. §1.1366-4(b).

EXAMPLE: Assume that zero basis grain on hand (FMV $200,000) was not liquidated prior to electing a change to "S" corporate status. Upon sale of the grain, the "S" corporation will be required to pay built-in gains tax of $42,000 ($200,000 x 21%). The shareholders will then pay federal and state income taxes on the remaining $158,000 of sale price ($200,000 - $42,000 built-in gains tax). If one assumes a shareholder level federal marginal tax rate of 25% and state marginal tax rate of 8%, the combined tax rate pertaining to the liquidation of the corporation's grain is **47.07%** ($94,140 of the $200,000 sale price).

AUTHOR'S NOTE: For a discussion of Form 1120-S reporting requirements involving built-in gains taxation, see the IRS Instructions for Form 1120-S

NOTE – NOL AND/OR CAPITAL LOSS CARRYOVERS: Recognized built-in gains may be offset by "C" corporate NOL carryovers or capital loss carryovers which had not been used at the date of "S" corporate conversion subject to normal carryover timeframe limitations (i.e. current 20-year carryover for NOLs). IRC §1374(b)(2).

NOTE - SPECIAL RULE (INSTALLMENT SALES): Generally, if an "S" corporation sells built-in gains property within the recognition period and the sale qualifies for the installment method, **the recognition period for that sale continues until the last installment is collected**, even if the collection period extends beyond the corporation's normal 5-year recognition period. IRC Reg. §1.1374-10(b)(4).

TAX PLANNING NOTE: A 2023 installment sale of all remaining "S" corporation assets subject to the built-in gain tax avoids built-in gain taxation for "S" corporate elections effective January 1, 2018 or prior, even for those installment payments deferred to later tax years. The 5-year recognition period would have expired 12/31/22.

ALTERNATIVES TO SALE OF ASSETS WITHIN THE 5-YEAR BUILT-IN GAIN RECOGNITION PERIOD: If shareholders must liquidate some or all of the corporation's property within the 5-year recognition period, the following avoidance alternatives should be considered:

(1) **Sale of corporate stock in lieu of liquidation of assets:** A sale of corporate stock in lieu of liquidation of assets will **not** trigger the built-in gains tax. However, the assets of the corporation would continue to be subject to built-in gains taxation rules for the remainder of the 5-year recognition period and the new purchaser of the stock would be responsible for any built-in gains taxation.

NOTE: A buyer of corporate stock subject to a built-in gains recognition period will likely require a significant discount from fair market value in negotiating the purchase price of the stock.

(2) **Like-kind exchange of property to avoid triggering built-in gain upon liquidation:** Property acquired in a like-kind exchange whose basis is determined, in whole or in part, by reference to the basis of an asset that was held by a "C" corporation when it became an "S" corporation is treated as being held by the corporation at the time of conversion. IRC §1374(d)(6). Thus, real estate subject to the 5-year built-in gain recognition rule can be exchanged for similar "like- kind" real estate without triggering the built-in gain tax (e.g. farm real estate exchanged for apartment building or other urban rental real estate). The exchanged asset will continue to be subject to built-in gains taxation for the remainder of the 5-year recognition period.

(3) **Long-term lease of assets to avoid triggering built-in gain tax on liquidation:** Shareholders may be able to enter into a long-term lease of corporate assets with an option to the buyer for purchase of the assets subsequent to the expiration of the 5-year built-in gain recognition period. If this alternative is being considered, care should be taken in drafting the lease agreement so that it does not constitute a sale for federal income tax purposes and to avoid exposure to various passive income tax problems discussed below.

ALTERNATIVES TO PAYMENT OF BUILT-IN GAINS TAX DURING THE 5-YEAR RECOGNITION PERIOD: Net recognized built-in gain for any taxable year is the **lowest** of the following three amounts:

(1) The total **remaining** net unrealized built-in gain resulting from the "S" corporate conversion;

(2) The amount of **recognized** built-in gain during the taxable year (pre-limitation amount); **and**

(3) The "S" corporate **taxable income for the tax year.**

Thus, if shareholders must liquidate some or all of the corporation's assets within the 5-year built-in gains recognition period, the corporation may still avoid payment of the built-in gains tax if the "S" corporation's taxable income can be reduced to $0 for the year of recognition and each subsequent remaining tax year during the 5-year recognition period. **The tax that would otherwise be paid on net recognized built-in gain is limited to the "S" corporation's taxable income.** IRC §1374(d)(2)(A)(ii).

If the "S" corporation has net recognized built-in gain during a taxable year, steps should be taken to attempt to reduce the "S" corporate taxable income to $0 to defer payment of the built-in gains tax (**e.g. deferral of income; salary**

increases or bonuses; accelerated expenses). Any net recognized built-in gain upon which tax is not paid during a taxable year will carry over to each subsequent taxable year during the 5-year recognition period. Thus, the net recognized built-in gains tax will be paid in a subsequent year unless "S" corporate taxable income can also be lowered to $0 for those tax years. If an "S" corporation's taxable income can be reduced to $0 for each taxable year during the 5-year recognition period, the built-in gains tax that would apply to recognized built-in gains carried over from prior taxable years will be eliminated forever.

EXCEPTION: See discussion for recognized built-in gains under installment sales discussed above.

Once the net recognized built-in gain has been established for a taxable year and the built-in gain tax has been computed, there is a limited ability to offset the tax with any business credit carryforward and/or alternative minimum tax credit that remains available and unused from a "C" corporate tax year. IRC 1374(b)(3). The "S" corporation must observe any limitations (e.g. carryover limitations, etc.) that apply to these two credits. No other credit is available to offset the built-in gains tax (except gas tax credits – Form 4136) for the "S" corporate year. All other credits pass through to "S" corporate shareholders.

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HISTORICAL CONTEXT

NOTE – PRIOR YEAR TEMPORARY REDUCTIONS OF THE 10-YEAR BUILT-IN GAINS TAX RECOGNITION PERIOD – (7 YEARS – 2009/2010) – (5 YEARS – 2011-2014): The American Recovery and Reinvestment Act of 2009 temporarily shortened the original 10-year recognition period for built-in gains to 7 years for tax years beginning in 2009 or 2010 (**calendar or fiscal**). The Small Business Jobs Act of 2010 further shortened the original 10-year recognition period (on a temporary basis) to 5 years **for tax years beginning in 2011 (calendar or fiscal).** Subsequent extender bill legislation extended the 5-year recognition period (on a temporary basis) **for tax years beginning in 2012-2014 (calendar or fiscal), until the PATH Act of 2015 permanently changed the built-in gain recognition period to 5 years for tax years beginning in 2015**. IRC §1374(d)(7).

Thus, for a tax year beginning in 2009 or 2010, no tax was imposed on an "S" corporation's net recognized built-in gain **if the completion of the 7th tax year in the 10-year recognition period preceded the beginning of the current tax year**. Similarly, for a tax year beginning in 2011-2014 no tax was imposed on a "S" corporation's net recognized built-in gain **if the completion of the 5th tax year in the 10-year recognition period preceded the beginning of the current tax year**.

For 2011-2014 these changes effectively terminated the built-in gains recognition period for any "C" to "S" corporate conversions that took place **prior to January 1, 2006.** Otherwise the provisions provided a window of opportunity for "C" corporations that converted to "S" corporate status during the 2006-2009 tax years. For these entities, during 2011-2014, if the 5th anniversary of the "C" to "S" corporate conversion date had been reached **prior to the beginning of the current tax year,** any sales of assets that would otherwise been subject to the built-in gains rules avoided built-in gains taxation for the year of sale. IRC §1374(d)(8).

EXAMPLE: ABC, Ltd., a calendar year taxpayer, elected to convert from a "C" corporation to an "S" corporation on **January 2, 2009.** Since the 5th anniversary of its 10-year recognition period would **not** have expired by the start of its 2014 calendar year, ABC, Ltd. would be subject to built-in gains taxation for any sale in 2014.

If the "C" to "S" corporate conversion had been made effective January 1, 2009, the 5th year of the corporation's recognition period **would have expired on December 31, 2013 and any 2014 sales would not be subject to built-in gains taxation.**

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PROBLEM -- RETENTION OF "C" CORPORATION EARNINGS & PROFITS

(A) ACCUMULATED EARNINGS PENALTY (GREATER THAN $250,000 "C" CORPORATION EARNINGS & PROFITS): A corporation may be liable for an accumulated earnings penalty tax if the IRS determines that the corporation is preventing the imposition of income tax upon shareholders by permitting old profits to accumulate instead of being distributed. IRC §532. Prior to 2003, the penalty tax imposed on improper accumulations was 38.6% of "accumulated taxable income" (the highest federal individual tax rate imposed). Effective for tax years beginning after 2002 through December 31, 2012, the accumulated earnings penalty tax rate was reduced to 15% of "accumulated taxable income". This reduction was due to the maximum tax rate for qualified dividends being reduced to 15% under the 2003 Tax Act. **Since the maximum tax rate for qualified dividends was increased to 20% for tax years beginning after December 31, 2012 by the American Taxpayer Relief Act of 2012 (ATRA), the accumulated earnings penalty tax rate has also been increased to 20% for tax years beginning after December 31, 2012.**

NOTE: An underpayment of accumulated earnings tax may be subject to negligence penalties. Rev. Rul. 75-330. Interest would be imposed on an accumulated earnings tax underpayment from the due date of the corporation's tax return, determined without regard to extensions. IRC §6601(b)(4).

ACCUMULATED EARNINGS CREDIT: A minimum amount of accumulated earnings and profits **($250,000 ($150,000 for personal service corporations))** is allowable before a corporation can be subject to the accumulated earnings tax penalty. IRC §535(c).

If a corporation's accumulated earnings and profits exceed $250,000, care should be taken in drafting annual minutes for the corporation to specify the various corporate business purposes for which earnings are being retained and not paid out as dividends. A corporation may retain earnings and profits for repayment of debt (non-shareholder loans), expansion of business (purchase of additional farm real estate, grain storage facilities), working capital needs, etc.). IRC Reg. §1.537-1(b)(1) states that the corporation must have **specific, definite and feasible plans** for the use of accumulated earnings and profits.

> **EXAMPLE MINUTES:** A discussion followed as to whether it would be appropriate for the corporation to consider declaring a cash dividend to the shareholders at this time. The President stated that it would not be wise for the Board of Directors to declare a dividend at this time as the corporation anticipated acquiring an additional 80 acres of farm real estate in the near future and the majority of available cash proceeds would be needed for this acquisition.

While the corporation in our example does not have accumulated earnings and profits in excess of the $250,000 threshold, the retention of earnings and profits may cause havoc if the corporation has significant passive income, as discussed below.

(B) PASSIVE INCOME/RETENTION OF "S" CORPORATE STATUS: An "S" corporation that has previously been a "C" corporation **and** has "C" corporate earnings and profits is only eligible to retain "S" corporate status for **three years** if more than 25% of its gross receipts are from passive sources (**cash rent**, interest, etc.). IRC §1362(d)(3). If the corporation were to rent all farmland it owned under a cash rental arrangement, virtually 100% of corporate income would be derived from "passive" income sources. The corporation would be in danger of losing its "S" corporate status (reverts back to a "C" corporation again) immediately at the **end of the third taxable year** in which this condition existed following the "S" corporate election.

(C) PASSIVE NET INCOME/FEDERAL "STING" TAX: Even though the corporation could utilize a cash rental lease arrangement for a limited time after making an "S" election and avoid losing its "S" status, **a "sting" tax at the highest corporate rate (currently 21%) is imposed on any "excess net" passive income in the meantime if the corporation has "C" corporate earnings and profits at the end of the taxable year and greater than 25% of its gross receipts are from passive income.** IRC §1375. Since the corporation in our example currently has "C" corporate earnings and profits, if the shareholders wish to cash rent corporate farmland after the "S" election is made, they can only avoid the "sting" tax in one of the following ways:

(1) **Avoid reporting any "excess net" passive income.** This can be accomplished only if the corporation is able to **prepay sufficient farm expenses** to offset all passive investment income (as defined by IRC §1362(d)(3)(C)) **and/or** create negative "net" passive income.

(2) **Distribute all accumulated "C" corporate earnings and profits to shareholders prior to the end of the first "S" corporate year-end.** IRC §1375(a)(1). **NOTE: Tax rate on qualified dividends is 0%/15%/20% for tax years beginning after 12-31-12.** In order to make a distribution of accumulated "C" corporation earnings and profits, the "S" corporation, with the consent of all of its shareholders, must elect under IRC §1368(e)(3) to treat these distributions as taxable dividends to the corporation's shareholders.

DEEMED DIVIDEND ELECTION: If the corporation did **not** have sufficient cash to pay out the entire accumulated "C" corporation earnings and profits, the corporation may make a deemed dividend election under IRC Reg. §1.1368-1(f)(3). Under this election, the corporation can be treated as having distributed all of its accumulated "C" corporate earnings and profits to the shareholders as of the **last day of its taxable year.** The shareholders, in turn, are deemed to have contributed the amount back to the corporation **in a manner that increases stock basis.** With the increased stock basis, the shareholders will be able to extract these proceeds in future years without additional taxation, as "S" corporate cash flow permits. **NOTE: The consent of all affected shareholders is also required to make this election.**

The election for a deemed dividend is made by attaching an election statement to the "S" corporation's **timely filed original or amended** Form 1120S. The election must state that the corporation is electing to make a deemed dividend under Reg. §1.1368-1(f)(3). Each shareholder who is deemed to receive a distribution during the tax year must consent to the election. Furthermore, the election must include the amount of the deemed dividend that is distributed to each shareholder. IRC Reg. §1.1368-1(f)(5). **See election forms following.**

DISCUSSION NOTE: "S" corporation distributions are normally taxed to the shareholders as an ordinary income dividends to the extent of accumulated earnings and profits (AE&P) after the accumulated adjustments account (AAA) and previously taxed income (PTI -- pre-1983 "S" corporation undistributed earnings) have been distributed. **Deemed dividends issued proportionately to all shareholders are not subject to one-class-of-stock issues and do not require payments of principal or interest.**

NAME(S):	TIN:

DIVIDEND ELECTION -- ELECTION TO TREAT CURRENT TAX YEAR DISTRIBUTIONS AS BEING FROM ACCUMULATED "C" CORPORATION RETAINED EARNINGS PURSUANT TO IRC §1368(e)(3) AND REG. §1.1368-1(f)(2)(i)

The corporation hereby elects under IRC §1368(e)(3) and Reg. §1.1368-1(f)(2)(i) to treat **all** current tax year distributions as being from accumulated "C" corporation retained earnings and not from the accumulated adjustments account (AAA) of the corporation. It is understood that this election is irrevocable when made and is only effective for the current tax year.

CONSENT OF AFFECTED SHAREHOLDERS

The undersigned shareholders comprise all of the shareholders of the above corporation to whom a distribution was made during the current taxable year. The undersigned hereby consent to the corporation election under IRC §1368(e)(3) and Reg. §1.1368-1(f)(2)(i) to treat all current tax year distributions as being from accumulated "C" corporation retained earnings and not from the accumulated adjustments account (AAA) of the corporation.

The undersigned hereby certify, under penalties of perjury, that to the best of their knowledge and belief the statements contained herein are true and correct.

SIGNATURE	ADDRESS	SSN

NOTE: "S" corporation distributions are normally taxed to the shareholders as an ordinary income dividends to the extent of accumulated earnings and profits (AE&P) after the accumulated adjustments account (AAA) and previously taxed income (PTI -- pre-1983 "S" corporation undistributed earnings) have been distributed. **If the corporation became a "S" corporation prior to 1983, a separate election will need to be made to avoid having the distributions herein treated as first coming from previously taxed income (PTI) to the extent thereof.**

FILING: **File with original Form 1120-S for the year during which distributions were made.**

(Revised 11/23)

NAME(S):	TIN:

DEEMED DIVIDEND ELECTION -- ELECTION TO TREAT PART OR ALL OF ACCUMULATED "C" CORPORATION RETAINED EARNINGS AS DISTRIBUTED DURING THE CURRENT TAX YEAR PURSUANT TO IRC §1368(e)(3) AND REG. §1.1368-1(f)(3)

The corporation hereby elects under IRC §1368(e)(3) and Reg. §1.1368-1(f)(3) to treat part or all of accumulated "C" corporation retained earnings as deemed distributed during the current tax year. It is understood that under this election the deemed dividend is considered to have been distributed in cash to the shareholders, in proportion to their stock ownership, on the last day of the tax year. Upon receipt, the shareholders are deemed to have immediately contributed the cash back to the corporation in a manner that increases stock basis. It is understood that this election is irrevocable when made.

CONSENT OF AFFECTED SHAREHOLDERS

The undersigned shareholders comprise all of the shareholders of the above corporation to whom a distribution was deemed made during the current taxable year. The undersigned hereby consent to the corporation election under IRC §1368(e)(3) and Reg. §1.1368-1(f)(3) to treat part or all of accumulated "C" corporation retained earnings as deemed distributed during the current tax year.

The undersigned hereby certify, under penalties of perjury, that to the best of their knowledge and belief the statements contained herein are true and correct.

SIGNATURE	ADDRESS	SSN	DIVIDEND AMOUNT

NOTE: "S" corporation distributions are normally taxed to the shareholders as an ordinary income dividends to the extent of accumulated earnings and profits (AE&P) after the accumulated adjustments account (AAA) and previously taxed income (PTI -- pre-1983 "S" corporation undistributed earnings) have been distributed. **If the corporation became a "S" corporation prior to 1983, a separate election will need to be made to avoid having the distributions herein treated as first coming from previously taxed income (PTI) to the extent thereof.**

FILING: **File with original Form 1120S for the year during which distributions were made.**

(Revised 11/23)

RETENTION OF "C" CORPORATION EARNINGS & PROFITS
(TAX PLANNING ALTERNATIVES)

ALTERNATIVE RECOMMENDATION -- CROP SHARE LEASE: Internal Revenue Code regulations provide that rents will not constitute passive investment income if the "S" corporation **provides significant services or incurs substantial costs in conjunction with rental activities.** Whether significant services are performed or substantial costs are incurred is a **facts and circumstances determination.** IRC Reg. §1.1362-2(c)(5)(ii)(B)(2). The significant services test can be met by entering into a lease format (generally crop-share) that requires **significant management involvement** by the corporate officers with regard to crop production decision-making (e.g. what/where to plant and timing thereof, tillage methods, type of seed, fall fertilization practices, chemical application, etc.).

NET-CROP SHARE LEASE: The corporation may wish to consider entering into a "net" crop share lease (while retaining significant management decision-making authority) upon making the "S" corporate election, as an alternative to a cash rent lease or a 50/50 crop share lease. Some form of bonus bushel clause is usually added to a "net" crop share lease in case a bumper crop is experienced, or high crop sale prices result within a particular crop year. "Net" crop leases in the Midwest, for example, normally provide the landlord with approximately 30% to 33% of the corn and 38% to 40% of the beans grown on the subject real estate.

Since crop share income is generally **not** considered "passive" (if the significant management involvement test can be met), a "net" crop share lease should allow the corporation to limit involvement in the farming operation and avoid passive investment income traps unless the corporation has significant passive investment income from other sources (interest, dividends, etc.) such that passive investment income still exceeds 25% of gross receipts.

NOTE -- "C" CORPORATION EARNINGS AND PROFITS: Corporate shareholders will always have to deal with the problem of income tax liability that will be incurred upon the distribution of "C" corporate earnings and profits unless the corporation is liquidated. Generally, distributions of "C" corporate earnings and profits should occur when income taxation to the shareholders can be minimized.

For 2013 and after, high income taxpayers experienced an increase in their effective tax rate for qualified dividends from 15% to 23.8%. A 20% tax rate now applies for qualified dividends if AGI is greater than (for 2023) $553,850 (MFJ), $492,300 (single), $523,050 (HOH) and $276,900 (MFS). In addition, the 3.8% Medicare surtax on net investment income (NIIT) applies to qualified dividends if AGI exceeds $250,000 (MFJ) and $200,000 (single/HOH). However, if accumulated "C" corporate earnings and profits can be distributed while minimizing shareholder tax rates (keeping total AGI below the net investment income tax (NIIT) thresholds and avoiding AMT) this may be a good time to make these distributions.

TAX PLANNING NOTE. The 2017 tax legislation commonly known as the "Tax Cut and Jobs Act" (TCJA) repealed the prior corporate alternative minimum tax (Former AMT) for tax years beginning after December 31, 2017. However, the "Inflation Reduction Act" of 2022 created the CAMT, which imposes a 15% minimum tax on the adjusted financial statement income (AFSI) of large corporations for taxable years beginning after Dec. 31, 2022. The CAMT generally applies to large corporations with average annual financial statement income exceeding $1 billion. The IRS will waive the penalty for a corporation's estimated income tax with respect to its CAMT for a tax year that begins after December 31, 2022, and before January 1, 2024. IRS Notice 2023-64.

CAUTION - TAXATION OF SOCIAL SECURITY BENEFITS: Be sure to consider the effect distribution of these earnings and profits will have upon the taxability of social security benefits for older shareholders, etc.

TAX PLANNING - GIFTING: Gifts of stock to children or grandchildren could be

considered so that dividends paid are taxed to those in lower tax brackets. However, tax benefits may be negated for children and grandchildren up to the age of 18-23 (for 2008 and after) if they receive sufficient dividends to cause the "kiddie" tax rules to be invoked.

IRC §303 STOCK REDEMPTIONS: A corporation may redeem a portion of the stock held by a deceased shareholder and treat such redemption as a capital gain redemption to the extent that **the amount of the redemption does not exceed the sum of estate taxes, inheritance taxes and the amount of administration expenses of the estate.** The capital gain reported is usually small or non-existent due to step-up in basis of a shareholder's stock at date of death.

NOTE: IRC §303 does **not** operate any differently with an "S" corporation than a "C" corporation.

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POSSIBLE PROBLEM -- "S" CORPORATE STATUS BY QSST TRUST

Once "S" corporate status has been elected, this classification can only be retained by a corporation having appropriate shareholders. After the death of the first spouse, the portion of corporate stock held by a by-pass trust could **only qualify** as an acceptable "S" corporate shareholder if the Trust met the definition of a QSST trust (Qualified Subchapter "S" Trust), as follows:

(1) All of the trust's income be either distributed or required to be distributed currently to **only one beneficiary** who is a citizen or resident of the United States;

(2) During the life of the current income beneficiary, there can be only **one** income beneficiary;

(3) Corpus distributions during the current income beneficiary's life can only be made to that beneficiary;

(4) The current income beneficiary's income interest must terminate on the earliest of the current beneficiary's death, or the termination of the trust; **and**

(5) If the trust terminates during the current income beneficiary's life, the trust assets are all distributed to the current income beneficiary. IRC §1361(d)(3) & (4).

Since the Trust, in our example, does meet the definition of a QSST an appropriate "S" corporate election under IRC §1361(d)(2) should be made. **See election form following.**

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TO: Internal Revenue Service
Ogden, Utah 84201-0013

RE: _____
TIN: _____

ELECTION TO TREAT QUALIFIED SUBCHAPTER S TRUST (QSST) AS AN ELIGIBLE SUBCHAPTER S SHAREHOLDER PURSUANT TO INTERNAL REVENUE CODE §1361(d)(2) AND REG. §1.1361-1(j)(6)

The undersigned hereby elects to have the _____ Trust treated as a Qualified Subchapter S Trust (QSST) for purposes of eligibility as a Subchapter S Shareholder pursuant to IRC §1361(c)(2). The undersigned also elects to be treated as the owner of the portion of said Trust that consists of the S corporation stock for purposes of IRC §678.

The undersigned states that the Trust meets the definition of a qualified subchapter S trust as the terms of the Trust provide that (1) during the life of the current income beneficiary, there shall be only one income beneficiary of the trust; (2) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary; (3) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust; and (4) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary. The undersigned is a citizen and/or resident of the United States.

In addition, the undersigned states that (1) the Trust is required to distribute (or the Trustee agrees to distribute) all of its income currently to the current income beneficiary; and (2) that no distributions of income or corpus will be in satisfaction of the grantor's legal obligations to support and maintain the income beneficiary.

The taxpayer understands that this election, once made, shall be irrevocable.

CURRENT INCOME BENEFICIARY INFORMATION

NAME	ADDRESS	SSN

TRUST INFORMATION

NAME	ADDRESS	SSN

SUBCHAPTER S CORPORATE INFORMATION

NAME	ADDRESS	SSN

The effective date of this election is the ____ day of _____, 202___.

_____
(Current Income Beneficiary)

Note: This election may not be filed any earlier than 2 months and 15 days before the effective date of the "S" corporate election; and no later than 2 months and 16 days from the date the stock is transferred to the Trust. This election form is mailed to IRS by separate mail. For late elections, generally follow the procedures outlined in Rev. Proc. 2003-43 and/or Rev. Proc. 2007-62.

Note: This election shall be effective for each successive beneficiary unless such beneficiary affirmatively refuses to consent to such election by filing such refusal with the Service Center with which the corporation files its income tax return pursuant to IRC Reg. §1.1361-1(j)(9).

(Revised 11/23)

ISSUE - (TIMING) WHEN TO LIQUIDATE THE "S" CORPORATION

If one ignores the "C" corporate earnings and profits issue, taxation **will generally be minimized** by waiting to liquidate until **the later of (1) the death of the shareholder(s); or (2) the expiration of the 5-year built-in gain period.**

At death, a decedent's stock ownership interest generally receives a step-up in basis to fair market value. This basis adjustment coupled with the basis increase that results from gain recognition inside the corporation upon liquidation of corporate assets (e.g. sale/distribution of assets, real estate, etc.) and the pass-through of the taxation of this gain to the shareholder (on Schedule K-1), results in only one level of taxation being incurred on liquidation (shareholder level). Since stock basis has been increased by death and pass-through of income, **no actual realization of gain results when cash or property is distributed to the decedent's estate/heirs (in exchange for stock) to complete the liquidation**, since the pass-through gain (Schedule K-1) to the estate/heirs will be offset by a matching loss from liquidation of the stock.

CAUTION IRC §1239 – ORDINARY INCOME TREATMENT: IRC §1239 was enacted to put an end to the practice of selling or exchanging depreciable assets to a controlled corporation in order to establish a higher depreciation basis at the expense of the capital gain provisions. **Accordingly, IRC §1239 requires ordinary income treatment of any gain recognized from the sale or exchange of property, directly or indirectly, between related persons, if the property is of a character subject to depreciation in the hands of the transferee.**

NOTE: Property of a character subject to the allowance for depreciation includes amortization of IRC §197 intangibles. IRC §197(f)(7).

Related persons for purposes of IRC §1239 include the following:

- A person and all entities which are controlled entities with respect to such person (i.e. the individual directly or indirectly owns more than 50% of the value of the outstanding stock of the corporation);
- A taxpayer and any trust in which such taxpayer is a beneficiary, unless such beneficiary's interest in the trust is a remote contingent interest; and
- Except in the case of a **sale or exchange** in satisfaction of a pecuniary bequest, **an executor of an estate and a beneficiary of such estate. For this purpose, related beneficiaries would include those individuals defined as related parties under IRC §267(c)(4).**

Under IRC §1239, when depreciable property is involved in a liquidation (tile, grain bins, farm buildings, etc.), a shareholder who is a related party to the liquidating corporation will realize ordinary income upon sale or exchange to the extent of any depreciation recapture.

TAX RESULT: If the assets of a corporation are being liquidated upon the death of a decedent (or at any other time when related parties are involved), ordinary income will be realized and recognized upon sale or exchange of certain depreciable property. This ordinary income will **not** be completely offset by a Schedule D capital loss recognized upon the liquidation of corporate stock.

NOTE: See example liquidation comparison computations for "C" and "S" corporations that follow this section when no depreciable property is involved.

TAX PROBLEM -- Distributions of Property in Liquidation of Deceased Shareholder's "S" Corporation Stock When Corporation Had More Than One Shareholder:
Distributions of property (other than cash) are treated as though the corporation sold the property to the shareholder for its fair market value, pursuant to IRC §311(b). The corporation recognizes gain to the extent the property's fair market

value exceeds its adjusted basis. When appreciated property is distributed to an "S" corporate shareholder in exchange for stock, the gain recognized at the corporate level passes through to **all** shareholders (via Schedule K-1) based on their percentage ownership in the corporation.

If the "S" corporation **only** had **one shareholder** whose interest is liquidated at death, gain recognition does not cause taxation problems due to a matching loss offset resulting from the stock basis adjustments discussed above. However, if the "S" corporation has **more than one shareholder**, a distribution of property to a single shareholder (deceased or otherwise) in liquidation of their stock interest will result in a taxation event for **all** corporate shareholders.

> **EXAMPLE:** Assume Farm Corp. has four equal shareholders. Mary, a shareholder who owns 25% of the "S" corporation's stock dies. The corporation distributes farm real estate to Mary's estate in liquidation of her stock interest. Mary's estate would report 25% of any gain at distribution and would be able to offset this taxable gain through a matching capital loss created by the liquidation of her stock in Farm Corp. **Unfortunately, the other shareholders would be responsible for paying tax on the remaining 75% of any gain.**
>
> An alternative to avoid this taxation problem when there are multiple shareholders in an "S "corporation is to simply have the remaining shareholders purchase the stock of the deceased shareholder. Implementing a corporate **buy-sell agreement** among the shareholders might be advantageous to accomplish the desired result.

FURTHER TAX PROBLEM – NEW CAPITAL GAINS HOLDING PERIOD FOR PROPERTY DISTRIBUTED PURSUANT TO A STOCK REDEMPTION: A shareholder's income tax basis in property distributed to him or her by the corporation is the property's fair market value at the date of distribution. **Unfortunately, the distributee shareholder's holding period begins when the shareholder actually or constructively receives the property**, because the distribution is treated as if the property were sold to the shareholder at its fair market value on that date. Since the shareholder's basis in the property is its fair market value (rather than a carryover of the corporation's basis), the corporation's **holding period does not tack** on to the shareholder's holding period. Thus, the redeeming shareholder would need to hold distributed property for 12 months (1 year) after distribution prior to sale to achieve capital gain income tax treatment on a subsequent sale.

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ALTERNATIVE TO LIQUIDATION – DIVISIVE REORGANIZATION: An alternative to liquidating the "S" corporation at the death of the surviving spouse is a divisive reorganization under IRC §355. In a divisive reorganization, part of the assets of a parent corporation are split-off to one or more (former) shareholders through a new corporation. A divisive reorganization typically involves three major steps:

(1) Formation of a new corporation (functions like a subsidiary);

(2) Transfer of part of the parent corporation's assets to the subsidiary (usually tax-free); **and**

(3) Distribution of the stock in the subsidiary to some of the parent corporation's shareholders in exchange for their stock in the parent corporation.

A divisive reorganization can be used to divide a single, functionally integrated business (e.g. farming operation) into two separate businesses and will allow surviving shareholders to postpone income recognition that would otherwise occur through corporate liquidation at the death of the first generation shareholders.

IRC Regs. §§1.355-1(b) & 1.355-3(c), Examples 4 & 5. See also, Rev. Rul. 75-160, 1975-1 CB 112; Coady v. Commissioner, 33 T.C. 771 (1960, acq., 1965-2 C.B. 4, nonacq., 1960-2 C.B. 8 (withdrawn), aff'd, 289 F.2d 490 (6th Cir. 1961); United States v. Marett, 325 F.2d 28 (5th Cir. 1963).

For a divisive reorganization to be tax-free, five tests under IRC §355 must be met: (1) control test; (2) "active conduct of a business" test; (3) distribution of "solely stock or securities"; (4) parent corporation must distribute all of the stock in the subsidiary (or enough for control); and (5) reorganization must not be used "primarily as a device for distribution of earnings and profits." However, there are only two tests/requisites that generally create issues which prevent consideration of this planning alternative. The two problematic requisites/tests restated are as follows:

(1) **Active conduct of trade or business requirement (5-years pre- distribution; 2 or more years post-distribution); and**

(2) **Trade or business purpose requirement.**

Note: There is no specified timeframe in either the statute or the regulations during which the active business requirement must be satisfied post-distribution. At least two-years is recommended to be able to satisfy the IRS that an active business has been conducted.

ACTIVE CONDUCT OF TRADE OR BUSINESS
(5-YEAR PRE-DISTRIBUTION/2 OR MORE YEAR POST-DISTRIBUTION)

For purposes of IRC §355, a trade or business must have been actively conducted by the distributing parent corporation **throughout the 5-year period** ending on the date of distribution. The regulations under IRC §355 expand this requirement and require continued operation of the business or businesses existing prior to the implementation of the divisive reorganization. Accordingly, a transitory continuation of one of the active businesses would not satisfy the active trade or business test provided by these regulations. IRC §355(b)(1)(A) and Regs. §1.355-3(a)(1).

EXAMPLES: The holding of stock and securities for investment purposes will **not** constitute the active conduct of a trade or business. **Also, the ownership and rental of real or personal property (e.g. farm real estate) will not constitute the active conduct of a trade or business unless the owner performs significant services with respect to the operation and management of the property. IRC Regs. §1.355-3(b)(2)(iv).**

See Rev. Rul. 73-234 and Rev. Rul. 86-126, for corporate farming examples where the active conduct of a trade or business was met (Rev. Rul. 73-234) and not met (Rev. Rul. 86-126).

Rev. Rul. 73-234, 1973-2 C.B 180: (Livestock share lease with active involvement) – "the fact that a portion of a corporation's business activities is performed by independent contractors will not preclude the corporation from being engaged in the active conduct of a trade or business if the corporation itself directly performs active and substantial management and operational functions".

Rev. Rul. 86-126, 1986-2 C.B 58: Corporation cash rented farmland, with sharing of expenses, to tenant who planted, raised, harvested and sold crops using tenant's equipment. Activities of corporate officers in leasing land, providing advice and reviewing accounts **not** substantial enough to meet active business requirement.

Observations from the Rulings:

1. In Revenue Ruling 86-126, the corporation, through its officers, occasionally inspected the farmland and decided which parcels of land to lease each year. The corporation also consulted with the tenant farmers regarding herbicides, insecticides, and fertilizer, as well as when to sell the crops. According to the Service, this activity is not enough to meet the "substantial managerial and operational activities" standard set forth in Revenue Ruling 73-234.

2. The Service found that the following factors set forth in Revenue Ruling 73-234 were lacking in Revenue Ruling 86-126: hiring seasonal workers; (2) supplying and maintaining equipment; (3) arranging financing; (4) planning crop rotation, planting and harvesting; (5) selling crops; and (6) accounting to the tenant farmers.
3. The Service held that it was the lack of these factors which distinguished the two rulings from each other.

4. Whether the taxpayer in Revenue Ruling 86-126 was any less involved in planning crop rotation and planting than the taxpayer in Revenue Ruling 73-234 is unclear.

5. In Revenue Ruling 86-126, the taxpayer took into consideration the soil conservation needs of the land, as well as market conditions and federal programs in determining which parcels to lease. The degree of involvement in planning crop rotation and planting by the taxpayers in the two rulings is not addressed.

NOTE: It does **not** appear that the use of a farm manager (agent) to perform these services for the corporation necessarily impairs the active conduct of a trade or business requirement. Webster Corp., 25 T.C. 55 (1955), acq. 1960-2 Cum. Bull. 7, aff'd 240 F 2d 164 (2nd Circ. 1957). **However, the officers and directors must be active in directing the activities of the agent, not mere spectators.** Also, merely leasing land under a crop-share lease will not be treated as an active business under IRC §355 unless it is demonstrated that more than a moderate degree of involvement in managerial decisions relating to the farm or ranch is required and has occurred.

A corporation engaged in a crop-share arrangement with tenant farmers should structure the arrangement so that the corporation provides financing. Security agreements, letters of credit, and loan guarantees could be used to provide the corporation a high level of assurance that the tenant farmer will ultimately pay his or her share of the expense associated with operating the farm.

Hiring seasonal workers was another factor the Service cited in distinguishing Revenue Ruling 72-234 from Revenue Ruling 86-126. Corporations contemplating a corporate split-off should attempt to hire seasonal workers, or at least be involved in the selection of seasonal workers.

The selling of crops and accounting for the proceeds should be done by the corporation rather than the tenant farmers. The Service apparently distinguishes an enterprise meeting the active trade or business requirement in I.R.C. §355 from an enterprise falling short of that requirement at least in part by who sells the product and who does the accounting.

A corporation engaged in farming under a crop-share arrangement should contract to sell the crops produced.

According to the Service, consultation with the tenant farmer regarding if and when to sell the crop is acceptable, but the actual sale of the crops should be done by the corporation to strengthen the corporation's claim that its farming business is "actively" conducted.

For the same reason, the responsibility of accounting for the operation should

be borne by the corporation rather than the tenant farmer.

Supplying and maintaining equipment used in the farm or ranch operation is a factor considered by the Service to be relevant in assessing the taxpayer's level of involvement in the business activity.

Unlike the question of who provides the accounting or who actually sells the crops, the question of who provides the equipment is not one to which the answer is easily manipulated.

The decision to purchase or lease agricultural equipment is not usually based on a desire to satisfy the complex rules relating to corporate separations.

It is unclear whether failing to use the corporation's equipment is an insurmountable obstacle on the path to a tax-free corporate split-off.

Revenue Ruling 86-126 does not single out the use of the corporation's own equipment as the critical or deciding factor in the determination of whether the corporation is carrying on "substantial operational and managerial activities."

It is simply one of several factors used to distinguish Revenue Ruling 73-234 from Revenue Ruling 86-126.

On the other hand, common sense suggests that in a business dependent on the use of significant machinery and equipment, using one's own equipment (or leased equipment) would be an important factor in assessing the level of involvement in the operational activities of the business.

However, the relatively recent popularity of the use of third parties in harvesting crops by farmers who are unquestionably substantially involved in the management and operational activities of the farm may render this factor less important than it has been previously.

A corporation contemplating a separation of its business should consider structuring its crop share agreements to make use of its farm equipment on the leased ground.

A corporation without equipment or one that is unable to use its equipment in a crop-share arrangement should attempt to structure the arrangement so that all the other factors listed in Revenue Ruling 73-234 are met.

CAUTION - TAX PLANNING: The corporation's officers and directors activities for the pre-distribution (5 yr.) and post-distribution (2 or more yr.) time frames should be well documented before a divisive reorganization is undertaken. Also, officers/directors should be paid reasonable salaries for services performed.

TRADE OR BUSINESS PURPOSE:

IRC Regs. §1.355-2(b)(2) provides that a **corporate business purpose** must be a real and substantial non-federal tax purpose germane to the business of the distributing corporation, as well as, the controlled corporation. A **shareholder purpose** (e.g. accomplishing personal estate planning objectives) by itself, is **not** a corporate business purpose. However, the regulations go on to explain that a shareholder purpose may be so nearly co-extensive with a corporate business purpose as to preclude any distinction between them, in which case the transaction meets the corporate business purpose requirement. **A transaction motivated in substantial part by a corporate business purpose will not fail the business purpose requirement merely because it is motivated in part by non-federal tax shareholder purposes.**

Within this guidance, the business purpose test generally is readily ascertainable (e.g. shareholder disputes or potential therefore, etc.). See examples below.

EXAMPLES: **Rev. Rul. 2003-52,** involved a family farming corporation owned by a father, mother and their two adult children, with active operation and management largely conducted by the two adult children. One child intended to focus on the livestock aspect of the corporate business; the other preferred to operate the grain farming enterprise. To allow each to devote their full attention to a single business strategy, the corporation reorganized into two corporations, with the son receiving the stock of the livestock business and the daughter receiving the stock of the grain enterprise. **The IRS approved the reorganization taking the position that it was motivated by substantial non-tax business reasons even though the reorganization advanced the personal estate planning goals of the mother and father and promoted family harmony.**

PLR 200323041 (3-11-03): (Separation of grain farming business (land, etc.) between brother and sister following father's death). A corporate split-off undertaken to avoid shareholder disputes in a family-owned grain farming corporation (engaged in a single line of business) will constitute an IRC §368(a)(1)(D) reorganization and the stockholders of the split-off corporation will **not** recognize gain or loss pursuant to IRC §355.

PLR 200425033 (3-4-04): Split-offs designed to resolve shareholder disputes having adverse effect on corporation's business.

PLR 200422040 (2-13-04): Family owned "S" corporation split-off to avoid disputes and accomplish parental estate planning.

LTR 201219003 (2-3-12): Related party "S" corporation (two (2) shareholders) split-off to avoid future management disputes between shareholders and among their family members and prolong life of corporation.

LTR 201402002 (1-10-14): Single business "S" corporation (4 equal shareholders) equal split-off into 4 separate corporations to allow each shareholder to independently own and manage a separate business according to his/her own goals and priorities.

NOTE: The IRS has ruled that the post-distribution business purpose requirement of IRC Reg. 1.355-2(b) remained satisfied even though the business purpose could not be achieved due to an unexpected change in circumstances following the divisive reorganization. In so ruling, the IRS noted that the "regulations do not require that the corporation in fact succeed in meeting its corporate business purpose, as long as, at the time of the distribution, such a purpose exists and motivates, in whole or substantial part, the distribution." **Rev. Rul. 2003-55.**

OTHER CONSIDERATIONS

NOTE – DE MINIMUS RULE - (LESS THAN 5% NONQUALIFYING ASSETS): While IRC §355 requires that the corporation seeking a divisive reorganization be engaged in the active conduct of a trade or business it does not require that all of the assets of the corporation be devoted to or used in an active trade or business. The corporation may hold non-qualifying assets (generally less than 5% of total – hunting cabin, etc.) as long as it is engaged in the active conduct of a trade or business. IRC Reg. §1.355-(3)(a)(ii).

TAX/BUSINESS PLANNING RECOMMENDATION – INDEMNITY AGREEMENT: It may be advisable to have the various shareholders enter into an agreement providing that any shareholder who violates the post-distribution active trade or business rule agrees to pay **all** taxes incurred by all shareholders if the divisive reorganization fails to pass IRS scrutiny.

CAPITALIZATION OF REORGANIZATION COSTS: Courts have regularly held that amounts incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses under IRC

§162(a) but rather capital expenditures under IRC §263(a). Thus, costs incurred to facilitate tax-free corporate reorganizations under IRC §368 are generally required to be capitalized. IRC Reg. §1.263(a)-5(a)(4).

NOTE – ADVANCE IRS RULINGS: In Rev. Proc. 2003-48 the IRS stated that, for ruling requests after 8/8/03, it would no longer rule on whether (1) a distribution of stock of a controlled corporation is carried out for business purposes, (2) the transaction is used principally as a device, or (3) a distribution and an acquisition are part of a plan under IRS §355(e). In Rev. Proc. 2013-32, the IRS announced a change in its letter ruling policy for the tax-free treatment of corporate spin-offs, reorganizations, and other nonrecognition transactions. For transactions submitted after August 23, 2013, the IRS would no longer issue so-called "comfort rulings" on whether transactions qualify for nonrecognition treatment under IRC §355 or on whether transactions constitute a reorganization within the meaning of IRC §368, regardless of whether the transaction presents a significant issue or is part of a larger transaction that involves issues upon which the IRS could rule.

However, the IRS further explained that it would rule on one or more issues, under the "nonrecognition provisions", that it determined to be "significant." The IRS defined a "significant issue" as an issue of law, the resolution of which was not essentially free from doubt and that is germane to determining the tax consequences of the transaction. The IRS also decided that it would restrict its rulings to tax consequences that result from application of the nonrecognition provisions to the extent that a significant issue was presented under a related IRC provision that addresses such tax consequences.

Recently, in Rev. Proc. 2016-45, the IRS announced that it would change its "no-rule" position regarding the first two issues above, namely:

a. The corporate business purpose requirement under Reg. 1.355-2(b); **and**

b. Whether a transaction is used principally as a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation, or both under §355(a)(1)(B) and Reg. §1.355-2(d).

The IRS noted that the policy change was only for significant legal issues and not for issues that are inherently factual in nature.

However, the IRS did not modify Section 3.01(50) of Rev. Proc. 2016-3 and will still not rule on whether the entire transaction qualifies for nonrecognition treatment under I.R.C. §355.

With Rev. Proc. 2016-3 in effect, taxpayers are unable to obtain a ruling on whether a Type D tax-free split-off reorganizations under I.R.C. §368(a)(1)(D) will receive nonrecognition treatment. Instead, if a transaction is challenged by the IRS, a taxpayer must document in detail how it meets all the requirements of a split-off reorganization, including the control requirement, establishing that the transaction is not a device to distribute earnings and profits, and the active trade or business requirement, among others.

In Rev. Rul. 2019-9, IRS suspended Rev. Rul. 57-464 and Rev. Rul. 57-492, pending completion of a study. The study IRS is conducting is to determine for purposes of IRC §355 whether a business can qualify as an active trade or business if entrepreneurial activities, as opposed to investment or other non-business activities, take place with the purpose of earning income in the future, but no income has yet been collected. IRS says that the active trade or business requirement analysis underlying the holdings in Rev. Rul. 57-464 and Rev. Rul. 57-492 focuses, in significant part, on the lack of income generated by the activities under consideration. Consequently, these rulings could be interpreted as requiring income generation for a business to qualify as an active trade or business.

TAX CONSEQUENCES OF CORPORATE LIQUIDATIONS

The following are numerical examples of the tax cost difference between the current liquidation of a "C" corporation versus current liquidation of an "S" corporation versus liquidation of an "S" corporation following the death of a shareholder.

The liquidation of a corporation is a taxable event, at **both** the corporation and shareholder levels. The same general rules apply to both C and S corporations, although the incidence of tax may be quite different due to **double taxation** on C corporation distributions and **single taxation** on S corporation distributions.

A. Complete Liquidation of C Corporation:

Farms, Inc. has two equal shareholders, John and Ann. The fair market value of the corporation's assets (all unimproved real estate – no depreciation taken) is $2,000,000; adjusted basis is $1,000,000. John and Ann each have $200,000 basis in their stock. The shareholders would like to liquidate the corporation and distribute its assets equally.

Tax on corp.:	
FMV of assets	$2,000,000
Adj. basis of assets	(1,000,000)
Gain on liquidating distribution (**all gain taxed at ordinary income rates**)	1,000,000
Corp. tax on gain at 21%	$ 210,000
Distributions to shareholders:	
Corporation's assets (pretax)	$2,000,000
LESS: Corp. tax liability	(210,000)
Amt. dist. to shareholders (total)	1,790,000
Amt. dist. per shareholder	895,000
LESS: Shareholder basis (each)	(200,000)
Gain recognized per shareholder	695,000
Tax per shareholder (25% fed./state)	$ 173,750
Total tax liability	
Tax on corporation	$ 210,000
Tax on John	173,750
Tax on Ann	173,750
Total tax	$ 557,500

- The shareholder's basis of the property received in a liquidation is its fair market value at the date of the distribution. IRC §334(a).

- The liquidating corporation recognizes all gains and losses on distribution of property in liquidation. IRC §336.

  - Losses may be limited on recently acquired property if not related to the corporation's business. IRC §336(d)(2).

  - Losses would be disallowed if property is distributed to the controlling shareholder or a related party, if the property was received as a contribution to capital or received in a IRC §351 exchange within 5 years, or if the distribution of loss property is not pro rata. IRC §336(d)(1).

- Shareholders report all gains and losses on the disposition of their shares in a complete liquidation (IRC §331). Different rules could govern if a shareholder was a corporation that owned at least 80% of the shares in the liquidated corporation (IRC §§332 and 337).

B. Complete Liquidation of S Corporation:

The same general liquidation rules apply to an S corporation as to a C corporation. However, the tax cost is significantly smaller **unless** the S corporation is subject to built-in gains taxation.

Assume the same facts as above, except that Farms, Inc. has always been an S corporation. Thus, it is exempt from the built-in gains tax. **If the corporation completely liquidates, there would be no tax at the corporate level.** The shareholders would, however, be required to recognize the corporation's gains and losses on the liquidating distribution which passes through to the shareholders.

Tax on corp.:		
FMV of assets		$ 2,000,000
Adj. basis of assets		(1,000,000)
Gain on liquidating dist.		1,000,000
Gain passed through per shareholder (50%)		500,000
Tax on pass-through gain (25% combined fed. & state)		$ 125,000
Distributions to shareholders:		
Corporation's assets		$2,000,000
Amt. dist. to each shareholder		1,000,000
LESS: Shareholder's basis (each):		
Basis before liquidating dist.	$200,000*	
Add gain passed through from corp.	500,000	(700,000)
Gain recognized per shareholder		300,000
Tax per shareholder (25% combined fed. & state))		$ 75,000
Total tax liability		
Gain pass-through from corp. (125,000 x 2)		$ 250,000
Dist. to shareholders (75,000 x 2)		150,000
Total		$ 400,000

*If shares are retained until death, a "step-up" to fair market value generally would be obtained. This would materially reduce any tax consequences.

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C. Complete Liquidation of S Corporation (At Death of Shareholder):

To illustrate the tax benefits of retention of stock until the death of a shareholder, consider the following example:

Agco, Inc. was incorporated in 1983 as a C corporation. This corporation was converted to S corporate status in 1987.

Agco, Inc. has one shareholder, Albert. Albert died in 2017 at a time when the fair market value of the corporation's assets were $2,000,000; adjusted basis was $1,000,000 (all unimproved real estate – no depreciation taken).

Prior to Albert's death, his basis in Agco Inc.'s stock (outside basis) was $0. At his death, Albert's basis in the Agco, Inc. stock receives a step-up to fair market value. Therefore, Albert's basis in the Agco, Inc. stock to his heirs is $2,000,000. The corporation is liquidated following Albert's death.

Tax on corp.:		
FMV of assets		$ 2,000,000
Adj. basis of assets (inside basis)		(1,000,000)
Gain on liquidating dist. (passed through to Albert's heirs)		$1,000,000
Distributions to shareholders:		
Corporation's assets		$2,000,000
LESS: Shareholder's basis:		
Basis before liquidating distribution	$2,000,000*	
Add gain passed through from corp.	1,000,000	(3,000,000)
Loss recognized (Albert's heirs on liquidation)		(1,000,000)
Total Gain/Loss on Liquidation		
Gain pass-through from corp.		$1,000,000
Loss recognized by Albert's heirs on liquidation		(1,000,000)
Total gain/loss on liquidation		$ -0-

***Step-up in basis at date of death**

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CAUTION – TAX PLANNING – LIQUIDATE IN SAME TAX YEAR AS SALE OF ASSETS: A corporation must be liquidated in the same tax year as the sale/distribution of assets to produce the desired tax result. If a sale/distribution of assets was accomplished in one tax year and the liquidation of the corporation in the following year, the capital loss produced upon liquidation would not offset the capital gain generated by the sale of assets.

In such a case, the capital loss produced upon liquidation would only offset other long-term capital gains for the tax year of the liquidation, plus $3,000 of ordinary income. The remaining long-term capital loss would be carried forward to subsequent tax years, but does not survive any particular heirs death.

LIABILITIES IN EXCESS OF BASIS - IRC §357

The transfer of liabilities to a corporation in connection with an IRC §351 incorporation does **not** result in gain recognition to the incorporator. **However, if a corporation assumes liabilities of an incorporator in excess of the adjusted tax basis of the assets transferred, the excess is recognized as taxable gain to the incorporator. IRC §357(c).**

NOTE: The gain will be ordinary income or capital gain, depending on the kind of property that is transferred to the corporation. If the property is depreciable, and if the corporation is more than 50% owned by one family, the gain is ordinary even though it would otherwise qualify as IRC §1231 capital gain. IRC §1239.

The computation of liabilities in excess of basis is **applied separately to each incorporator** by aggregating the adjusted tax basis of all assets being transferred by the incorporator against all liabilities transferred from the incorporator. A transfer of property to a corporation subject to liabilities in excess of the basis of the property leaves the shareholder with a $-0- basis for the stock. The basis of the stock is reduced below $-0- by the excess of the liabilities over the basis, and it is returned to $-0- by the gain recognized under IRC §357(c).

SEGGERMAN FARMS CASE: In 1993, a father and two sons formed a farm

corporation with each transferring assets and liabilities from their personal farming operations into the new corporation. The father transferred assets with a fair market value of $445,820 subject to liabilities totaling $402,903. Unfortunately, most of the assets transferred were zero-basis raised inventory, supply items and depreciated equipment with a total adjusted tax basis of $66,201. Accordingly, liabilities exceeded the father's adjusted tax basis by $336,702.

Similarly, each son transferred assets to the corporation with an adjusted tax basis of $30,517 subject to liabilities of $121,911 and $113,111, respectively. Liabilities, therefore, exceeded the adjusted tax basis of each son by $91,394 and $82,594, respectively.

Upon audit, the IRS assessed tax liability on the father and each son for their respective gain from liabilities in excess of basis under IRC §357(c). Total family liability in excess of basis = $510,690.

The Seggermans' argument against this assessment was that they remained liable on the debts as individuals because of their **ongoing personal guarantees** of the corporate debt. The Seggermans argued that the personal guarantees were the equivalent of a loan to the corporation; and, therefore, should be counted as additional basis. The Tax Court disagreed with this argument, holding that **personal guarantees do not represent an economic outlay on the part of the individuals** and distinguished the Seggermans' position from one in which promissory notes were transferred to a corporation to create additional basis.

In the Tax Court's view, the corporation had clearly assumed the liabilities, and that assumption of debt, in excess of the adjusted tax basis of the assets, triggered gain to the individuals under IRC §357(c). In rejecting the taxpayer's reliance on Lessinger (loan receivable) and Peracchi (note) (cases discussed below), the 7th Circuit noted that in those cases the taxpayers had incurred "genuine" indebtedness to the corporation. Seggerman Farms, Inc. v. Comm., T.C. Memo 2001-99; aff'd 2002-2 USTC 50,728, CA-7, 10/24/2002.

TAX PLANNING: In planning any incorporation, (particularly involving cash method farmers) one must carefully compare liabilities which will be transferred to the corporation with the adjusted tax basis of the assets transferred by each incorporator. Raised inventory and accelerated methods of depreciation often produce low basis assets which may be secured by substantial operating debt and equipment loans.

STRATEGIES TO AVOID LIABILITIES IN EXCESS OF BASIS: Strategies to avoid the liability in excess of basis problem generally involve either **retaining liabilities personally or adding additional cash or higher basis assets.** The incorporator might also consider **adding a personal note** due to the corporation, relying on the Lessinger and Peracchi cases. The Courts otherwise have been mixed on the issue whether an incorporator's note may provide basis in an incorporation.

(1) Transferring shareholder's **personal note** (loan receivable) should be considered to add basis for purposes of IRC §357(c). Lessinger v. Comm., 872 F2d 519 (2d Cir. 1989).

(2) A **personal note** contributed to a corporation by the incorporator had basis. The note was enforceable by the corporation, and likely to be enforced or called by either the corporation or its creditors, due to the lack of capital within the corporate entity. Peracchi v. Comm., 143 F3d 487 (9th Cir. 1998).

LEGISLATIVE ASSISTANCE: In 1999, Congress enacted changes to IRC §357(c), effective for transactions after October 18, 1998. The amendment struck the words **"plus the amount of liabilities to which the property is subject"** from IRC §357(c) and provided relief for taxpayers transferring assets subject to liabilities where the transferor remains personally liable on the debt but for which the corporation did not assume liability.

NOTE: The effective date of the legislative change post-dated the Seggerman fact pattern. While the Tax Court in Seggerman noted this change in tax law, it stated that the law change would **not** have effected their decision. Apparently, the Tax Court took the position that the Seggerman family debt obligations were assumed by the corporation.

The 1999 amendment also added IRC §357(d)(1)(A) which provides guidance in determining the amount of liabilities (or portion thereof) assumed by the corporation and states that "a recourse liability (or portion thereof) shall be treated as having been assumed if -- the transferee corporation has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor is relieved of such liability."

CORPORATE-PROVIDED MEALS AND LODGING (C CORPORATIONS)

IRC §162 allows an employer to **deduct the costs of providing on-premises meals and lodging to employees**, if those employees are **required to reside** on employer business premises for ordinary and necessary business reasons. Employees will receive non-taxable fringe benefit treatment on the value of the meal and lodging benefits under IRC §119.

IRC §119 non-taxable fringe benefit treatment applies to the value of meals and lodging furnished to an employee, the spouse of the employee, or any of the employee's dependents. The meals and lodging must be furnished (1) on the business premises of the employer; (2) for the convenience of the employer; and (3) as a condition of employment.

ON-PREMISES TEST: The corporation must either **own or lease** the residence in which the corporate-provided meals and lodging are being furnished. If the corporation does not own the residence, there should be a **written lease** and a specific rental payment by the corporation to give it access to the residence.

IN-KIND MEALS VS. REIMBURSED GROCERY COSTS: The employer meal deduction under IRC §162 is available for on-premises meals (e.g. furnishing in-kind meals) **not** the reimbursement of grocery costs. (See Dobbe Holland America Bulb Farms, Inc. v. Comm., T.C. Memo 2000-330 (10-25-00)). However, **groceries that are prepared into meals and consumed on business premises are excludable from employee income.**

In order to be eligible for the deduction, an employee of the corporation should have defined duties that include preparation of on-premises corporate-provided meals. The employee should also be compensated for those duties as part of his or her employment agreement with the corporation.

NOTE: The definition of **groceries includes non-food items such as napkins, toilet tissue, soap, etc.** because these items are an intrical part of the furnishing of meals and lodging. The Courts apparently are **not** concerned whether groceries are purchased directly using the corporate checking

account. It is permissible for corporate employees (farm wives) to purchase groceries and be later reimbursed by the corporation. John M. Harrison, T.C. Memo 1981-211.

Employer-provided lodging can include household utilities (Rev. Rul. 68-579 and Harrison, T.C. Memo 1981-211); household furnishings (Turner, 68 T.C. 48, 1977); and telephone services (Hatt, T.C. Memo 1969-229).

Note. Under Regs. Sec. 1.274-12(a)(1), a taxpayer may deduct 50% of an otherwise allowable meal expense if: 1) the expense is not lavish or extravagant under the circumstances; 2) the taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages; and 3) The food and beverages are provided to a taxpayer or a business associate.

In addition, in the case of food and beverages provided during or at an entertainment activity, the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. This rule may not be circumvented through inflating the amount charged for food and beverages.[14]

In the third requirement in the final version of Regs. Sec. 1.274-12(a)(1), the IRS made a critical change from the proposed regulations to the description of persons who are considered suitable recipients of tax-deductible business meals, adding "taxpayer" to that description. This change allows self-employed taxpayers to access the deduction.

After 2025, harvest meals and meals in employer-provided housing are non-deductible.

The following is a sample resolution to be utilized with corporate minutes to document the corporate-provided meal and lodging fringe benefit arrangement.

CORPORATE-PROVIDED MEALS AND LODGING
EXAMPLE RESOLUTION
(GRAIN FARMING)

WHEREAS, the corporation's employees are required to perform duties which include extended working hours during the crop production cycle, and said duties include a requirement to reside on corporate farm premises to supervise and secure grain inventory and machinery/equipment of the corporation; and

WHEREAS, in consideration for those extended hours and on-site duties, the corporation has provided on-premises meals and lodging as a condition of employment within the definitions of IRC §119;

NOW, THEREFORE, IT IS RESOLVED that effective immediately the corporation shall make its on-premises eating facility available to all of its employees, to allow those employees to attend to their extended duties and on-site supervision requirements.

"C" CORPORATION LONG-TERM CARE INSURANCE -- MEDICAL FRINGE BENEFIT FOR SHAREHOLDER/EMPLOYEES

A qualified long-term care insurance (LTC) policy is given equivalent treatment to other medical insurance under the tax law. IRC §7702B(a)(3). At the same time, IRC §213(d)(10) **restricts deductibility by individuals** as follows:

LONG-TERM CARE PREMIUM LIMIT PER PERSON FEDERAL		
Age	**2022 Amount**	**2023 Amount**
0-40	$ 450	$ 480
Over 40-50	$ 850	$ 890
Over 50-60	$1,690	$1,790
Over 60-70	$4,510	$4,770
Over 70-	$5,640	$5,960

"C" CORPORATION APPLICATION: The above deduction limits are **not** applicable to LTC insurance provided as an employer fringe benefit (similar to other health care insurance). Thus, a "C" corporation which provides its shareholders/ employees with health care insurance fringe benefits may deduct the full cost of providing these individuals with LTC insurance as part of its fringe benefit package, as long as the corporation's medical fringe benefit package meets Affordable Car Act (ACA) requisites.

Some insurance companies are structuring policies with front loaded premium costs designed strictly for "C" corporation purposes. For example, such a contract might provide for a substantial premium for 15 or 20 years, resulting in a paid-up policy extending nursing home benefits for the life of the employee.

Employer-provided health plans are deductible as ordinary and necessary business expenses under IRC §162(a) and IRC Reg. §1.162-10(a). "C" corporation employees will receive non-taxable fringe benefit treatment on employer-provided health and accident coverage under IRC §106(a).

NO APPLICATION TO "S" CORPORATIONS/PARTNERS/SELF-EMPLOYED INDIVIDUALS: The LTC insurance fringe benefit is **not** available to more than 2% shareholder/employee owners of an "S" corporation. Such individuals are treated as partners rather than employees under IRC §1372(a). As such, employer-provided health and LTC insurance premiums in these situations must be reported to the "S" corporate shareholder/employee as W-2 income (federal and state withholding taken, and subject to FICA/MED taxes (unless single employee exception met)), with the employee claiming the self-employed health insurance deduction on their individual Form 1040 (100% for 2008 and after) subject to LTC deduction limitations. Partners and self-employed individuals will experience similar tax treatment with regard to deductibility of health care expenses.

NOTE: IRC §162(l) cross-references to the LTC deduction limits provided in IRC §213(d)(10). The cross-reference restricts the self-employed health insurance deduction to the IRC §213(d)(10) limits. IRC §162(l)(2)(C). **Thus, self-employed individuals, partners, LLC members and more than 2% "S" corporate shareholders can only deduct LTC premiums up to the age-base maximums of IRC §213(d)(10).**

NOTE: Benefits paid under a qualified LTC insurance policy are generally excluded from taxable income. However, some indemnity or cash products that pay a daily or monthly benefit without regard to actual bills are subject to a per diem limitation of $420/day for 2023. Unless there are bills to support the higher amount, benefits over that amount are subject to tax.

LATE AND DEFECTIVE SUB 'S' ELECTIONS

If reasonable cause exists, the Service may grant relief for an improperly made Sub S Election or a Late Sub S Election. IRC §1362(b)(5). In August, 2013, the IRS released Rev. Proc. 2013-30 (generally effective 9-3-13 and after) which updates and consolidates all prior relief provisions for late and/or defective "S" corporate elections (Rev. Procs. 2003-43, 97-48, 2004-48, 2007-62, etc.). The new guidance obsoletes part or all of these prior revenue procedures. Rev. Proc. 2013-30 provides relief to correct a late or defective Sub 'S' Election, ESBT Election, QSST Election, QSub election or entity classification election (via Form 8832).

As long as the applicable requirements are met, relief for late or defective elections will be granted automatically **without a user fee**. When relief is not available under Rev. Proc. 2013-30, the corporation may still obtain a Private Letter Ruling. The procedural requirements for requesting a Private Letter Ruling are described in Rev. Proc. 2013-1 (or its successors). It appears that although reasonable cause is necessary for relief, as long as you have the filing fee, the IRS has been quite lenient in providing relief.

"S" CORPORATION ELECTION: An eligible corporation can make the election to be treated as an "S" corporation for a tax year as follows:

(1) At any time during the preceding tax year; **or**

(2) At any time during the tax year the election is to be effective as long as it is made by no later than the 15th day of the third month of that tax year.

The election is made by filing a completed Form 2553 (Election by a Small Business Corporation). IRC §1362(b)(1) and Reg. §1.1362-6(a)(2). If the election is made after the 15th day of the third month of the tax year and by no later than the 15th day of the third month of the following tax year, the election is treated as made for the following tax year. IRC §1362(b)(3). However, if IRS determines that there was reasonable cause for the failure to make a timely election, the Service may treat the election as timely made and §1362(b)(3) shall not apply. IRC §1362(b)(5).

REV. PROC. 2013-30 (§4.02-General Requirements For Relief): To receive relief where the only defect is a late election, the corporation must establish that:

(1) It intended to be classified as an "S" corporation;

(2) The failure to qualify is only a result of the lack of timely filing;

(3) Less than 3 years and 75 days have passed since the intended effective date of the election;
and

(4) Reasonable cause exists for the failure to timely file, **and** the corporation has acted diligently to correct the mistake upon discovery.

REV. PROC. 2013-30 (§4.03-General Procedural Requirements For Relief): The corporation must complete and submit Form 2553 and attach applicable supporting documents as set forth below. Form 2553 must be signed by an authorized officer of the corporation and all shareholders holding an interest in the corporate stock at any time from the intended effective date of the "S" election to the new date of the election. Form 2553 must have the following notation at the

top of the front page **"FILED PURSUANT TO REV. PROC. 2013-30",** and must be filed with the Service Center where the original 'S' election would have been filed.

REASONABLE CAUSE/INADVERTENCE STATEMENT (§4.03(1)): In addition to any supporting documents, a "Reasonable Cause/Inadvertence Statement" must be attached to Form 2553 describing the reasonable cause for failure to timely file the "S" corporate election and the diligent actions taken by the corporation to correct the mistake upon its discovery. This statement must contain a signed and dated penalty of perjury declaration as follows:

> "Under penalties of perjury, I (we) declare that I (we) have examined this election, including accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct and complete."

FILING METHODS: A request for late filing relief may be submitted by one of three methods:

(1) **Independent Filing:** Filing Form 2553 independent of Form 1120S within the three years and 75 days after the effective date (date the "S" election was intended to be effective).

(2) **Filing with Current Year Form 1120-S:** Attaching Form 2553 to the "S" corporation's current year Form 1120S, provided that the "S" corporation has filed all Forms 1120S between the effective date and the current year, and provided that the current year Form 1120S is filed within 3 years and 75 days after the effective date.

NOTE: An extension to file the current year Form 1120S does not extend the due date for relief beyond 3 years and 75 days.

(3) **Filing with Late Filed Form 1120-S:** Attaching Form 2553 to one of the "S" corporation's late filed prior year Forms 1120S, if the "S" corporation has not filed Form 1120S (or any other income tax return) for the tax year that includes the effective date or any year following the effective date.

a) The late filed return for the year including the effective date cannot be filed more than three years and 75 days after the effective date.

b) All other delinquent Forms 1120-S must be filed **simultaneously and consistently** with the requested relief.

c) Form 1120S must state at the top of the front page "INCLUDES LATE ELECTION(S) FILED PURSUANT TO REV. PROC. 2013-30" or comply with other specific instructions included with the Form 1120S instructions.

ADDITIONAL SUPPORTING DOCUMENTATION: If applicable due to timing of the requested late election relief, the following additional supporting documentation must accompany Form 2553:

(1) Statements from all shareholders during the "S" status period that they have filed their income tax returns consistent with the "S" corporation election, signed and dated under penalties of perjury.

(2) Representations that the entity is eligible for "S" status, intended to

be classified as an "S" corporation as of the effective date of the election, failed to qualify solely because the "S" corporation election was not timely filed, has filed no tax returns inconsistent with its requested "S" status, and has reasonable cause for the election failure and acted diligently to correct the mistake upon discovery, all signed and dated under penalties of perjury by an authorized corporation officer.

NOTE – EXCEPTION TO 3 YEAR 75 DAY FILING REQUIREMENT: The requirement to file for relief within three years and 75 days of the effective date is **waived if all of the following conditions are met:**

(1) The corporation fails to qualify as an "S" corporation solely because the Form 2553 was not timely filed;

(2) The corporation and all of its shareholders reported their income consistent with "S" corporation status for the year the "S" corporation election should have been made, and for every subsequent taxable year (if any);

(3) At least six months has elapsed since the date on which the corporation filed its tax return for the first year the corporation intended to be an "S" corporation;

(4) Neither the corporation nor any of its shareholders was notified by the IRS of any problem regarding the "S" corporation status within six months of the date on which the Form 1120S for the first year was timely filed;

(5) The completed Form 2553 includes the statement(s) described in Rev. Proc. 2013-30, §5.02 (i.e., statements from all shareholders who held stock between the effective date and the election date that they have reported their income on all returns consistent with "S" corporation status); **and**

(6) The corporation is not seeking late corporate classification election relief concurrently with a late "S" corporation election under this revenue procedure.

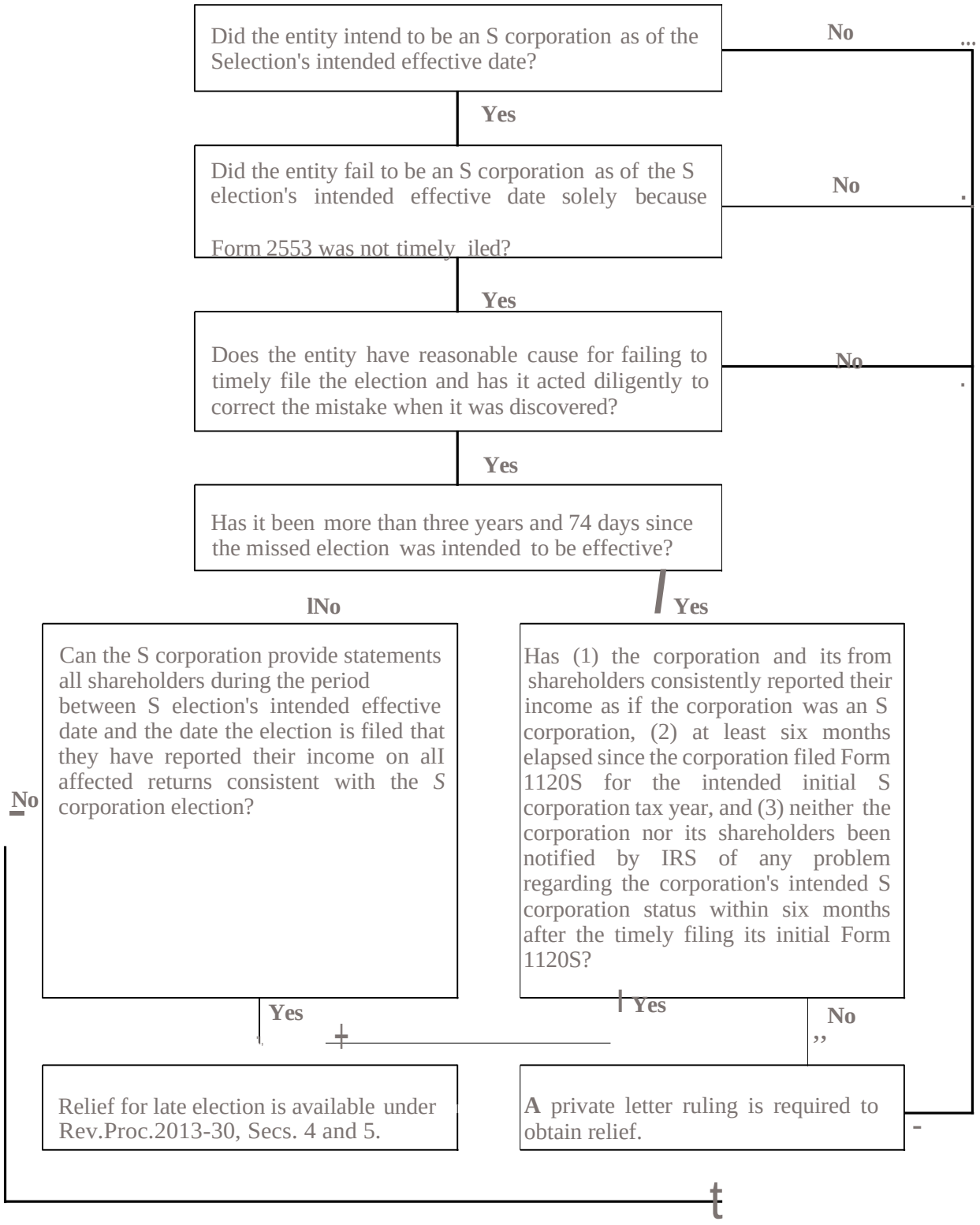
IRS ACCEPTANCE/REJECTION NOTIFICATION: Upon receipt of Form 2553, IRS will determine whether the requirements for relief for late filing have been met, and the taxpayer will be notified of the outcome (Rev. Proc. 2013-30, §4.05).

QSST OR ESBT FAILURE TO FILE: In the case of an inadvertently invalid "S" election or an inadvertent termination of the "S" election due to the failure to make the timely QSST or ESBT election, the late QSST or ESBT election must include a statement, signed under penalties of perjury that the failure to timely elect was inadvertent, and diligent action was taken by the person or entity seeking relief to correct the mistake upon discovery. No reasonable cause statement is required to support a late QSST or ESBT.

NOTE: Following is a procedural diagram for use in requesting relief from late "S" corporate elections. Rev. Proc. 2013-30 contains similar procedural diagrams for use in requesting relief from late QSST & ESBT elections, late Qsub elections and late entity classification elections.

Appendix 1

Flowchart for Determining Relief for Late Election to Be a S Corporation



Source Rev. Proc. 2013-30, 2013-36 IRB.

Form **2553**

(Rev. December 2017)

Department of the Treasury
Internal Revenue Service

Election by a Small Business Corporation

(Under section 1362 of the Internal Revenue Code)
(Including a late election filed pursuant to Rev. Proc. 2013-30)

▸ **You can fax this form to the IRS. See separate instructions.**
▸ **Go to *www.irs.gov/Form2553* for instructions and the latest information.**

OMB No. 1545-0123

Note: This election to be an S corporation can be accepted only if all the tests are met under *Who May Elect* in the instructions, all shareholders have signed the consent statement, an officer has signed below, and the exact name and address of the corporation (entity) and other required form information have been provided.

Part I Election Information

Type or Print		
	Name (see instructions)	**A Employer identification number**
	Number, street, and room or suite no. If a P.O. box, see instructions.	**B** Date incorporated
	City or town, state or province, country, and ZIP or foreign postal code	**C** State of incorporation

D Check the applicable box(es) if the corporation (entity), after applying for the EIN shown in **A** above, changed its ☐ name or ☐ address

E Election is to be effective for tax year beginning (month, day, year) (see instructions) . . . . . ▸ _____

Caution: A corporation (entity) making the election for its first tax year in existence will usually enter the beginning date of a short tax year that begins on a date other than January 1.

F Selected tax year:

(1) ☐ Calendar year
(2) ☐ Fiscal year ending (month and day) ▸ _____
(3) ☐ 52-53-week year ending with reference to the month of December
(4) ☐ 52-53-week year ending with reference to the month of ▸ _____

If box (2) or (4) is checked, complete Part II.

G If more than 100 shareholders are listed for item J (see page 2), check this box if treating members of a family as one shareholder results in no more than 100 shareholders (see test 2 under *Who May Elect* in the instructions) ▸ ☐

H Name and title of officer or legal representative whom the IRS may call for more information	Telephone number of officer or legal representative

I If this S corporation election is being filed late, I declare I had reasonable cause for not filing Form 2553 timely. If this late election is being made by an entity eligible to elect to be treated as a corporation, I declare I also had reasonable cause for not filing an entity classification election timely and the representations listed in Part IV are true. See below for my explanation of the reasons the election or elections were not made on time and a description of my diligent actions to correct the mistake upon its discovery. See instructions.

Sign Here

Under penalties of perjury, I declare that I have examined this election, including accompanying documents, and, to the best of my knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete.

Signature of officer	**Title**	**Date**

Name | **Employer identification number**

Part I **Election Information** *(continued)* **Note:** If you need more rows, use additional copies of page 2.

J Name and address of each shareholder or former shareholder required to consent to the election. (see instructions)	**K** **Shareholder's Consent Statement** Under penalties of perjury, I declare that I consent to the election of the above-named corporation (entity) to be an S corporation under section 1362(a) and that I have examined this consent statement, including accompanying documents, and, to the best of my knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete. I understand my consent is binding and may not be withdrawn after the corporation (entity) has made a valid election. If seeking relief for a late filed election, I also declare under penalties of perjury that I have reported my income on all affected returns consistent with the S corporation election for the year for which the election should have been filed (see beginning date entered on line 3) and/or all subsequent years. Signature	Date	**L** Stock owned or percentage of ownership (see instructions) Number of shares or percentage(s) of ownership	Date(s) acquired	**M** Social security number or employer identification number (see instructions)	**N** Shareholder's tax year ends (month and day)

Name | Employer identification number

Part II Selection of Fiscal Tax Year (see instructions)

Note: All corporations using this part must complete item O and item P, Q, or R.

O Check the applicable box to indicate whether the corporation is:

1. ☐ A new corporation **adopting** the tax year entered in item F, Part I.
2. ☐ An existing corporation **retaining** the tax year entered in item F, Part I.
3. ☐ An existing corporation **changing** to the tax year entered in item F, Part I.

P Complete item P if the corporation is using the automatic approval provisions of Rev. Proc. 2006-46, 2006-45 I.R.B. 859, to request (1) a natural business year (as defined in section 5.07 of Rev. Proc. 2006-46) or (2) a year that satisfies the ownership tax year test (as defined in section 5.08 of Rev. Proc. 2006-46). Check the applicable box below to indicate the representation statement the corporation is making.

1. Natural Business Year ▸ ☐ I represent that the corporation is adopting, retaining, or changing to a tax year that qualifies as its natural business year (as defined in section 5.07 of Rev. Proc. 2006-46) and has attached a statement showing separately for each month the gross receipts for the most recent 47 months. See instructions. I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2006-46 from obtaining automatic approval of such adoption, retention, or change in tax year.

2. Ownership Tax Year ▸ ☐ I represent that shareholders (as described in section 5.08 of Rev. Proc. 2006-46) holding more than half of the shares of the stock (as of the first day of the tax year to which the request relates) of the corporation have the same tax year or are concurrently changing to the tax year that the corporation adopts, retains, or changes to per item F, Part I, and that such tax year satisfies the requirement of section 4.01(3) of Rev. Proc. 2006-46. I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2006-46 from obtaining automatic approval of such adoption, retention, or change in tax year.

Note: If you do not use item P and the corporation wants a fiscal tax year, complete either item Q or R below. Item Q is used to request a fiscal tax year based on a business purpose and to make a back-up section 444 election. Item R is used to make a regular section 444 election.

Q Business Purpose—To request a fiscal tax year based on a business purpose, check box Q1. See instructions for details including payment of a user fee. You may also check box Q2 and/or box Q3.

1. Check here ▸ ☐ if the fiscal year entered in item F, Part I, is requested under the prior approval provisions of Rev. Proc. 2002-39, 2002-22 I.R.B. 1046. Attach to Form 2553 a statement describing the relevant facts and circumstances and, if applicable, the gross receipts from sales and services necessary to establish a business purpose. See the instructions for details regarding the gross receipts from sales and services. If the IRS proposes to disapprove the requested fiscal year, do you want a conference with the IRS National Office?

☐ Yes ☐ No

2. Check here ▸ ☐ to show that the corporation intends to make a back-up section 444 election in the event the corporation's business purpose request is not approved by the IRS. See instructions for more information.

3. Check here ▸ ☐ to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event (1) the corporation's business purpose request is not approved and the corporation makes a back-up section 444 election, but is ultimately not qualified to make a section 444 election, or (2) the corporation's business purpose request is not approved and the corporation did not make a back-up section 444 election.

R Section 444 Election—To make a section 444 election, check box R1. You may also check box R2.

1. Check here ▸ ☐ to show that the corporation will make, if qualified, a section 444 election to have the fiscal tax year shown in item F, Part I. To make the election, you must complete **Form 8716,** Election To Have a Tax Year Other Than a Required Tax Year, and either attach it to Form 2553 or file it separately.

2. Check here ▸ ☐ to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event the corporation is ultimately not qualified to make a section 444 election.

Name	Employer identification number

Part III **Qualified Subchapter S Trust (QSST) Election Under Section 1361(d)(2)* Note:** If you are making more than one QSST election, use additional copies of page 4.

Income beneficiary's name and address	Social security number

Trust's name and address	Employer identification number

Date on which stock of the corporation was transferred to the trust (month, day, year) . . . . . a

In order for the trust named above to be a QSST and thus a qualifying shareholder of the S corporation for which this Form 2553 is filed, I hereby make the election under section 1361(d)(2). Under penalties of perjury, I certify that the trust meets the definitional requirements of section 1361(d)(3) and that all other information provided in Part III is true, correct, and complete.

Signature of income beneficiary or signature and title of legal representative or other qualified person making the election	Date

* Use Part III to make the QSST election only if stock of the corporation has been transferred to the trust on or before the date on which the corporation makes its election to be an S corporation. The QSST election must be made and filed separately if stock of the corporation is transferred to the trust **after** the date on which the corporation makes the S election.

Part IV **Late Corporate Classification Election Representations** (see instructions)

If a late entity classification election was intended to be effective on the same date that the S corporation election was intended to be effective, relief for a late S corporation election must also include the following representations.

1 The requesting entity is an eligible entity as defined in Regulations section 301.7701-3(a);

2 The requesting entity intended to be classified as a corporation as of the effective date of the S corporation status;

3 The requesting entity fails to qualify as a corporation solely because Form 8832, Entity Classification Election, was not timely filed under Regulations section 301.7701-3(c)(1)(i), or Form 8832 was not deemed to have been filed under Regulations section 301.7701-3(c)(1)(v)(C);

4 The requesting entity fails to qualify as an S corporation on the effective date of the S corporation status solely because the S corporation election was not timely filed pursuant to section 1362(b); **and**

5a The requesting entity timely filed all required federal tax returns and information returns consistent with its requested classification as an S corporation for all of the years the entity intended to be an S corporation and no inconsistent tax or information returns have been filed by or with respect to the entity during any of the tax years, **or**

b The requesting entity has not filed a federal tax or information return for the first year in which the election was intended to be effective because the due date has not passed for that year's federal tax or information return.

"C" CORPORATION PARTIAL STOCK REDEMPTIONS

The 2003 Tax Act established parity between long-term capital gains and dividend tax rates (currently 0%/15%/20%). As a result, "C" corporate shareholders may be able to achieve virtually the same tax result for 2016 regardless of whether they are taking funds out of a corporation in the form of dividends or through some form of stock redemption or liquidation. **A full or partial redemption of the stock of an individual (e.g. senior shareholder) or particular group of shareholders (e.g. grandchildren) might be desirable to accomplish funding goals (retirement, education, etc.) to targeted groups given present tax rate structures; particularly, if the redemption can be accomplished at the 0% or 15% dividend/long-term capital gain rates.** Since specific individuals or groups can be targeted, a redemption should be preferable to the issuance of dividends, which normally must be declared and **issued proportionately** to all shareholders.

In a closely-held family corporation, a partial redemption inevitably results in dividend tax treatment. This is due to the fact that:

a. The family attribution rules of IRC §302(c) apply to partial redemptions.

b. An attempt to arrange the IRC §302(b)(2) substantially disproportionate redemption (qualifying for capital gain "sale or exchange" treatment) in a closely-held family corporation inevitably fails the percentage reduction tests, because the redeemed shareholder is considered to continue to own stock held by other family shareholders. This causes the redemption to be recharacterized as a dividend.

EXAMPLE – PARTIAL REDEMPTION OF STOCK TREATED AS DIVIDEND - SENIOR SHAREHOLDER (RETIREMENT): Agri Ltd., a "C" corporation, is owned 80% by Dad and 20% by Son. Dad is approaching retirement age, and is interested in reducing his ownership in the corporation. Several years ago when Dad investigated the possibility of having the corporation redeem some of his stock, he was informed that a partial redemption would be taxed as a dividend at ordinary income rates with significant taxation resulting. **Long-term capital gains treatment could only be accomplished through a complete redemption of Dad's stock, along with Dad's agreement to discontinue his involvement in the corporation as an officer, employee, director, or stockholder for 10 years.** IRC §302(b)(3) & (c)(2)(A).

Following the reduction in dividend tax rates under the 2003 Tax Act, the corporation can redeem a portion of Dad's stock (effectively transferring a higher percentage of ownership to Son) at 0% or 15% federal tax rates for 2014 and after, if the taxpayer's AGI can be kept below net investment income (NII) tax thresholds and AMT thresholds. The partial redemption could be accomplished using excess cash liquidity, or the corporation could redeem Dad's stock under the terms of an installment note that could be paid in full if federal tax rates for qualified dividends increase in future years.

CAUTION – NO STOCK BASIS OFFSET: Regardless of whether an installment note is utilized or not, the required dividend tax treatment for the partial redemption will result in the entire proceeds being taxed in the current

year. **Also, since dividend tax treatment is required, Dad may not offset any tax basis he has in the stock against the dividend distribution unless all of the corporation's current and accumulated earnings and profits (E&P) have been exhausted (i.e. the dividend will generally be taxable in full with no basis offset).** Once E & P have been exhausted, any remaining redemption payment reduces shareholder basis in redeemed shares. Any remaining basis in Dad's stock will be transferred to the remaining shares that he still owns. IRC Regs. §1.302-2(c).

TAX PLANNING OBSERVATION (2013 and after): For shareholders with low basis in stock, there will be little difference in the tax result between taxation as a dividend and taxation as a long-term capital gain, as long as dividends and long-term capital gains continue to be taxed at equivalent rates to individual taxpayers. For 2013 and after, the 3.8% Medicare contribution tax (NIIT on net investment income) will apply to stock redemption payments in addition to the qualified dividend or long-term capital gain tax rates, if modified AGI exceeds $200,000 (single/HOH); $250,000 (MFJ); or $125,000 (MFS). In addition, the qualified dividend and long-term capital gain rates increase from 15% to 20% if AGI exceeds $400,000 (single); $425,000 (HOH); $450,000 (MFJ); or $225,000 (MFS).

****

PRESENT VALUE ANALYSIS
(2017 Tax Rates vs. Future Tax Liability)

There has been a great deal of discussion surrounding the desirability of making distributions of "C" corporate earnings and profits in tax years when a taxpayer could take advantage of the favorable 15% tax rate on qualified dividends. Incurring tax early in anticipation of higher future tax rates is only economical and efficient if the tax event would otherwise occur at a date in the future when the future tax liability would be greater, considering the time value of money.

Net present value of 15% tax rate as compared to possible future rates:

NET PRESENT VALUE (15% RATE)		
Rate of Return	**Approx. 20%**	**Approx. 28%**
4%	7 yrs.	16 yrs.
6%	5 yrs.	11 yrs.

CORPORATE - STOCKHOLDER LOANS

When a corporation makes a loan to a shareholder or vice-versa, the below-market (imputed interest) loan rules of IRC §7872(c) & (e) will apply unless the transaction falls under one of the following exceptions:

1. The aggregate corporate – shareholder loans are $10,000 or less (the de minimis rule) -- IRC §7872(c)(2); **or**

2. The corporate – shareholder loan reflects an adequate interest rate. For this purpose, adequate rate interest means a rate at least equal to the applicable federal rate (AFR) -- IRC §7872(e).

Thus, when a corporation charges at least the AFR, IRC §7872 below-market (imputed interest) loan rules can be completely avoided.

TAX PLANNING: Corporations should make sure that all corporate – shareholder notes in excess of $10,000 reflect an interest rate equal to the appropriate AFR rate. For example, the October, 2023 AFR rates are as follows:

0 ‒ 3 yrs. Short-Term and Demand	**3 ‒ 9 yrs. Mid-Term**	**9 & above Long-Term**
5.22%	4.43%	4.46%

Consider re-issuing existing demand loans for a fixed term at current (presumably lower) AFR interest rates (i.e.. 3 to 9 year mid-term AFR rate loans), to lock lower interest rates for the term of the note. Also, evaluate the wisdom of making new corporate-shareholder loans to take advantage of possible current low interest rates.

See examples of corporate-shareholder demand notes and mid-term notes in Section E of the Manual.

NOTE – DOCUMENTATION (CORPORATE MINUTES): Any time a corporation loans funds to a shareholder, there is a risk that the IRS will attempt to characterize all or part of the distribution as a taxable dividend. The primary documentation that a distribution is intended to be a loan rather than a dividend should be in the written loan documents, and both parties should follow through in observing the terms of the loan. It is also helpful if the corporate minutes document the following:

1. Need for the borrowing (how the funds will be used);

2. Corporate officers' authorization of the loan; **and**

3. Summary of the loan terms (interest rate, repayment schedule, loan rollover provisions, etc.).

NOTE: The presence of a fixed maturity date, a fixed rate of interest and a defined schedule of payments with at least actual interest payments are factors that indicate debt rather than disguised equity (contribution to capital). Also, when a corporation has the ability to obtain outside debt financing, it's more likely that purported shareholder loans are, in fact, debt rather than equity. In other words, there's no tax-law requirement for a corporation to borrow from commercial lenders when shareholders are willing to provide loans. In such case, properly structured shareholder advances should be

respected as legitimate loans. Consider documenting through corporate minutes the "win-win" situation of shareholder loans vs. bank loans in the current economy, given bank lending rates as opposed to anticipated shareholder return through bank account investments.

S CORPORATION SHAREHOLDER LOANS AND SHAREHOLDER DEBT BASIS

Shareholders of an S corporation may deduct their allocated share of the S corporation's loss to the extent of their basis in the S corporation's stock and in debt owed to the shareholder. IRC §1366(d)(1). Basis in S corporation debt is increased by an economic outlay by the shareholder on behalf of the corporation, and by direct debt owed by the S corporation to the shareholder. Under new final regulations (effective 7-23-14), two tests must be met:

(1) These must be actual indebtedness that runs directly from the S corporation to the shareholder; **and**

(2) The debt of the S corporation must be **bona fide indebtedness** to the shareholder under established federal tax principles. IRC Reg. §1.1366-2(a)(2)(i). Thus, the loan must be supported by facts of **bona fide indebtedness** such as a reasonable interest rate, a written instrument, payments on the note, etc.

NOTE: Guarantees of a shareholder do **not** initially result in basis in the indebtedness. However, when a shareholder makes a payment on a guarantee, basis may increase to the extent of the repayment. IRC Reg. §1.1366-2(a)(2)(ii). The contribution of a shareholder's own unsecured demand promissory note to an S corporation generally does not increase basis in stock. Rev. Rul. 81-187.

NOTE: If a shareholder substitutes personal indebtedness for an S corporation's commercial indebtedness, as long as the debt substitution completely eliminates the S corporation as the primary obligor to the bank, the fact that the S corporation guarantees the debt is irrelevant.

COMMENT – CAPITAL CONTRIBUTIONS: If a shareholder desires to increase their general S corporation tax basis but does not have sufficient personal funds for a capital contribution to increase stock basis, they could borrow funds from a commercial lender, securing the debt with property outside the corporation, and then advance those funds to the S corporation as a capital contribution.

Appendix 1

Shareholder Advances-Loan or Contributions to Capital (Equity)?

Factor	Description	Indications
I. Descriptions on Documents	The names given to the instruments, if any, evidencing the p urported indebtedness.	Obviously, if shareholder advances are not described as loans payable on the corporation's books and as loans receivable in the shareholder's financial records, the case for treating advances as debt is weakened.
2. Maturity Date and Repayment Schedule	The presence or absence of a fixed maturity date and defined schedule of payments.	Presence of this factor indicates debt rather than equity. Absence indicates the opposite. **Note:** According to *Indmar,* fixed maturity dates and repayment schedules are not required for bona fide demand loans (payable at any time upon the demand of the shareholder-lender). That said, loans with a fixed maturity date and repayment schedules are less problematic than purported demand loans.
3. Interest Rate and Payments	The presence or absence of a fixed rate of interest and actual interest payments.	Presence of this factor indicates bona fide.debt rather than disguised equity. Absence indicates the opposite. **Observation:** The presence of these first three factors is indicative of the existence of a fixed legal obligation to repay, which is the most important characteristic of bona fide debt. As noted above, however, Factor 2 is not necessary for a bona fide demand loan.
4. Capitalization	The adequacy or inadequacy of the corporation's capitalization.	An excessively high existing debt-to-equity ratio is indicative of shareholder cash advances being equity.
5. Overlap between Shareholders and Lenders	The identity of interest between the purported creditors and the stockholders.	When purported loans are made by shareholders strictly in proportion to their stock ownership interests, this is indicative of equity.
6. Security	The security, if any, for the purported loans.	A lack of adequate security is indicative of equity.
7. Availability of Debt from Outside Sources	The corporation's ability or inability to obtain debt financing from outside lending sources.	When a corporation has·the ability to obtain outside debt financing, it's more likely that purported shareholder loans are, in fact, debt rather than equity. In other words, there's no tax-law requirement for a corporation to borrow from commercial lenders when shareholders are willing to provide loans. In such case, properly structured shareholder advances should be respected as legitimate loans.
8. Subordination	The extent to which the purported shareholder loans were subordinated to the claims of outside creditors.	Subordination to debts owed to all outside creditors is indicative of equity.

These factors are based on the Sixth Circuit's *Roth Steel* decision as updated by its more-recent *Indmar* decision and as modified by us. See *lndmar Products Co., Inc., 97* AFfR 2d 2006-1956 (6th Cir. 2006); and *Roth Steel Tube Co.,* 58 AFfR 2d 86-5808 (6th Cir. 1986).

Warning: No single factor is conclusive. The relevance and relative importance of each factor depends on the specific facts of the case at hand. That said, the first 3 factors are very significant.

CORPORATE LIQUIDATION REPORTING REQUIREMENTS – FORM 966:

FILING REQUIREMENTS: Form 966 is required to be **filed within 30 days after adoption of a resolution or plan to dissolve** a corporation or to liquidate part or all of a corporation's stock. IRC §6043(a)(1). The Form 966 return is to be **filed with the IRS Service Center at the address where the corporate income tax return is filed.** If the resolution or plan is amended, an additional Form 966 must be filed within 30 days after adoption of the amendment or supplement. A return must be filed on Form 966 **whether or not** any part of the gain or loss to the shareholders is recognized.

Form 966 must contain a **certified copy** of the **resolution or plan** attached and must contain:

(1) The name and address of the corporation;

(2) The place and date of incorporation;

(3) The date of the adoption of the resolution or plan and the dates of any amendments or supplements; **and**

(4) The IRS Service Center where the last corporate income tax return was filed and the taxable year covered by the last return. IRC Reg. §1.6043-1(b)(1).

NOTE – FAILURE TO FILE: Failure to file does **not** effect the reporting of income tax consequences deriving from the liquidation. The willful failure to file Form 966 could result in criminal penalties. Rev. Rul. 65-80.

NOTE – COSTS OF LIQUIDATION: Costs incurred in connection with a corporate liquidation (e.g. filing fees, attorney/accountant fees, etc.) are deductible for the year of dissolution. Expenses incurred after liquidation cannot be deducted on the corporate income tax return for the year of liquidation.

FINAL CORPORATE INCOME TAX RETURN: When a corporation stops conducting business, liquidates and dissolves, a return must be filed for the fractional part of the year during which the corporation was in existence **if the corporation retains no assets.** Simply retaining a nominal amount of cash will negate the filing requirement until the time all of the remaining cash is either distributed or paid out. IRC Regs §1.6012-2(a)(2).

Form **966**
(Rev. October 2016)
Department of the Treasury
Internal Revenue Service

Corporate Dissolution or Liquidation

(Required under section 6043(a) of the Internal Revenue Code)

[a] **Information about Form 966 and its instructions is at *www.irs.gov/form966.***

OMB No. 1545-0123

Please type or print		
	Name of corporation	**Employer identification number**
	Number, street, and room or suite no. (If a P.O. box number, see instructions.)	Check type of return ☐ 1120 ☐ 1120-L ☐ 1120-IC-DISC ☐ 1120S ☐ Other [a]
	City or town, state, and ZIP code	

1	Date incorporated	**2** Place incorporated	**3** Type of liquidation ☐ Complete ☐ Partial	**4** Date resolution or plan of complete or partial liquidation was adopted
5	Service Center where corporation filed its immediately preceding tax return	**6** Last month, day, and year of immediately preceding tax year	**7a** Last month, day, and year of final tax year	**7b** Was corporation's final tax return filed as part of a consolidated income tax return? If "Yes," complete 7c, 7d, and 7e. ☐ Yes ☐ No
7c	Name of common parent		**7d** Employer identification number of common parent	**7e** Service Center where consolidated return was filed

		Common	Preferred
8	Total number of shares outstanding at time of adoption of plan of liquidation		
9	Date(s) of any amendments to plan of dissolution		
10	Section of the Code under which the corporation is to be dissolved or liquidated		
11	If this form concerns an amendment or supplement to a resolution or plan, enter the date the previous Form 966 was filed		

Attach a certified copy of the resolution or plan and all amendments or supplements not previously filed.

Under penalties of perjury, I declare that I have examined this form, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of officer | Title | Date

Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Who Must File

A corporation (or a farmer's cooperative) must file Form 966 if it adopts a resolution or plan to dissolve the corporation or liquidate any of its stock.

Exempt organizations and qualified subchapter S subsidiaries should not file Form 966. Exempt organizations should see the instructions for Form 990, Return of Organization Exempt From Income Tax, or Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation. Subchapter S subsidiaries should see Form 8869, Qualified Subchapter S Subsidiary Election.

CAUTION

Do not file Form 966 for a deemed liquidation (such as a section 338 election or an election to be treated as a disregarded entity under Regulations section 301.7701-3).

When To File

File Form 966 within 30 days after the resolution or plan is adopted to dissolve the corporation or liquidate any of its stock. If the resolution or plan is amended or supplemented after Form 966 is filed, file another Form 966 within 30 days after the amendment or supplement is adopted. The additional form will be sufficient if the date the earlier form was filed is entered on line 11 and a certified copy of the amendment or supplement is attached. Include all information required by Form 966 that was not given in the earlier form.

Where To File

File Form 966 with the Internal Revenue Service Center at the address where the corporation (or cooperative) files its income tax return.

Distribution of Property

A corporation must recognize gain or loss on the distribution of its assets in the complete liquidation of its stock. For purposes of determining gain or loss, the

CORPORATE SALARIES – REASONABLE COMPENSATION

Employees of a corporation too often take a nominal salary, not wanting to pay FICA/MED taxes. **An audit may result in the IRS increasing the salary to a higher level with resulting FICA/MED tax liabilities, plus late payment interest and penalties.**

NOTE – PAYROLL TAX PENALTIES: When an "S" corporation is assessed payroll taxes for unreported compensation, the resulting penalties and interest are generally significantly greater than in an income tax deficiency assessment. The quarterly payroll deposit rules will typically have been violated, resulting in cascading penalties that include failure to timely deposit and failure to properly report.

Salaries are required to be "reasonable" for the personal services actually rendered. IRC §162(a)(1). Unfortunately, "reasonable" is not defined in the Code. IRC Regs. §1.162-7(a)(3) & Regs. §1.1366-3(a) provide only that reasonable compensation is an amount paid for like service by like enterprises under like circumstances. Each situation must be addressed based on its unique facts and circumstances. The courts have enumerated a number of factors to be used to determine the reasonableness of salaries:

1. Reasonable considering the employee's **qualifications (training, experience).**
2. Reasonable considering the **nature and extent of the employee's work** - (consider the role the shareholder plays in the corporation, including his or her position, hours worked, and duties performed).
3. Reasonable in **comparison** to compensation paid for **similar services** by **similar entities.**
4. Reasonable in relation to **salary history of the entity** - (consider the corporation's compensation policy for all employees and the shareholder's individual salary history, including the corporation's internal consistency in establishing the shareholder's salary).
5. Reasonable considering **the character and financial condition of the corporation.**
6. Reasonable considering if a hypothetical, independent investor would conclude that there is an **adequate return on investment** after considering the shareholder's compensation.

The courts have also considered **additional factors** in deciding whether the amount of compensation is reasonable, including:

- The size and complexity of the business.
- A comparison of salaries paid to sales and net income.
- General economic conditions.
- Comparison of salaries to shareholder distributions and retained earnings.
- The corporation's dividend history.
- Whether the employee and employer dealt at arm's length.
- Whether the employee guaranteed the employer's debt.

The court decisions confirm that no single factor controls, but rather a combination of the factors must be considered. Furthermore, these factors are **not** all inclusive and may **not** be given equal weight. Fewer or additional factors may be appropriate, depending on the surrounding facts and circumstances.

TAX PLANNING: Before year-end, each shareholder/employee's compensation should be reviewed for reasonableness, and increased by payment of a **year-end bonus** if needed. While reasonableness is based on the facts and circumstances, in many situations compensation can be set at the low end of a wide salary range that is both reasonable and supportable. The better the documentation (e.g. corporate minutes) explaining why wages and bonuses are appropriate, the more likely that the payments can withstand IRS attack.

In her 2007 Annual Report to Congress, the Taxpayer Advocate, in a section discussing "S" corporations, reported that in the 2005 taxable year, 982,480 "S" corporations with one shareholder paid **no officers' compensation.** Had all profitable "S" corporations that reported no officers' compensation been Schedule C's, they would have paid an estimated $4.9 billion in self-employment tax. **Thus, the reasonableness of "S" corporation salaries should become a major audit concern at some time in the future.** See: David E. Watson P.C. v. United States, 668 F.3d 1008 (8th Cir. 2012), cert. den., 568 U.S. 888 (2012).

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CORPORATE COMPENSATION
EXAMPLE RESOLUTION

The Chairman stated that it was appropriate to consider the fixing of salaries for corporate officers and the corporate policy concerning bonuses. The Chairman noted that the corporation's business operations have struggled during the past year due to a widespread economic downturn. Accordingly, the salaries offered to corporate officers and employers have been lowered to preserve the financial stability of the corporation. After full consideration and upon motion duly made and seconded, the following resolutions were unanimously adopted:

RESOLVED, that the following salaries be established for the position set opposite their respective names beginning with the month of _____, 202____, and continuing until further action of the Board of Directors:

President	$_____ per month
Vice-President	$_____ per month
Secretary	$_____ per month
Treasurer	$_____ per month

FURTHER RESOLVED, that the Board of Directors shall have the authority to authorize payment of a bonus to corporate officers and employees at such times as the Board of Directors shall deem advisable and in accordance with sound business policy.

FURTHER RESOLVED, that any payment by the corporation to any officer or Director for any reason, including (without limitation) salaries, bonuses, payment of expenses, pensions, pension plans and trusts, profit-sharing plans and trusts, stock bonus plans, stock option plans, fees, and incentive, insurance, medical, and welfare plans and other fringe benefits, shall be made subject to reimbursement by such officer or Director to the corporation to the full extent that any such payment is disallowed as a deductible expense of the corporation for Federal income tax purposes. It shall be the duty of the Board of Directors to enforce such reimbursement by any means, including (without limitation) withholding from future compensation or other payments. Service as an

officer or Director of the corporation and acceptance of any such payment shall constitute agreement to the provisions of this resolution, the Bylaws, the conditions of payment and the obligation to repay.

TAX POINTERS -- CORPORATIONS

CORPORATE DIRECTOR FEES. Must be reported for Social Security tax purposes in the year earned, irrespective of when reported for income tax purposes.

PERSONAL SERVICES CORPORATION TAX. A flat 21% rate applies to the taxable income of a "qualified personal service corporation". (Examples: doctor, dentist, lawyer, accountant, architect, actuary, engineer, performing artist, etc.)

PERSONAL HOLDING COMPANY PENALTY TAX. When more than 60% of a "C" corporation's adjusted ordinary gross income comes from personal holding company income (interest, dividends, cash rental, etc), **and** 50% of the stock is owned by five (5) or fewer shareholders at any time during the last half of the taxable year, **a 20% penalty tax** (for 2013 and after) may be levied on **"undistributed personal holding company income"**, less any "deficiency dividend" that might be declared pursuant to the provisions of IRC 547.

NOTE: Since the maximum tax rate for qualified dividends was increased to 20% for tax years beginning after December 31, 2012 by the American Taxpayer Relief Act of 2012 (ATRA), the personal holding company penalty tax rate has also been increased to 20% for tax years beginning after December 31, 2012.

Steps should be taken to avoid this by changing the mix of income. Engage in an active trade or business which would produce more than 40% of the gross income, reduce the passive income, (i.e. by custom farming or crop share if farm entity). As a last resort, one can declare a "deficiency dividend" to avoid the tax, but this will **not** avoid interest or penalties.

Unlike the accumulated-earnings tax, which is subjective, the determination of whether a corporation is a personal holding company is a mechanical test that does not depend on whether there is a tax-avoidance motive. If a corporation is determined to be a personal holding company, Schedule PH must be attached to Form 1120.

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QSST ELECTIONS (TRUSTS/ESTATES)

"S" CORPORATE STOCK – QSST ELECTIONS. When handling either an estate or a revocable trust where "S" corporate stock is included, an election is required to be filed to treat the trust into which the stock passes as a qualified subchapter S trust (QSST). If the election is **not** made, the subchapter S election may be revoked.

SEE QSST ELECTION FORM AND FORM 2553 EARLIER IN THIS SECTION

WHERE A TRUST ACQUIRES STOCK IN AN "S" CORPORATION. The beneficiary must file an election consenting to the QSST trust status **within two months and 15 days after acquisition of such stock**. This is an election by the beneficiary, individually. The election is effective the first day of the tax year in which it is made.

NOTE - LETTER RULING: One of the QSST **requirements** is there be **only one income beneficiary.** In a 2011 letter ruling, following the death of a QSST income beneficiary, the QSST's assets were divided into two shares, with the income from each share payable to a different beneficiary. The IRS ruled that the two QSST shares were substantially separate and independent shares within the meaning of IRC §663(c); and, therefore, each share could be considered to be a separate trust for QSST eligibility purposes. The income beneficiary of each share was not required to file a new individual QSST election for his or her separate share for the trust's prior QSST election to continue. Ltr. Rul. 201119005.

SEPARATE ELECTION FOR EACH "S" CORPORATION. If there is more than one "S" corporation, the beneficiary **must** make a separate election for each one. **They cannot be combined.**

WHERE THE STOCK IS IN A GRANTOR TRUST. Since the grantor was the owner of the stock and the value of the stock is going to be included in the estate of the decedent, the trust has a two-year period within which to make a QSST election to continue as a shareholder of an "S" corporation. IRC *Regs. §1.1361-1(j)(7)(ii).*

TRANSFER TO A TESTAMENTARY TRUST. If "S" corporate stock is transferred to a testamentary trust, then as per IRC *Regs. §1.1361-(1)(h)(3)* the trust has a period of two-years within which to make the QSST election. The two-year period results since during this two-year period the **estate** is considered to be the shareholder of the "S" stock. IRC *Regs. §1361(c)(2)(b)(iii).*

THE ESTATE AS A SHAREHOLDER. An estate can continue to hold stock until the estate tax is finally determined. If an IRC §6166 election was made, this can continue for up to 15 years. The estate can hold the stock during regular administration **and** for at least a two-year period. IRC *Regs. §1361(c)(2)(A)(ii).*

Form 8937 – REPORT OF ORGANIZATIONAL ACTIONS AFFECTING BASIS OF SECURITIES

The IRS has developed a form that must be filed by a corporation in conjunction with a stock distribution to shareholders, a stock split, merger or acquisition. Form 8937 is required to be filed by the issuer of a "specified security" when an organizational action is taken that **affects the basis of that security** as it applies to **all of the security's holders**, or all holders of a class of the security. For example, Form 8937 must be filed by a C Corporation if it makes a **nontaxable cash distribution** to shareholders, or makes a **nontaxable stock distribution** to shareholders. **Form 8937 is not required to be filed for a distribution of property to shareholders that will be taxable as a dividend (reported on Form 1099-DIV).**

For these purposes, a specified security is defined as follows:

(1) Any share of stock in an entity organized as a corporation or treated for federal tax purposes as a corporation; **or**

(2) Any interest treated as stock (i.e. note, bond, debenture).

ACQUIRING AND SUCESSOR ENTITIES: An acquiring or successor entity must satisfy these reporting obligations if the original issuer has not done so. If neither the original issuer nor the acquiring or successor entity satisfies the reporting obligations, both are jointly and severally liable for any applicable non-filing or late filing penalties.

WHEN TO FILE: Form 8937 must be filed with the IRS before the **earlier** of:

(1) The 45th day following the organizational action; **or**

(2) January 15 of the year following the calendar year of the organizational action.

You may file Form 8937 before the organizational action is finalized if the quantitative effect on basis is determinable. **NOTE:** For purposes of determining this filing deadline, a redemption occurs on the last day a holder may redeem a security.

ISSUER STATEMENTS: The corporation is required to provide a copy of Form 8937 to each security holder of record as of the date of the organizational action, and also provide a copy of Form 8937 to all subsequent holders of record up to the date upon which the original security holder was provided with a copy of Form 8937.

The corporation may provide a written statement instead of a copy of Form 8937. The written statement must include the same information as provided on Form 8937, and must indicate that the information is being reported to IRS.

S CORPORATION EXCLUSION FROM FILING: An S corporation is generally **not required to file** Form 8937 as it can satisfy the reporting requirement for any organizational action affecting the basis of its stock **if it reports the effect of the organizational action on a timely filed Schedule K-1** (Form 1120S) for each shareholder, and timely gives a copy of all proper parties.

WHERE TO FILE: Department of the Treasury, Internal Revenue Service, Ogden, UT 84201-0054.

Form **8937**
(December 2017)
Department of the Treasury
Internal Revenue Service

Report of Organizational Actions Affecting Basis of Securities

[a] **See separate instructions.**

OMB No. 1545-0123

Part I Reporting Issuer

1 Issuer's name	2 Issuer's employer identification number (EIN)

3 Name of contact for additional information	4 Telephone No. of contact	5 Email address of contact

6 Number and street (or P.O. box if mail is not delivered to street address) of contact	7 City, town, or post office, state, and ZIP code of contact

8 Date of action	9 Classification and description

10 CUSIP number	11 Serial number(s)	12 Ticker symbol	13 Account number(s)

Part II Organizational Action Attach additional statements if needed. See back of form for additional questions.

14 Describe the organizational action and, if applicable, the date of the action or the date against which shareholders' ownership is measured for the action [a]

15 Describe the quantitative effect of the organizational action on the basis of the security in the hands of a U.S. taxpayer as an adjustment per share or as a percentage of old basis [a]

16 Describe the calculation of the change in basis and the data that supports the calculation, such as the market values of securities and the valuation dates [a]

Part II **Organizational Action** *(continued)*

17 List the applicable Internal Revenue Code section(s) and subsection(s) upon which the tax treatment is based ▸

18 Can any resulting loss be recognized? ▸

19 Provide any other information necessary to implement the adjustment, such as the reportable tax year ▸

Sign Here	Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than officer) is based on all information of which preparer has any knowledge. Signature ▸ Date ▸ Print your name ▸ Title ▸				
Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	Firm's name ▸			Firm's EIN ▸	
	Firm's address ▸			Phone no.	

Send Form 8937 (including accompanying statements) to: Department of the Treasury, Internal Revenue Service, Ogden, UT 84201-0054

Appendix 1
Treatment of Partners and More-than-2% S Corporation Shareholders for Various Fringe Benefits

Treated as Partners[1]	Treated as Employees[2]
Qualified employee achievement award [IRC Sec. 74(c)].	Qualified educational assistance program[7] (IRC Sec. 127).
Group term life insurance coverage ofup to $50,000 per partner (or shareholder) (IRC Sec. 79).	Qualified dependent care assistance progr (IRC Sec. 129).
Disability insurance coverage (IRC Sec. 105).	**No-additional-cost services [IRC Sec. 132(b) and Reg. 1.132-l(b)(l)].**
Medical reimbursement plans (IRC Sec. 105).	**Qualified employee discounts [IRC Sec. 132(c) Reg.** 1.132-1)Cl)].
Premiums for accident, health, and long-term care insurance coverage for the partner (or shareholder), spouse, and dependents (IRC Sec. 106).	**Working condition fringe benefits {IRC Sec. l32(d) and Reg. 1. 132-l(b)(2)(1i)]. These mclude the business-use port10n of a company-provided vehicle, professional dues, company-paid Job-related education expenses, company-provided cell phones, and job placement assistance.**
Meals or lodging furnished for the convenience of the company (IRC Sec. 119).	*De minimis* **fringe benefits [IRC Sec. 132(e) and Reg. 1.132-l(b)(4)1. These mclude personal use of an employer-provided cell phones or computer maintained exclusively at 1:iusiness establishment, occasional employee cocktail parties or picnics, occasional use of the copy machine, and local telephone calls.**
Cafeteria plan[3] [IRC Sec. 125; Prop. Reg. 1.12 -l(g)(2)].	**On-premises athletic facilities' [IRC Sec. 132(j) and Reg. 1.132-l(b)(3)].**
Qualified transportation fringes[4] [IRC Sec. 132(0].	**Qualified retirement planning services [IRC Sec. 132(m)].**
Qualified moving expense reimbursements[5] [IRC Sec. 132(g)].	
Qualified ado£tion assistance program[6] [IRC Sec. 137(c)(2)].	
Health savings accounts (IRC Sec. 223).	

1 This means the benefits can't be provided tax-free to the partner or more-than-2% S corporation shareholder.

2 These benefits can be provided tax-free to the partners and more-than-2% S corporation shareholders on the same basis as other employees.

3 Partners and shareholders cannot participate in a cafeteria plan, as doing so would disqualify the plan.

4 However, under the *de minimis* benefit rules, a partner can be provided a tax-free monthly pass (not to exceed $21) to commute on public transportation [Reg. l.132-9(b), Q & A 24(b)].

5 Neither the Code nor regulations state whether a partner is considered an employee or partner for qualified moving expenses, but the IRS classifies them as partners in Publication 15-B. Thus, the conservative approach would be to treat partners as ineligible for these benefits.

6 Neither the Code nor regulations state whether a partner is considered an employee or partner for adoption assistance programs (AAPs). In Publication 15-B, the IRS states that partners and more-than-2% S corporation shareholders are *not* considered employees eligible for AAP benefits. Thus, the conservative approach would be to treat partners as ineligible for employer-provided adoption assistance.

7 However, no more than 5% of the benefits during the year may be provided to more-than-5% ovVD.ers (or their spouses or dependents).

However, no more than 25% of the benefits maybe paid to a more-than-5% stockholder or owner.

9 However, the facility must not primarily benefit officers, owners, or highly compensated employees.

10 The services must be available on substantially the same terms to each member of the group of em_ployees normally provided education and information regarding the employer's qualified plan. Also, neither the Code nor regulations define employee for this benefit, but IRS Pub. 15-B does not list partners as being ineligible to receive retirement planning services as a tax-exempt fringe benefit.

Form **8925**
(Rev. September 2017)
Department of the Treasury
Internal Revenue Service (99)

Report of Employer-Owned Life Insurance Contracts

a **Attach to the policyholder's tax return. See instructions.**
a **Go to *www.irs.gov/Form8925* for the latest information.**

OMB No. 1545-2089

Attachment Sequence No. **160**

Name(s) shown on return	**Identifying number**
Name of policyholder, if different from above	Identifying number, if different from above
Type of business	

1	Enter the number of employees the policyholder had at the end of the tax year	**1**	
2	Enter the number of employees included on line 1 who were insured at the end of the tax year under the policyholder's employer-owned life insurance contract(s) issued after August 17, 2006. See *Section 1035 exchanges* on page 2 for an exception	**2**	
3	Enter the total amount of employer-owned life insurance in force at the end of the tax year for employees who were insured under the contract(s) specified on line 2	**3**	
4a	Does the policyholder have a valid consent for each employee included on	**4b**	

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

Future Developments

For the latest information about developments related to Form 8925 and its instructions, such as legislation enacted after they were published, go to *www.irs.gov/Form8925*.

Purpose of Form

Use Form 8925 to report the number of employees covered by employer-owned life insurance contracts issued after August 17, 2006, and the total amount of employer-owned life insurance in force on those employees at the end of the tax year. Policyholders must also indicate whether a valid consent has been received from each covered employee, and the number of covered employees for which a valid consent has not been received.

For more information, see sections 101(j) and 6039I, and Notice 2009-48, 2009-24 I.R.B. 1085, available at *www.irs.gov/irb/2009-24_IRB/ar11.html.*

Definitions

Employer-owned life insurance contract. For purposes of Form 8925, an insurance contract is an employer-owned life insurance contract if it is owned by a policyholder as defined below, and covers the life of the policyholder's employee(s) on the date the life insurance contract is issued. If you have master contracts, see section 101(j)(3) for additional information.

Policyholder. For purposes of Form 8925 and these instructions, a policyholder is an "applicable policyholder" as defined in section 101(j)(3)(B). Generally, a policyholder is the person who owns the employer-owned life insurance contract, and who is (a) engaged in a trade or business that employs the person insured under the employer-owned life insurance contract and (b) the direct or indirect beneficiary of the employer-owned life insurance contract.

Related person. A related person is considered a policyholder if that person is (a) related to the policyholder (defined earlier) under sections 267(b) or 707(b)(1), or (b) engaged in a trade or business under common control with the policyholder. See sections 52(a) and (b).

Employee. Employee includes an officer, director, or highly compensated employee under section 414(q).

Insured. An individual must be a U.S. citizen or resident to be considered insured under an employer-owned life insurance contract. Both individuals covered by a contract covering the joint lives of two individuals are considered insured.

Notice and consent requirements. To qualify as an employer-owned life insurance contract, the policyholder must meet the notice and consent requirements listed below before the issuance of the contract.

1. Provide written notification to the employee stating the policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued.

The written notification must include a disclosure of the face amount of life insurance, either in dollars or as a multiple of salary, that the policyholder reasonably expects to purchase with regard to the employee during the course of the employee's tenure. Additional notice and consent are required if the aggregate face amount of the employer-owned life insurance contracts with regard to an employee exceeds the amount of which the employee was given notice and to which the employee consented. See Q&A-9 and Q&A-12 in Notice 2009-48.

2. Provide written notification to the employee that the policyholder will be a beneficiary of any proceeds payable upon the death of the employee.

3. Receive written consent from the employee. See *Valid consent* under the instructions for line 4a.

Electronic notification and consent. The written notification and consent requirement can be met electronically only if the system for electronic notification and consent meets requirements 1 through 3, above. See Q&A-11 in Notice 2009-48 for more information.

Issue date of contract. Generally, the issue date of a life insurance contract is the date on the policy assigned by the insurance company on or after the date of application. For purposes of meeting the notice and consent requirements, the

issue date of the employer-owned life insurance contract is the later of (1) the date of application of coverage, (2) the effective date of coverage, or (3) the formal issuance of the contract. See Q&A-4 in Notice 2009-48 for more information.

Who Must File

Generally, every policyholder owning one or more employer-owned life insurance contracts issued after August 17, 2006, must file Form 8925 for each tax year the contract(s) is owned.

Section 1035 exchanges. Policyholders are not required to complete Form 8925 for a life insurance contract issued after August 17, 2006, as part of a section 1035 exchange for a contract issued before August 18, 2006. See Q&A-15 in Notice 2009-48 for more information.

However, any material increase in the death benefit or other material change to the contract will cause it to be treated as a new contract and the policyholder is required to file Form 8925. See Q&A-14 in Notice 2009-48 for more information.

For master contracts under section 264(f)(4)(E), the addition of covered lives is treated as a new contract only for the additional covered lives.

See sections 1035 and 264(f)(4)(E) and Notice 2009-48 for more information.

When To File

Attach Form 8925 to the policyholder's income tax return for each tax year, during which the policyholder has employer-owned life insurance contract(s) in force.

Recordkeeping

You must keep adequate records to support the information reported on Form 8925.

Specific Instructions

Name of Policyholder

Enter the name of the policyholder (defined earlier).

Identifying Number

The identifying number of an individual is a social security number. For all other taxpayers, it is an employer identification number.

Type of Business

Enter the policyholder's trade or business activity.

Line 4a

Valid consent. Before the issuance of the employer-owned life insurance contract, the employee must provide written consent (a) to be insured under the contract and (b) that coverage may continue after the insured terminates employment.

Note. The written consent is not valid unless the related employer-owned life insurance contract is issued (see *Issue date of contract* on page 1) within a year after the consent was executed, or before the employee terminates employment with the trade or business of the applicable policyholder, whichever is earlier. For additional notice and consent requirements that may apply, see item 1 under *Notice and consent requirements* on page 1. Also, see Q&A-9 in Notice 2009-48 for more information.

Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated burden for individual and business taxpayers filing this form is approved under OMB control numbers 1545-0074 and 1545-0123. The estimated burden for all other taxpayers who file this form is shown below.

Recordkeeping . . . 2 hrs., 23 min.

Learning about the law or the form ..... 1 hr., 00 min.

Preparing the form . . 1 hr., 4 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.

FAMILY LIMITED PARTNERSHIP
(GIFTING ISSUES)

A Family Limited Partnership (FLP) is generally utilized by an older generation (parents) to retain control of assets in a manner that allows them to pass on partial or fractional ownership to younger generations (children/grandchildren) while reducing possible estate tax liability. In a FLP, the general partnership interest may reflect an ownership interest in 1-5% of the FLP assets, with the limited partnership interest reflecting a 95-99% ownership interest. The parents initially receive all of the membership units in the FLP.

NOTE – SPOUSAL OWNERSHIP: It is generally desirable to equalize property ownership between spouses before putting the assets in the partnership.

BUSINESS PURPOSE: There must be a business purpose for the transfer of assets to a FLP, other than to reduce taxes, although this is certainly in the background. Later, gifts will likely be made of the limited partnership membership units to family members.

Forming an FLP and immediately gifting smacks of lack of business purpose. The form of the transaction and/or the entity itself may be ignored for gift and estate tax purposes. Don't be too greedy. Allow profits to flow through to the various FLP owners and make distributions of profits (except for necessary reserves for adequate cash flow) to protect against gifts being treated as gifts of a future interest.

> **NOTE – PROBLEMS WITH GIFTS OF A PRESENT INTEREST – ANNUAL EXCLUSION:** In a 2010 Tax Court case, taxpayers claimed annual exclusions for gifts of limited partnership interests to their children on the theory that the children had an immediate income right and could transfer the interests. Thus, they were treated as gifts of a present interest. The Tax Court denied the exclusion (as gifts of a future interest) after noting that the partnership agreement did not allow capital account withdrawals and prohibited partners from disposing of their interests to third parties without the consent of all partners and only after a purchase option by the other partners with no time limit for exercising the option. Walter M. Price, TC Memo 2010-2.
>
> In a 2012 Tax Court case, annual exclusions for gifts of limited partnership interests were claimed on gifts to children and a trust benefitting grandchildren, and others. The partnership was funded primarily by stock which had a history of paying dividends. The limited partnership made annual income distributions to the limited partners. Even though the partnership agreement included restrictions on transfer, the Court found the gifts met the present interest test as the gifts conferred on donees a substantial, present economic benefit by reason of use, possession or enjoyment of **income from the property**, if not from the property itself. The Court noted as requisites for the present interest test that a donor could prove that (1) the limited partnership would generate income; (2) some part of that income would flow steadily to the donees; and (3) that part of the income could be readily ascertained. Wimmer v. Commissioner, TC Memo 2012-157.

PRACTICE POINTER: **To protect against a gift being treated as a gift of a future interest, consider adding a "Crummey" notice provision to the partnership operating agreement providing that for a period of 30-60 days following a gift of a membership interest, the donee can have the gifted interest redeemed by the FLP at fair market value.**

NOTE – GIFTING/VALUATION DISCOUNTS: It is a good idea to **not** start gifting on day one. Prior to gifting limited partnership membership units, the assets of the FLP need to be carefully appraised at fair market value. The fair market value of the net assets of the partnership (assets less liabilities) divided by the total number of ownership units will give the fair market value per partnership unit. A certified evaluation is important.

Equally important is an appraiser's statement as to the percent of discount from fair market value that may be claimed for lack of marketability and minority interest factors. Conservatively, current minority interest/marketability discounts will range from not less than 20%-25%, to not more than 30%-35% with lack of marketability considerations comprising 40% to 60% of these total discounts. Both appraisals are necessary and important and **both** generally require a certified appraisal. Such appraisals should accompany any gift tax return reporting the gifting of limited partnership interest in the FLP.

GIFT TAX RETURNS: Consider filing gift tax returns for all FLP gifted interests if valuation discounts are being claimed. Filing a gift tax return and disclosing any discount starts the running of the statute of limitations during which the IRS can audit the return and take issue with any valuation discount being claimed. **If no gift returns are filed, the entire gifting process is subject to review at the decedent's death.** One must have full disclosure when filing gift tax returns including:

1. A description of the transferred property and any consideration received by the transferor;
2. The identify of, and relationship between, the transferor and each transferee;
3. If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument;
4. A detailed description of the method used to determine the fair market value of property transferred, or a copy of an appraisal of the property can be attached to the return. The appraisal will meet the disclosure requirements only if **the appraiser and the appraisal meet specified requirements.**

NOTE: The IRS has paid a great deal of attention to FLP gifting techniques due to wide use and abuse (e.g. combined marketability and minority interest discounts of up to 60 to 65% have been taken in some cases). Do not utilize discounts above the 20%-35% range without significant documentation for the discount taken.

NOTE: FLPs are also frequently utilized by siblings in conjunction with their joint ownership of family land holdings following the death of their parents. In this regard, FLPs are a convenient entity to deal with asset management and control issues, and issues involving eventual transfer/sale among siblings or their heirs. In addition, out-of-state land owners can use this entity format to avoid multi-state probate issues at death.

ELECTION TO OBTAIN A "STEP-UP IN BASIS" FOR DECEDENT'S INTEREST IN A PARTNERSHIP, IRC §754 & REG §1.754-1(b)(1)

A partnership is an entity with a basis for the assets within the partnership **(inside basis)**. Likewise, there is a basis for each partner for their interest in the partnership **(outside basis)**.

A typical farm partnership **might** consist of father and son, or perhaps two brothers, each with an equal share in the partnership. Often, the basis of the items within the partnership will be very low. This is because current items are expensed within the crop year and capital items are subject to liberal IRC §179 expensing, additional first-year depreciation and/or MACRS depreciation that results in writing down the asset far more rapidly than it actually depreciates.

As a result, when a partner passes away the basis of the asset within the partnership will be very low, many times zero, (e.g. corn or beans in the bin) since all expenses were written off. If sold, the sales price is all reported as income.

If a farmer was a self-employed sole proprietor and passed away, the farmer would generally obtain a "step-up in basis" to fair market value at date of death. Growing crops receive a step-up depending on when the person passed away within the growing season. As a result, the self-employed farmer's estate can sell the crops, or the machinery, and pay little, or no, income tax because of the step-up in basis.

IRC §754 allows an election on the **first return of the partnership after date of death of the deceased partner**, to step-up to fair market value, **the interest of the deceased partner**. Thus, the decedent is put on the same basis as the self-employed farmer. **HOWEVER, THIS RESULTS ONLY IF AN IRC §754 ELECTION IS TIMELY FILED ON THE FIRST RETURN DUE AFTER DEATH OF DECEASED PARTNER.**

See election form at the end of these materials.

****

For record keeping purposes, it is a good idea to take the extra time to set forth on the IRC §754 election the various items that the election will affect. One should itemize, clearly describe the item, show the basis in the partnership, show the fair market value, then the interest of decedent and the amount added to the basis of decedent for each item.

An example which might follow below the election:

Item	Partnership Basis	Decedent's Percent	Decedent's Basis	Fair Market Value Date of Death	Added to Basis Of Decedent
J.D. Tractor	$ 40,000	50%	$20,000	$65,000 x ½ = $32,500	$ 12,500*
10,000 bu corn @ $2.20	-0-	50%	-0-	22,000 x ½ = 11,000	11,000**
5,000 bu beans @ $7.50	-0-	50%	-0-	37,500 x ½ = 18,750	18,750**
10 stock cows raised	-0-	50%	-0-	10,000 x ½ = 5,000	5,000***
Jupiter, the Bull	3,500	50%	1,750	5,000 x ½ = 2,500	750****

Items * and *** and **** would be depreciated over the MACRS life expectancy with the resulting depreciation each year deducted from the income share of the successor to decedent, such as the spouse or children.

The grain (Items **) would be deducted as an expense allocated to the interest of such successor in the year of sale.

EXAMPLE: Net income of the partnership (w/o the IRC §754 additional basis) is $80,000 x 50% =

To the other partner	$ 40,000
To successor partner	
The interest of decedent	40,000
LESS: ½ of corn sold	
Basis as per §754	- 11,000
LESS: ½ of beans sold	
Basis as per §754	- 18,750
LESS: Addl. depr. on tractor,	- 1,339
cows & bull as per §754	- 863
Net taxable income to	
Successor	$8,048

(1) If the partnership is dissolved, the additional basis will pass to the successor in interest of the deceased partner.

(2) If the property is sold within the partnership, compute the income of the partnership **without** regard to this additional basis. The additional depreciation or expense deduction is then used to reduce the taxable income of the successor to such partnership interest. It does not affect the other partners, flowing only to reduce the income of the successor(s).

Note: The election must be made on the first return of the partnership due after date of death. IRC Reg. §1.754-1(b).

NOTE: This election is not available in a "C" or "S" corporation, or a LLC taxed as a corporation.

One should carefully keep track of the additional basis and make proper record of the amount claimed each year so one obtains the full benefit of IRC §754. For the person who overlooks such an election, the estate remains in the same position as the decedent had been (as far as basis of assets is concerned). They would continue with only a "carryover basis".

If one overlooks an election, one might be able to obtain permission from IRS to make the election on a late return. See: Ltr. Rul. 201251004, Sept. 14, 2012.

Beware of the fact that once an IRC §754 election is made, it is permanent. For example, if a partner buys into a partnership when assets are valued high and passes away when values are significantly lower, a mandatory downward adjustment is required.

If the election is overlooked and the partner disposes of the assets within two years, check IRC §732(d). It permits the selling partner to elect within said two-year period a stepped-up basis upon such sale.

The following election should be attached to the first partnership return due after death of a partner, with a schedule of property using the format contained above.

****

NAME(S):	TIN:

ELECTION TO ADJUST BASIS OF PARTNERSHIP PROPERTY PURSUANT TO INTERNAL REVENUE CODE §754 AND REG. §1.754-1(b)(1)

The partnership hereby elects, pursuant to IRC §754 and Reg. §1.754-1(b)(1), to adjust the basis of partnership property as a result of a distribution of property or a transfer of a partnership interest as provided in IRC §734(b) and §743(b). This election is made in conjunction with the partnership's Form 1065, U.S. Partnership Income Tax Return.

The partnership understands that this election, once made, shall be irrevocable unless a revocation of said election, showing reasonable cause, is approved by the District Director of the IRS district in which the partnership's Form 1065 is required to be filed.

Dated this _____ day of _____, 202_____.

_____

_____, General Partner

Business **Entity Comparison** Chart

	Soh, **Proprietorship**	**General** Partftarship	Limited **Partnership**	Limited **liability Company**	Corporation
Definition	One person owns all the assets, owes all the liabilities, and operates in his or her personal capacity	A voluntary association of two or more persons who jointly own and carry on a business for profrt	A partnership with one or more general partners and one or more limited parmars	Statutorily authorized company that is characterized by limited liabifrty and management by members or managers	Having lawful authority to act as a single person distinct from the shareholders who own it
Formation	No fonnal requirements	No formal requirements	Filing with state	Filing with state	Filing with state
Govamlng Documents	None	Partnership agreement	Partnership agreement	Article$ of organization and operating agreement	Articles of incorporation and bylaws
Owners	Sole proprietor	General partners	GeneraVlimited partners	Members	Shareholders
Number of **Dwners**	1	Unlimited	Unlimited	Unlimtted	Unlimited except 100 shareholders for S corp.
Personal Uabilities of Owners	Unlimited liability for the obligations of the company	Unlimited liabirrty of partners for obligetions of company	Unlim ed liab!ity for general pertn er(s), generally no liability for limited partners	Generally no liability of members for obligations of company	Generally no liability of shareholders for obligations of company
Taxation	Pass-through	Pass-through	Pass-through	Typically pass-through but may elect taxation as corporation	Entitytaxa on unless elect subcheotar S
Applicable Tax RQles	Individual tax rates	Tax rate of partner	Tax rate of partner	Tax rate of partner or shareholder if taxed as a partnership or S corp; ff taxed as a C corp. the C rates apply	Corporate tax rates for C corporation; tax rates of shareholders for S corporation

Business Entity Comparison Chart !continued)

	Sola Proprielarship	**General Portnarsllip**	**ll111ited Partnership**	**Limited** Liability **Company**	**CO(JIOrBlion**
Tax Treatment of **Liquidation**	No tax	Ganerally no tax	Generally no tax	Generally no tax if taxed as partnership; g enerally win be corporate- and shareholder-level taxes if taxed as corporation	Generally wm be corporate and shareholder level taxes
Management	Sole proprietor has full control	Typically each partner has an equal voice	General partners manage; limited partners have 6mited management authority	E'rther member-manager or manager managed !controlled by opera1ing agreement)	Board of directors elected by shareholders
Cost of **Creation**	Low	Medium	Medium to high	Medium to high	Medium to high
Raising Capita.l	Proprieto(s own funds	Contributions from parmers or adding partners	Contributions from permers or addfng partners	Contributions, add members, or seU interest, determined by operating agreement	Sell stock for contributed property or for cash
Transfer of Ownership	Freely transferable	**May be** limitations	May be limitation	May be limitations; controlled by operating agreement	Freely transferable
ConYerting the Entity **fonn**	Converting to **corporation,** par1nership, or LLC is generaDy tax free	Converting to **corp:oration,** limited partnership, or LIC Is generally tax free	Change to LLC or corporation is generally tax free	Converting from a par1nership to a C or S corporation generally tax free	Change to S from C or to CfromSis genereUy tax free; otherwise may be a liquidation with lex consequences
Dissolution and Liquidation Costs	Low	Medium	Medium	Medium if taxed as partnership and high *tt* taxed as corp.	High

Appendix 1

Comparison of Corporate and Noncorporate Attributes

Explanation: This table illustrates the differences between operating a business as an S corporation, C corporation, proprietorship, partnership, or LLC.

Attribute	S Corporation	C Corporation	Proprietorship	Partnership	LLC[a]
Continuity of life	Indefinite; but stock ownership must be monitored	Indefinite	Ceases on death of proprietor	Terminates if 50% or more of total interest in capital and profits is sold or exchanged within a 12-month period	Generally no; but available in some states. Terminates for federal taxes if 50% or more of capital and profits interests are transferred during a 12-month period
Transferability of interests	Generally freely transferable; can be restricted through buy/sell agreements; must observe limitations on who can own stock	Generally freely transferable; can be restricted through buy/sell agreements	Freely transferable by selling the entire business	Generally subject to partners' approval; can be restricted through buy/sell agreements	Generally subject to members' approval; can be restricted through buy/sell agreements
Management	Centralized; board of directors; corporate officers	Centralized; board of directors; corporate officers	Centralized	General partnership: not centralized; Limited partnership: generally centralized	Can be either centralized or not centralized
Liability of owners	Generally limited to assets in corporation	Generally limited to assets in corporation	Unlimited	General partnership: unlimited; Limited partnership: general partner unlimited, limited partner limited to assets in partnership	Limited to assets in the LLC
Contribution of property	Nontaxable only if transaction meets Section 351 requirements	Nontaxable only if transaction meets Section 351 requirements	Nontaxable transaction	Generally a non-taxable transaction; assumption of liabilities by partnership may trigger gain recognition	Generally a nontaxable transaction; assumption of liabilities by LLC may trigger gain recognition
Taxability of income	Generally taxable to shareholder	Taxable to corporation	Taxable to proprietor	Taxable to partner	Taxable to member
Deductibility of losses	Generally deductible by shareholder; liabilities do not increase basis for deducting losses except for direct loans from shareholder	Deductible by corporation	Deductible by proprietor	Generally deductible by partner to extent of basis; liabilities may increase basis for deducting losses	Generally deductible by member to extent of basis; liabilities may increase basis for deducting losses
Special allocation of income/loss	Not permitted	Not applicable	Not applicable	Permitted as long as there is substantial economic effect	Permitted as long as there is substantial economic effect

Attribute	S Corporation	C Corporation	Proprietorship	Partnership	LLC[a]
Passive losses	May not offset active or portfolio income (limits apply at shareholder level)	May offset active income but not portfolio income of closely held corporation; may not offset active or portfolio income of personal service corporation	May not offset active or portfolio income	Cannot offset active or portfolio income (limits apply at partner level)	Cannot offset active or portfolio income (limits apply at member level); generally, members treated as limited partners
Tax year	Generally must use calendar year or make Section 444 election	May select any fiscal year if not a personal service corporation	Must use tax year of proprietor	Generally must use fiscal year of majority interest partners or make Section 444 election	Generally must use fiscal year of majority interest members or make Section 444 election
Qualified retirement plans for employee-owner	Payments are deductible if plan is nondiscriminatory	Payments are deductible if plan is nondiscriminatory	Payments to a Keogh Plan or SEP are deductible	Payments to a Keogh Plan or SEP are deductible	Payments to a Keogh Plan or SEP are deductible
Life insurance for employee-owner	Deductible as compensation	Premiums for first $50,000 group-term life are deductible and not taxable to employee	Premiums are not deductible	Premiums are not deductible	Premiums are not deductible
Health insurance for employee-owner	Deductible by corporation as compensation; 100% deductible by more-than-2% shareholder	Payments are deductible	100% deductible	Typically deductible by partnership as guaranteed payment; reported as income by partners; 100% deductible by partner	Typically deductible by LLC as guaranteed payment; reported as income by members; 100% deductible by member
Distribution to owner	Nontaxable to shareholder to extent of basis in stock; distribution of appreciated property results in gain recognition by corporation	Not deductible by corporation; generally ordinary income to shareholder; distribution of appreciated property results in gain recognition by corporation	Nontaxable	Nontaxable to extent of basis in partnership; disproportionate distribution of Section 751 assets may trigger gain	Nontaxable to extent of basis in LLC; disproportionate distribution of Section 751 assets may trigger gain
Gain on sale of interest	Capital	Capital; up to 100% of gain from qualified small business stock may be excluded	Capital and/or ordinary depending upon character of assets	Capital (unless *hot asset* partnership rules apply under IRC Sec. 751)	Capital (unless *hot asset* partnership rules apply under IRC Sec. 751)
Loss on sale of interest	Ordinary to extent of Section 1244 stock; otherwise, loss is capital	Ordinary to extent of Section 1244 stock; otherwise, loss is capital	Capital and/or ordinary depending upon character of assets	Generally capital	Generally capital
Liquidating distribution	At corporate level treated as sale of property; gain passes through and increases shareholder basis; could trigger built-in gains tax	At corporation level treated as sale of property; gain to shareholder if FMV exceeds stock basis	Nontaxable	Generally, nontaxable; cash distribution in excess of basis will trigger gain; disproportionate distribution of Section 751 assets may trigger gain	Generally, nontaxable; cash distribution in excess of basis will trigger gain; disproportionate distribution of Section 751 assets may trigger gain

Attribute	S Corporation	C Corporation	Proprietorship	Partnership	LLC[a]
Accumulation of earnings	No restrictions	Corporation could be subject to accumulated earnings tax on unreasonable accumulation	No restrictions	No restrictions	No restrictions
Section 179 dollar limitation applied at single level?	No; The dollar limitation applies at the S corporation level and again at the shareholder level	Yes	Yes	No; The dollar limitation applies at the partnership level and again at the partner level	No; The dollar limitation applies at the LLC level and again at the member level
Maximum tax rate	Generally taxed at individual shareholder level	35%, with 3% increase for taxable income between $15 million and $18.33 million	35% (effective rate may be higher if exemptions are phased out and itemized deductions are limited)	Taxed at partner level	Taxed at member level
Use of tax credits	Passed through to shareholders to be applied against their tax	Used to offset corporate tax	Used to offset tax of the individual	Passed through to partners to be applied against their tax	Passed through to members to be applied against their tax
Use of NOLs	Passed through to shareholder; limits apply at shareholder level	Used to offset corporate income subject to certain limits	Used to offset individual's income subject to certain limits	Passed through to partner; limits apply at partner level	Passed through to members; limits apply at member level
At-risk rules	Limits apply at shareholder level	Only applicable to certain closely held corporations	Limits apply at proprietor level	Limits apply at partner level	Limits apply at member level
Charitable contributions	Passed through to shareholder; limits apply at shareholder level	Deductible by corporation subject to certain percentage limits	Deductible by individual subject to certain percentage limits	Passed through to partner; limits apply at partner level	Passed through to member; limits apply at member level
Self-employment income to owners	No	No	Yes	Yes, general partners; No, limited partners	Unclear
Cash accounting method	Unrestricted unless inventories are maintained or is a tax shelter[b]	Restricted	Unrestricted	Unrestricted unless inventories are maintained or is a tax shelter[b] or has a C corporation partner	Unrestricted unless inventories are maintained or is a tax shelter[b] or has a C corporation partner
Classes of stock/ownership interests	Restricted	Unrestricted	N/A	Unrestricted	Unrestricted
Number of investors	Limited to 100	Unlimited	N/A	At least two	At least two[c]
Eligible investors	Restricted	Unrestricted	N/A	Unrestricted	Unrestricted

Notes:

[a] Assumes the LLC is a multimember LLC treated as a partnership for tax purposes and not as an association taxable as a corporation.

[b] If a gross receipts test is met, the cash method may be used even if inventories are maintained.

[c] Reg. 301.7701-3(b)(1)(ii) disregards a single-member LLC as a separate entity.

WASHBURN UNIVERSITY
SCHOOL OF LAW

FEDERAL ESTATE & GIFT TAX UPDATE
AND
CORPORATE LIQUIDATIONS/REORGANIZATIONS

JOINT MEETING OF THE BOISE ESTATE PLANNING COUNCIL AND IDAHO STATE BAR
TAX, PROBATE & TRUST SECTION
BOISE, ID
DECEMBER 4, 2023

Roger A. McEowen
Professor of Agricultural Law and Taxation
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1

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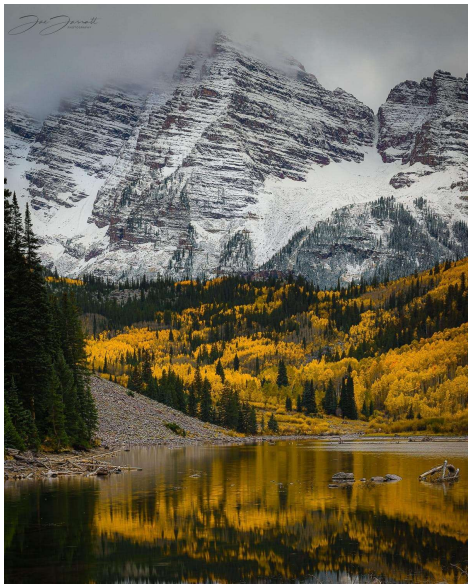
Current Developments in Estate and Gift Taxation



3

Gross Estate Calculations and Deductions [1]

- **Revenue Reconciliation Act of 2017**
  - Increase in exemptions equivalents
    - Sunsets at end of 2025 and reverts to ATRA 2013 levels
    - $5 million (in 2011 dollars)
    - ATRA does not have a sunset provision
    - Post-2017, inflation adjustments are based on the C-CPI-U
      - Less favorable (attempts to account for persons' ability to alter consumption patterns in response to price changes)

4

Exemptions and Rates

- **Applicable exclusion**
  - $12,920,000 (2023)
  - $13,610,000 (2024
- **Annual exclusion**
  - $17,000 (2023)
  - $18,000 (2024)
- **Installment payment of FET**
  - $1,750,000 (2023 2% portion)
  - $1,850,000 (2024 2% portion)
- **Max. special use valuation reduction**
  - $1,310,000 (2023)
  - $1,390,000 (2024)

5

Inflation Adjustments

- **Inflation Adjustments**
  - 2032A rates

	2022
AgFirst	5.14
AgriBank	4.57
CoBank	4.47
Texas	4.95

	2023
AgFirst	5.33
AgriBank	4.83
CoBank	4.83
Texas	5.22

6

Basis

2

- **Basis step-up retained for assets included in gross estate**
  - Incentive to not make gifts for estates under the applicable exemption

7

Portability

2-3

- **Surviving spouse can use the unused exemption of deceased spouse**
  - Election by filing Form 706
    - Schedule on return to compute amount of available exemption
    - Note: There is a box to check if the estate decides not to elect portability
    - Can use good faith estimates of value
      - Put them in a range of values included on the return
      - Note: To establish basis, may still need evidence of actual value

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Portability

- **Upon death of surviving spouse, estate's exemption is surviving spouse's remaining exemption plus unused exemption from first spouse**
- **During life, surviving spouse can use deceased spouse's "excess exemption" to fund lifetime gifts**
  - Fixed number that is not adjusted annually for inflation

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Portability

- **Exemption only portable between decedent and "last deceased spouse" dying after 2010.**
- **Upon remarriage and survival of second spouse, lost is the first spouse's ported over amount.**
  - Choose spouses wisely.
- **Inapplicable for GSTT**

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Clawback

3-4

- **Final regulations in late 2019**
  - For deaths after 2025, estate can claim greater of then current exemption equivalent or amount of exemption equivalent used in conjunction with gifts made before 2026.
    - Example in regulations
- **Proposed regulations in 2022**
  - Addresses various types of transfers
    - Clawback can occur in these situations
      - Gifts during life that are treated as transfers at death

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Closing Letters

4

- **New procedure**
  - $67 user fee to get an estate closing letter
  - Issued after Form 706 has been accepted after an adjustment to which the estate agrees or after an adjustment of the DSUEA

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Basis Consistency

- **Executor must provide IRS and beneficiaries with statement identifying the value of each interest in property reported on the return and other information IRS requests**
  - Form 8971
  - Due 30 days after 706 filed
  - Inapplicable to returns filed solely for portability purposes

Portability

5

- **Extended time to use simplified method to get extension to elect portability on Form 706**
  - Fifth anniversary of decedent's death

Split-Dollar Life Insurance

5-7

- Split-dollar is not a type of insurance but rather merely an approach to funding or paying for the cost of life insurance.
  - A private split-dollar insurance arrangement is one in which two persons or trusts together purchase insurance on the life of a particular person. In the estate planning context, this typically, involves the insured and an irrevocable life insurance trust ("ILIT").

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Split-Dollar Life Insurance

- For example, a taxpayer might have her revocable trust entered into a split-dollar arrangement with an irrevocable trust, or ILIT, she created.
  - The trust might advance funds to the ILIT to help pay part of the cost of the insurance. Effectively the revocable trust and the ILIT "split" the cost of paying for insurance.

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Split-Dollar Life Insurance

- There are two general types of split-dollar arrangements:
  - (1) the economic benefit regime under Reg. Sec. 1.61-22; and
  - (2) the loan regime under Reg. Sec. 1.7872-15.

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Split-Dollar Life Insurance

- In a traditional or typical life insurance plan an ILIT buys and owns life insurance. The donor makes gifts to the ILIT so that the ILIT has money to pay the insurance premiums.
  - The way this was typically done was for the gifts to be made so that each beneficiary can withdraw from the trust the amount of the annual exclusion gift (currently $17,000/donee).

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Split-Dollar Life Insurance

- **Example:**
  - Joe has three children as beneficiaries of an ILIT. Joe gifts $51,000/year to the trust without any gift tax implications.
    - But if the insurance premiums were $150,000 annual gifts would be insufficient by $99,000/year.
      - One solution might be to use an economic benefit split dollar arrangement (loan regime split dollar or GRATs are other options).

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Split-Dollar Life Insurance

- In an economic benefit split-dollar arrangement the ILIT might pay only for the term cost of the life insurance. That would avoid the need for large gifts to the ILIT.
- If the ILIT only pays the term cost for life insurance, even if the policy held in the ILIT is a permanent life insurance policy with annual premiums much more costly than just the term cost, a third party pays the difference between the term cost and the actual annual premium.

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Estate of Morrissette

- **Mom's revocable trust was the third party that paid most of the insurance cost**
  - But since the ILIT owns the policy, the death benefit, reduced by what must be repaid to the family member or trust advancing part of the premium costs, is outside the taxpayer's estate.
  - The person or trust advancing a portion of the premiums is not making a gift, rather it is an advance that will be repaid.
    - The advancing party may retain the full right to recover the greater of the cash value or the total premiums paid from the policy death benefits.

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Estate of Morrissette

- **Basic set-up:**
  - (1) grandparent (or grandparent's revocable trust) advances premium dollars to an ILIT,
  - (2) the ILIT purchases life insurance on the lives of the children, and
  - (3) the beneficiaries of the ILIT are the grandchildren.
  - **Note:** The grandparent is typically the wealthier generation that can afford to fund the life insurance plan. But there are lots of variations.

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Estate of Morrissette

- Mom (elderly) advanced the funds to the ILIT
  - The life insurance policies held in the ILIT were funded with a few premiums over a relatively short period of time.
  - The insureds were children.
  - Mom's estate valued her interest in the advances with a significant valuation discount.
    - Because her estate is only entitled to repayment of the advances when each of the insured children dies which actuarily is likely to be decades into the future. Thus, on a present value basis the value may not be substantial.
      - Advances of $30 million valued at $7 million

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Estate of Morrissette

- **Tax Court**
  - Arrangement was valid
    - Entire premium or cash value not included in estate
  - But estate had undervalued decedent's retained rights
    - Not reasonable that estate converted a $30 million premium value into about $7 million for tax purposes

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More Split-Dollar

6

- ***Estate of Levine***
  - Big taxpayer win
    - Cash surrender value not included in gross estate
    - Receivable of $6.5 million (the amount paid the up-front premiums for two separate policies with a total face value amount of $17.25 million was discounted to $2.82 million (a 65% discount!)

Estate of Levine

- **Facts:**
  - Marion created an irrevocable life insurance trust (ILIT) to own two life insurance policies. The ILIT was signed by Marion's children and a business associate, all as attorneys-in-fact, and had a trust company as an independent trustee.
  - The ILIT also had an investment committee in the form of a single individual, the same business associate who signed the ILIT, along with the children. The court found that this committee had a fiduciary duty to direct the ILIT's investments prudently.
  - To pay the $6.5 million upfront premiums to purchase the two insurance policies, the ILIT borrowed most of through a split-dollar agreement.
  - Under the split-dollar agreements:
    - The ILIT agreed to buy the policies.
    - Marion's also had a revocable trust, which agreed to pay the premiums on the policies (borrowed the money to pay the premiums).
    - The ILIT agreed to assign the policies to the revocable trust as collateral.
    - The ILIT agreed to pay the revocable trust back for its investment – the greater of: (1) premiums paid, or (2) the cash surrender values (CSVs) of the policies either on the death of the insureds or at the date of termination, if the arrangement was terminated prior to maturity.
  - Finally, only the ILIT had the right to terminate the arrangements and surrender the policies.

Estate of Levine

- The preceding steps all took place towards the end of 2008.
- After Marion's death, on Jan. 22, 2009, the IRS challenged her estate tax return and eventually issued a notice of deficiency for a little more than $3 million, plus penalties based on the difference between the value of the receivable listed the estate tax return and the $6.5 million.
- After stipulations, the Tax Court had to decide the value of the split-dollar receivable in the estate and what the penalties should be if any undervaluation was found.

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Estate of Levine

- **The court had to decide the following:**
  - Whether Treasury Regulation §1.61-22 govern the estate tax consequences here?
    - If not, what was the nature of the decedent's ownership interest, as created by the split-dollar transaction?
  - Does IRC §§2036 or 2038 require inclusion of the policies' CSVs in the gross estate?
  - Does IRC §2703 and its valuation rules apply to the estate's property interest and, if so, how does that impact the value of the interest?

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Estate of Levine

- **Tax Court's decision:**
  1. Treas. Regs. §1.61-22 only governs the gift tax consequences of the transaction and doesn't help the IRS with the estate tax issue.
  2. On the issue of what property was transferred, the court held that the property "at issue cannot be the life-insurance policies, as these policies have always been owned by the insurance trust." However, the transferred property also can't be the receivable itself because this asset belonged first to the revocable trust and then to the estate.
  3. So what rights were retained?
     1. Marion retained the split-dollar receivable, and nothing else. The court also found that holding this receivable didn't give Marion a right to the CSVs of the policies – only to wait until termination or maturity of the policies and then collect the $6.5 million or the CSV.

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Estate of Levine

- **Tax Court's decision:**
- On the last point the court found a very significant difference between *Levine* on one hand and *Cahill* and *Morrissette* on the other:
  - In *Estate of Morrissette v. Comm'r*, the donor and donee could mutually agree to terminate the agreement.
  - In *Estate of Cahill*, the agreement could be terminated only by written agreement of donor and donee, acting unanimously.
  - In contrast, in *Levine*, the ILIT, by its investment committee, had the sole right to terminate the arrangement.
  - The court held that without "any contractual right to terminate the policies, we can't say that Levine had any sort of possession or rights to their cash-surrender values."

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Estate of Levine

- **What about the ability to surrender the policies?**
  - The IRS argued that Marion stood on both sides of these transactions and therefore could unwind the arrangements at will.
  - The Tax Court noted that the attorneys-in-fact, who were trustees of the ILIT, held power over the revocable trust, agreed the court.
    - However, the ILIT had an independent trustee, and the trustee was directed by the investment committee – which was just one of the trustees of the revocable trust.
  - The court found that the investment committee's sole member had a fiduciary duty to the beneficiaries of the ILIT (which included Marion's grandchildren) that would have prevented him from surrendering the policies.

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Estate of Levine

- **What about the ability to surrender the policies?**
  - Therefore, the ability to surrender the policies for their CSV couldn't be characterized as a right retained by Marion, and the IRS' efforts to gain Section 2036 inclusion of the policies in the estate failed. The IRS arguments for inclusion under Section 2038 failed for the same reasons.

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Estate of Levine

- **The IRC §2703 argument**
  - IRS argued that the split-dollar arrangement was Marion's way of placing a restriction on her right to control the $6.5 million in cash paid for the policies and, thus, to reduce its value.
  - By disregarding this restriction according to the valuation rules of Section 2703, the IRS also arrived as its preferred value without any discounts.

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Estate of Levine

- **The IRC §2703 argument**
  - The court held that the reference to "any property" in Section 2703 refers to the property of an estate, not some other entity's property. And because the property in *Levine* is the receivable – not the policies – Section 2703 doesn't help the IRS. Because there were no restrictions on the split-dollar receivable (Marion could have sold it or done anything she wished with it), there were no restrictions to disregard.

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Estate of Demuth

7

- **Value of checks written before death but paid after death included in gross estate**
  - Could have stopped payment before death meant it was a revocable transfer

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U.S. v. Allison

- **Cashier's check included in gross estate**
  - No delivery and acceptance until after death

36

Estate of Moore v. Comr.

8

- **Farm transferred to partnership before death included in gross estate**
  - No valid business reason for partnership

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Charitable and Marital Deduction

8

- ***CCA 202233014***
  - CRUT created by estate
    - 75% of unitrust payments to charity or spouse in trustee's discretion
      - No deduction because transfer to charity not ascertainable or severable from spouse's interest
      - No marital deduction because spouse's interest could not be established as of date of decedent's death

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Estate of Grossman v. Comr.

9

- **The potential peril of serial marriages**
  - Estate left to third wife
  - Court said third marriage was valid

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Estate Tax Deductions

9-10

- **Prop. Regs. applicable to estates of decedents dying on or after adoption of final regs.**
  - Apply p.v. concepts to claims and expenses paid or to be paid after 3-year grace period after decedent's date of death
  - Guidance on deductibility of interest on loans incurred to pay estate tax
  - Guidance on deductibility of claims based on decedent's personal guarantee
  - Modify rules for provision of a "written appraisal document"

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U.S. v. Parks

10

- **Late special use election**
  - Election can be made on late return if it is the first return filed.

No Appraisal, No Charitable Deduction

11-14

- ***Estate of Hoensheid v. Comr., T.C. Memo. 2023-34***
  - *The common scenario:*
    - When a corporation is to be acquired through a taxable sale of shares, a shareholder who is otherwise charitably inclined may be advised to contribute a portion of the corporation's stock to a charity or to a donor-advised fund that will thereafter make charitable contributions.
    - The person making the contribution would be seeking to enjoy a double tax benefit:
      - An income tax deduction for the charitable contribution equal to the fair market value of the donated shares
      - For appreciated shares, relief from the obligation to include the unrealized gain inherent in the contributed shares in gross income.
      - Also, the donee will not be taxed on the gain recognized on the sale of the contributed shares to the buyer.)

No Appraisal, No Charitable Deduction

11-14

- ***Estate of Hoensheid v. Comr., T.C. Memo. 2023-34***
  - But, here IRS asserted a deficiency on the basis that a shareholder who donated some of his shares to a tax-exempt organization (a donor-advised fund) should be taxed on gain realized from the sale of those shares by the donee under the anticipatory assignment of income doctrine.
    - Notwithstanding that there appears not to have been any binding agreement to sell the stock of the corporation at the time of the donation.
    - Further, the valuation obtained by the donor, from the investment bank that advised the sellers with respect to the sale of stock of the corporation, was found not to meet requirements under I.R.C. §170(f)(11) for a qualified appraisal.
  - Tax Court also sustained the IRS's denial of a charitable contribution to the shareholder.

No Appraisal, No Charitable Deduction

11-14

- ***Estate of Hoensheid v. Comr., T.C. Memo. 2023-34***
  - Takeaways:
    - Must engage a qualified appraiser and assure that the appraiser's report complies with the requirements of a qualified appraisal.
    - The court's conclusion that the assignment of income doctrine applied is more surprising.

No Charitable Deduction for CRAT Gifts

- ***Estate of Block v. Comr., T.C. Memo. 2023-30***
  - Facts:
    - Decedent had established a revocable trust on Sept. 2, 1997. In 2015, she executed a will, which transferred her residuary estate to the trust. She also amended and restated the trust at that time.
    - Upon death, a subtrust (the Katz Trust) was created for the benefit of her sister, Harriet, and then for Harriet's spouse, if he survived Harriet. On the death of the survivor of them, any remaining assets were to be distributed to the Jewish Community Foundation of Greater Hartford, Inc.

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No Charitable Deduction for CRAT Gifts

- ***Estate of Block v. Comr., T.C. Memo. 2023-30***
  - Facts:
    - The decedent intended the Katz Trust to be a CRAT and directed that the terms be construed accordingly. Article 4.1(A) of the trust instructed the trustees to pay Harriet (or her spouse, as the case may be) an annuity of the greater of all net income or $50,000, at least annually.
    - Upon an IRS audit, the trustees executed an amendment, which revised Article 4.1(A) to say that Harriet or her spouse should receive an annuity amount equal to $50,000. The amendment purported to be effective as of the decedent's date of death. At the conclusion of its audit, the IRS disallowed the entire charitable deduction ($352,085) with respect to the Katz Trust.

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No Charitable Deduction for CRAT Gifts

- ***Estate of Block v. Comr., T.C. Memo. 2023-30***
  - The law:
    - IRC Section 2055(a), allows a deduction from the value of a decedent's gross estate for transfers to charity.
    - When split-interest transfers (that is, those that involve conveying an interest in property to both charitable and non-charitable beneficiaries for less than full and adequate consideration) are involved, Congress includes limitations to avoid potential abuse. Manipulating how the trust assets are invested could have a detrimental effect on the charitable beneficiary.
      - Section 2055(e)(2)(A) only allows a deduction for the charitable remainder portion of a split-interest transfer when the remainder passes in trust and the trust is either a CRAT, charitable remainder unitrust (CRUT) or a pooled income fund (PIF).

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No Charitable Deduction for CRAT Gifts

- ***Estate of Block v. Comr., T.C. Memo. 2023-30***
  - The law:
    - Section 2055(e)(3)(A) goes on to provide that a qualified reformation can save an estate's charitable deduction if a trust initially failed to qualify as a CRAT or a CRUT.
    - A qualified reformation can only happen if the remainder interest is a reformable interest under Section 2055(e)(3)(B).
      - All payments to the noncharitable beneficiaries under the terms of the original trust must have been either a specific dollar amount or a fixed percentage of the fair market value of the property; and
      - The remainder interest must have been exclusively charitable. There's even an exception to the specific dollar amount or fixed percentage rule.
    - A judicial proceeding brought within 90 days of the due date for the estate tax return that qualified the trust as either a CRAT or a CRUT, retroactive to the decedent's date of death, can cure an initially nonfixed interest.

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No Charitable Deduction for CRAT Gifts

- ***Estate of Block v. Comr., T.C. Memo. 2023-30***
  - The ruling:
    - The trust provisions, as they were at the decedent's death, weren't limited to a specific dollar amount and therefore didn't qualify as a CRAT.
    - Under the default rules, the Katz Trust charitable remainder wasn't a reformable interest.
      - The estate's only option was a judicial reformation, but the court quickly dismissed the estate's argument that the amendment effected a qualified reformation.
        - » It was executed long after the 90-day period following the estate tax return due date and wasn't instituted by a court.
      - The court also declined to accept the estate's substantial compliance argument.

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No Charitable Deduction for CRAT Gifts

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- ***Estate of Block v. Comr., T.C. Memo. 2023-30***
  - The ruling:
    - In an effort to bind the IRS to its prior decisions, the estate argued that Revenue Procedure 2003-57, and Rev. Proc. 2003-59 allow trustees to act without court involvement to amend the terms of a trust to ensure it qualifies as a CRAT and retroactively qualifies for an estate tax deduction.
      - The court wasn't convinced. It pointed out that major defects, like an income interest not expressed as an annuity interest, require a judicial proceeding to commence before an IRS audit is initiated. Because the original Katz Trust violated the CRAT rules, it didn't fall within the reasoning of the two revenue procedures discussed above. Ultimately, the court disallowed the entire charitable deduction.
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Gifts and Valuation

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- ***Nelson v. Comr.***
  - IRS found themselves as a benefactor of two formula clauses, one from a gift and one from a sale, that were respected by the Court.
  - However, due to the way the clauses were drafted without an adjustment based on values as finally determined for Federal gift tax purposes, the IRS came out ahead when the Court determined that the valuations used in the gift and sale were too low.

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Gifts and Valuation

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- ***Smaldino v. Comr.***
  - Indirect gifts of transferred LLC interests

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Gifts and Valuation

- ***Buck v. United States***
  - Court denied IRS' motion for summary judgment and refused to aggregate the gift of partial interests in real estate together for purposes of valuing the gifts and thus determining appropriate discounts.
  - The IRS alleged that no discount was warranted where the taxpayer gifted his two sons each a 48% interest in several tracts of land and retained the remaining 4% of each tract.
  - Under the IRS theory, since the taxpayer owned the entirety of each tract prior to the gift, the two gifts of 48% interests in the tracts, one to each son, should be valued together and thus no discount was warranted.
    - The Court disagreed.

Buy-Sell Agreements

- A key component of business succession planning, particularly for small businesses with two or more family groups in the ownership structure.
  - This issue is applicable for both corporations and LLCs

Buy-Sell Agreements

- A buy-sell agreement provides for the possible or mandatory buyout of an owner's interest in the business upon the occurrence of certain stated events such as death, disability, termination of employment and divorce.
- Often these agreements are funded at least in part by life insurance or disability insurance.

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Buy-Sell Agreements

- **Useful document to assist in transitioning the family farming operation to the next generation of owners.**
- **Useful in balancing out the inheritances among heirs**
  - On-farm heirs get control and non-farm heirs get non-control interests and cash

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Buy-Sell Agreements

- **Mechanics**
  - Typically a separate document
  - But, some (or all) of its provisions may be in bylaws, partnership agreement, LLC operating agreement and, sometimes, in an employment agreement with owner-employees

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Buy-Sell Agreements

- **Valuation**
  - For operations potentially subject to federal estate tax, valuation is a big issue.
  - Buy-sell agreement not only provides a market for unmarketable shares, but can also establish value for FET purposes of the decedent's interest

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Buy-Sell Agreements

- **Valuation**
  - General rule:
    - Value determined without regard to any option, agreement, or other right to acquire or use the property at a price less than the FMV of the property, or any restriction on the right to sell or use the property
  - Exceptions…

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Buy-Sell Agreements

- **Valuation**
  - Exception: a buy-sell agreement can peg the value of the deceased owner's interest if…
    - It is a bona fide business arrangement;
    - Is not a device to transfer property to members of the decedent's family for less than full and adequate consideration in money or money's worth;
    - It contains terms that are comparable to other arrangements entered into by persons in arms' length transactions;
      - Need expert witness testimony for this
    - It contains a purchase price that is fixed and determinable under the agreements;
    - Is legally binding during life and after death; and
    - Was entered into for a bona fide business reason and is not a substitute for a testamentary disposition for full and adequate consideration
      - Make sure to document the business reason
      - It must be more than expressing a desire to maintain family control

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Buy-Sell Agreements

- Buy-sell agreements are needed to plan for the occurrence of these critical events, which may place the business' continued success and survival at risk. In a two partner/owner business, the surviving partner would rarely wish to be partners with the deceased partner's spouse or children, along with these possible issues:
  - The surviving business owner may have to hire additional staff to cover the work done by the deceased partner.
  - The surviving partner may be less enthusiastic about sharing ownership, decisions, control and profits with a passive, non-working partner.
  - The deceased partner's spouse and children often do not work in the business.
  - The deceased partner's family needs cash to take the place of the lost income from the deceased partner.

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Buy-Sell Agreements

- A properly drafted buy-sell agreement can solve all of these problems, particularly if funded with life insurance.
- The agreement sets the value or the process to determine values, terms or payment and other business terms for the surviving partner to acquire the business interest of the deceased partner.

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Buy-Sell Agreements

- Buy-sell agreements are prepared in either a cross purchase or redemption format.
- A cross purchase:
  - Provides for the surviving partner to individually acquire the interest of the deceased partner from his or her family or other heirs.
  - Provides a step-up in income basis in the shares or business interest for the amount paid.
  - Avoids any corporate or state law that may restrict distributions directly from the business.
  - Helps avoid a conflict of interest in the negotiations as described in the tax case below for the redemption format.
  - Helps to avoid the issue as to whether the value of the business should include the death benefit paid for tax and business purposes.

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Buy-Sell Agreements

- A cross purchase can be more complicated because each owner holds a life insurance policy on the other owner.
- For a two-person ownership structure, only two insurance policies are owned—one held by each owner on the life of the other.
  - If we have three owners, then we would need six insurance policies—one policy held by each owner on the life of each of the others.
  - This complexity can be avoided through the formation and use of an insurance partnership or LLC. Using the insurance partnership, only three policies would be required.

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Buy-Sell Agreements

- A redemption format provides for the business to reacquire the business interest upon death of an owner or the occurrence of another event.
  - This is a deceptively simple arrangement that raises additional issues for both income tax and business purposes.
  - The redemption format does not provide a step-up in basis at purchase.
  - Corporate law distribution restrictions may interfere with the payment of the purchase price.

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Buy-Sell Agreements

- **Hybrid agreement**
  - A contract between the business and the owners whereby the owners agree to offer their shares first to the corporation and then to the other owners on the occurrence of certain events.
    - "Wait and see" – identity of purchaser not known until actual time of purchase as triggered in the agreement
      - Corporation has first opportunity to buy shares, then the remaining shareholders, then corporation may be obligated to buy any remaining shares

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Buy-Sell Agreements

- ***Connelly v. United States, 70 F.4th 412 (8th Cir. 2023).***
  - The IRS successfully argued that the value of the company for estate tax purposes was $3.5 million more than the amount agreed to be paid in the buy-sell agreement.
    - In other words, the seller was taxed for estate tax purposes for a value of $3.5 million more than was received in the sale. This is a net cost of almost $1 million in additional tax to be paid.
      - This is particularly important because this buy-sell agreement was a very typical arrangement and was almost certainly very similar to many other agreements in place today.

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Buy-Sell Agreements

- ***Connelly v. United States, 70 F.4th 412 (8th Cir. 2023).***
  - Facts:
    - Michael and Thomas, two brothers, were the sole shareholders of Crown C Supply, Inc., a closely held family business that sold roofing and siding materials. Michael was the majority shareholder, owning 77.18% of the outstanding stock, while Thomas owned the remainder (22.82%).
    - Thomas and Michael entered into a classic "wait-and-see" buy-sell agreement. The brothers would meet annually to determine value. If not within a stated time frame, such as two years, then a backup appraisal process was established in the agreement. The brothers' buy-sell agreement required the company to buy back the shares of the first brother to die, and the company bought life insurance to ensure it had enough cash to satisfy the redemption obligation. The buy-sell agreement didn't expressly require that the life insurance be used in the redemption.

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Buy-Sell Agreements

- ***Connelly v. United States, 70 F.4th 412 (8th Cir. 2023).***
  - Facts:
    - Michael died in October 2013. Pursuant to the buy-sell agreement, the company redeemed Michael's shares from his estate for $3 million, and Michael's estate paid federal estate tax on his shares in the company based upon this $3 million figure.
    - Unfortunately, the IRS audited Michael's estate tax return and assessed additional estate tax of over $1 million. Thomas, as executor of Michael's estate, paid the deficiency and filed suit, seeking a refund. The dispute involved the proper valuation of Crown C on the date of Michael's death.

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Buy-Sell Agreements

- ***Connelly v. United States, 70 F.4th 412 (8th Cir. 2023).***
  - Facts:
    - Their buy-sell agreement was a redemption format, so Crown C was entitled to receive the life insurance proceeds to fund the purchase of Michael's shares. The court held that Crown C was worth roughly $3.5 million more than it was worth the day before Michael's death and included the death benefit in the company valuation.
      - This was despite the obligation for the company to pay the funds to purchase the shares of the deceased partner.

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Buy-Sell Agreements

- ***Connelly v. United States, 70 F.4th 412 (8th Cir. 2023).***
  - Lessons:
    - The value of an interest in any closely held business entity, irrespective of whether it's a family-owned or controlled business, should be as finally determined as the fair market value for federal estate and gift tax purposes.
    - This is a term of art defined in the Internal Revenue Code. Treas. Reg. §20.2031-1(b) defines the term "fair market value" as:
      - *The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.*

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Buy-Sell Agreements

- ***Connelly v. United States, 70 F.4th 412 (8th Cir. 2023).***
  - Note:
    - The Connelly seller received the value stated in the agreement and isn't entitled to any more compensation.
    - The estate will pay the additional federal estate tax of $1 million based on a value $3.5 million higher than the purchase price received.
      - This in turn will significantly reduce the net to Michael's heirs and legatees. In essence, the IRS included the death proceeds in the value of the company despite the obligation for the company to pay the death benefit to the deceased partner's family.

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Buy-Sell Agreements

- ***Connelly v. United States, 70 F.4th 412 (8th Cir. 2023).***
  - Lesson:
    - If you establish a valuation procedure in a buy-sell agreement, follow it. The subject company and Michael's estate disregarded the valuation procedure in the sales transaction, but then tried to assert it on the estate's behalf in the litigation, which the court refused to consider.
    - The court observed that "The parties' own conduct demonstrates that the Stock Agreement was not binding after Michael's death. Thomas and the Estate failed to determine the price-per-share through the formula in the Stock Agreement." In other words, the parties did not follow the terms of the agreement. The district court then proceeded to determine the fair market value of Michael's stock.

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Buy-Sell Agreements

- ***Connelly v. United States, 70 F.4th 412 (8th Cir. 2023).***
  - Comment:
    - The district court observed, "the Estate and the IRS therefore agree that the fair market value of Crown C was approximately $3.86 million, exclusive of the $3 million in life insurance proceeds used to redeem Michael's shares. The IRS claims, however, that those proceeds must be included in Crown C's value under 26 C.F.R. § 20.2031-2(f)(2), resulting in a $6.86 million fair market value for Crown C."
    - 26 C.F.R. § 20.2031-2(f)(2) provides, in pertinent part, as follows:
      - *In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity. The primary remaining valuation issue was whether to include the $3 million in life insurance death proceeds.*
    - The court determined that the buy-sell was not truly binding during life and after death.

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Buy-Sell Agreements

- ***Connelly v. United States, 70 F.4th 412 (8th Cir. 2023).***
  - Lesson:
    - Don't rely upon the Schedule A valuation method, and if you do, give that method a very short shelf life and build in a backup appraisal method.

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Buy-Sell Agreements

- ***Connelly v. United States, 70 F.4th 412 (8th Cir. 2023).***
  - Lesson:
    - If the agreement is a redemption agreement, and the parties intend to obtain life insurance to be held by the entity as the owner and beneficiary, the buy-sell agreement must clearly define the rules.
    - In particular, the buy-sell agreement must clearly state whether the insurance death proceeds are to be counted in the determination of the enterprise value.
    - Similarly, whether the requirement that all of the life insurance proceeds must be paid as part of the redemption price should be considered in that valuation.

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Importance of a Buy-Sell Agreement

- **Extracts the off-farm heirs from the business**
- **Carefully consider the events that will trigger the agreement and who has the right to buy the interest**
- **How will it be funded?**
  - How does *Connelly* impact this?

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New Considerations Post-*Connelly*

- A "trusteed" or "escrowed" buy-sell.
  - The policies are transferred to and then owned by and payable to a trustee or escrow agent who also holds the respect owners' shares.
  - When an owner dies, the trustee or escrow agent receives the proceeds and applies them to the purchase of the stock.
  - This can make things simpler from an administrative standpoint, but it doesn't solve the cash flow or transfer for value issues, with a partnership required to address the latter.

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New Considerations Post-*Connelly*

- Use a special purpose insurance limited liability company LLC that's owned by the insureds.
  - This entity is taxed as a partnership for federal tax purposes, which addresses the transfer for value issue.
  - It will take ownership of the policies and designate itself as beneficiary.
  - The LLC will obtain the funds to pay premiums by way of the owners' capital contributions and, perhaps, rental payments from the company for equipment or other items that the LLC will lease to the company.
    - Of course, the owners will have to get the funds for those contributions from the company.
    - In any event, when an owner dies, the LLC collects the proceeds and makes a distribution to the remaining owners to finance their purchase obligation under the cross-purchase agreement.

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"Tax Affecting" of S Corporation Stock

23

- ***Estate of Cecil v. Comr., T.C. Memo. 2023-24***
  - 2010 transfer of S corporation voting and non-voting stock to children and grandchildren.
  - Issue:
    - Valuation of S corp. for purposes of valuing the gifts
  - All experts used a "tax affected" valuation approach (assuming a corporate tax rate) to arrive at C corp. equivalent value?
    - Does this apply when a DCF method is used?

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Valuation of S Corporate Stock

- Courts have applied tax affecting based upon the facts and circumstances presented in each case.
- Traditionally, Courts have generally frowned upon tax affecting in business valuations.
  - But the Tax Court concluded tax affecting was appropriate in the case of *Estate of Jones vs. Commissioner*, *T.C. Memo. 2019-101.*
- Conversely, the Tax Court concluded in *Estate of Jackson vs. Commissioner*, T.C. Memo. 2021-48, that tax affecting was not appropriate.
- This inconsistent case law provides taxpayers and valuation experts with little judicial guidance on the appropriateness and applicability of tax affecting

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Valuation of S Corporate Stock

- Along with the issue of tax affecting, there are many other areas which can lead to valuation disputes between the taxpayer's valuation experts and the IRS's valuation experts. Valuation disputes include, but are not limited to:
  - Timing
  - Disputes over comparable properties
  - Applicability of stock restriction arrangements
  - Historical reliance on economic data sets, and
  - Other methods and valuation approaches

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Valuation of S Corporation Stock

- **Remember the Importance of Adequate Disclosure**
  - The IRS generally may not revalue a prior gift in determining the available applicable credit if the gift was adequately disclosed on a gift tax return and the statute of limitations to assess the gift tax has expired.
  - Recognizing the IRS is on the lookout in reviewing gift tax and estate returns, taxpayers should confirm that they have met the regulatory hurdles for adequate disclosure on gift tax returns
    - *See* Treas. Reg. §301.6501(c)-1(f)).
  - Taxpayers' failure to adequately disclose gifts on gift tax returns allows the IRS the opportunity to re-value gifts (potentially many years after the fact).
  - Valuation experts and tax professionals can aid taxpayers with preparing valuation reports and advise taxpayers on the adequate disclosure requirements.

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Retirement Plans (p. 28)

- **Secure Act**
  - 529 plan accounts can be used for qualified student loan repayments up to $10k annually
  - Penalty-free withdrawals from 401(k) accounts to defray costs of having or adopting child
  - Eliminates the stretch (on distribution rules) for non-spouse beneficiaries
  - Secure Act 2.0
    - Delays RMD date to age 73 by 2022, to age 74 by 2029 and age 75 beginning in 2033.

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McNulty

30-31

Gold Coins in IRAs Cost a Pretty Penny

- Mr. & Mrs. McNulty invested their IRAs investments in gold coins
- Transferred $750K out of other IRAs and 401(k) accounts into gold IRA
- Their research was limited to a gold IRA promoter's website
- They took personal possession of the gold coins in their home safe

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McNulty

Gold Coins in IRAs Cost a Pretty Penny

- Ignored advice to hold coins in a depository
- Did not tell CPA who prepared tax returns that they had taken possession

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McNulty

Basic IRA Requirements

- **IRA is technically a trust with a trustee acting as fiduciary**
- **§408 imposes 2 major requirements on assets in IRA:**
  - Assets must be deposited in an "adequate vault"
  - Must not allow IRA assets to be commingled with other property

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McNulty

Did Mrs. McNulty receive distributions from her IRA when she received shipments of gold coins?
Are Mr. & Mrs. McNulty liable for substantial understatements of income tax?

- **McNultys set up LLC that they operated out of their home that they alleged was the custodian**
- **IRS argued Mrs. McNulty received a distribution from her IRA when she took physical possession of the gold coins**

Tax Court upheld IRS's deficiency assessments of $250,558 for 2015 and $18,094 for 2016, plus an accuracy penalty

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Miscellaneous

- **Income tax rates for trusts and estates**
  - Top brackets begin…
    - $$14,451 (2023)
    - $15,201 (2024)

Malpractice

- ***Wellin v. Farace***
  - Background: The IRS has long taken the position that a grantor trust doesn't exist for income tax purposes even though it may be an enforceable arrangement under local law and is respected for estate and gift tax purposes.
    - That means that there are no income tax effects by the transfer of assets between a grantor trust and its grantor even if the transfer is a sale or for consideration and even if the trust is structured so it isn't includible in the grantor's estate for estate tax purposes.

Wellin v. Farace

- One of the more common "sophisticated" estate-planning arrangements built on the grantor trust framework has been a sale of appreciated assets to a grantor trust, especially for a note.
  - This is commonly called an "installment sale to a grantor trust" or simply a "note sale.
    - "Although income and gain after the sale on the assets sold may be received and kept by the trust, they're taxed to the grantor.
    - This later factor allows the trust to grow on an income tax free basis, one of the most powerful factors in all of tax planning. And the grantor's payment of income tax on trust income reduces (burns) the grantor's estate, possibly providing further estate tax savings.

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Wellin v. Farace

- Lawyer recommended that Wellin contribute his Berkshire Hathaway shares (worth about $90 million at the time) to a partnership in exchange of 98.9% of the interests in the partnership.
- A limited liability company (called a limited liability corporation by the court), controlled by Wellin's children from a prior marriage, held the 1.1% controlling interest in the partnership. Wellin sold his 98.9% partnership interest to a grantor trust, of which the children from his prior marriage were the beneficiaries, for a note which, according to the court, was worth only $50 million.
- Late in the year before the year in which Wellin died. The partnership, again controlled by the children, sold the Berkshire Hathaway stock for $157 million, causing the recognition of considerable gain. That gain experienced by the partnership was attributed to the partners of which Wellin's grantor trust was the 98.9% partner and, because it was a grantor trust, was, in turn, attributed under the grantor trust rules to Wellin as the trust's grantor.

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Wellin v. Farace

- Wellin became concerned over the loyalty of the lawyer to him and filed a suit to set aside sale of the partnership units to the trust he had created. He discharged the law firm that had represented him in that transaction.

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Wellin v. Farace

- About two years after Wellin died, his estate sued the lawyer and the law firm for negligence, breach of fiduciary duty and breach of contract, which were premised on the same underlying facts and conduct by the defendants.
- The particular claim at issue, according to the court, was the estate's allegation that the defendants failed to inform Wellin about the "risks and consequences" of the 2009 transaction, including his potentially substantial tax exposure.

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Wellin v. Farace

- **The attorney said the claims were barred by the statute of limitations**
  - Trial court agreed
  - Appellate court reversed
    - Fact questions remained regarding when the alleged malpractice was discovered or discoverable

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Sec. 199A Reg. and Pass-Through Entities[35]

- **Final regs.**
  - Grantor of a grantor trust is entitled to the deduction
  - Rules for calculating QBI at the estate/trust level and allocating it to beneficiaries
  - Multiple trusts by the same grantor will be combined for Sec. 199A purposes if the trusts are established for tax avoidance purposes

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Deduction C Corp. Shareholder Compensation

37

- ***Clary Hood, Inc. v Comr., 69 F.4th 168 (4th Cir. 2023)***
  - Bonuses were more like non-deductible dividends based on the multi-factor approach of the Regulations.

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FBAR Penalties Don't Die

- ***United States v. Gaynor, (M.D. Fla. Sept. 6, 2023)***
  - FBAR penalties survive the taxpayer's death

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Whistleblower Can't Collect

- ***Raffaelli v. Comr., T.C. Memo. 2023-79***
  - Petitioner wants reward for taxpayer's failure to report $350,000 gift
  - IRS says "no"
    - Discretionary
    - No documents or gift letter provided
    - No bank statement

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Income Tax Basis

- **Do the assets in an intentionally defective grantor trust (IDGT) get a basis increase upon the grantor's death?**
- **With an IDGT, the grantor sells assets to a grantor trust, and the trust pays for the assets by issuing a note to the grantor. There is no gain because the seller (grantor) is treated as still owning the assets.**
- **Rev. Rul. 85-13, says that a grantor trust is ignored for income tax purposes, but not for estate tax purposes. So, therefore, the assets transferred to the trust are out of the transferor's estate.**
- **As for basis, in the typical transaction the basis of the assets in the grantor's hands is lower than what the basis in the assets will be at death. The trust takes the grantor's (low) basis.**

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The IRS Position

- **CCA 200923024 says that there is no gain recognition when assets leave a grantor trust at death – there is no deemed sale at death.**

1. **But the IRS followed that up with CCA 200937028 saying that you do not get a step-up in basis for assets in a grantor trust when the grantor dies.**
2. **But, in 2012, the IRS issued a PLR 201245006 saying that there is a stepped-up basis on assets in a grantor trust when the grantor dies.**
3. **In 2015, the IRS said it wouldn't issue any more rulings while it "studied the matter." Rev. Proc. 2015-37.**
4. **With Rev. Rul. 2023-2, the IRS settled the debate by taking the position that there is no step-up in basis because the property wasn't a bequest, devise or inheritance from the decedent and didn't fall within one of the six other types of property listed in I.R.C. §1014(b) that qualify for a basis adjustment at death.**

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Estate/Transfer Tax Proposals

40-42

- **2023 was a quiet year**
- **Prior years**
  - STEP Act
    - Tax transfers of appreciated property at death or by lifetime gift
  - For the 99.5% Act
    - Lower exemption and higher rates
    - Limit or eliminate valuation discounting
    - Severely curtail sophisticated planning with trusts

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IRS Statistics

- **Deaths in 2018**
  - 2,839,205
- **Deaths in 2019**
  - 2,854,838
- **Deaths in 2020**
  - 3,358,814
    - [345,323]
- **Deaths in 2021**
  - 3,458,697
    - [416,893]
- **Deaths in 2022**
  - 3,273,705
    - [244,986]
    - {109.680}

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Estate Tax Data

42-43

- **2021**
  - 6,158 returns filed
    - 2,584 with a tax due
  - Taxable returns reported $18.4 billion in tax paid
    - Less than one half of one percent of federal revenue
- **So, what's the purpose of the federal estate tax???**

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U.S Treasury FY 2024 “Greenbook” Proposals

- **Reporting of trust asset values**
- **Defined value formula clauses**
- **Eliminate present interest requirement for gifts (with a major catch)**

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Bonus Coverage - Structuring LLCs for S.E. Taxation

NIM

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Overview – The Code

- **Sec. 1402(a) – Net Earnings from Self Employment (NESE) includes distributive share of income or loss from a trade or business carried on by a partnership**
  - i.e., default rule is all partnership income is included, unless specifically excepted
    - General exceptions for rentals (a)(1); dividends and interest (a)(2); certain gains & losses (a)(3)
- **Sec. 1402(a)(13) – added to Code in 1977**
  - there shall be excluded the distributive share of any item of income or loss of a limited partner, as such,…"
    - Specifically excludes from NESE a limited partner's share of distributive income or loss (or at least someone that is truly acting as a L.P.)
    - History of LP
    - Prior to prevalence of LLC

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The LLC Conundrum

- **Boils down to a single point of inquiry:**
  - What is the definition of "limited partner" for purposes of applying the Sec. 1402(a)(13) exception?

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The LLC Conundrum

- **Historic dividing line between general partners and limited partners was very clear**

	GP	LP
• Authority to contract	X	
• Unlimited liability for partnership debts and obligations	X	
• Participation in management	X	

  - Note that "back in the day" **any** management participation by LP would create liability exposure

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Regulation History

- **No regulations needed prior to LLC proliferation**
  - Code was not ambiguous at the time within the existing landscape
- **Proposed Regs. first issued in 1994**
- **Prop Regs. withdrawn and new set issued in 1997**
  - Followed by six-month Congressional moratorium in 1998 on finalization
  - Moratorium expired – and still we wait

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Additional Historic Notes

- **1977 Tax Act Committee Reports recognize potential for individual to own both GP and LP interests**
  - Only GP interest constitutes NESE
- **Committee Reports clarify intent that return on invested capital is properly excluded**

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Formal Rules

- **The specific language outlined in the Code remains the ONLY formal rules that exist**
- **Proposed Regulations are just that – proposed**
  - Nevertheless, IRS has informally stated on several occasions that taxpayers can rely on proposed regulations when not in conflict with final regulations

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1997 Proposed Regulations

- **"Pure" limited partner (non-manager) not subject to SE**
- **Non-manager has:**
  1. No personal liability,
  2. No authority to contract, ***and***
  3. Does not participate more than 500 hours;

  Or

- **If Partnership is a personal service partnership, all partners are subject to SE tax**

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1997 Proposed Regulations

- **Two exceptions to SE taxation for > 500-hour participants (i.e., *only* violation is > 500 hours), requires two classes of interest**
  1. Bifurcation: LLC has > one class of interest and individual holds > one class
     - Interest of the non-manager class will not be NESE
     - The manager class is subject to SE
  2. > 500-hour LLC member holds only a non-manager class
     - Guaranteed payment for hours will be SE income
     - Distributable income of that class will not be NESE, regardless of hours
- **Both provisions require**
  - ≥ 20% non-manager interests
  - Of members who have ≤ 500 hours

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1997 Proposed Regulations

- **Intent – Exclude from NESE those amounts that are demonstrably returns on capital invested in the partnership**
- **Approach – Utilize a non-manager class to define and measure the amount that is "demonstrably a return on capital"**

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Applying Proposed Regulation

- **Create non-manager interests for minimizing SE tax**
  - Sufficient amount of non-manager interests to achieve 20% level
- **Utilize guaranteed payment for services for active participants**
  - Consider profit allocation tiers to isolate LP's return on capital investment
  - Return that is equivalent to LP should not be NESE

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Bottom Line Regarding Regulations

- **Proposed regulations (attempt) to reflect historic distinctions**
- **Provide planning opportunities whenever "pure" limited partners (i.e., non-managers) exist**
- **Personal service partnership partners are by definition subject to SE tax**
- **Apply a functional test rather than relying on state law labels**

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LLCs and S.E. Tax - *Castigliola*

- It is conceivable that a taxpayer who is a limited partner under state law may not be a limited partner for purposes of section 1402(a)(13), although no court has yet addressed that fact pattern.

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Soroban Capital Partners LP v. Comr., 161 T.C. No. 12 (2023)

- **Facts:**
  - The petitioner was a limited partnership that made guaranteed payments and distributed ordinary income to its limited partners. However, the petitioner excluded distributions of ordinary income to its limited partners from its computation of net earnings from self-employment. Its basis for doing so was that the limited partners' interest conformed to state law.
  - The IRS disagreed asserting that wasn't enough and that the functions and roles of the limited partners also had to be analyzed for self-employment tax purposes.
  - The Tax Court agreed with the IRS.

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Soroban Capital Partners LP v. Comr., 161 T.C. No. 12 (2023)

- **This is the first time the Tax Court was asked to determine the self-employment tax status of limited partner in a state law limited partnership (having passed on the issue in a 2020 case).**
- **The Tax Court determined that the functional analysis test applied based largely on statutory construction of I.R.C. §1402(a)(13) which excludes from self-employment tax "the distributive share of any item of income or loss of a limited partner, as such."**
  - The Court concluded that the "as such" language meant that there wasn't a blanket exclusion for a limited partner. Instead, the statute only applies to a limited partner that is acting as a limited partner. If a limited partner is anything more than merely an investor, self-employment tax applies to the partner's distributive share.

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C to S Conversion

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C to S Conversion

- **Factual scenario**
- **The problem is eventual liquidation of the C corp. with BIG**
- **Make S election**
- **Asset appraisal**
- **Like-kind exchange**
- **Long-term lease?**
- **Alternatives**

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C to S Conversion

- **Problem of C corporate retained earnings**
- **"Sting" tax**
- **Tax planning alternatives**
- **Stock redemption?**
- **QSST**

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S Corporation Liquidation

- Upon the death of an S corporation shareholder, the decedent's stock ownership interest receives a step-up in basis to fair market value.
  - This basis adjustment coupled with the basis increase that results from gain recognition inside the corporation upon liquidation of corporate assets (e.g. sale/distribution of assets, real estate, etc.) and the pass-through of the taxation of this gain to the shareholder (on Schedule K-1), results in only one level of taxation being incurred on liquidation, and that is at the shareholder level.

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S Corporation Liquidation

- Since stock basis has been increased by death and pass-through of income, no gain recognition results when cash or property is distributed to the decedent's estate/heirs (in exchange for stock) to complete the liquidation, since the pass-through gain (Schedule K-1) to the estate/heirs will be offset by a matching loss from liquidation of the stock.

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S Corporation Liquidation

- Distributions of property (other than cash) are treated as though the corporation sold the property to the shareholder for its fair market value, pursuant to I.R.C. §311(b).
- The corporation recognizes gain to the extent the property's fair market value exceeds its adjusted basis.
- When appreciated property is distributed to an "S" corporate shareholder in exchange for stock, the gain recognized at the corporate level passes through to all shareholders (via Schedule K-1) based on their percentage ownership in the corporation.

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S Corporation Liquidation

- If the "S" corporation only had one shareholder whose interest is liquidated at death, gain recognition does not cause taxation problems due to a matching loss offset resulting from the stock basis adjustments discussed above.
  - In other words, when the S corporation recognizes table gain, that gain increases the estate's basis in the stock in an amount equal to the taxable gain that the S corporation recognizes.
    - This taxable gain is reported to the estate on the corporation's final Schedule K-1 (Form 1120S).

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S Corporation Liquidation

- The estate's tax basis in its S corporation stock is increased to the fair market value of the S corporation's stock upon the shareholder's death and is further increased as a result of the deemed sale of the S corporation stock upon liquidation.
- Simultaneously, the estate recognizes a taxable loss equal to the gain reported to the estate on the corporation's final Schedule K-1.
  - The loss on the deemed sale of the S corporation stock in the liquidation is reported on the estate's or heir's Schedule D (Form 1040 or Form 1041).
- Typically, the S corporation gain on the Schedule K-1 (Form 1120S) reported on Schedule E (Form 1040 or Form 1041) and the loss on the Schedule D will net out with no tax due by the estate or the heirs for the S corporation gain on liquidation.

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S Corporation Liquidation

- In some instances, a farming S corporation may have one spouse as a shareholder and own ordinary income assets such as grain and equipment.
  - Upon the shareholder's death with the corporate stock passing to the surviving spouse, the sale of those assets by the surviving spouse will trigger ordinary income to the surviving spouse that will be taxed at the highest rate. If the surviving spouse then liquidates the S corporation, a capital loss will be triggered in a like amount that will be reported at $3,000 per year (or offset against other capital gains).

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S Corporation Liquidation

- The business will now have a new step-up in basis in all of its asset which the heirs can contribute tax-free to a new partnership.
  - However, if the "S" corporation has more than one shareholder, a distribution of property to a single shareholder (deceased or otherwise) in liquidation of their stock interest will result in a taxation event for all corporate shareholders.

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S Corporation Liquidation

- **Example:**
  - Assume that Farm Corp. has four equal shareholders. Mary, a shareholder who owns 25 percent of the S corporation's stock dies. The corporation distributes farm real estate to Mary's estate in liquidation of her stock interest. Mary's estate would report 25 percent of any gain at distribution and would be able to offset this taxable gain through a matching capital loss created by the liquidation of her stock in Farm Corp.
  - Unfortunately, the other shareholders would be responsible for paying tax on the remaining 75 percent of any gain.

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S Corporation Liquidation

- An alternative to avoid this taxation problem when there are multiple shareholders in an S corporation is to simply have the remaining shareholders purchase the stock of the deceased shareholder. Implementing a corporate buy-sell agreement among the shareholders might be advantageous to accomplish the desired result.

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S Corporation Liquidation

- A shareholder's income tax basis in distributed property distributed by the corporation is the property's fair market value at the date of distribution.
  - The distributee shareholder's holding period begins when the shareholder actually or constructively receives the property, because the distribution is treated as if the property were sold to the shareholder at its fair market value on that date.
- Since the shareholder's basis in the property is its fair market value (rather than a carryover of the corporation's basis), the corporation's holding period does not tack on to the shareholder's holding period.
  - Thus, the redeeming shareholder would need to hold distributed property for one year after distribution prior to sale to achieve capital gain income tax treatment on a subsequent sale.

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C to S Conversion

- **When to liquidate the S corporation?**
- **Divisive reorganization?**
  - Trade or business requirement
- **Tax considerations of corporate liquidations**

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Corporate Reorganizations

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Divisive Reorganization

- **Why?**
  - Tax saving
  - Avoiding a stock sale triggering gain recognition
  - Avoiding possible recasting of a stock redemption as a dividend
  - Nontaxable if done properly

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Basics

- **Secs. 368 and 355**
- **Type "D"**
  - Divisive
  - Acquisitive

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Typical Transaction

- **Feuding shareholders**
- **Transfer assets to new subsidiary in exchange for stock in new corporation**
- **Original corporation distributes stock in new corporation to disgruntled shareholders in exchange for stock in original corporation**
  - Split-off

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Anti-Abuse Rules

- **Business purpose**
- **Satisfy Sec. 368(a)(1)(D)**
  - The term "reorganization" means:
    - A transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

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"Business Purpose" Basics

- **Not principally a device to distribute earnings and profits**
  - Facts and circumstances test
    - Is it pro rata?
    - What's the ratio for each corporation of the value of the assets used in the active trade or business?
  - What is evidence of "device"?

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Business Purpose

- **Is there a corporate business purpose?**
- **What are the contours of the requirement?**
- **Recent business purpose rulings**

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Active Conduct of Trade or Business Requirement

- **5 years immediately before the distribution**
  - No definition
- **What about a farm business leasing land?**
  - Page 30
  - Key Rev. Rul. (p. 30)
  - Another key Rev. Rul. (p. 31)
  - Planning considerations

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What About After the Division?

- The "post" requirement is contained Sec. 355(b)(1)(A) which must be read together with Sec. 355(b)(2)(B).
- There you will find an explicit 5-year trade or business requirement in the "pre" period and a trade or business requirement for the "post" period.
- So, then, what does "trade or business" mean in the "post" period.
  - Turning to the regs., in Treas. Reg. Sec. 1.355-3(b)(2)(ii), you will find elaboration.
    - Facts and circumstances test
      - Required is proof of "performance of active and substantial management and operational functions."
      - Obviously, there is a time period required to be able to establish satisfaction of the "post" trade or business test. How long does "substantial" take?

THANK YOU!

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