The Texas Tax Lawyer

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CHAIR'S MESSAGE

Thank you for the privilege of serving as the 2014 – 2015 Chair of the Tax Section of the State Bar of Texas. Things are already off to an excellent start thanks to the hard work of my fellow officers, Alyson Outenreath (Vice Chair), David Colmenero (Secretary), and Stephanie M. Schroepfer (Treasurer), as well as the efforts of all of our Council Members, Committee Chairs, Vice-Chairs, and the many other members who volunteer, without whom our Section could not be a success.

Website Update. We have just begun the process creating a new and more modern website. The new website will have numerous enhanced features: enhanced graphics, a new look and feel, more streamlined navigation, additional information and new resources. It is anticipated that the new website will be launched sometime during the first quarter of 2015.

Tax Section Administrator. I am very pleased to inform you that Vicki McCullough has been hired as our Administrator to assist the Tax Section with its leadership initiatives, operations and administration. Vicki is based in Austin and be reached at (512) 771-3969 or Vicki@Sequiturmarketing.com. We look forward to working with Vicki and helping us bring the Tax Section to a new level of service and as a resource to our members. Welcome Vicki!

Leadership Academy. The second class of the Tax Section Leadership Academy currently has 21 young tax lawyers who have participated in programs in San Antonio, Austin and Houston. The Leadership Academy allows young tax lawyers to develop their leadership skills as well as network with other tax lawyers throughout the state. The criteria for selection is:

- Three to six years' experience;
- Member of the State Bar of Texas in good standing;
- Member of the Tax Section of the State Bar of Texas; and
- Commitment to attend four quarterly sessions around the State.

Many thanks to David Colmenero for his efforts in launching the Leadership Academy, and Dan Baucum for continuing the effort as our Chair, along with the invaluable assistance of Susan House. If you have any questions, please contact Dan Baucum at (214) 780-1470 or dbaucum@shacklaw.net.

Continuing with the Section's Core Programs. This year, we will continue our core programs for the Tax Section.

- **COGS Projects**. Under the leadership of our Committee on Government Submissions ("COGS") Chair Robert Probasco, with Co-Chairs Henry Talavera and Catherine Scheid, we have already submitted four COGS projects this year addressing (1) participation in an I.R.C. §6103(n) summons interview, (2) proposed revisions to Circular 230, (3) discrimination testing standards for softly frozen defined benefit pension plans, and (4) proposed regulations regarding disguised sales and the allocation of liabilities. Many thanks to Richard Hunn, Robert Probasco, Dustin Whittenburg, Stephanie Schroepfer, Henry Talavera, David Peck, and Gary Huffman for their hard work on the comments. If you wish to get involved with a COGS project or have ideas for leading one yourself, please contact Robert ("Bob") Probasco at (214) 335-7549 or Bob.Probasco@gmail.com.

- **24/7 Free CLE Library**. The Tax Section has implemented a 24/7 library of free CLE Webcast programs accessible at any time to Section members through the Tax Section website. We are currently updating the library and will be sending updates when new programs are added for current CLE.

  In addition, there are videotaped interviews with Texas Tax Legends, including Stanley Johansen, Charles Hall, David Glickman, Larry Gibbs, Richard Freling, Buford Berry, Ronald Mankoff, and Bob Davis. If you have any questions, please contact Michael Threet, the head of our CLE Committee, at (214) 651-5000 or Michael.Threet@haynesboone.com.

- **Live CLE**. The Tax Section sponsors and conducts live CLE programs, including the annual Property Tax program, the annual International Tax program, State and Local Tax Committee events and a Tax Law Survey in a Day program. In addition, the Section co-sponsors various live CLE program, including the Texas Society of CPAs Free CPE Day and the Advanced Tax Law Program conducted by the TexasBarCLE. Please check the calendar for the dates and locations of upcoming meetings

  Mark your calendars for our 18th Annual International Tax Symposium to be held at The Center for American and International Law, 5201 Democracy Drive, Plano, Texas, on November 6, 2014, and November 7, 2014 at The Hess Club, 5430 Westheimer Road in Houston, Texas. For further information, contact Austin Carlson, Chair of the International Tax Committee, at (713) 986-7188 or acarlson@lrm.com.

- **Pro Bono**. The Tax Section assists pro se taxpayers during Tax Court calendar calls in Dallas, Houston, Lubbock, El Paso, and San Antonio. Check the calendar on the Tax Section's website for the next calendar call in your city and contact Juan Vasquez, Jr., Pro Bono Chair, at (713) 654-9679 or juan.vasquez@chamberlainlaw.com. The Tax Section also provides support to appropriate charitable and governmental programs such as Texas C-Bar and VITA.

- **Texas Tax Lawyer**. Thanks to the hard work of Rob Morris, the Tax Section publishes three issues of the Texas Tax Lawyer each year. The Texas Tax Lawyer is distributed to members electronically and, upon request, in hardcopy. The issues include articles on hot topics, substantive outlines from Committee Webcasts, COGS submissions, and annotated forms. Please contact Rob Morris at (713) 651-8404 or robert.morris@nortonrosefulbright.com.

- **Law School Outreach**. We hold luncheons each year with students at the SMU Dedman, University of Texas, University of Houston, and Texas Tech University Schools of Law. Every other year, we hold luncheons at Baylor, LSU, and South Texas Law Schools. We also would like to hold luncheons periodically at Saint Mary's, Texas Southern, and Texas Wesleyan Law Schools. If you wish to serve as a panelist, please contact the head of our law school student outreach program, Abbey Garber, at (972) 308-7913 or abbey.b.garber@irscounsel.treas.gov.

- **Outstanding Texas Tax Lawyer**. Congratulations to the Honorable Judge Juan F. Vasquez of the United State Tax Court as the 2014 recipient of the Tax Section's Outstanding Texas Tax Lawyer. This year's nomination form is on our website and is included in this issue of the Texas Tax Lawyer. Nominations must be made by January 15, 2015. Please take a few minutes and consider nominating a worthy individual for this award.

- **Annual Meeting and Tax Legends Lunch**. The Section Annual Meeting this year will be held in San Antonio, Texas on June 18-19, 2015. It will include CLE programs and our Legends Lunch. Stay tuned for more information.

Nominating Committee

The Tax Section's nominating committee for 2015 – 2015 consists of Mary McNulty as Chair and Tina Green, Elizabeth Copeland and me as an ex officio member. Nominations for Chair-Elect, Secretary, Treasurer, or an Elected Council Member position can be submitted to any member of the nominating committee or any Officer of the Section at any time on or before March 1, 2015.

Act Now/Get Involved

If you are not already involved in the Section's activities, I strongly encourage you to get involved. Contact one of the chairs of the above activities or join a committee.

If you are not sure who to contact and what would be the best fit for your skills, then email me at andrius.kontrimas@nortonrosefulbright.com. You will help us build an even stronger Tax Section and have some fun in the process!

Thank you and I look forward to working with all of you for a great year!

Andrius R. Kontrimas

2014-2015 Chair

TAX SECTION
THE STATE BAR OF TEXAS

LEADERSHIP ROSTER

2014 - 2015

Officers

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TAX SECTION

THE STATE BAR OF TEXAS

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2014-2015

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TAX SECTION
OF
THE STATE BAR OF TEXAS
Revised 8/20/14
2014-2015
CALENDAR

June 2014	
1	**Deadline for Student Scholarship Applications**
11-13	**30th Annual Texas Federal Tax Institute – Hyatt Regency Hill Country Resort, San Antonio**
17	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
26-27	**SBOT 2014 Annual Meeting - Austin Convention Center**
20	**Council Retreat** Hosted by: Norton Rose Fulbright (Andrius R. Kontrimas) 98 San Jacinto Boulevard, Suite 1100 Austin, TX 78701-4255 Telephone: +1 512 474 5201 2:00 pm – 5:00 pm
25-27	**Leadership Academy - Austin** Hosted by: Jackson Walker 100 Congress Avenue, Suite 1100 Austin, Texas 78701 Telephone: +1 512 236 2000
27	**Tax Section Annual Meeting** Austin Convention Center 8:00 am – 4:40 pm (post on website at least ***20 days in advance***; elect 3 new Council members)
July 2014	
22	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
August 2014	
1	**Scholarship Program** Review and revise scholarship applications; submit changes to Tax Section for approval.
1	**Bar Leaders Conference – New Chair and Treasurer Orientation** Westin Domain – Houston 10:30 a.m. – 2:30 p.m.
8-10	**ABA Annual Meeting** Boston, Massachusetts

19	**Officer Retreat** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 11:30 a.m. – 3:30 p.m.
19	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
28-29	**32nd Annual Advanced Tax Law Course** co-sponsored by the State Bar of Texas Tax Section. Westin Galleria Hotel Dallas, Texas
September 2014	
5	**Council and Committee Chairs and Vice Chairs Meeting** **MANDATORY IN PERSON ATTENDANCE** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 10:30 a.m. – 12:30 p.m.
15-16	**Pro Bono Committee Calendar Call Assistance (regular and small case)** United States Tax Court Lubbock, Texas
18-19	**Pro Bono Committee Calendar Call Assistance (regular and small case)** United States Tax Court El Paso, Texas
18-20	**ABA Joint Fall CLE Meeting** Sheraton Downtown Denver, Colorado
23	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am

25 – 26	**Leadership Academy Meeting** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 8:15 a.m. – 4:45 p.m.
27	**Deadline for appointing Nominating Committee (list in Texas Tax Lawyer and on website)**
October 2014	
1	**Scholarship Program** Verify email addresses of law school contacts and professors for purposes of creating the master distribution list.
3	**Submission Deadline - Fall 2014 Issue of the Texas Tax Lawyer**
21	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
24	**Council of Chairs Meeting** Texas Law Center in Austin 10:30 am – 2:30 pm
27	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court San Antonio, Texas
November 2014	
1	**Scholarship Program** Verify email addresses of law school contacts and professors for purposes of creating the master distribution list.
3	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Houston, Texas
3	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Dallas, Texas
5	**Open nominations for Outstanding Texas Tax Lawyer. Nominations due January 15, 2015.**
6	**18th Annual International Tax Symposium – Plano, Texas** **The Center for American and International Law** **5201 Democracy Drive** **Plano, Texas 75024**
7	**18th Annual International Tax Symposium – Houston, Texas** **The Hess Club** **5430 Westheimer Road** **Houston, Texas**

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7	**Council Meeting** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 10:30 a.m. – 12:30 p.m.
18	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
December 2014	
1 and 8	**Pro Bono Committee Calendar Call Assistance (small case)** United States Tax Court Houston, Texas
1 and 8	**Pro Bono Committee Calendar Call Assistance (regular case)** United States Tax Court Dallas, Texas
16	**COGS Call** Dial In: 866.203.7023 Conference Code: 7136515591# 9:00 am
January 2015	
15	**Leadership Academy Meeting** Dallas Bar Association – Belo Mansion Dallas, Texas
15	**Deadline for annual meeting program agenda** Nominations due for Outstanding Texas Tax Lawyer Open nominations for Officers and Elected Council (Council vote follows January 16th meeting)
20	**Scholarship Program** o Email applications to law schools; o Post application on Tax Section website; and o Email applications to tax law professors.
20	**COGS Call** 9:00 am
29	**Council and Committee Chairs and Vice Chairs Meeting** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 3:00 pm – 5:00 pm
29-31	**ABA Mid-Year Meeting** Hilton Americas Houston, Texas

February 2015	
6	**Submissions Deadline – Winter 2015 issue of the *Texas Tax Lawyer***
14	**Tax Court Pro Bono Program Annual Renewal**
17	**COGS Call** 9:00 am
20	**Council of Chairs Meeting** Texas Law Center in Austin 10:30 am – 2:30 pm
March 2015	
1	**Nominations deadline for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members**
TBA	**Property Tax Conference**
24	**COGS Call** 9:00 am
April 2015	
1	**Nominating Committee's Report** due to Council (Must be submitted at least 10 days before April 17, 2015 Council meeting).
3	**Scholarship Program** Deadline for submission of completed applications.
10	**Scholarship Program** Scholarship Committee meets to discuss and select scholarship recipients.
17	**Council Meeting** Hosted by: Norton Rose Fulbright (Andrius Kontrimas) 1301 McKinney Street, Suite 5100 Houston, Texas 77010-3095 Telephone No.: 713 651 5482 Elect Chair-Elect, Secretary, and Treasurer 10:30 a.m. – 12:30 p.m.
21	**COGS Call** 9:00 am
24	**Submissions Deadline – Spring 2015 issue of the Texas Tax Lawyer**
May 2015	o
1	**Scholarship Program** o Contact recipients of the scholarships; and Send email notifications to individuals not selected.
7-9	**ABA May Meeting** Grand Hyatt Washington, DC
19	**COGS Call** 9:00 am

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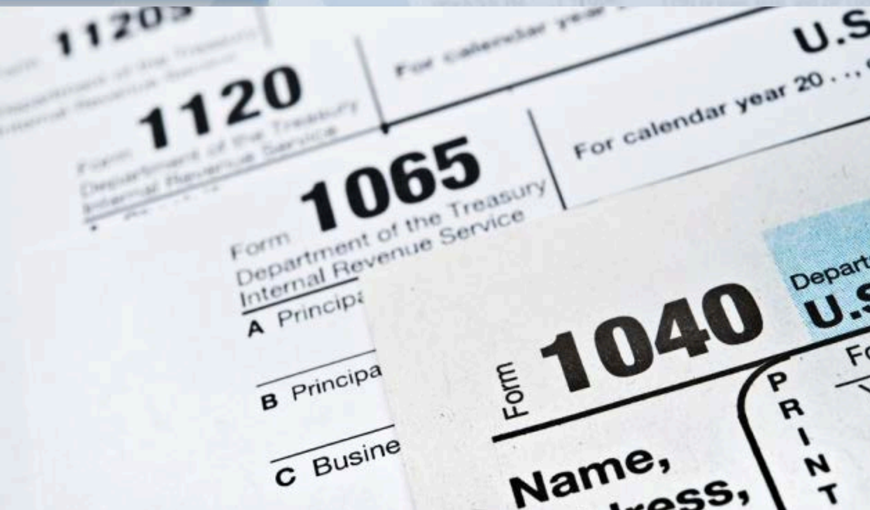
June 2015	
18-19	**SBOT 2015 Annual Meeting – San Antonio, Texas**
18 or 19	**Scholarship Program** Award of Scholarships at State Bar Annual Meeting.
23	**COGS Call** 9:00 am
July & Aug 2015	
30-4	**ABA Annual Meeting** Chicago, Ill
Sept 2015	
17-19	**ABA Joint Fall Meeting** Sheraton Hotel & Towers Chicago, Ill

State Bar of Texas

Tax Section



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PARTNERSHIP TAXATION – RECENT DEVELOPMENTS

Craig M. Bergez
Mandy L. Diaz
Porter Hedges LLP

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I. INTRODUCTION

This paper discusses recent developments with respect to Subchapter K of the Internal Revenue Code of 1986, as amended (the "Code"),[1] that interest and appear significant to the authors as of press time. This may include legislative developments, proposed and final Treasury regulations, rulings and other items published by the IRS, and court decisions. Our objective is to be reasonably current, descriptive, and helpful.

II. LEGISLATIVE DEVELOPMENTS

A. General. The prospects for the passage of significant tax legislation that would contain material provisions regarding Subchapter K during 2014 are poor at this point. However, the momentum for tax reform appears to be building. Accordingly, it is possible that there could be some movement on tax legislation that would include changes to Subchapter K following the elections in November.

[1] All references to "Sections" in this paper are to the Code except as otherwise indicated.

B. Tax Reform Act of 2014.

1. Discussion Draft. In that regard, the outgoing Chairman of the House of Representative's Ways and Means Committee, Rep. Dave Camp (R-MI),[2] recently published a discussion draft of a bill that would amend the Code to provide comprehensive tax reform. The bill, which is labeled the "Tax Reform Act of 2014," contains many proposed changes to Subchapter K. Information regarding the bill, including a copy of the bill and explanations prepared by the staff of the Joint Committee on Taxation, is available at http://tax.house.gov/.

2. Subchapter K Provisions. The changes to Subchapter K proposed in the Tax Reform Act of 2014 ("TRA14") are as follows:[3]

a. Repeal Guaranteed Payment Rules. Section 3611 of TRA14 would repeal the rules regarding guaranteed payments by striking Section 707(c) from the Code. Thereafter, payments received by partners would constitute either distributive shares of partnership profits received in the capacity of a partner, or amounts received in a capacity other than as a partner under Section 707(a). This provision also would repeal the special rules that can treat certain payments to deceased or retiring partners as guaranteed payments by striking Section 736. Thereafter, such payments would be subject to generally applicable rules (including those regarding income in respect of a decedent).

b. Mandatory Basis Adjustments. Section 3612 of TRA14 would require the basis adjustments currently contemplated under Section 743 to apply to all transfers of partnership interests, not just, as is the case under current law, if an election has been made to apply them (pursuant to Section 743(a) and Section 754) or if the partnership has a substantial built-in loss immediately following the transfer. As a companion matter, this provision would repeal the special rules and exceptions provided in current Section 743 to electing investment partnerships and securitization partnerships with respect to the requirement that certain basis adjustments occur automatically if the partnership has a substantial built-in loss immediately following the transfer.

c. Other Mandatory Basis Adjustments. Section 3613 of TRA14 generally would require basis adjustments similar to the adjustments currently contemplated under Section 734 to apply to all distributions of partnership property, not just, as is the case under current law, if an election has been made to apply them (pursuant to Section 734(a) and Section 754) or if the partnership has a substantial basis reduction with respect to the distribution. The provision would modify the current adjustment rules to provide that the basis adjustments would be made in a manner that generally would preserve for each remaining partner the amount of net gain or loss that the partner would have taken into account prior to the distribution if all partnership assets were sold at fair market value. As a companion matter, this provision would repeal the special rules provided in current Section 734 to securitization

[2] On March 31, 2014, Rep. Camp announced that he plans to retire upon expiration of his current term at the end of this year. See, O'Keefe and Kane, *Dave Camp to Retire After His Current Term*, The Washington Post (Mar. 31, 2014). He has been Chairman of the House Ways and Means Committee since January 5, 2011.

[3] See, Technical Explanation of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title III – Business Tax Reform, prepared by the staff of the Joint Committee on Taxation, JCX-14-14 (Feb. 26, 2014). It appears that TRA14 is a thoughtful reflection by Chairman Camp and the staff of the House Ways and Means Committee of the current practical status of potential tax reform legislation (as opposed to setting forth a mere "wish list" of changes to the Code). In that regard, unlike some prior tax reform proposals, TRA14 would retain Subchapter K (and not, for example, merge it together with Subchapter S pursuant to the formation of a new regime applicable to private companies). See, Yin, "*Comments on the Taxation of Passthrough Entities*," 140 Tax Notes 358 (2013). Nonetheless, TRA14 provides for significant changes to Subchapter K.

partnerships with respect to the requirement that certain basis adjustments occur automatically if the partnership has a substantial basis reduction with respect to a distribution.

d. Corresponding Basis Adjustments. Section 3614 of TRA14 would require the basis of a lower-tier partnership's assets to be adjusted if a distribution by an upper-tier partnership to one of its partners causes an adjustment to the upper-tier partnership's basis in its interests in the lower-tier partnership pursuant to Section 734 (as revised pursuant to Section 3613 of TRA14). The adjustments would correspond to the adjustment imposed on the upper-tier partnership. This provision also would require similar corresponding adjustments by a lower-tier partnership upon a distribution by the upper-tier partnership of an interest in the lower-tier partnership, or upon a disposition of an interest in the upper-tier partnership that triggers an adjustment in the upper-tier partnership's basis in its interest in the lower-tier partnership pursuant to Section 743 (as revised pursuant to Section 3612 of TRA14).

e. Limitations on a Partner's Share of Loss. Section 3615 of TRA14 would require the adjusted basis of property that is the subject of a transfer that constitutes a charitable contribution described in Section 702(a)(4), and the amount of taxes described in Section 702(a)(6), to be taken into account for purposes of applying the loss limitation provided by Section 704(d). Such changes would supplement existing Treasury Regulations that require items described in subsections (1), (2), (3), (7), and (8) of Section 702(a) to be taken into account for purposes of applying the loss limited provided by Section 704(d).[4]

f. Hot Asset Rules. Section 3616 of TRA14 would expand the scope of the "hot asset" rules by eliminating the requirement that inventory be "appreciated substantially in value" in order to be taken into account for purposes of Section 751(b), and by requiring the Treasury Department to issue regulations applying Section 751(b) on the basis of a partner's share of items of income and gain, as opposed to the partner's share of partnership assets in general. Additionally, the provision would revise the definition of "unrealized receivables" in Section 751(c) by replacing the flush language thereof with language providing that the term applies to all property other than inventory to the extent that such property would require recognition of ordinary income in the event it were sold for fair market value at the time in question.

g. Anti-Mixing Bowl Rules. Section 3617 of TRA14 would expand the scope of the "anti-mixing bowl" rules by eliminating the seven-year time limitation during which Section 704(c)(1)(B) and Section 737 are applicable, thereby preserving application of the "anti-mixing bowl" rules with respect to contributed property for an indefinite period of time.

h. Family Partnership Rules. Section 3618 of TRA14 would provide that the determination of whether the holder of a capital interest in a partnership in which capital is a material income-producing factor is a partner is determined without regard to whether the interest was obtained by gift from any other person. The provision would strike Section 704(e)(1) (which contemplates that anyone who owns such an interest shall be respected as a partner) from the Code, and thereby clarify that the determination of whether such a holder is a partner is made under generally applicable rules defining a partnership and a partner. The new language would be added to Section 761(b).

i. Technical Terminations. Section 3619 of TRA14 would repeal the rule pursuant to which a partnership is considered terminated upon a sale or exchange of 50% or more of the total interests in partnership capital and profits by striking Section 708(b)(1)(B) from the Code.

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[4] Treas. Reg. §1.704-(d)(2)

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Thereafter, a partnership would be considered terminated only if the partnership stops conducting any activities pursuant to Section 708(b)(1)(A).

j. Publicly Traded Partnerships. Section 3620 of TRA14 would expand the scope of the "publicly traded partnership" rules (which generally treat a publicly traded partnership as a corporation for federal income tax purposes)[5] by limiting the scope of the exception for a partnership that has a sufficient amount of "qualifying income" to continue to be treated as a partnership (as opposed to a corporation). The provision would limit qualifying income solely to income and gains from mining and natural resources activities. Accordingly, thereafter, income and gains derived from real estate and commodities activities would no longer constitute qualifying income.

k. Carried Interests. Section 3621 of TRA14 would require a portion of net capital gain allocable to partners who receive partnership interests in connection with the performance of services (i.e., so-called "carried interests") for partnerships conducting certain types of activities to be treated as ordinary income. Generally, the requirement would apply to income and gains other than income and gain attributable to capital invested by the partner. The types of activities that are relevant for these purposes are activities consisting in whole or in part of raising or returning capital, investing in, or providing advice with respect to investing in, trades or businesses, and developing trades or businesses (i.e., classic "private equity" and similar or related activities). The language would be set forth in new Section 1061. As a companion matter, Section 83(e) would be revised to provide that Section 83 would not apply to a partnership interest to which Section 1061 applies.

l. TEFRA Partnership Audit Rules. Section 3622 of TRA14 would reform the TEFRA partnership audit rules by striking Subchapters C and D of Chapter 63, and Part IV of Subchapter K of Chapter 1 (i.e., "Subchapter K"), from the Code. The provision would then add a new Subchapter C to Chapter 63 of Code (with new Sections 6221 to 6241 of the Code). The provision generally would provide a single system of centralized audit, adjustment, and collection procedures for partnerships (as opposed to the current rules, which provide different procedures for partnerships with 10 or fewer partners, electing partnerships with more than 100 partners, and all other partnerships), and provide that all items attributable to a partnership are determined at the partnership level.

III. TREASURY REGULATIONS[6]

A. Section 752 Regulations.

1. Overview. On December 16, 2013, the government published proposed regulations[7] under Section 752 to provide guidance regarding the extent to which a partner is treated as bearing the economic risk of loss for a partnership liability when (a) more than one partner bears an economic risk of loss for the liability (i.e., when there is "overlapping" risk of loss), or (b) a partner is treated as having a payment obligation with respect to the liability, or the liability is a nonrecourse loan to

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5 IRC §7704(a)

6 On July 23, 2014, the government published final regulations under Section 708(b)(1)(B) regarding the deduction of unamortized start-up and organizational expenses following a so-called "technical termination" of a partnership thereunder. TD 9681, 78 Fed. Reg. 42680 (7/23/14). The final regulations essentially follow the proposed regulations that were published on December 9, 2013. REG-126285, 78 Fed. Reg. 73753 (12/9/13). Subsequent versions of this paper may include further coverage of the final regulations.

7 REG-136984-12, 78 Fed. Reg. 76092 (12/16/13)

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the partnership (with no other partner bearing the economic risk of loss for the liability), and such partner is related to another partner.[8]

2. Background.

a. General Rules for Allocation of Liabilities. Partnership liabilities are separated into two categories for purposes of Subchapter K. A liability is considered a "recourse" liability to the extent that any partner, or a person related to any partner, bears the economic risk of loss for the liability.[9] A liability is considered a "nonrecourse" liability to the extent that no partner, nor any person related to any partner, bears the economic risk of loss for the liability.[10] For this purpose, an obligation generally is considered a "liability" of a partnership only to the extent that incurring the obligation either (a) creates or increases basis of any partnership asset (or involves the partnership borrowing cash), (b) gives rise to an immediate deduction to the partnership, or (c) gives rise to an expense that is not deductible in computing the partnership's taxable income and is not properly chargeable to capital.[11]

A partner's share of partnership liabilities generally is included in the adjusted basis of the partner's interest in the partnership.[12] The way this occurs is that any increase in a partner's share of partnership liabilities (or any increase in a partner's individual liabilities by reason of assuming any partnership liabilities) is considered a contribution of money by the partner to the partnership.[13] Conversely, any decrease in a partner's share of partnership liabilities (or any decrease in a partner's individual liabilities by reason of the partnership assuming any of the partner's liabilities) is considered a distribution of money by the partnership to the partner.[14]

b. Economic Risk of Loss. A partner's share of a partnership recourse liability is the amount of the liability, if any, with respect to which the partner (or a person related to the partner) bears the economic risk of loss.[15] A partner bears an economic risk of loss for a liability to the extent that, if the partnership were constructively liquidated and the liability were to become due and payable, the partner (or a person related to the partner) would (a) be obligated to make a payment to any person (including a contribution to the partnership), and (b) not be entitled to reimbursement for such payment from another partner (or any person related to another partner).[16] A partner also bears an economic risk of loss for a liability to the extent that the liability constitutes a nonrecourse loan to the

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8 See American Bar Association Section of Taxation, *Comments on Proposed Regulations on Recourse Liabilities of Partnerships and Related Parties*, (9/2/14).

9 Treas. Reg. §1.752-1(a)(1)

10 Id. at (2)

11 Id. at (4)

12 IRC §705

13 IRC §752(a)

14 IRC §705(b)

15 Treas. Reg. §1.752-2(a)

16 Treas. Reg. §1.752-2(b)(1). For this purpose, the constructive liquidation is deemed to consist of the following events / actions occurring simultaneously: (i) all liabilities become payable in full; (ii) all assets, including cash, have a value of zero (other than property contributed to the partnership by a partner solely to secure payment of a liability, which is valued at its book value); (iii) all assets are sold for no consideration (except for assets securing the balance due on non-recourse loans, the consideration for which is the amount of such balances); (iv) all items of income, gain, deduction, and loss are allocated to the partners; and (v) the partnership liquidates. Id.

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partnership that the partner (or a person related to the partner) makes (or acquires an interest in) and the economic risk of loss for the liability is not borne by any other partner.[17] For these purposes, an amount of indebtedness is taken into account once.[18]

c. Tiered Partnerships. If a partnership (the "upper-tier" partnership) owns an interest in another partnership (the "lower-tier" partnership), directly or indirectly through one or more further partnerships, the liabilities of the lower-tier partnership are allocated to the upper-tier partnership in an amount equal to the sum of (a) the amount of the economic risk of loss borne by the upper-tier partnership with respect to the liabilities, plus (b) the amount of any other economic risk of loss borne by any partners of the upper-tier partnership with respect to the liabilities.[19] The amount of the lower-tier partnership's liabilities allocated to the upper-tier partnership are then treated as liabilities of the upper-tier partnership for purposes allocating the upper-tier partnership's liabilities to the partners of the upper-tier partnership (except for a liability owed by the lower-tier partnership to the upper-tier partnership).[20]

d. Related Party Rules.

(1) General. For purposes of Section 752, a person is related to a partner if the person has a relationship to the partner described in either Section 267(b) or Section 707(b)(1), except that (i) those provisions are applied by substituting "80 percent or more" for "more than 50 percent" in each instance, (ii) brothers and sisters are not included in a person's family, and (iii) Section 267(e)(1) (which treats all partners as related for certain purposes) and Section 267(f)(1)(A) (which applies a "more than 50 percent" standard to define a "controlled group") are disregarded.[21]

(2) Constructive Ownership of Stock. When determining whether a covered relationship exists, the stock of corporations is treated as constructively owned by certain persons specified in Section 267(c). For example, if a partnership owns stock of a corporation, the stock is considered owned proportionately by the partners of the partnership.[22] As a result, if a partnership owns stock in a corporation, and a partner owns 80% or more of the capital interests or profits interests in the partnership, the partner will be considered related to the corporation. Accordingly, if the corporation has a payment obligation with respect to a liability of the partnership, or is a lender to the partnership, and no other partner has an economic risk of loss with respect to the liability, the 80% partner will be treated as bearing the economic risk of loss for the liability.

(3) Persons Related to Multiple Partners. If a person is related to more than one partner, the person is treated as related to the partner with whom the person has the highest percentage of related ownership (the "greatest percentage" rule).[23] If such percentage is the same for two or more partners, and there is no other partner with a higher percentage of

17 Treas. Reg. §1.752-2(c)(1)

18 Treas. Reg. §1.752-4(c)

19 Treas. Reg. §1.752-2(i)

20 Treas. Reg. §1.752-4(a)

21 Treas. Reg. §1.752-4(b)(1)

22 IRC §267(c)(1)

23 Treas. Reg. §1.752-4(b)(2)(i)

related ownership, the liability is allocated equally between the partners with the same percentage of related ownership.[24]

(4) Related Partner Exception. Notwithstanding the general related party rules, two or more persons who directly or indirectly own interests in the same partnership are treated as not related to each other for purposes of determining the economic risk of loss borne by them for liabilities of the partnership.[25] The Tax Court in IPO II v. Commissioner[26] interpreted this rule in a manner that could be construed as allowing for relationships between otherwise related partners to be "turned off" without limitation.

3. Proposals.

a. Overlapping Risk of Loss. The government has been asked to provide guidance regarding the manner in which partners should share a partnership liability with respect to which multiple partners bear an economic risk of loss. The proposal provides that, if the aggregate amount of the economic risk of loss that partners have with respect to a liability exceeds the amount of the liability, then each such partner shall be considered as bearing economic risk of loss in an amount that is proportionate to the amount of the partner's individual economic risk of loss relative to the aggregate amount of the economic risk of loss of all such partners. This proposal is derived directly from the rule addressing such circumstances in the temporary regulations that preceded the existing final regulations. Such rule (which was set forth under §1.752-1T(d)(3)(i) of the temporary regulations) was removed before the regulations were finalized as part of an effort to simplify the scope and application of such regulations. The government believes that such rule still reflects a reasonable approach to the issues surrounding "overlapping" economic risk of loss.

b. Tiered Partnerships. The current rules under Section 752 generally allocate a liability of a lower-tier partnership to an upper-tier partnership to the extent that either the upper-tier partnership or a partner of the upper-tier partnership bears an economic risk of loss with respect to the liability. However, if the allocation is based on a partner of the upper-tier partnership bearing an economic risk of loss with respect to the liability, there is no guidance about the manner in which the allocation should be made if the partner is also a partner of the lower-tier partnership. The proposal is to allocate the liability solely to the partner (and not to any extent to the upper-tier partnership). The government believes that such a rule would be more administrable, and ensure that no other person is allocated any share of the liability either by or through the upper-tier partnership (which the government believes is the correct result).

c. Related Party Rules.

(1) Constructive Ownership of Stock. The current rules under Section 752 provide that, if a partnership owns stock in a corporation, and the corporation has a payment obligation with respect to a liability of the partnership, or is a lender to the partnership, and no other partner has an economic risk of loss with respect to the liability, a partner of the partnership owning 80% or more of the capital or profits interests in the partnership will be treated as bearing the economic risk of loss for the liability.[27] The proposal is to eliminate constructive ownership of the corporation's stock under such circumstances so that such partner

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24 Id.

25 Treas. Reg. §1.752-4(b)(2)(iii)

26 122 T.C. 295 (2004)

27 See Treas. Reg. §1.752-4(b)

would not be treated as having an economic risk of loss for the liability as a result of such constructive ownership. The government believes that such a rule would mitigate the risk that a partner could use the partner's ownership interests in the partnership to "bootstrap" into a greater liability allocation under such circumstances than the economic risk of loss analysis would justify in the absence of the attribution rule.

(2) Greatest Percentage Rule. The government has been asked to terminate the "greatest percentage" rule. The proposal is to act on this request and remove the greatest percentage rule. As a result, if a person is a lender to a partnership, or has a payment obligation with respect to a partnership liability, and such person is related to two or more partners, then those partners would share the liability equally. The government believes that this is an appropriate simplification, particularly in light of the burden of determining precise ownership percentages under certain circumstances, and avoids the possible impropriety of an "all or nothing" approach based on relatively small differences in ownership percentages under certain circumstances.

(3) Related Partner Exception. The government believes the related partner exception should be applicable only when a partner directly bears the economic risk of loss for a partnership liability. Under other circumstances, treating partners as related can help to appropriately determine the parties who bear the economic risk of loss for a partnership liability. Accordingly, the proposal is for the related partner exception to be applicable only under circumstances in which a partner is the lender to a partnership, or has a payment obligation with respect to a liability of the partnership.

B. AJCA Regulations.

1. Overview. On January 16, 2014, the government published proposed regulations[28] providing guidance regarding the changes made to the Code by Section 833 of the American Jobs Creation Act of 2004.[29] Those changes generally related to the treatment of "built-in loss" property contributed to a partnership, and the prevention of inappropriate loss duplication or transfer among partners. The proposed regulations also would conform applicable regulations to the changes made by The Taxpayer Relief Act of 1997[30] that extended the relevant time period under Section 704(c)(1)(B) and Section 737(b)(1) from five years to seven years, and provide additional guidance regarding the "Section 704(c) layers" issues addressed in Notice 2009-70[31] and related public comments.

2. Background.

a. Section 704(c)(1)(C). The AJCA added Section 704(c)(1)(C) to the Code (effective for transactions occurring after October 22, 2004) in order to prevent a built-in loss associated with property contributed to a partnership from being allocated or transferred to a partner other than the contributing partner. For this purpose, a built-in loss is the excess, if any, of the adjusted basis of the property at the time of contribution (prior to application of Section 704(c)(1)(C)) over its fair market value at such time.[32] Section 704(c)(1)(C) provides that (i) a built-in loss may be taken into account

28 REG-144468-05, 79 Fed. Reg. 3042 (1/16/14)

29 Public Law 108-357, 118 Stat. 1418 (the "AJCA")

30 Public Law 105-34, 111 Stat. 788 (the "TRA97")

31 2009-2 C.B. 255

32 IRC §704(c)(1) (flush language)

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solely for purposes of determining the amount of partnership items allocated to the contributing partner, and (ii) the adjusted basis of the contributed property in the hands of the partnership must be treated as equal to its fair market value at the time of contribution for purposes of determining the amount of partnership items allocated to partners other than the contributing partner (except as otherwise provided in regulations).[33]

b. Mandatory Basis Adjustments. The AJCA also amended Section 734 and Section 743 of the Code (effective for transactions occurring after October 22, 2004), including by adding Section 734(d) and Section 743(d) to the Code, in order to prevent the duplication of losses, and the inappropriate transfer of losses among partners. However, in a compromise to administrative concerns, these provisions apply only with respect to built-in losses in excess of $250,000. Any built-in losses in amounts less than this threshold remain governed by other generally applicable Subchapter K rules.

(1) Section 743. As amended by the AJCA, Section 743 generally requires a partnership to adjust the basis of its property upon a sale or exchange of an interest in the partnership (or upon the death of a partner) if the partnership has a substantial built-in loss with respect to its property immediately after the transfer (even if the partnership does not make or have in effect a Section 754 election for the year of transfer or death). For this purpose, a partnership has a substantial built-in loss with respect to its property if the adjusted basis that the partnership has in its property exceeds by more than $250,000 the fair market value of the property at the time of transfer (or death).

However, the AJCA also added Section 743(e) to the Code in order to provide alternative rules for "electing investment partnerships" (or "EIP"). The special rules for EIPs were intended as a matter of administrative convenience for venture capital funds, buyout funds, and funds of funds, which generally had not made Section 754 elections (even when it might be beneficial). The rules generally prohibit transferees from claiming losses from the sale or exchange of partnership property unless it can be shown that the losses exceed the losses recognized by the transferor (or the transferor's predecessor transferors). This essentially creates a partner-specific basis adjustment (or loss disallowance) scheme, without requiring the partnership to adjust the basis of all its property. A partnership will constitute an EIP if a number of requirements are satisfied (in addition to making the EIP election), including that substantially all of the partnership's assets are held for investment, at least 95% of the assets contributed to the partnership by its partners constituted money, the partnership agreement has substantive restrictions on a partner's ability to cause the partnership to redeem the partner's interest in the partnership, and the term of the partnership is not more than 15 years.[34] If a partnership is an EIP, the AJCA added Section 6031(f) to the Code in order to require the EIP to provide the transferee with the information necessary in order to comply with the election requirements.

Additionally, the AJCA added Section 743(f) to the Code in order to provide a special rule exempting certain "securitization partnerships" from application of the mandatory "built-in loss" basis adjustment rules. For this purpose, a securitization partnership is any partnership the sole business activity of which is to issue securities that provide for a fixed principal (or similar) amount, but only if (i) such securities are primarily serviced by the cash flows of a discrete pool (either fixed or revolving) of receivables or other financial assets

33 IRC §704(c)(1)(C)

34 IRC §743(e)(6)

that by their terms convert into cash in a finite period, and (ii) the sponsor of the pool reasonably believes that such assets "are not acquired so as to be disposed of."[35]

(2) Section 734. As amended by the AJCA, Section 734 generally requires a partnership to adjust the basis of its property upon a distribution of partnership property to a partner if the basis reduction contemplated under Section 734(b)(2) would be substantial (even if the partnership does not make or have in effect a Section 754 election for the year of distribution). For this purpose, a partnership would have a substantial basis reduction with respect to a distribution if the distribution involves the liquidation of the partner's interest in the partnership, and the sum of the following items exceeds $250,000: (a) the amount of any loss recognized by the partner with respect to the distribution pursuant to Section 731(a)(2) (which allows a loss to be recognized under certain circumstances upon liquidation of a partner's interest in a partnership if the distributed items consist solely of money, unrealized receivables, and/or inventory), and (ii) the amount of the excess, if any, of the adjusted basis to the partner of distributed property (other than money) pursuant to Section 732 over the adjusted basis to the partnership of the distributed property immediately before the distribution (as adjusted pursuant to any election made with respect to the distribution under Section 732(d)).[36]

However, the AJCA added Section 734(e) to the Code in order to provide a special rule exempting certain "securitization partnerships" from application of the mandatory "substantial basis reduction" adjustment rules. For the purpose, the term "securitization partnership" means the same thing as it is for purpose of Section 743(f).

(3) Interim Reporting Requirements. Notice 2005-32 sets forth general procedures for complying with the AJCA's mandatory basis adjustment rules until further guidance is provided. The procedures provide that any partnership required to make basis adjustments pursuant to Section 734's "substantial basis reduction" rules must comply with the current reporting rules under Section 734 as if an election under Section 754 were in effect with respect to the relevant distribution.[37] Similarly, the procedures provide that any partnership required to make basis adjustments pursuant to Section 743's "built-in loss" rules must comply with the current reporting rules under Section 743 as if an election under Section 754 were in effect with respect to the relevant transaction.[38] Additionally, the procedures provide that a transferee of an interest with respect to which basis adjustments are required pursuant to Section 743's "built-in loss" rules also must comply with the current reporting rules under Section 743 as if an election under Section 754 were in effect with respect to the relevant transaction.[39]

c. Rules for Allocating Basis Adjustments.

(1) Section 734(b) - Section 755(c). The AJCA added Section 755(c) to the Code (effective for distributions occurring after October 22, 2004) in order to prevent an increase in the adjusted basis of partnership assets pursuant to Section 734(b) if the corollary basis reduction would be derived from stock in a corporation that is a partner in the partnership (or any person related to such a corporation). Prior to the addition of Section 755(c),

35 IRC §743(f)(2)

36 IRC §734(d)

37 Treas. Reg. §1.734-1(d)

38 Treas. Reg. §§1.743-1(k)(1), (3), (4) & (5)

39 Id. at (2)

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Section 1032 (which protects corporations from recognizing gain or loss derived from transactions with respect to their own stock) could protect a corporation from adverse consequences associated with any such basis reduction even if the increase was allocated to, for example, depreciable property held by the partnership. Accordingly, it was theoretically possible for Section 734 and Section 755 to be applied so as to shift basis among assets in order to create deductions (or reduce gain) without any offsetting economic cost to the partners.

Section 755(a) and Section 755(b) provide that any adjustments to basis required by Section 734 (and Section 743) generally shall be made in a manner that has the effect of reducing the difference between the fair market value and the adjusted bases of partnership properties, except that adjustments attributable to (a) capital assets and Section 1231(b) property, on the one hand, and (b) any other partnership property, on the other hand, must be made to property of a like character (without reducing the basis of any assets below zero). Section 755(c) provides that any decrease in adjusted basis required by Section 734(b) shall not be made to stock of a corporation that is a partner in the partnership (or any person related to such corporation within the meaning of Section 267(b) or Section 707(b)(1)), and the amount of any decrease that would have been allocated to such stock shall be allocated to other partnership property (except that gain must be recognized with respect to such reallocated amounts to the extent that such amounts exceed that aggregate adjusted basis of such other property immediately before the reallocation).

(2) Section 743(b) – Section 755. The Treasury regulations under Section 755 provide guidance specifically regarding the allocation of basis adjustments resulting from substituted basis transactions.[40] For this purpose, such transactions include transactions in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in the partnership interest (for example, if the partnership interest is contributed to a partnership or corporation pursuant to Section 721 or Section 351, respectively), and (for transactions occurring on or after June 9, 2003) transactions in which the transferee's basis in the partnership interest is determined by reference to other property held by the transferee (for example, if the transferee receives the partnership interest as a distribution from a partnership in which the transferee is a partner).[41]

The rules regarding substituted basis transactions provide that a positive basis adjustment can be made to partnership assets only if the transferee would be allocated net gain or income (including the amount of any remedial allocations made to the transferee under Section 704(c)) from the hypothetical sale of the partnership's assets contemplated under the Section 755 rules.[42] Similarly, such rules provide that a negative basis adjustment can be made to partnership assets only if the transferee would be allocated a net loss (including the amount of any remedial allocations made to the transferee under Section 704(c)) from the hypothetical sale of the partnership's assets contemplated under the Section 755 rules.[43] The rules applicable outside of the context of a substituted basis transaction do not look to such "bottom line" results as a condition to making basis adjustments.[44]

40 Treas. Reg. §1.755-1(b)(5)(i)

41 Id.

42 Id. at (ii)

43 Id.

44 Treas. Reg. §1.755-1(b)(1)

If a negative basis adjustment is permitted, the rules provide that the decrease must first be allocated to properties with unrealized depreciation (in proportion to the transferee's shares of the respective amounts of unrealized depreciation before adjustment, but not in excess of the amount of such shares).[45] Any remaining decrease generally is allocated to properties of the same class as the properties from which the adjustment(s) is(are) derived in proportion to the transferee's share of the adjusted basis of such assets (following the foregoing adjustment).[46]

Also, as a companion matter, the Treasury regulations under Section 743 provide that a transferee's basis adjustments are determined without regard to any prior transferee's basis adjustments.[47] Accordingly, if a transferee acquires a partnership interest in a non-substituted basis transaction, and then transfers the partnership interest in a substituted basis transaction, the adjustments in the second transaction could vary from the first transaction.[48]

d. Reverse Section 704(c) Allocations. The Treasury regulations under Section 704(c) provide that the principles of Section 704(c) apply to allocations with respect to property that has been revalued pursuant to either Section 1.704-1(b)(2)(iv)(f) or Section 1.704-1(b)(2)(iv)(s) of the Treasury regulations if the resulting book value of such property is different from the partnership's adjusted tax basis in such property at such time (thereby giving rise to allocations known as "reverse Section 704(c) allocations").[49] A partnership does not need to use the same allocation method for reverse Section 704(c) allocations as for standard allocations under Section 704(c) with respect to contributed property (known as "forward Section 704(c) allocations").[50] However, the methods used must be reasonable and consistent with the principles of Sections 704(b) and 704(c).[51]

In Notice 2009-70,[52] the government asked for comments regarding the application of the rules relating to the creation and maintenance of forward and multiple reverse Section 704(c) allocations (known as "Section 704(c) layers"), including among other things whether reverse Section 704(c) allocations should be netted against existing Section 704(c) allocation layers or whether separate Section 704(c) layers should be maintained.

e. Section 704(c)(1)(B) and Section 737. TRA97 extended the time periods during which Section 704(c)(1)(B) and Section 737 are applicable with respect to contributed property (generally for contributions occurring after June 8, 1997) from five years to seven years. The Treasury regulations under Sections 704, 737, and 1502 have not been revised to reflect such changes.

3. Proposals.

a. Section 704(c)(1)(C). The proposal provides further guidance regarding (1) the scope of Section 704(c)(1)(C), (2) the nature of the Section 704(c)(1)(C) adjustments, (3)

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45 Treas. Reg. §1.755-1(b)(5)(iii)(B)

46 Id.

47 Treas. Reg. §1.743-1(f)

48 Id.

49 Treas. Reg. §1.704-3(a)(6)(i)

50 Id.

51 Id.

52 2009-2 CB 255

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distributions by partnerships holding Section 704(c)(1)(C) property, (4) the transfer by a partner contributing built-in loss property to a partnership (the "Section 704(c)(1)(C) partner") of the partner's interest in the partnership, (5) the transfer by the partnership of the property contributed with a built-in loss that is the subject of Section 704(c)(1)(C) (the "Section 704(c)(1)(C) property"), and (6) the reporting requirements associated with the foregoing.

(1) Scope of Section 704(c)(1)(C). The proposal provides that Section 704(c)(1)(C) applies to property to which Section 704(c) applies and that has a built-in loss at the time of contribution. Accordingly, Section 704(c)(1)(C) property is subject to the general rules under Section 704(c) in addition to the special rules under Section 704(c)(1)(C). However, the proposal provides that Section 704(c)(1)(C) would not apply to reverse Section 704(c) allocations. Additionally, the proposal provides that Section 704(c)(1)(C) should be applied without regard to any liability described in Section 1.752-7 of existing Treasury regulations.

(2) Nature of Section 704(c)(1)(C) Adjustments. The proposal is for the nature of the adjustment contemplated by Section 704(c)(1)(C) to be generally structured in a manner similar to the adjustments provided by Section 743(b) with respect to positive basis adjustments. In particular, the proposal provides that a built-in loss associated with contributed property would be treated as an adjustment (the "Section 704(c)(1)(C) basis adjustment") with respect to the basis of such property in the hands of the partnership solely for the account of the contributing partner. The proposal would provide that, pursuant to Section 704(c)(1)(C)(ii), the adjusted basis that the partnership obtains in the property would be the fair market value of the property at the time of contribution. As a result, with respect to contributed property that is eligible for cost recovery, the proposal provides that the amount of any Section 704(c)(1)(C) adjustment that is recovered by the Section 704(c)(1)(C) partner in a particular year is added to the partner's distributive share of the partnership's depreciation or amortization deductions derived from the property for the year.

The rules regarding the Section 704(c)(1)(C) basis adjustment are otherwise similar to the rules for adjustments under Section 743(b) provided by Sections 1.743(j)(1) through (3) of the Treasury regulations. The government believes that structuring the Section 704(c)(1)(C) rules so that they generally follow the Section 743(b) structure would simplify application and administration of the Section 704(c)(1)(C) rules by providing a framework that is familiar to the government and taxpayers.

(3) Distributions by Partnerships. The proposal is to apply principles similar to Section 743 in order to determine the consequences from the distribution of Section 704(c)(1)(C) property to the Section 704(c)(1)(C) partner or another partner, or a distribution to a Section 704(c)(1)(C) partner in complete liquidation of such partner's interest in the partnership when the partnership retains some or all of the Section 704(c)(1)(C) property. If the Section 704(c)(1)(C) property is distributed to the Section 704(c)(1)(C) partner, the proposal is to include the Section 704(c)(1)(C) adjustment for purposes of determining the amount of any adjustment under Section 734 (for example, with respect to application of the "substantial basis reduction" rules), but not for purposes of determining the allocations to remaining partnership property under Section 755.

If the Section 704(c)(1)(C) property is distributed to another partner, the proposal is that the distributee partner does not take the Section 704(c)(1)(C) adjustment into account under Section 732 (i.e., for purposes of determining the partner's adjusted basis in such property). However, the government has asked for comments regarding

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whether the Section 704(c)(1)(C) adjustment should be taken into account with respect to distributed corporate stock for purposes of Section 732(f) (an anti-abuse rule regarding the distribution of stock of a corporation that is controlled by a corporate partner). The Section 704(c)(1)(C) partner reallocates the Section 704(c)(1)(C) adjustment among the remaining items of partnership property pursuant to the "class of property" rules Section 755. Such rules do not consider a partner's allocable share of income, gain, or loss for purposes of making such reallocations. However, the government has asked for comments regarding whether such shares should be taken into account for purposes of reallocations made pursuant to the requirements of Section 704(c)(1)(C). Additionally, the proposal confirms that the amount of the Section 704(c)(1)(C) adjustment is taken into account for purposes of determining the amount of any loss that the Section 704(c)(1)(C) partner is required / allowed to recognize as a result of the distribution pursuant to Section 704(c)(1)(B) (one of the so-called "anti-mixing bowl rules).

If the partnership makes a distribution to a Section 704(c)(1)(C) partner in complete liquidation of such partner's interest in the partnership, and the partnership retains some or all of the Section 704(c)(1)(C) property, the proposal is to reallocate the Section 704(c)(1)(C) adjustment to the distributed property in accordance with the "class of property" rules under Section 755 (after applying any consequences from the so-called "anti-mixing bowl" rules under Section 704(c)(1)(B) and Section 737) for purposes of determining the partner's adjusted basis in the distributed property under Section 732. However, if none of the property distributed is of a like class with the retained Section 704(c)(1)(C) property, the proposal is that the Section 704(c)(1)(C) adjustment is not reallocated to the distributed property for such purposes. In such case, the proposal is to treat the unallocated Section 704(c)(1)(C) adjustment as a positive basis adjustment for purposes of Section 734(b). If the distribution also triggers negative adjustments under Section 734(b), they are netted with the Section 704(c)(1)(C) adjustment amounts in order to determine the nature of any adjustment made under Section 734(b). The partnership would be treated as having a Section 754 election in place, even if no such election has been made, for purposes of making any negative adjustment under Section 734(b) pursuant to the foregoing analysis.

(4) Transfers by Section 704(c)(1)(C) Partner. If a Section 704(c)(1)(C) partner transfers all or any portion of the partner's ownership interest in the partnership, the proposal is that the transferee generally will not succeed to any portion of the partner's Section 704(c)(1)(C) basis adjustment.[53] The portion of the Section 704(c)(1)(C) basis adjustment attributable to the portion of the partner's ownership interest that is the subject of the transfer instead is generally eliminated. However, the proposal is to provide an exception in the case of a transfer of ownership interests pursuant to certain non-recognition transactions. Specifically, the proposal provides that, in the case of transactions subject to Sections 351, 381, 721, and 731 (but not in the case of gifts), the transferee generally does succeed to (and "steps into the shoes" of the partner with respect to) the portion of the Section 704(c)(1)(C) basis adjustment attributable to the portion of the partner's ownership interest that is the subject of the transfer (including for purposes of Section 168(i)(7)).

The proposal also provides that, regardless of whether the partnership has a Section 754 election in place or the transaction involves a "substantial built-in loss," the amount of the Section 704(c)(1)(C) adjustment to which the transferee succeeds must be reduced by the amount of any negative adjustment that would have occurred under Section

[53] Pursuant to Section 722, the Section 704(c)(1)(C) partner's adjusted basis in the ownership interest includes the amount attributable to the Section 704(c)(1)(C) adjustment, and is taken into account by the partner upon transfer. The proposal does not change this result.

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743(b) in connection with the transaction had a Section 754 election been in place at the time of the transaction.

(5) Transfers of Section 704(c)(1)(C) Property. If the partnership transfers the Section 704(c)(1)(C) property, the proposal provides that the Section 704(c)(1)(B) partner can generally take the Section 704(c)(1)(C) adjustment into account for purposes of determining the partner's tax consequences from the transfer. Additionally, if the property is transferred (or deemed transferred) in a non-recognition transaction, the property received in exchange for the Section 704(c)(1)(C) property will be treated essentially as "substituted" property, and the remaining Section 704(c)(1)(C) adjustment associated with the transferred property will thereafter become associated with such "substituted" property.

If the partnership is an upper-tier partnership that in turn transfers the property to a lower-tier partnership, the proposal is that (1) the ownership interest in the lower-tier partnership would become "substituted" property for the upper-tier partnership (with the portion of its adjusted basis in the ownership interest in the lower-tier partnership attributable to the Section 704(c)(1)(C) adjustment segregated solely for the benefit of the Section 704(c)(1)(C) partner), and (2) the lower-tier partnership would succeed to the upper-tier partnership's Section 704(c)(1)(C) adjustment (and determine its adjusted basis in the property without regard to such adjustment). If any Section 704(c)(1)(C) adjustment at any tier is subsequently recovered or reduced, the proposal provides that corollary adjustments must be made at the other tiers in order to prevent loss duplication. Additionally, the proposal acknowledges that a new Section 704(c)(1)(C) adjustment could be created if the value of the property decreases between the time it is obtained by the upper-tier partnership and the time it is contributed to the lower-tier partnership. In that case, the proposal provides that the new adjustment is segregated solely for the benefit of the upper-tier partnership (and its partners).

If the transfer is to a corporation, the proposal is that (1) the stock in the corporation would become "substituted" property for the partnership (with the portion of its adjusted basis in the stock attributable to the Section 704(c)(1)(C) adjustment segregated solely for the benefit of the Section 704(c)(1)(C) partner), and (2) the corporation's adjusted basis in the property pursuant to Section 362 would be determined by taking into account the Section 704(c)(1)(C) adjustment. The proposal provides that any gain that the partnership is required to recognize in connection with the transfer would be determined without regard to the Section 704(c)(1)(C) adjustment. However, any gain that the Section 704(c)(1)(C) partner is required to recognize is determined by taking the adjustment into account.

If the transfer is deemed to occur pursuant to technical termination of the partnership pursuant to Section 708(b)(1)(B), the proposal is that the Section 704(c)(1)(C) status would not be disturbed.

(6) Reporting Requirements. The proposal provides that a partnership holding property with respect to which there is a Section 704(c)(1)(C) adjustment must attach a statement to the tax return for the year of contribution setting forth the name and taxpayer identification number of the contributing partner, the amount of the adjustment, and nature of the property to which it relates.

b. Mandatory Basis Adjustments. The proposal provides guidance that generally tracks the statutory language for the changes made by the AJCA to Section 743 and Section 734. However, it also provides additional guidance in certain areas.

(1) Section 743. The proposal provides that the consequences associated with transferring a partnership interest at a time when the partnership has a substantial built-in loss are limited to that specific transaction, and that the partnership is not thereby deemed to have made a Section 754 election as a general matter (other than with respect to that specific transaction). The proposal also provides that the determination of whether a partnership has a substantial built-in loss is made without regard to Section 704(c)(1)(C) adjustments (or Section 743(b) adjustments).

The proposal provides specials rules regarding tiered partnerships with respect to determining fair market value and making basis adjustments. Regarding fair market value, the proposal provides that the fair market value of an ownership interest in a lower-tier partnership held by an upper-tier partnership shall include the amount of liabilities of the lower-tier partnership allocated to the upper-tier partnership pursuant to Section 752 (so that such allocation of liabilities to the upper-tier partnership does not automatically create a loss asset for the upper-tier partnership, since the equity / fair market value of the ownership interest in the lower-tier partnership would always be less than the adjusted basis that the upper-tier partnership has in such interest under such circumstances).

Regarding basis adjustments, the proposal provides that, when a partner transfers an ownership interest in an upper-tier partnership at a time when the upper-tier partnership has a substantial built-in loss, all lower-tier partnerships in which the upper-tier partnership has a direct or indirect interest are deemed to have made a Section 754 election for the year of transfer (with respect to that particular transaction). As a result, the proposal provides for corollary adjustments to be made at each lower-tier partnership. The government has requested comments regarding the administrative burden associated with this proposal, and ideas about how to minimize that burden while still achieving the statutory objective.

The proposal further provides regarding tiered partnerships that, when all such partnerships have Section 754 elections in effect, the portion of the interests in the lower-tier partnerships that are deemed transferred by sale or exchange upon the transfer of an ownership interest in the upper-tier partnership by sale or exchange (or upon death) is the amount proportionate to amount transferred in the upper-tier partnership. Accordingly, the lower-tier partnership must adjust the adjusted basis in its properties proportional to the adjustment made by the upper-tier partnership in its adjusted basis in its ownership interest in the lower-tier partnership.

The proposal includes a general anti-abuse rule. The proposal does not include a *de minimis* exception for transfers of small ownership interests. However, the government has asked for comments regarding whether such an exception would be appropriate.

With respect to EIPs, the proposal provides that the rules regarding tiered partnerships should be applied to EIP's in the same manner as all other partnerships. Accordingly, the proposal generally does not include any special tiered partnership rules for EIPs. The proposal includes items that previously were set forth in Notice 2005-32[54] (which sets forth interim guidance regarding application of the EIP rules). In this regard, the proposal provides that, with respect to the requirement that a partnership must never have been engaged in a trade or business in order to qualify as an EIP, an upper-tier partnership will not be treated as engaged in a trade or business conducted by a lower-tier partnership if the amount of the adjusted basis that the upper-tier partnership has in its ownership interest in the lower-tier

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partnership is less than an amount equal to 25% of the total capital that the partners of the upper-tier partnership are required to contribute to the upper-tier partnership during the entire term of the upper-tier partnership (known as the "25% Rule"). The preamble to the proposal says that the government views the 25% Rule as a bright-line rule the violation of which disqualifies a partnership from EIP status.

Additionally, the proposal provides that the rules set forth in Section 1.731-2(e)(3) (setting forth circumstances in which a partnership is not treated as engaged in a trade or business for purposes of the "investment partnership" status provided under Section 731(c)(3)(C)) should apply for purposes of analyzing the "trade or business" requirement under the EIP rules. Those rules are incorporated into the EIP rules by cross reference.

The proposal provides that an EIP election must be made on a timely filed original return (including extensions). The government has asked for comments regarding the treatment of an EIP that fails to qualify in a year subsequent to the year of election, but then again qualifies in a later year. The government also has asked for comments regarding the treatment of EIPs that have revoked the election and later desire to make the election again.

(2) Section 734. The proposal provides that the consequences associated with a distribution of partnership property with respect to which there is a substantial basis reduction are limited to that specific distribution, and that the partnership is not thereby deemed to have made a Section 754 election as a general matter (other than with respect to that specific distribution). The proposal also confirms that the requirements of Section 734(d)(1) are applied on a partner-by-partner and distribution-by-distribution basis.

The proposal provides specials rules regarding tiered partnerships. Regarding basis adjustments, the proposal provides that, when an upper-tier partnership makes a distribution with respect to which there is a substantial basis reduction, all lower-tier partnerships in which the upper-tier partnership has a direct or indirect interest are deemed to have made a Section 754 election for the year of transfer (with respect to that particular distribution). As a result, the proposal provides for corollary adjustments to be made at each lower-tier partnership.

The proposal also provides regarding tiered partnerships that, when all tiered partnerships have Section 754 elections in effect, if an upper-tier partnership makes an adjustment to the basis of its ownership interest in a lower-tier partnership, the lower-tier partnership must make an adjustment to the upper-tier partnership's share of the lower-tier partnership's assets. Accordingly, the lower-tier partnership must adjust the adjusted basis of its assets proportional to the adjustment made by the upper-tier partnership in its adjusted basis in its ownership interest in the lower-tier partnership. The government has requested comments regarding the administrative burden associated with this proposal, and ideas about minimizing such burden while still achieving the statutory objective.

c. Rules for Allocating Basis Adjustments. The proposal provides guidance that generally tracks the statutory language for the changes made by the AJCA to Section 7554. However, it also provides additional guidance in certain areas.

(1) Section 734(b) – Section 755(c). The proposal provides that a person should be treated as related to a corporate partner for purposes of Section 755(c) if the person is related to the corporate partner under either Section 267(b) or Section 707(b)(1) (even though the statutory language in Section 755(c) states "sections 267(b) and 707(b)(1)" – emphasis

added). The government believes this broad interpretation more appropriately reflects the intent of Congress (notwithstanding any contrary implication from the statutory language).

(2) Section 743(b) – Section 755. The proposal regarding substituted basis transactions is to remove the requirements that there needs to be a net gain or net income in partnership property for an increase to be allocated to a particular class of property, and an overall net loss in partnership property for a decrease to be allocated to a particular class of property. The proposal provides that, if there is an increase in basis to be allocated to partnership assets, it is allocated to capital gain property and ordinary income property first based on the share (and to the extent of such share) of capital gain or ordinary income attributable to the transferred interest that would be allocated to the transferee from a hypothetical sale of all partnership assets (including the amount of any remedial allocations made to the transferee under Section 704(c)). The proposal is that any remaining increase would be allocated based on the relative fair market value of the assets in each class.

Similarly, the proposal provides that, if there is a decrease in basis to be allocated to partnership assets, it is allocated to capital gain property and ordinary income property first based on the share (and to the extent of such share) of capital loss or ordinary loss attributable to the transferred interest that would be allocated to the transferee from a hypothetical sale of all partnership assets including the amount of any remedial allocations made to the transferee under Section 704(c)). The proposal is that any remaining loss would be allocated based on the transferee's relative share of the adjusted basis of the assets in each class. Additionally, the proposal provides that a negative adjustment is no longer limited to the transferee's share of the partnership's adjusted basis in all depreciated assets in a class.

The proposal further provides that the transferee in a substituted basis transaction succeeds to the portion of the transferor's basis adjustment that is attributable to the transferred partnership interest, and that such portion is taken into account in determining the transferee's share of the adjusted basis to the partnership of its assets.

d. Reverse Section 704(c) Allocations. The proposal provides guidance regarding several items associated with so-called "reverse Section 704(c) allocations." The proposal provides that reverse Section 704(c) allocations (whether positive or negative) do not affect existing Section 704(c) allocations (or layers). As a result, forward Section 704(c) allocations are not affected by reverse Section 704(c) allocations. In this regard, the proposal provides that partnerships must maintain separate layers for all forward Section 704(c) allocations and reverse Section 704(c) allocations. The proposal does not permit partnerships to use a netting approach. However, the government has asked for comments regarding the circumstances under which it might be appropriate to allow partnerships to use a netting approach in order to mitigate the administrative burden associated with maintaining separate layers (for example, with respect to small partnerships).

The proposal provides that partnerships may use any reasonable method to allocate items of income, gain, deduction, and loss from an item of property among and between Section 704(c) layers. The proposal does not apply any default rules in this regard (for example, it does not require items to be allocated to either the oldest or newest layer first, or pro rata based on the relative amounts in each layer). The government has asked for comments regarding examples of item allocations that would reflect reasonable approaches to allocations.

e. Section 704(c)(1)(B) and Section 737. The proposal revised existing Treasury regulations under Sections 704, 737, and 1502 to reflect the seven year time period currently applicable under Section 704(c)(1)(B) and Section 737. The proposal also provides that the time period is calculated beginning on the day of contribution (and thus including the day of contribution as the first day of the time period) and ending on the last day immediately before the seventh anniversary of the day of the contribution (i.e., the last day that is within seven years of the contribution date).

C. Section 707 Regulations.

1. Overview. On January 30, 2014, the government published proposed regulations[55] under Section 707 to address certain deficiencies and technical difficulties in the existing Treasury regulations under Section 707.

2. Background.

a. General. Section 707(a)(2)(B) will apply to cause a transfer of property to a partnership to be treated as a sale of the property to the partnership (and not a tax-deferred contribution of the property to the partnership governed by Section 721) if (i) as a related matter, there is a direct or indirect transfer of money or other property by the partnership to the transferor (or another partner), and (ii) when viewed together, the foregoing transfers are properly characterized as a sale or exchange of property (i.e., a "disguised sale") either between the partnership and a partner acting in a capacity other than as a partner, or between two more partners acting in capacities other than as partners.

On November 26, 2004, the government published proposed Treasury regulations to address certain deficiencies and technical ambiguities in the existing Treasury regulations under Section 707(a)(2)(B) (which were adopted in 1999).[56] That proposal was withdrawn in 2009. However, the government continues to believe that certain aspects of the existing regulations need to be clarified and/or revised (which is the basis for the current proposal).

b. Debt-Financed Distributions. The general rules that treat certain transactions as "disguised sales" are subject to several exceptions. One such exception provides that a distribution or transfer of funds to a partner does not get taken into account as a payment in a disguised sale transaction to the extent that (i) the funds are traceable to a partnership liability incurred within 90 days of the distribution or transfer, and (ii) the amount of the funds does not exceed in amount the portion of such liability that is allocated to the partner for these purposes (the so-called "debt financed distribution exception").[57] The portion of such a liability allocated to a partner for these purposes is the portion of the liability allocated to the partner pursuant to the principles of Section 752 that is proportionate to the amount of the liability that is traceable to the distribution made to the partner.[58] Also, all liabilities incurred pursuant to a plan in which the partnership transfers funds to more than one partner are basically aggregated and treated as one liability.[59]

c. Preformation Capital Expenditures. Another exception to the basic disguised sale rules provides that a distribution or transfer of funds to a partner does not get taken into account as a payment in a disguised sale transaction to the extent that it is made to reimburse the partner for capital expenditures incurred by the partner (i) within the two-year period preceding the transfer of property by the partner to the partnership that gave rise to the disguised sale inquiry, and (ii) with respect

55 REG-119305-11, 79 Fed. Reg. 4826 (1/30/14)

56 REG-149519-03, 69 Fed. Reg., 68,838 (2004)

57 Treas. Reg. §1.707-5(b)

58 Id. at (2)(i)

59 Id. at (2)(ii)

to organization or syndication costs under Section 709, or property contributed by the partner to the partnership (the "preformation capital expenditure exception").[60] For capital expenditures incurred with respect to contributed property, the preformation capital expenditure exception is limited to an amount equal to 20% of the fair market value of such property at the time of contribution, unless such fair market value is no more than 120% of the contributing partner's adjusted basis in such property at such time (in which case, there is no such limitation on use of the preformation capital expenditure exception).

d. Qualified Liabilities. Another exception to the basic disguised sale rules applies to "qualified liabilities." Under the basic rules, when a partnership acquires contributed property subject to a liability or assumes a liability of the partner in connection with obtaining contributed property from the partner, the partnership is treated as making a payment to the partner (which then is taken into account for purposes of making the disguised sale analysis) to the extent that the amount of the liability exceeds the amount of the portion of the liability allocated to the partner immediately after the transaction pursuant to the principles of Section 752.61 However, if the liability is a "qualified liability," it is taken into account as part of a disguised sale only if the transaction otherwise constitutes a disguised sale (i.e., only if there is other consideration to the partner that triggers the disguised sale analysis).62 If the transaction otherwise constitutes a disguised sale, the amount of a qualified liability that needs to be taken into account is subject to certain limitations.63 For this purpose, a liability is a "qualified liability" if it satisfies the requirements of any one or more of four categories of liabilities, including certain liabilities incurred more than two years prior to the date of the transaction, certain liabilities incurred within two years (but not in anticipation) of the transaction, liabilities that are traceable to capital expenditures with respect to the contributed property (a "capital expenditure qualified liability"), and liabilities arising in the ordinary course of a trade or business in which the contributed property was used if all material assets related to that trade or business are part of the contribution (an "ordinary course qualified liability").64 There is no requirement that either capital expenditure qualified liabilities or ordinary course qualified liabilities encumber the property transferred in the contribution transaction (whereas the other two categories of qualified liability do require the liability to be an encumbrance on the contributed property).

e. Anticipated Reductions. A partner's share of a partnership liability for purposes of making the disguised sale analysis must be determined by taking into account (i.e., essentially must be reduced retroactively by) any subsequent reduction in the partner's share of the liability if (i) it is / was anticipated at the time of the transaction that the partner's share of the liability will / would be subsequently reduced, and (ii) the reduction is part of a plan that has as one of its principle purposes minimizing the extent to which the taking subject to or assumption of the liability is taken into account for purposes of the disguised sale analysis.

f. Tiered Partnerships. The existing Treasury regulations under Section 707 provided limited guidance regarding tiered partnerships. They provide that, if a lower-tiered partnership succeeds to a liability of an upper-tier partnership, the liability retains the same status as a qualified liability or non- qualified liability for purposes of the disguised sale analysis in the hands of the lower-tier partnership as it had in the hands of the upper-tier partnership. They also provide that similar rules apply to other related party transactions to the extent set out in other guidance published by the government. However, that is all.

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60 Treas. Reg. §1.704-4(d)

61 Treas. Reg. §1.707-5(a)(1)

62 Id. at (5)

63 Id.

64 Id. at (6)

g. Netting of Liabilities. The Treasury regulations under Section 752 provide that changes (i.e., increases and decreases) in a partner's share of various partnership liabilities arising out of a single transaction are netted for purposes of determining the tax consequences to the partner from the transaction under Section 752.[65] The Treasury regulations under Section 707(a)(2)(B) do not contain a similar rule. However, the government believes that it would be appropriate to apply the same principles for purposes of Section 707(a)(2)(B) in the context of a merger or consolidation of two or more partnerships under Section 708(b)(2)(A).

h. Disguised Sale by Partnership to Partner. The disguised sale rules are also applicable with respect to transactions pursuant to which a partnership transfers or distributes property to a partner. In the case of such transactions, the existing Treasury regulations under Section 707(a)(2)(B) provide that rules similar to the rules applicable in the case of transactions involving transfers of property by partners to partnerships shall apply with respect to the partner taking the property subject to a liability, or assuming a liability of the partnership, as part of the transaction. In this regard, such regulations provide that the partner is treated as making a payment to the partnership (which then is taken into account for purposes of making the disguised sale analysis) to the extent that the amount of the liability to which the property is subject, or that is assumed by the partner, exceeds the amount of the portion of the liability that was allocated to the partner immediately prior to the transaction. This determination is made regardless of the amount of time during which either such liability has been outstanding as a liability of the partnership prior to the transaction, or any portion of the liability has been allocated to the partner.

3. Proposals.

a. Debt Financed Distributions. The proposal adds an example to illustrate application of the principle that all liabilities incurred pursuant to a plan in which the partnership transfers funds to more than one partner are aggregated and treated as one liability for purposes of the debt financed distribution exception.

The proposal also provides guidance a regarding the coordination of the debt financed distribution exception with other exceptions to application of the disguised sale rules (including, for example, the exception for payments of reasonable guaranteed payments for the use of capital, and the preformation capital expenditure exception).[66] Specifically, the proposal provides that the transfer should first be analyzed under the debt financed distribution exception, and only amounts that are not covered by the debt financed distribution exception (and, thus, could be treated as payments made as part of a disguised sale transaction) should thereafter be analyzed under the other exceptions to the disguised sale rules (i.e., the debt financed distribution exception would have priority over all other exceptions to application of Section 707(a)(2)(B)).

b. Preformation Capital Expenditures. The proposal provides that the fair market value limitation and the exception to the fair market value exception are applied on a property-by-property basis (i.e., separately for each item of property contributed in a transaction in which multiple items of property are contributed to the partnership).

The proposal also provides that, for purposes of the preformation capital expenditure exception (and the debt financed distribution exception), the term "capital expenditure" has the same meaning as it does under the Code generally, except that it (i) includes capital expenditures that

65 Treas. Reg. §1.752-1(f)

66 See Treas. Reg. §1.707-4

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the partner elects to deduct (for example, under Section 179), but (ii) does not include deductible expenditures that the partner elects to capitalize. As a result, the proposal would clarify that the preformation capital expenditure exception does not apply merely to expenditures that are required to be capitalized.

The proposal also provides that the preformation capital expenditure exception does not apply to amounts paid or transferred to reimburse a partner for expenditures that are funded from the proceeds of a capital expenditure qualified liability (i.e., a qualified liability traceable to capital expenditures with respect to property contributed in the transaction, and that is assumed by the partnership in a transaction) to the extent that the amounts exceed the amount of the portion of the liability allocated to the partner following the transaction pursuant to the general principles of Section 752. The rationale is that, if a partner funds capital expenditures from the proceeds of a qualified liability, the preformation capital expenditure exception should only apply to the portion of those expenditures that are proportional to the portion of the liability with respect to which the partner retains an economic responsibility for repayment following the transaction.

c. Qualified Liabilities. The proposal creates a new category of qualified liability. Specifically, the proposal provides that a liability incurred in connection with a trade or business (though not in the ordinary course of the trade or business) in which the contributed property was used will be treated as a qualified liability if all material assets related to that trade or business are part of the contribution, and the liability was not incurred in anticipation of the transaction. This category alleviates the need for the liability to be an encumbrance on the contributed property under the circumstances to which it applies (even though the liability is not incurred in the ordinary course of conducting the trade or business). The rationale is that requiring an encumbrance is not necessary to achieve the objectives of Section 707(a)(2)(B) under such circumstances.

d. Anticipated Reductions. The proposal provides that a liability the anticipated payment or reduction of which is subject to the entrepreneurial risks of the partnership's operations is not a liability the subsequent payment or reduction of which needs to be taken into account as an anticipated reduction of the liability for purposes of determining the contributing partner's share of the liability when making the disguised sale analysis.

However, the proposal also provides that, if a partner's share of a liability is reduced due to a reduction or decrease in the net value of the partner or a related person pursuant to the proposed changes to the Treasury regulations under Section 752 (discussed below), and that occurs within two of the transaction, the reduction is presumed to have been in anticipation of the transaction (and thus must be taken into account when determining the partners share of the liability for purposes of making the disguised sale analysis) unless the facts and circumstances clearly establish that the reduction or decrease in net value was not anticipated at the time of the transaction. The proposal also includes disclosure requirements with respect to any such reduction.

e. Tiered Partnerships. The proposal confirms that the debt financed distribution exception applies in the context of tiered partnerships, and provides guidance regarding contributions of ownership interests in partnerships. Specifically, the proposal provides that, when a partner contributes an ownership interest in one partnership (i.e., the lower-tier partnership) to another partnership (i.e., the upper-tier partnership), the upper-tier partnership's subsequent shares of the lower-tier partnership's liabilities are treated as qualified liabilities with respect to the contributing partner to the extent that such share of liabilities would have been treated as qualified liabilities if the transaction had involved the transfer by the lower-tier partnership of all of its assets to the upper-tier partnership with the upper-tier partnership either thereby taking assets subject to such liabilities or assuming such liabilities as part of the transaction.

f. Netting of Liabilities. The proposal provides that, when two or more partnerships merge or consolidate pursuant to an "assets-over" merger within the meaning of the Treasury regulations under Section 708(b)(2)(A), changes (i.e., increases and decreases) in a partner's share of partnership liabilities as a result of the transaction are netted with each other for purposes of determining the application of the disguised sale rules with respect to the transaction.

g. Disguised Sale by Partnership to Partner. There is no proposal regarding disguised sales by partnerships to partners. However, the government believes that, when determining the amount of consideration treated as paid by the partner to the partnership with respect to liabilities assumed or taken subject to by the partner as part of the transaction, it might not be appropriate to take into account liabilities allocated to the partner prior to the transaction if the partner did not have meaningful economic exposure to the liability prior to the transaction. Accordingly, the government has asked for comments regarding a possible proposal pursuant to which allocations of liabilities immediately prior to a transaction will be taken into account for this purpose only to the extent of the partner's lowest allocable share of the liability within the 12-month period preceding the transaction, or some other meaningful period of time.

D. More Section 752 Regulations.

1. Overview. On January 30, 2014, as part of the same notice that set forth the foregoing proposals regarding the Treasury regulations under Section 707, the government published proposed regulations[67] under Section 752 to address certain issues associated with determining a partner's share of liabilities under Section 752. These proposed regulations have attracted a fair amount of attention (not much of which is flattering!).[68]

2. Background. The basic rules governing the allocation of liabilities are discussed above with respect to the proposed regulations under Section 752 that the government released on December 16, 2013.[69]

a. Satisfaction Rule. For purposes of determining the extent to which a partner (or a person related to a partner) has a payment obligation with respect to a partnership liability, and thus whether the partner has an economic risk of loss with respect to the liability for purposes of Section 752, all statutory and contractual obligations relating to the liability are taken into account.[70] Additionally, each partner (and each person related to each partner) is presumed to perform all of the partner's (or related person's) obligations to make payments, regardless of the partner's (or related person's) actual net worth, unless the facts and circumstances indicate a plan to avoid the obligation (the "satisfaction rule").[71] However, there is an exception to the satisfaction rule for disregarded entities. Specifically, the payment obligation of an entity that is disregarded as an entity separate from its owner generally is taken into account only to the extent of the net value of the entity (the "net value

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67 REG-119305-11, 79 Fed. Reg. 4826 (1/30/14)

68 See, Rubin, Whiteway, and Finklestein, "*A 'Guaranteed' Debacle: Proposed Partnership Liability Regulations*," 143 Tax Notes 219 (2014); Lipton, "*Proposed Regulations on Debt Allocations: Controversial, and Deservedly So*," 120 J. Tax'n 156 (2014). See also American Bar Association Section of Taxation, *Comments on Proposed Regulations Under Sections 707 and* 752, (8/8/14); New York State Bar Association Taxation Section, *Report on the Proposed Regulations on the Allocation of Partnership Liabilities and Disguised Sales*, Rep. No. 1307 (5/30/14) (expressing a somewhat more moderate view).

69 See the discussion above in Part III.A.2 of this paper.

70 Treas. Reg. §1.752-2(b)(3)

71 Treas. Reg. §1.752-2(b)(6)

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requirement").[72] For this purpose, the net value of a disregarded entity generally is based on the fair market value of all assets other than the ownership interest in the partnership with respect to which the net value is being determined.[73] The net value requirement does not apply to the extent that the owner of the disregarded entity is required to make a payment with respect to the disregarded entity's payment obligation (i.e., to "backstop" the disregarded entity's obligation).

With respect to non-recourse liabilities, the satisfaction rule can treat a partner that/who has guaranteed the payment of a nonrecourse liability (or that/who is related to a person that/who has guaranteed the payment of the liability) as having a payment obligation, and thus an economic risk of loss, with respect to such liability.[74] In such case, the liability will be allocated to such partner even if it is reasonably likely that the partnership will be able to satisfy the liability out of profits or capital. The government is concerned that this has led some parties to enter into guaranty arrangements, or other payment obligations, that are not commercial solely for purposes of achieving an allocation of partnership liabilities to one or another partner, and that Congress intended for only bona fide, commercial payment obligations to be given effect under Section 752.

b. Reimbursement Rights. For purposes of determining the extent to which a partner (or a person related to a partner) has a payment obligation with respect to a liability, and thus whether the partner has an economic risk of loss with respect to the liability for purposes of Section 752, the payment obligation of the partner (or related person) is reduced by the amount of any reimbursement to which the partner (or related person) is entitled to receive from any other partner (or any person who is related to any other partner).[75]

c. Nonrecourse Liabilities. Partnership nonrecourse liabilities (i.e., the liabilities of a partnership with respect to which no partner, or person related to a partner, bears and economic risk of loss) are allocated to partners in three tiers. Specifically, a partner's share of the nonrecourse liabilities of a partnership is the sum of (i) the partner's share of partnership minimum gain determined in accordance with the Treasury regulations under Section 704(b), (ii) the amount of taxable gain that the partner would be allocated pursuant to Section 704(c) (whether "forward" or "reverse") if the partnership disposed of all of its property that is held subject to one or more nonrecourse liabilities solely in exchange for full satisfaction of such liabilities (and nothing further), and (iii) with respect to all nonrecourse liabilities not allocated pursuant to the two foregoing tiers (i.e., the so-called "excess nonrecourse liabilities"), the partner's proportionate share of such liabilities based on the partner's proportionate share of the partnership's profits.[76] For purposes of the third tier, a partner's share of partnership profits is determined based on all of the facts and circumstances relating to the economic arrangement of the partners.[77] However, the partnership agreement may specify the partners' shares of partnership profits for this purposes as long as such specified shares are reasonably consistent with allocations (that have "substantial economic effect" within the meaning of the Treasury regulations under Section 704(b)) of some other significant item of partnership income or gain (the "significant item method").[78] Alternatively, the excess nonrecourse liabilities can be allocated in accordance with the

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72 Treas. Reg. §1.752-2(k)

73 Id. at (2)

74 Treas. Reg. §§1.752-2(b)(1), (d)(2) & (f) *Example 5*

75 Treas. Reg. §1.752-2(k)

76 Treas. Reg. §1.752-3(a)

77 Id. at (3)

78 Id.

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manner in which it can be reasonably expected that the deductions attributable to such liabilities will be allocated (the "alternative method").[79] Additionally, with respect to property contributed to a partnership subject to a nonrecourse liability (or property subject to "reverse" Section 704(c) allocations), the partnership may first allocate an excess nonrecourse liability to the contributing partner (or continuing partners in the case of "reverse" Section 704(c) allocations) in an amount equal to the portion of any Section 704(c) gain associated with the contributed property that exceeds the amount of gain applicable for purposes of the second tier of the nonrecourse allocation rules (i.e., the amount of gain triggered by assuming that the only consideration received in a deemed sale transaction is satisfaction in full of the nonrecourse liability) (the "additional method").[80] However, the additional method does not apply for purposes of the disguised sale rules.[81]

3. Proposals.

a. Satisfaction Rule.

(1) Recognition of Liabilities. The proposal provides that a payment obligation is recognized for purposes of the satisfaction rule, and the other provisions regarding the determination as to whether a partner has an economic risk of loss with respect to a partnership liability, only if certain requirements are satisfied with respect to the payment obligation. Specifically, the proposal provides that a payment obligation must satisfy seven new requirements in order to be recognized for such purposes. Those requirements are as follows:

(A) the partner (or related person) is either (i) required to maintain a commercially reasonable net worth throughout the term of the payment obligation, or (ii) subject to commercially reasonable contractual restrictions limiting or prohibiting transfers of assets for inadequate consideration;

(B) the partner (or related person) is required periodically to provide commercially reasonable documentation regarding the partner's (or related person's) financial condition;

(C) the term of the payment obligation does not end prior to the term of the partnership liability;

(D) the payment obligation does not require the primary obligor (or any other obligor) with respect to the partnership liability to hold money or other liquid assets in an amount that exceeds the obligor's reasonable needs;

(E) the partner (or related person) received arms' length consideration for assuming the payment obligation;

(F) in the case of a guaranty or similar arrangement, the partner (or related person) is or would be liable up to the full amount of such partner's (or related person's) payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied (provided that such arrangement is treated as modified by any right of indemnity, reimbursement, or similar arrangement other than

79 Id.

80 Id.

81 Id.

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a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable); and

(G) in the case of an indemnity, reimbursement, or similar arrangement, the partner (or related person) is or would be liable up to the full amount of such partner's (or related person's) payment obligation if, and to the extent that, any amount of the payment obligation of the party benefiting from the arrangement is satisfied (thus triggering the payment obligation under the arrangement; provided that such arrangement is treated as modified by any further right of indemnity, reimbursement, or similar arrangement other than a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable)

(2) Anti-Abuse Rule. The proposal expands the anti-abuse rule associated with the rules governing the recognition of payment obligations to provide that a payment obligation of a partner (or related person) will not be recognized if the facts and circumstances indicate that the partnership liability with respect to which the payment obligation relates is part of a plan or arrangement involving the use of tiered partnerships, intermediaries, or similar arrangements (for example, multiple "tranches" of debt obligations) to convert a single liability into more than one liability with the principal purpose of circumventing the requirements of paragraphs "(F)" and "(G)" of the new requirements set forth above (i.e., the "anti-bottom-dollar guaranty" rules). The government has asked for comments regarding arrangements that might be used to circumvent the anti-bottom-dollar guaranty rules, and whether the anti-abuse rule should be further broadened to address any such arrangements. The government also has asked for comments regarding the circumstances under which a payment obligation for a portion of each dollar of a partnership liability should be recognized (for example, a payment obligation for 25% of the unpaid amount of a partnership obligation; i.e., a so-called "vertical slice"), as opposed to the "all-or-nothing" approach of the anti-bottom-dollar guaranty rules.

(3) Net Value Requirement. The proposal provides that application of the net value requirement will be expanded beyond just disregarded entities. Specifically, the proposal provides that the net value requirement will be applied to all partners (or related persons), including grantor trusts, but not including individuals or decedent's estates, with respect to all partnership liabilities other than trade payables. The proposal also provides the net value requirement will continue to apply to disregarded entities even if the owner of the disregarded entity is an individual or decedent's estate. The proposal further provides that any partner (or related person) who / that is subject to the expanded rules is treated as a disregarded entity for purposes of applying the existing rules regarding the net value requirement. Additionally, the proposal provides obligations for partners who could have an economic risk of loss with respect to a partnership liability to provide information regarding their net value (or the net value of persons related to them). The government has asked for comments regarding whether the net value requirement should be extended to individuals and decedent's estates.

b. Reimbursement Rights. The proposal provides that the universe of reimbursement rights that are taken into account as a reduction in the amount of a payment obligation will be expanded to include any source of reimbursement that effectively eliminates a partner's payment risk, and not merely reimbursement rights from other partners (or persons related to other partners). Specifically, the proposal provides that a payment obligation of a partner (or person related to a partner) is reduced by the amount of any reimbursement to which the partner (or related person) is entitle to receive from any other person.

c. Nonrecourse Liabilities. The proposal provides that both the significant item method and the alternative method are eliminated as acceptable approaches for allocating excess nonrecourse liabilities. The government believes that those methods may not properly reflect the partners' shares of the partnership profits that generally are used to repay such liabilities, and thus are not consistent with the underlying rationale for allocating excess nonrecourse liabilities. The proposal provides instead that the partnership agreement may specify the partners' shares of partnership profits for purposes of allocation excess nonrecourse liabilities as long as such specified shares are in accordance with the partners' liquidation value percentages. For this purpose, a partner's "liquidation value percentage" is the ratio (expressed as a percentage) of the liquidation value of the partner's interest in the partnership divided by the aggregate liquidation value of all of the partners' interests in the partnership. A partner's liquidation value percentage is determined upon formation of the partnership, and upon the occurrence of any event that would provide a basis for revaluing partnership property for purposes of maintaining partnership capital accounts (even if capital accounts are not adjusted upon the occurrence of the event).[82] Also, the proposal provides that any change in a partner's share of partnership liabilities upon the occurrence of a revaluation event must be taken into account for purposes of determining the tax consequences to the partner from the revaluation event.

For these purposes, the liquidation value of a partner's interest in a partnership would be the amount of cash that the partner would receive with respect to the interest if, immediately after formation of the partnership or occurrence of the revaluation event (as appropriate), thee partnership sold all of its assets for cash equal to the fair market value of such assets (which, pursuant to Section 7701(g), in the case of any property subject to any nonrecourse indebtedness, shall not be less than the amount of such nonrecourse indebtedness), satisfied all of its liabilities (other than liabilities described in Section 1.752-7 of the Treasury regulations), paid an unrelated third party of assume all of its liabilities described in Section 1.752-7 of the Treasury regulations in a taxable transaction, and then liquidated (distributing any of its then remaining cash to its partners).

The government has asked for comments regarding other methods that would reasonably measure a partner's interest in partnership profits that are not overly burdensome, as well as whether exceptions should be provided to exclude certain events from triggering a redetermination of a partner's liquidation values.

IV. IRS RULINGS AND OTHER GUIDANCE

A. Revenue Procedures.

1. Rev. Proc. 2014-12.[83] The IRS provides a safe harbor pursuant to which it will not, as a matter of enforcement policy, challenge allocations of Section 47 rehabilitation credits to partners under circumstances that satisfy the requirements of the safe harbor.

This revenue procedure was issued in response to the Third Circuit's decision in Historic Boardwalk Hall, LLC v. Commissioner,[84] in which the Court held that an investor's interest in a partnership was not sufficiently meaningful to treat the investor as a partner. As a result, the Court upheld the IRS's position that Section 47 tax credits allocated to the investor should instead be re-allocated to other partners (the promoter in this instance). The decision was quite disruptive to the

[82] See Treas. Reg. §1.704-1(b)(2)(iv)*(f)(5)*

[83] 2014-3 IRB 415 (12/30/13).

[84] 694 F.3d 425 (3d. Cir. 2012), *cert. denied*. See the discussion regarding Historic Boardwalk in the text below under Part V.A.4.

rehabilitation tax credit market because the commercial terms of the transaction in question apparently were generally comparable to those used in other transactions. That in turn thwarted achievement of Congress's objective when it promulgated Section 47, which was to support the market for, and thereby encourage, the rehabilitation of historic buildings. Accordingly, in apparent acknowledgement that its victory in Historic Boardwalk was at least somewhat pyric, the government promulgated Rev. Proc. 2014-12 and its safe harbor as a compromise in order to try and save the market and the opportunity for achieving the goals behind the promulgation of Section 47.

Generally, Section 38 provides certain taxpayers with a credit against income for certain business taxes, including the investment credit determined under Section 46 and the rehabilitation credits described in Section 47.[85] The rehabilitation credit is equal to (a) 10% of the qualified rehabilitation expenditures with respect to any qualified rehabilitated building other than a certified historic structure, and (b) 20% of the qualified rehabilitation expenditures with respect to any certified historic structure.[86] However, the rehabilitation credit itself was not the subject of Historic Boardwalk, and is not the focus of the safe harbor. The subject of Historic Boardwalk, and the safe harbor, was / is allocation of the credit.

An allocation of tax credits (and the recapture of tax credits) generally is not reflected in capital accounts pursuant to the existing Treasury regulations under Section 704(b).[87] As a result, an allocation of tax credits generally cannot have economic effect for purposes of "substantial economic effect" rules in such Treasury regulations, and must be allocated in accordance with the partners' interests in the partnership.[88] Special rules apply regarding the circumstances under which an allocation of tax credits will be deemed in accordance with the partners' interests in the partnership. With respect to the rehabilitation credit under Section 47, allocations of the credit will be deemed in accordance with the partners' interests in the partnership generally if the partners' shares of the credit are determined in accordance with the ratio in which the partners divide the general profits of the partnership regardless of whether the partnership has a profit or loss for its taxable year during which the qualified rehabilitation building is placed in service.[89]

Those are the general rules. However, the problem in Historic Boardwalk was more fundamental. The government and Third Circuit determined that the investor was not a bona fide partner, and thus that the Section 47 credits that were the subject of the case were not merely allocated improperly under Section 704(b) but rather were improperly conveyed to the investor pursuant to a sale transaction. As a result, the safe harbor set forth in Rev. Proc. 2014-12 is directed primarily towards terms and conditions that the government believes justify treating an investor as a bona fide partner.

The safe harbor consists of a relatively lengthy list of terms and conditions that an arrangement must satisfy in order to be covered by the safe harbor. For example, the principal of the partnership (usually the manager or general partner) must maintain a 1% interest in all material items of partnership income, gain, loss, deduction, and credit at all times during the partnership's existence. Additionally, there are many requirements intended to require the investor[90] to (a) maintain a certain level

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85 IRC §§38(a), 38(b)(1), & 46(1).

86 IRC §47(a)

87 Treas. Reg. §1.704-1(b)(4)(ii)

88 Id.

89 Treas. Reg. §§1.46-3(f)(2)(i), 1.704-1(b)(4)(ii)

90 Generally, an investor is a partner that holds an interest in the partnership other than the principals.

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of capital, (b) hold a "bona fide equity investment"[91], and (c) require such investor's capital contributions to be a contribution of cash or other property (i.e., no contribution of promissory notes or borrowed money from the partnership -- or a principal -- in which such investor is investing). In this regard, the investor must at all times hold a minimum interest in all material items of partnership income, gain, loss, deduction, and credit that is equal to at least 5% of the largest percentage interest that the investor has in such items at any time. Additionally, the investor must contribute at least 20% of the investor's total expected capital contribution by the time the building is placed in service, and at least 75% of the investor's total expected capital contributions must be fixed in amount before such time. There also are significant requirements regarding nature and extent of guarantees associated with any arrangement (reflecting a theme from other guidance promulgated by the government in other areas), including a prohibition against any agreement protecting the investor with respect to the investor's ability to claim the Section 47 credit, receive the cash equivalent of the credit, or receive a return of the investor's capital in the event the investor is unable to claim or maintain use of the credit.

The specification of a list of commercial requirements such as those included in the safe harbor inevitably raises questions and concerns about the propriety of the government basically setting the terms for a commercial market. A response might be that the safe harbor is just that, and is not intended to be a government specification for market transactions. However, as a practical matter, it is.[92] As a result, one hopes that the government will actively monitor this area, and make adjustments to the safe harbor as necessary or appropriate in order to avoid creating economic distortions and resolve ambiguities in the safe harbor. For example, Section 4.02(2)(b) of the revenue procedure provides that the investor's interest "must constitute a bona fide equity investment with a reasonably anticipated value commensurate with the investor's overall percentage interest in the Partnership." That is a subjective standard that can be problematic in a market that is desperate for certainty. There are other ambiguous provisions that can be equally problematic. Accordingly, while Rev. Proc. 2014-12 is quite helpful under the circumstances, one hopes that additional constructive guidance is forthcoming from the government in this area.[93]

B. Private Letter Rulings.

1. PLR 201421001 (05/23/2014). The IRS applied Rev. Rul. 99-5[94] and ruled that (a) each series in a limited liability company will constitute a partnership for U.S. federal income tax purposes, (b) reverse Section 704(c) allocations made pursuant to the partial netting approach will be reasonable within the meaning of Treas. Reg. §1.704-3(e)(3), and (c) any in-kind distributions of marketable securities will not constitute distributions of cash for purposes of Section 731.

This ruling involves a domestic trust that is in the process of liquidating and whose assets consist largely of marketable securities and a wholly-owned limited liability company of which the trustee is the sole manager. Due to pending litigation and other matters, the trustee determined that it was appropriate and desirable to, in lieu of distributing all of the assets to the trust's remainder beneficiaries, create two additional series of its limited liability company. One such series would hold mainly equity securities and the other series would hold mainly fixed income securities. The trustee then

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91 Generally, this requires that the value of such interest cannot be fixed in amount, and must be dependent on the success or failure of the partnership and not be limited to a preferred return.

92 See Rev. Proc. 2007-65, 2007-2 C.B. 967 (regarding the wind energy production tax credit).

93 See Lipton, "*New Rehabilitation Credit Safe Harbor – Limiting Historic Boardwalk Hall*," 120 J. Tax'n 128 (2014) for further discussion regarding Rev. Proc. 2014-12.

94 1999-1 CB 434.

planned to distribute the various ownership interests in the limited liability company to the trust's remainder beneficiaries pursuant to the terms of the trust.

The trustee requested rulings confirming, among other items that: (a) prior to distribution of the limited liability company interests from the trust, the limited liability company will continue, despite the creation of multiple series, to constitute a disregarded entity, (b) once the interests in the limited liability company are distributed, each series will constitute a partnership for federal U.S. income tax purposes, (c) the election by each partnership to allocate reverse Section 704(c) allocations pursuant to the partial netting approach will be reasonable within the meaning of Treas. Reg. §1.704-3(e)(3), and (d) any in-kind distributions of the marketable securities (i.e., qualified financial assets) will not constitute distributions of cash for purposes of Section 731.

The IRS granted each of these rulings and applied Situation 1 of Rev. Rul. 99-5 to confirm that each series of the limited liability company will constitute a partnership subsequent to the distribution of the LLC ownership interests to the trust's remainder beneficiaries. Additionally, based on representations made by the trustee that each of the series will constitute a "securities partnership" as defined in Treas. Reg. §1.704-3(e)(3)(iii), each partnership's election to make reverse Section 704(c) allocations utilizing the partial netting approach will be reasonable within the meaning of Treas. Reg. §1.704-3(e)(3) as long as such election is not made with the intent to shift built-in gains and losses among the partners. Finally, the ruling confirms that each partnership will be an "investment partnership"[95] for purposes of Section 731 and, therefore, in-kind distributions will not be treated as distributions of money.

C. Chief Counsel Advice.

1. CCA 201436049 (09/05/2104). The Office of Chief Counsel advised that members of a limited liability company whose primary source of income was fees from providing investment management services are not limited partners within the meaning of Section 1402(a)(13), and thus were subject to self-employment tax with respect to their distributive shares of the company's profits. The management company is the investment manager for a family of investment partnerships that carry on extensive trading and investment activities, and is one of two general partners of each the investment partnerships (the other general partner appears to be a company that has the right to receive a "carried interest" with respect to each of the investment partnerships). The owners and employees of the management company provide extensive research, trading, and investment services to the investment partnerships. In exchange for providing those services, the management company receives a quarterly management fee based on the amount of assets under management in each of the investment partnerships.

Each of the owners of the management company worked full time for the management company, and was issued a Form W-2 for an amount of compensation paid to them during each calendar year that the management company stated was "reasonable compensation" for each owner. The management company's taxable income was allocated pro rata to the owners based on the relative number of ownership units held in the management company. However, the only amounts reported as being subject to self-employment tax were guaranteed payments made to the owners consisting of health insurance premiums and parking benefits paid by the management company on behalf of the owners. The management company was the successor to a S corporation that previously had provided the same services to the investment partnerships as were provided by the management company. It appears that the management company was following the same reporting practices as were previously followed by the S corporation.

95 Generally, an "investment partnership" is a partnership which has never engaged in a trade or business and the assets of which are comprised of money and securities. IRC §731(c)(3)(C)(i).

The Chief Counsel Advice references the legislative history to Section 1402(a)(13) and states that it clarifies that Congress did not intend for Section 1402(a)(13) to apply to partners who actually perform services for the partnership. The Chief Counsel Advice then reviews the Tax Court's decision in Renkmeyer v. Commissioner[96] and the District Court's decision in Reither v. U.S[97] as support for the conclusion that the earnings received by the owners of the management company are not in the nature of the investment (or passive) income that Congress intended to by covered by Section 1402(a)(13) (and thus exempt from self-employment tax). Additionally, the Chief Counsel Advice states that, based on Rev. Rul. 69-184[98] and Reither, it is not appropriate to treat the owners as employees to any extent (and thus report any amounts paid to the owners as wages on Forms W-2), and that doing so does not thereby convert any portion of their distributive shares of the management company's profits into income that is in the nature of income to which Section 1402(a)(13) is applicable.

2. CCA 201425011 (06/20/2014). The Office of Chief Counsel advised that an IRS Form 1065 filed on behalf of a limited liability company taxed as a partnership for U.S. federal income tax purposes was not a validly filed tax return because it was not signed by a member manager of the limited liability company. Accordingly, it would not be an adequate filing for purposes of starting the statute of limitations with respect to the assessment of partnership items.[99]

The tax return that is the subject of this Chief Counsel Advice was signed by someone who signed the return by writing in the name of a legal entity that was a member of the limited liability company (as opposed to, for example, the name of an individual acting on behalf of the legal entity).[100] The Chief Counsel's office concluded that this was not an adequate signature for purposes of concluding that the Form 1065 was a valid return.

The Chief Counsel Advice observes that neither the Code nor any Treasury regulations address the execution of Forms 1065 by or on behalf of limited liability companies taxed as partnerships. The only guidance available is provided by the instructions to Form 1065 and IRS Publication 3402 (Taxation of Limited Liability Companies; Rev. March 2010). The instructions to Form 1065 state that "Form 1065 is not considered to be a return unless it is signed by a general partner or LLC member manager."[101] Publication 3402 has a similar statement, and then goes on to state that:

> A member manager is any owner of an interest in the LLC who, alone or together with others, has the continuing authority to make the management decisions necessary to conduct the business for which the LLC was formed. If there are no

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96 136 T.C. 137 (2011) (concluding that partners in law firm organized as a Kansas limited liability partnership could not take advantage of Section 1402(a)(13) to avoid self-employment taxes on their distributive shares of the law firm's profits).

97 919 F.Supp.2d 1140 (D. N.M. 2012) (concluding that a doctor and his wife could not take advantage of Section 1402(a)(13) to avoid self-employment taxes on their distributive share of profits from a limited liability company through which the doctor and his wife conducted a diagnostic imaging business, even though the company had reported some amounts as wages to them on Forms W-2).

98 1969-1 C.B. 256.

99 IRC §6229

100 The limited liability company had two members, a "corporation sole" with no owner / members, and a foreign entity that was the legal entity whose name was signed on the Form 1065. The individual who was an owner of, and apparently controlled, the foreign entity apparently implied in an interview with the government that he did not who had signed the foreign entity's name to the Form 1065, and that it might have been the tax return preparer.

101 Instructions for Form 1065, U.S. Return of Partnership Income, p.4 (Feb 12, 2014).

elected or designated member managers, each owner is treated as a member manager.[102]

In his regard, the Chief Counsel Advice states that it is not adequate for a mere officer or employee of the limited liability company to sign the return (nor for the return prepare to sign the return on the "taxpayer" line of the return). The Chief Counsel Advice further states that the available guidance in this area (including certain cases addressing comparable issues) indicates that a Form 1065 must be signed by an individual who is identified as such (with presumably some indication of the representative capacity in which the signature is provided when applied to the return on behalf of a member that is a legal entity).

The situation addressed by the Chief Counsel Advice is unusual, and likely does not reflect a normative approach to this topic by practitioners. As a result, the guidance provided by the Chief Counsel Advice likely is not particularly significant for most taxpayers and practitioners. However, the Chief Counsel Advice is a reminder that it would be helpful if the government would provide some definitive guidance in this area and remove the needless ambiguity that has developed with respect to limited liability companies regarding something as basic as who is authorized to sign a Form 1065.

The Chief Counsel Advice concludes by observing that the statute of limitations of most significance for the taxpayer is the statute of limitations associated with the taxpayer's own separate tax return. However, while the limited liability company's tax return is not the "return" of the partner for purposes of starting the assessment period under Section 6501(a) with respect to the partner, the statute of limitations governing review of the partnership's Form 1065 is still important.

3. CCA 201418051 (05/02/2014). The Office of Chief Counsel advised that state law controls who can act as a limited liability company's tax matters partner under Section 6231. In this instance, under the state law at issue, the person who would have the authority to serve as tax matters partner would be the current officer/manager of the limited liability company. Although it is unclear from the text of the Chief Counsel Advice, the current officer/manager must also be a member of the limited liability company.[103]

4. CCA 201411035 (03/14/2014). The Office of Chief Counsel advised that an entity owned by a husband and wife is presumed to be a partnership for U.S. federal income tax purposes unless they elect out of Subchapter K to be treated as a disregarded entity.[104] Although not many facts are provided, the Office of Chief Counsel determined that the entity was a "qualified joint venture" under Section 761(f) and that earnings from the entity should therefore be treated as attributable to a trade or business conducted by each spouse as a sole proprietor (and subject to self-employment tax).[105]

5. CCA 201402005 (1/10/2014). The Office of Chief Counsel advised that, in determining the beginning of a partnership proceeding, the IRS must issue a notice of the beginning of the administrative proceeding at least 120 days before issuing a notice of final partnership administrative adjustment (known as an "FPAA") to a partnership's tax matters partner.

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102 IRS Publication 3402, Taxation of Limited Liability Companies, p.2 (Rev. March 2010).

103 IRC §6231

104 The Office of Chief Counsel cites to IRS §§761(a) and (f) as support for this presumption.

105 If the husband and wife were residents of a community property state, the IRS would respect their treatment of the entity as a disregarded entity. See Rev. Proc. 2002-69, 2002-2 CB 831.

6. CCA 201402007 (1/10/2014). The Office of Chief Counsel advised that each year is a separate cause of action in TEFRA proceedings. Therefore, in TEFRA proceedings, the IRS is free to adjust items in a year, regardless of how prior or later years were reported. The Office of Chief Counsel, citing to Kligfeld v. Commissioner[106] and G-5 Holding v. Commissioner,[107] further advised that the IRS can issue an FPAA in a closed year for purposes of preventing partners from carrying forward a loss to an open year.

7. CCA 201402009 (1/10/2014). The Office of Chief Counsel advised that, if any partner's Section 6501 limitations period is open for partnership items, the IRS may issue an FPAA that is binding on that partner. The Section 6501 limitations period begins to run from the date of the filing of an actual tax return (and not the filing of an information return of a pass-through entity). The Office of Chief Counsel further advised that Section 6229 operates to extend (and not shorten) a partner's Section 6501 limitations period.

8. CCA 201402011 (1/10/2014). Consistent with the advice given in CCA 201402009, the Office of Chief Counsel advised that when a tax matters partner signs a Form 872-P in a TEFRA proceeding, the tax matters partner is extending the minimum period for assessment for all partner returns claiming a disallowed partnership loss, including carryforward years, regardless of the year in which such partner claims the partnership loss.

9. CCA 201402012 (1/10/2014). The Office of Chief Counsel advised that the bankruptcy of a tax matters partner terminates its authority to act as tax matters partner of a partnership under Treas. Reg. §§301.6231(a)(7)-1(l)(1)(iv) and 301.6231(c)-7(a). In this instance, since the bankruptcy was disclosed on Form 872-P, an agreement entered into during the bankruptcy of a tax matters partner was likely invalid under Section 6229(b)(2).

V. COURT DECISIONS

A. Appellate Courts.

1. McLauchlan. The Fifth Circuit in McLauchlan v. Commissioner[108] affirmed the Tax Court's decision to uphold the IRS's assessment of a deficiency based on the disallowance of certain deductions taken for business expenses incurred by a law firm partner.

McLauchlan was a partner in a law firm structured as a partnership for U.S. federal income tax purposes. He reported income from, and deducted certain expenses incurred in connection with, his law practice on Schedule C of his individual income tax return.[109] The IRS issued a notice of deficiency and disallowed the deductions on the grounds that McLauchlan was a partner in a partnership and, therefore, was not entitled to report profits and losses from the partnership on his Schedule C, or to take deductions from the partnership on Schedule C. The Tax Court determined that the expenses were not properly deductible by McLauchlan even if he had properly reported the activities from his law firm on Schedule E.[110]

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[106] 128 T.C. 192 (2007)

[107] 128 T.C. 186 (2007)

[108] 113 AFTR 2d 2014-1188 (5th Cir. Mar. 6, 2014) (per curiam).

[109] The taxpayer in this case acknowledged that he was not entitled to deduct the expenses on Schedule C, and claimed that they were properly deductible on Schedule E as unreimbursed partnership expenses.

[110] TC Memo 2011-289.

Generally, partners may not deduct partnership expenses incurred by the partner, even if those expenses were incurred in furtherance of the partnership business.[111] However, partnership expenses incurred by a partner that, pursuant to a partnership agreement, are required to be paid by the partner out of his own funds may be deducted.[112] In making its determination, the Tax Court reviewed the law firm's partnership agreement, heard testimony regarding the reimbursement policies of the law firm, and determined that the expenses did not constitute unreimbursed partnership expenses.

Specifically, the partnership agreement for the law firm provided that expenses for "business meals, automobiles, travel and entertainment, conventions, continuing legal education seminars and professional organizations" would be reimbursed by the partnership if approved by the managing partner. As a result, the Fifth Circuit confirmed that any expenses deducted by McLauchlan, other than those identified in the partnership agreement, were not deductible since the partnership agreement did not require McLauchlan to pay any such expenses. As for the expenses identified in the partnership agreement, based on testimony given during the Tax Court proceeding, the Tax Court determined that the law firm had a liberal reimbursement policy and such expenses likely would have been reimbursed had McLauchlan presented the expenses for reimbursement. The Fifth Circuit determined that, allowing a partner to deduct an expense for failure to seek a reimbursement when one is available would give a taxpayer an improper right to convert partnership expenses into individual expenses. Therefore, the disallowed expenses were either reimbursable partnership expenses or expenses he was not required, by the partnership agreement, to incur.

This case is a reminder to review partnership agreements carefully and that the language in an agreement can affect the opportunity for partners to claim expense deductions even for unreimbursed expenditures. If a partner is expected to pay expenses of the partnership, the partnership agreement should explicitly require the partner to pay such expenses and provide that such expenses will not be reimbursed. Otherwise, partners must seek reimbursement for expenses when it is available. The failure to do so will not permit them to deduct such expenses.

2. <u>NPR Investments</u>. The Fifth Circuit in <u>NPR Investments, LLC v. U.S</u>[113] affirmed the District Court's determination that an FPAA was validly issued.[114]

Three named partners in a Texas law firm each formed a single-member limited liability company through which they each made an investment in offsetting foreign currency options. Subsequent to investing in such options, each of the partners transferred ownership of their single-member limited liability company to NPR Investments, LLC, a limited liability company ("<u>NPR</u>"), previously established for purposes of creating an offsetting-option tax shelter (OPS). Days after transferring ownership of their single-member limited liability companies to NPR, each of the individuals withdrew as a member from NPR. At the time of withdrawal, each member received cash and foreign currencies. The foreign currencies were then contributed to their law firm, and gains or losses were specially allocated by the law firm to the contributing partner.

NPR timely filed its first and only tax return. In answering the question on the tax return of whether the partnership was subject to TEFRA, NPR indicated that it was not. Relying on

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111 <u>See</u> <u>Cropland Chem. Corp. v. Comm'r</u>, 75 T.C. 288, 295 (1980).

112 <u>See</u> <u>Klein v. Comm'r</u>, 25 T.C. 1045, 1052 acq., 1956-2 C.B. 4 (1956).

113 740 F.3d 998 (5th Cir. 2014)

114 The Fifth Circuit reversed the District Court's judgment as it related to valuation misstatement and substantial underpayment penalties, and vacated the District Court's judgment as it related to the taxpayer's reasonable-cause defenses. The discussion of this case is limited to the analysis regarding the validity of the FPAA.

the indication that NPR was not subject to TEFRA, the IRS examined the NPR tax return and ultimately sent a no-change letter to NPR and subsequently issued deficiency notices to two of the individual partners of NPR. Upon review by an IRS manager, the IRS determined that it would be necessary to follow the TEFRA audit procedures.

Due to the near impossibility that NPR would realize a profit, the IRS issued a notice of FPAA in which the IRS determined that NPR was a sham, lacked economic substance and must be disregarded which resulted in a disallowance of any losses claimed by the taxpayers on their individual returns. Among other rulings, the District Court in the lower proceeding determined that the FPAA was validly issued. The validity of the FPAA hinged on whether it was a "second notice" for purposes of Section 6223(f).[115] The Court found that NPR misrepresented a material fact when it indicated on its tax return that it was not subject to the TEFRA audit procedures and therefore affirming the District Court's judgment. Since the Court determined there was a misrepresentation, the Court did not answer the question of whether the notice of no-change constituted a "first" notice of FPAA.

In addition to its determination that the FPAA was validly issued, the Fifth Circuit Court of Appeals reversed the District Court's determination finding that the valuation misstatement penalty under Section 6662 applied. This is largely due to the fact that the U.S. Supreme Court decision in United States v. Woods (overturning the decision of the Fifth Circuit's decision that the valuation misstatement penalty did not apply when the underlying transaction was disregarded) had been issued approximately two weeks prior to the decision in *NPR.*

3. Superior Trading. The Seventh Circuit in Superior Trading, LLC v. Commissioner[116] affirmed the determination of the Tax Court that an entity established to perpetrate a tax shelter was a sham and should not be respected for tax purposes and the taxpayers involved are subject to the gross valuation misstatement penalties under Section 6662.

Warwick, LLC, an Illinois limited liability company, was formed by a lawyer named John Rogers. A Brazilian retailer transferred receivables with a face value of $30 million dollars, but of doubtful collectability, to Warwick, LLC and later sold its interests in Warwick, LLC to investors. These investors subsequently claimed bad debt deductions generated by the distressed receivables. It was determined by the Tax Court that Mr. Rogers' intent in organizing Warwick, LLC was to establish a distressed asset/debt tax shelter referred to as "DAD" and the claimed losses were disallowed.

Mr. Rogers' entity, Jetstream Business Limited, was a member of Superior Trading, LLC along with the Brazilian trader, and was the managing member of Superior Trading, LLC. As the managing member, Jetstream was charged with taking steps to collect amounts due under the receivable to Warwick. In finding that Warwick LLC was a sham partnership, the Court pointed to the fact that Jetstream's attempts to collect on the receivables transferred to Warwick were "window dressing" only due to the fact that none of the steps required under Brazilian law to collect such amounts were taken by Jetstream Business Limited.

Mr. Rogers argued that Warwick, LLC should be respected as a partnership for U.S. federal income tax purposes because it was a validly formed limited liability company under Illinois law and under the check-the-box regulations, because it had multiple members, its default classification for U.S. federal income tax purposes was as a "partnership." The Court did not dispute this allegation;

115 Generally, if an FPAA is mailed to a partner, a second notice may not be mailed for the same taxable year absent a showing of fraud, malfeasance, or misrepresentation of a material fact.

116 728 F.3d 676 (7th Cir. 2013).

however, the Court noted that the purpose of the check-the-box regulations is to provide the default treatment of an entity should it exist and not to serve as a guaranty that any such entity shall be entitled to the benefits of any such regulations.

The Seventh Circuit Court of Appeals adopted the majority view of the U.S. Courts of Appeals and the Tax Court that the valuation misstatement penalty is still applicable when the underlying transaction is disregarded because of lack of economic substance. Subsequent to the Seventh Circuit's opinion in *Superior Trading*, the U.S. Supreme Court issued its opinion in United States v. Woods[117] reversing a decision by the Fifth Circuit Court of Appeals and confirming the application of the valuation misstatement penalty in cases such as that in *Superior Trading*.

4. Historic Boardwalk Hall. The Third Circuit in Historic Boardwalk Hall, LLC v. Commissioner[118] reversed and remanded the Tax Court's determination that a corporate member of a limited liability company was a valid "partner" for federal income tax purposes, and thus could claim Section 47 rehabilitation tax credits. The Court found that the members of the limited liability company did not join together in a meaningful manner that justified treating them as partners for U.S. federal income tax purposes, but instead were focused on an impermissible sale of the Section 47 rehabilitation tax credits to the corporate member in question.

The main issue in this case was whether a corporate member of a limited liability company was a "bona fide partner" for U.S. federal income tax purposes entitling such corporate member to an allocation of a portion of the historic rehabilitation tax credits claimed by Historic Boardwalk Hall, LLC119 associated with steps taken to restore the Historic Boardwalk Hall in Atlantic City, New Jersey.

After consulting with Sovereign Capital Resources, a financial advisor, the New Jersey Sports and Exposition Authority ("NJSEA") entered into a transaction with Pitney Bowes pursuant to which Pitney Bowes agreed to make significant capital contributions to HBH in exchange for a 99.9% membership interest in HBH and a 3% preferred return. The parties entered into several agreements to implement the transaction, including an amended and restated operating agreement, a construction completion guaranty, an operating deficit guaranty, a tax benefits guaranty agreement, and an environmental indemnity. Among other provisions intended to protect Pitney Bowes, the new operating agreement contained a put and call option pursuant to which NJSEA could acquire Pitney Bowes' interest in Historic Boardwalk Hall, LLC and required NJSEA to enter into a guaranteed investment contract in an amount sufficient to secure the payment of the purchase price for Pitney Bowes' interest.[120]

The Court found that Pitney Bowes was not a "bona fide partner" of HBH based on the substance of the transaction. To assist in its analysis, the Court looked to the "totality of the circumstances" test in Commissioner v. Culbertson,[121] as applied in Trousdale v. Commissioner[122] and TIFD III-E, Inc. v. U.S.,[123] and determined that Pitney Bowes did not have a "meaningful stake in the

117 134 S. Ct. 557 (2013)

118 694 F.3d 425 (3d Cir. 8/27/12), *cert denied.*

119 Historic Boardwalk Hall, LLC is a New Jersey limited liability company created by the NJSEA for purposes of providing a vehicle through which it could enter the market for rehabilitation tax credits. An interest in Historic Boardwalk Hall, LLC was sold to a wholly-owned subsidiary of Pitney Bowes, Inc.

120 The purchase price was equal to the present value of any unrealized tax benefits and cash distributions.

121 337 U.S. 733 (1949).

122 219 F.2d 563 (1955)

123 459 F.3d 220 (2d Cir. 2006).

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successor or failure" of HBH largely due to the agreements that the parties entered into that protected Pitney Bowes from any meaningful downside risk[124] and no real potential upside risk from the venture. The Court also noted that, despite the purpose clause provided in the amended and restated limited liability company operating agreement, the parties' intent from the very beginning was to sell the tax credits and not to enter into a true business relationship.[125] In an effort to prevent taxpayers from being discouraged from undertaking the actions the rehabilitation tax credits are intended to encourage, the Court acknowledged the importance of the historic rehabilitation tax credits and emphasized that it was the arrangement at issue in this case and the tax credits themselves were not "under attack."

In response to the uncertainty that the decision created around historic rehabilitation tax credits projects and partnerships, the IRS issued Rev. Proc. 2014-12 in order to set forth the circumstances under which the IRS will, as a matter of enforcement policy, respect the status of investors as partners in partnerships that earn Section 47 tax credits and the allocation of such tax credits to such investors (and other partners in the partnerships).[126]

B. Tax Court.

1. VisionMonitor Software. The Tax Court in VisionMonitor Software, LLC v. Commissioner[127] applied long-standing authority to conclude that a partner's issuance of a promissory note to the partnership does not create outside basis for the partner.[128]

VisionMonitor Software, LLC ("VMS") is headquartered in Houston. So, the case has some regional flair. VMS is engaged in the business of providing energy companies with enterprise wide software solutions for managing their environmental performance (according to the VMS website). It was founded by Torgeir Mantor in 2002, along with Alan Smith and American Metallurgical Coal Company ("AMC"). Messrs. Mantor and Smith contributed a significant amount of their savings to the enterprise. However, it appears that AMC was the principal financial sponsor. As occurs with many start-up enterprises, VMS lost money during its early years. As a condition for continuing to support VMS, AMC required Messrs. Mantor and Smith to also dedicate more capital to the enterprise. That apparently was problematic because Messrs. Mantor and Smith did not have the ability to contribute any more cash. However, after talking with their lawyer, they issued promissory notes to VMS in varying

124 In addition to the protections provided to Pitney Bowes through the various agreements entered into in connection with the investment, the lack of downside risk arose due to the fact that the project was fully-funded prior to the contributions by Pitney Bowes, and the fact that Pitney Bowes was not required to make additional contributions until it was assured that sufficient tax credits had been generated to guaranty a return of the money to be contributed.

125 In response to the NJSEA's argument that a partnership existed because the parties respected the corporate formalities in forming HBH, the Court provided that "recruiting teams of lawyers, accountants, and tax consultants does not mean that a partnership, with all its tax credit gold, can be conjured from a zero-risk investment of the sort that [Pitney Bowes] made here."

126 See the discussion regarding Rev. Proc. 2014-12 in the text above under Part IV.A.1.

127 T.C. Memo. 2014-182 (9/3/14)

128 A promissory note issued by a partner to the partnership can (under certain circumstances) be taken into account for purposes of determining whether the partner has an obligation to restore a deficit capital account balance. Treas. Reg. §1.704-1(b)(2)(ii)*(c)(1)*. However, the partner's capital account balance is not actually increased unless and until principal payments are made on the promissory note, or there is a taxable disposition of the promissory note by the partnership. Treas. Reg. §1.704-1(b)(2)(iv)*(d)(2)*. Similarly, the IRS long ago concluded that the issuance of a promissory note does not increase outside basis because the partner's tax basis in the promissory note is zero. Rev. Rul. 80-235, 1980-2 C.B. 229.

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amounts over several years beginning in 2004. They also agreed to freeze their salaries. That apparently satisfied AMC's concerns, and the company ultimately became profitable in 2012.

The lawyer that Messrs. Mantor and Smith consulted did not issue a written legal opinion, and did not review any documents before providing his advice. However, he apparently advised Messrs. Mantor and Smith that the promissory notes were appropriate capital contributions, and would create outside basis for them. Apparently pursuant to that advice, Messrs. Mantor and Smith claimed losses from VMS on their personal tax returns.

The Tax Court quickly concluded, based on long-standing precedent (including Dakohta Hills,[129] Gemini Twin Fund III,[130] and Oden[131]), that the promissory notes did not provide any outside basis for Messrs. Mantor or Smith because they had no basis in their promissory notes. VMS argued that the Tax Court's decision in Gefen[132] supported its position. However, the Tax Court easily distinguished Gefen on the grounds that the taxpayer in that case obtained her additional outside basis by agreeing to guaranty the partnership's recourse obligations to a third party creditor (which is not comparable to the issuance of promissory notes to a partnership).

The Tax Court also concluded that the substantial-understatement penalty was applicable to the case. The only defense that VMS proffered was that it had relied on the advice of its lawyer. The Tax Court said that, pursuant to the Tax Court's decision in Neonatology Associates,[133] a three-prong test must be satisfied in order for VMS to prevail with that defense: (1) the adviser must be a competent professional with sufficient expertise to justify reliance; (2) the taxpayer must provide necessary and accurate information to the adviser; and (3) the taxpayer must actually rely in good faith on the adviser's judgment. The Tax Court had no problem with the first prong of the test (based on the lawyer's credentials and familiarity with VMS's business). It expressed some concerns regarding the second prong of the test, but ultimately concluded that it had been satisfied as well. Finally, the Tax Court concluded that the third prong of the test also was satisfied. The Tax Court found that VMS had actually relied on the lawyer's advice, and said that it could not find that reliance on the lawyer's "reading of the subtleties in the caselaw [was] in bad faith." Accordingly, the Tax Court said, "That makes this a split result" (the government is able to collect the tax, but not any penalties).

2. Gateway Hotel Partners. The Tax Court in Gateway Hotel Partners, LLC v. Commissioner[134] respected the substance and form of a financing arrangement involving a partnership; therefore, distributions of Missouri historical tax credits by Gateway Hotel Partners, LLC ("GHC") to its partners were distributions and not disguised sales.

GHC was formed for purposes of redeveloping the Statler and Lennox Hotels located in St. Louis, Missouri. At all relevant times, the members of GHC were Washington Avenue Historic Developer ("WAHD") and Housing Horizons, LLC ("HH"). The managing member of WAHD

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129 Dakohta Hills Offices Ltd. P'ship v. Commissioner, T.C. Memo. 1998-134.

130 Gemini Twin Fund III v. Commissioner, T.C. Memo. 1991-315, *aff'd without published opinion*, 8 F.3d 26 (9th Cir. 1993).

131 Oden v. Commissioner, T.C. Memo. 1981-184, *aff'd without published opinion*, 679 F.2d 885 (4th Cir. 1982).

132 Gefen v. Commissioner, 87 T.C. 1471 (1986).

133 Neonatology Assocs., P.A. v. Commissioner, 115 T.C. 43, 99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

134 T.C. Memo. 2014-5 (1/9/14).

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was Historic Restoration, Inc., an S corporation ("HRI"). WAHD was engaged to perform the development services on behalf of GHC.

The costs associated with the redevelopment of the hotels was to be partially funded with the Missouri historical tax credits that would be generated upon completion of the redevelopment of the hotels. In order to finance the costs during the redevelopment period, bridge loan financing was sought from the Missouri Development Finance Board. Upon completing its due diligence, the Missouri Development Finance Board determined that HRI should be the borrower under the bridge financing. In connection with the financing, HRI, WAHD, HH, and GHC entered into various agreements pursuant to which, among other things, (a) HRI agreed to contribute the bridge loan proceeds to WAHD as a capital contribution, (b) WAHD agreed to contribute the proceeds from HRI's capital contribution to GHC as a capital contribution, and (c) distributions of cash and/or property (including the Missouri historical tax credits) would be made up the chain to HRI upon receipt of the Missouri historical tax credits by GHC. For administrative ease, and aware of the arrangement described above, the Missouri Development Finance Board transferred the bridge loan proceeds directly to GHC.

Upon completion of the redevelopment of the hotels, GHC distributed the Missouri historical tax credits as agreed by the parties. The IRS issued an FPAA finding that the transfer by GHC of the Missouri historical tax credits constituted a disguised sale and not a distribution by a partnership to a partner. This determination was based, partially, on the fact that the bridge loan proceeds were transferred directly to GHC and that WAHD was never credited with a capital contribution to GHC to reflect the parties agreement with respect to the dropdown of the bridge loan proceeds.

The Tax Court focused on the substance of the arrangement and not its form. After analyzing whether the arrangement constituted indebtedness or equity, and whether the contribution and subsequent distribution constituted a disguised sale, the Tax Court found that, the substance of the transaction was as the parties had agreed and the distributions of the Missouri historical tax credits constituted partnership distributions and not a taxable sale of the historical tax credits.

This case raised significant concerns about the lengths to which the IRS may be willing to go to re-characterize the tax treatment of a transaction that it does not like. However, the Tax Court's decision provides some reassurance that thoughtful tax planning will be respected upon judicial review in appropriate circumstances. On the other hand, the case also serves as a reminder of the close scrutiny to which tax planning can be subjected, and the importance of drafting documents to carefully reflect the manner in which parties intend for transactions to be interpreted for tax purposes.

3. Crescent Holdings. The Tax Court in Crescent Holdings, LLC v. Commissioner,[135] determined that an unvested, forfeitable, and nontransferable interest in a limited liability company granted to an employee of a subsidiary of the limited liability company constituted a capital interest for U.S. federal income tax purposes. As a result, because no election under Section 83(b) was made with respect to the interest, the taxpayer was not properly allocated profits and losses of the partnership for the years in question (which thus needed to be re-allocated to other members of the limited liability company).

In order to induce an individual employee ("P") to serve as chief executive officer of a subsidiary, Crescent Holdings, LLC ("Holdings") issued to P a 2% interest in Holdings.[136]

[135] 141 T.C. No. 15 (12/2/13)

[136] P is the petitioner in this case. The tax matters partner of Crescent Holdings, LLC filed an election to intervene.

None of the interests granted to P were vested on the date of grant, and the terms and conditions of the grant provided that the interests would be forfeited if P's employment was terminated within 3 years of the date of grant. Upon receipt of the interest, P did not make an election under Section 83(b). The agreement pursuant to which the interest was granted provided that P would be entitled to receive distributions *pari passu* with the other partners, and, if received, the distributions would not be forfeited.

For the taxable year in which P received the 2% interest in Holdings and the following year, P received a Schedule K-1 from Holdings representing his distributive share of its profits and losses. Despite having protested the propriety of the receipt of the Schedule K-1s, and not having received any distributions from Holdings, P paid the associated tax liability in each of those years. Just prior to the date that the interest would vest, P terminated his employment with the subsidiary of Holdings.

The IRS issued a FPAA for both taxable years for which P received a K-1. P claimed that the 2% interest was subject to Section 83, and that, since no election pursuant to Section 83(b) was made, P was not a partner in Holdings and, thus, was improperly issued a Schedule K-1. Holdings claimed that the interest was a "profits interest" pursuant to Rev. Proc. 93-27[137] and Rev. Proc. 2001-43,[138] and thus that P was properly treated as a partner during the years in question. The IRS claimed that P received a capital interest subject to Section 83; and, thus, that P was not a partner and no profit and loss should have been allocated to P for the two years for which the IRS issued the FPAA. The Tax Court determined that the interest constituted a capital interest largely due to the fact that the limited liability company agreement for Holdings provided that P would have received a distribution had Holdings liquidated on the date of the grant of the interest to P. Since P's interest in Holdings was subject to a substantial risk of forfeiture, and no Section 83(b) election was made by P, P was not a partner of Holdings and should not have been allocated profits or losses for the years at issue.[139]

Incentivizing key employees with equity interests in tax partnerships has, in recent years, become a significant part of overall compensation planning and administration. This case provides some reminders about the basic principles applicable to such interests, and how to properly structure the transactions pursuant to which such interests are granted. For example, if a partnership intends to grant an employee a "profits interest," care should be taken to ensure that the employee does not have a right to receive any partnership assets if the partnership were to hypothetically sell its assets and liquidate immediately following the grant. Additionally, if a partnership grants a capital interest to an employee under circumstances that subject the interest to a substantial risk of forfeiture, the employee cannot be treated as the owner of the interest for federal income tax purposes (and, thus, no income, gain, deduction, or loss should be allocated to the employee pursuant to the interest) unless and until vesting occurs or a valid election under Section 83(b) is made with respect to the interest. In the absence of satisfying either of those conditions, income otherwise allocable to the employee pursuant to the interest must be allocated to other partners.

4. <u>Cahill</u>. The Tax Court in <u>Cahill v. Commissioner</u>[140] determined that a taxpayer was a partner, despite the lack of a signature by the partner to the partnership agreement, when the partnership acted as though he was a partner, there was an intent to pool resources to develop business

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137 1993-2 C.B. 343

138 2001-2 C.B. 191

139 It is not clear whether the Court's holding would have been the same had P received distributions of income during the time that he held the 2% interest in Holdings.

140 T.C. Memo. 2013-220 (9/18/13)

with the partnership, and the taxpayer otherwise entered into a revenue sharing agreement pursuant to which he agreed to receive a Schedule K-1 from the partnership.

Mr. Cahill was a professional in the insurance and re-insurance industry. In 2008, Mr. Cahill began developing business with two other professionals in the insurance and re-insurance industry, Mr. Friemann and Mr. Christie. In order to formalize their agreements with respect to compensation for Mr. Cahill, Mr. Friemann, Mr. Christie, and Mr. Cahill entered into a memorandum of understanding which was formalized by the execution of a revenue sharing agreement. Pursuant to these agreements, among other things, the parties contemplated that Mr. Cahill would have available to him a monthly amount equal to $50,000 less any income Mr. Cahill earned from outside sources. The parties agreed that any amounts distributed to Mr. Cahill would be reported as income to Mr. Cahill either pursuant to the issuance of a Form 1099 or the issuance of a Schedule K-1.

Mr. Cahill received a Schedule K-1 for the 2008 tax year reporting the distributions to Mr. Cahill as guaranteed payments. Mr. Cahill did not report these amounts on his individual income tax return as he claimed they were loans from the partnership.[141] The Court ultimately found that the amounts distributed to Mr. Cahill were not loans, and further found that they were guaranteed payments since the amounts that Mr. Cahill received were not dependent on the profits of the partnership and there was not an unconditional obligation to repay a sum certain at a determinable date.[142]

This case is a reminder that the determination as to whether a person is a partner in a partnership is made based on all surrounding facts and circumstances, and that the absence of an executed document labeled "partnership agreement" is not necessarily determinative.

5. <u>Taurus FX Partners</u>. The Tax Court in <u>Taurus FX Partners, LLC v. Commissioner</u>[143] ruled that an FPAA was valid when it was sent to the tax matters partner at the address for the partnership provided on the tax return under audit.

The case involves a limited liability company that was a partnership for U.S. federal income tax purposes. Taurus FX Partners, LLC ("<u>Taurus</u>") was a partner of the partnership during the year under audit by the IRS. The Tax Court found that the law is well settled in this area, and, if notice addresses are not updated in accordance with the rules prescribed in the Code and Treasury regulations, the IRS cannot be charged with the knowledge of such information when issuing an FPAA. This was the case despite the fact that the IRS had corresponded with Mr. Postma, the single-member of Taurus, and had current information for Mr. Postma.

The Tax Court acknowledged that in a corporate and individual income tax context generally the last known address is the appropriate address to which notices must be sent. However, in each of those instances, the tax liability of the corporation or individual is at stake. In the case of partnership proceedings, the subject tax liabilities are not of the partnership since the partnership does not pay any taxes and the partners of the partnership at the time of the issuance of the notice may be vastly different from the partners of the partnership at the time under audit. Taurus did not update its address in accordance with the prescribed rules and therefore the FPAA was valid.

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141 This argument is based, in part, on the fact that the revenue sharing agreement provided that any amounts paid to Mr. Cahill would accrue interest.

142 The Court looked to Rev. Rul. 73-301, 1973-2 C.B. 216 for the proposition that, for purposes of Section 707(a), a loan by a partnership is made only when there is an unconditional obligation to repay the amount on a date certain.

143 T.C. Memo. 2013-168 (7/22/13)

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This case is a reminder that partnerships should properly notify the IRS of any change in address that has occurred after the filing of the last tax return. Despite the ability of the IRS to use other information in its possession, it is not obligated to do so.

6. Mingo. The Tax Court in Mingo v. Commissioner[144] determined that gain from the sale of a partnership interest may not be reported using the installment method to the extent that proceeds from the sale would have constituted compensation.

The taxpayer in this case was a partner at PriceWaterhouseCoopers LLP ("PwC") and sold her partnership interest in the consulting arm of PwC, PwC, to IBM in 2002. The value assigned to Ms. Mingo's partnership interest at that time was $832,090, of which $126,240 was comprised of Ms. Mingo's share of unrealized receivables. In exchange for her interest in PwC, IBM issued to Ms. Mingo a convertible promissory note that contained a conversion feature which would allow Ms. Mingo to convert all or a portion of the unpaid principal balance into shares of IBM stock at any time after 12-months following the sale to IBM. In the year of the sale, Ms. Mingo and her husband did not report any income from the sale on their joint tax return. From the year of sale to 2007, the year when Ms. Mingo exercised the conversion privilege in the note for IBM stock, Ms. Mingo and her husband reported only interest income from the promissory note. In 2007, Ms. Mingo reported both a capital gain and a capital loss arising from the conversion and the sale of a certain number of shares of IBM stock in order to pay the tax liability associated with the unrealized receivables. On audit, the IRS assessed a deficiency for the year of sale and, alternatively, assessed a deficiency in the year during which Ms. Mingo exercised the conversion privilege.

The court discusses and analyzes whether Ms. Mingo had established an accounting method under Code Section 446 with respect to the treatment of the unrealized receivables and therefore whether a Code Section 481 adjustment was appropriate in this instance. Ultimately, the Tax Court determined that an accounting method had been established since (a) the issue at hand involved the proper time for reporting income and not permanently avoiding the reporting of income, (b) the sale of Ms. Mingo's partnership interest was a material item, and that Ms. Mingo had established a pattern of consistent treatment with respect to the gain since Ms. Mingo only reported interest income from the note for the tax years for the taxable years beginning with the year of sale through the year in which Ms. Mingo exercised the conversion privilege. In assessing a deficiency in the 2003 tax year, the IRS initiated a change of accounting method and assessed an amount presenting the appropriate Section 481 adjustment. Although the tax year of the change was 2002, the Tax Court determined that the Section 481 adjustment was appropriately assessed for the 2003 tax year.[145] Ms. Mingo, as a result, had an adjusted tax basis in the promissory note equal to the Section 481 adjustment which reduced the capital gain recognized in 2007 recognized in connection with the exercise of the conversion privilege.[146]

It has been clear that, in the context of a sale of a partnership interest, amounts that would be treated as ordinary income under Section 1245 or Section 1250[147] and other unrealized

144 T.C. Memo 2013-149 (06/12/2013)

145 There was clearly a timing issue involved in this case. It appears that the 2002 tax year was outside of the statute of limitations for assessment of additional tax. The Tax Court concluded that a Section 481(a) adjustment may include amounts attributable to tax years outside the period of limitations on assessment.

146 As of the date of this paper, there is an appeal pending in the Fifth Circuit.

147 IRC §453(i)(1)(A)

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receivables[148] must be recognized in the year of the disposition. However, this case highlights the need to gather all necessary information when determining how to report the sale of a partnership interest.

7. Jimastowlo Oil. The Tax Court in Jimastowlo Oil, LLC v. Commissioner[149] determined that it lacked jurisdiction to rule on substantive issues raised by the IRS in FPAAs issued to two limited liability companies finding that the "income programs" in which the limited liability companies had invested constituted partnerships and therefore the IRS must first make adjustments at the partnership level.

During trial, the Tax Court *sua sponte* raised the jurisdictional issue of whether the Court could decide substantive issues arising in connection with FPAAs issued by the IRS in connection with an audit of two limited liability companies that were partnerships for U.S. federal income tax purposes. This issue surrounded whether the "income program" in which the limited liability companies participated constituted a partnership for federal income tax purposes (of which the limited liability companies were partners), making the substantive issues "partnership items" under Section 6231(a)(3) which, pursuant to Section 6221, must first be determined at the partnership level.

The "income program" was offered by Energytec, a Nevada corporation, and each limited liability company obtained a 7.93% working interest in certain wells held by Energytec. Prior to making the investments in the "income program" each of the limited liability companies was provided with a report which contained a history of the production of each well and, among other things provided an estimate of net operating income for each "income program," an estimated first distribution date, and an estimated period during which production would continue. At the time of the investment by the limited liability companies, the wells were not operated pursuant to the terms of a joint operating agreement or other written agreement. When presented with draft joint operating agreements in May 2006 (one of the tax years under audit), neither limited liability company signed the joint operating agreement.

For the first few months, each of the limited liability companies received distributions in the amount projected in the reports. However, in May 2006 (the same month during which the limited liability companies refused to sign a joint operating agreement), Energytec issued a "working interest report" providing that each of the limited liability companies had received distributions in an amount which did not fluctuate irrespective of the production of the applicable wells or expenses associated with those wells. Therefore, Energytec determined that each of the limited liability companies needed to return the excess distributions to Energytec and could either pay the amounts to Energytec or Energytec would offset any outstanding amounts by withholding future distributions.

The IRS argued that the "income programs" did not constitute partnerships for federal income tax purposes and that the limited liabilities were mere tenants in common. However, citing Treas. Reg. §301.7701-1(a)(2), the Tax Court noted that "[a] joint venture or other contractual arrangement may create a separate entity for federal income tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom." Based on testimony given during the trial, and other information, including the reports provided to prospective investors in the "income programs," the Tax Court found that Energytec was operating the working interests as agents for each of the limited liability companies pursuant to an informal joint operating agreement. Therefore, the "income programs" constituted partnerships for U.S. federal income tax purposes and the Tax Court lacked jurisdiction to address the substantive issues raised in the audit.

148 Sorensen v. Comm'r., 22 T.C. 321 (1954); CCA 200722027 (6/1/2007).

149 T.C. Memo. 2013-195 (8/26/13)

Section 1.761-2(a)(ii) of the Treasury regulations specifically contemplates that unincorporated organizations for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted (i.e., working interests) may elect to be excluded from the rules Subchapter K. It is common in the oil and gas industry for working interests to be owned jointly by several owners. In deciding this case, the Tax Court has put all working interest owners on notice that, absent an election to the contrary, their joint ownership may constitute a partnership for U.S. federal income tax purposes.

8. Azimzadeh. The Tax Court in Azimzadeh v. Commissioner[150] determined that a partnership did not exist despite the taxpayer's contention when the only factor supporting a finding of the existence of a partnership was the fact that both purported partners had the ability to withdraw funds from the limited liability company's bank account.

Mr. Azimzadeh operated Stevens Creek Auto Center, a used car business in California that was the source of most of Mr. Azimzadeh's income during 2006. After auditing the 2006 tax return for Mr. Azimzadeh and his wife, the IRS issued a notice of deficiency claiming $200,000 in unreported income, disallowance of certain losses, and imposing additions to tax and penalties. At trial, an issue arose regarding whether Mr. Azimzadeh operated Stevens Creek Auto Center as a partnership with Ray Barghi (or his entity). If Mr. Azimzadeh operated the car dealership as a partnership then the deficiencies assessed against Mr. Azimzadeh and his wife would be reduced.

The Tax Court relied on the following factors delineated in Luna v. Commissioner[151] to determine whether Mr. Azimzadeh and Mr. Barghi carried on a "trade, business, financial operation, or venture and divided the profits therefrom":[152]

(A) the agreement of the parties and their conduct in executing its terms;

(B) the contributions, if any, which each party has made to the venture;

(C) the parties' control over income and capital and the right of each to make withdrawals;

(D) whether each party was a principal and coproprietor sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other receiving for his services contingent compensation in the form of a percentage of income;

(E) whether business was conducted in the joint names of the parties;

(F) whether the parties filed federal partnership returns or otherwise represented to the IRS or to persons with whom they dealt that they were joint venturers;

(G) whether separate books of account were maintained for the venture; and

(H) whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

In analyzing the foregoing factors, the Tax Court determined that the only factor weighing in favor of the existence of a partnership was the fact that Barghi had the authority to withdraw

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150 T.C. Memo. 2013-169 (7/23/13).

151 42 T.C. 1067, 1077-78 (1964).

152 Id. See Treas. Reg. §301.7701-1(a)(2).

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funds from Stevens Creek's only bank account, and in fact had made several large withdrawals. The remaining factors were neutral or weighed against the finding of a partnership.

This case serves as a reminder of the importance of documentation. The Luna test is fact intensive and, without the proper records and documentation, it is difficult to satisfy the burden of proof that a partnership exists. The Court's determination turned on Mr. Azimzadeh's lack of documentation or support for his contention that the parties intended to form a partnership.

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FEDERAL TRANSFER TAXES FOR INTERNATIONAL CLIENTS

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FEDERAL TRANSFER TAXES FOR INTERNATIONAL CLIENTS*

I. INTRODUCTION

Our nation has always been one of immigrants and continues to be so. It also has become a haven for temporary visitors who come to the U.S. for education, work under temporary visas or even investment purposes. Foreign investment in the U.S. also continues to be quite strong. All of these people acquire property in the U.S., and, many times, also have property in their country of origin. At the same time, many U.S. persons acquire property or invest in other countries.

A person's ownership at death of property located in both the U.S. and abroad can raise several different transfer tax issues. Texas attorneys who practice probate law should be at least familiar with the special issues surrounding non-citizens owning property in the U.S. Regardless of whether the non-citizen has a taxable estate, special care should be taken to address the unique issues facing the estate. The issues only become more complicated if the estate is potentially subject to U.S. taxation. Further, the mere ownership of real estate in the U.S. almost always causes estate tax problems for non-residents.

The goal of this article is to explore the federal tax implications facing estates with international contacts. The article does not, however, address tax implications under the Foreign Account Tax Compliance Act and other U.S. law for U.S. persons who make transfers to foreign trusts, or for U.S. persons who receive benefits from a foreign trust, as these issues would constitute a substantial article in their own rights.

II. FEDERAL TRANSFER TAX ISSUES

Several special rules apply to estates with international contacts, especially when non-U.S. citizens are involved. For example, transfers to non-U.S. citizen spouses are not eligible for the unlimited marital deduction. Further, the estate tax exemption for decedents who are neither citizens nor residents of the U.S. is only $60,000. Details of the transfer tax scheme as far as it relates to international issues follow. Note that executors have an affirmative duty to file Gift Tax Returns that were not filed by the decedent. *See* 26 C.F.R. § 25.6019-1(g). Accordingly, this article also discusses the gift tax as it applies to citizens, resident aliens and non-resident aliens.

A. Definitions for Federal Transfer Tax Purposes

Federal law makes significant distinctions for transfer tax purposes between (i) citizens, (ii) resident aliens ("RAs") and (iii) non-resident aliens ("NRAs").[1] Because federal transfer taxes apply differently to each of these categories, the attorney handling an estate with international contacts always should determine a decedent's citizenship and residency status. The following explains the differences between the three concepts.

1) U.S. Citizens

The U.S. imposes transfer taxes on its citizens regardless of their residency. 26 U.S.C. (hereinafter "Code") §§ 2001(a) (the estate tax is imposed on every decedent "who is a *citizen* or resident of the United States") (emphasis supplied), 2501(a) (the gift tax is imposed on all individuals, both residents and nonresidents, with certain exceptions for residents of certain possessions), 2612(c) (the generation-skipping transfer tax is imposed on transfers that would otherwise be subject to the estate or gift tax).

If one is born in the territory of the U.S., he or she is a citizen. U.S. CONST., AMEND. XIV. U.S. territory, for citizenship purposes, includes the fifty states, the District of Columbia, Puerto Rico, Guam, the U.S. Virgin Islands and the Northern Mariana Islands. 8 U.S.C. § 1101(a)(38); Covenant of Political Union between the United States and Northern Mariana Islands. For citizenship purposes, native reservations within the U.S. are considered U.S. territory. *Id.* § 1401(b). The territory of the U.S. also extends twelve nautical miles from shore. *Cunard S.S. Co. v. Mellon*, 262 U.S. 100 (1923). Therefore, persons born on private ships or airplanes within the territorial limit also are citizens. Note that there are some narrow exceptions to the natural born rule related to children of recognized diplomats.

Citizenship based on birth to a U.S. citizen parent or parents is statutory in nature and not guaranteed by the Constitution. Rules governing citizenship *jus sanguinis* have changed over the years, so an analysis

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[1] Federal law also draws distinctions between NRAs and recent expatriates (that is, persons who have relinquished their U.S. citizenship) and former long-term RAs who have recently left the U.S. *See* Code §§ 2107 (imposing an estate tax on certain expatriates), 2501(a)(3) (expatriates who are subject to Section 877(b) in the year the gift is made not eligible to escape the gift tax for transfers of tangible properties), 877(e) (applying similar rules to former long-term RAs). Other than to point out that it takes some time for expatriates and former long-term RAs to avoid the clutches of the IRS's long fingers, the paper will, for the most part, ignore this distinction. *See* Heimos, 837-3rd T.M., *Non-Citizens – Estate, Gift and Generation-Skipping Taxation*, § V, for an exhaustive analysis of the distinctions among such persons.

of the rules in effect at the time of birth must be made. Currently, and generally speaking, a person born outside the U.S. but to a U.S. citizen parent is a U.S. citizen under the following circumstances:

- Both parents are U.S. citizens and either parent resided in the U.S. at any time before the person's birth;
- One parent is a U.S. citizen who resided in the U.S. for a continuous period of at least one year immediately before the person's birth and the other parent is a U.S. national (e.g., born in American Samoa); or
- One parent is a U.S. citizen and resided in the U.S. for at least five years, two of which occurred after the parent attained the age of 14.

See 8 U.S.C. § 1401.

Persons also may become citizens by naturalization. Ironically, it is many times easier to document citizenship by naturalization because of the necessary administrative hurdles to achieve naturalization than by other means.

Consistent with the Byzantine nature of federal law in general and the Code in particular, the practitioner should note that the gift tax does not necessarily apply to all U.S. citizens. For example, U.S. citizens who are residents of U.S. possessions are not considered "citizens" for gift tax purposes, but only if their U.S. citizenship is based on their citizenship of the possession or their birth within the possession. Code §§ 2501(b), (c); *see also* 26 C.F.R. (hereinafter "Regs.") § 25.2501-1(c). Rather, such persons are considered non-resident, non-citizens for purposes of the gift tax. *Id*. For practical purposes, this means a person born in Puerto Rico, for example, is not subject to the gift tax as a U.S. citizen for gifts made while residing in Puerto Rico despite being a U.S. citizen. That same person, however, is subject to the estate tax.

2) Resident Non-Citizen

Once the attorney determines the decedent was not a citizen, the next question is whether he or she was a U.S. resident for transfer tax purposes. While the concepts of residency for income tax purposes and transfer tax purposes are similar, they are not identical. One may be a resident for one purpose, but not the other.

For transfer tax purposes, the Code imposes a tax on "residents". Code §§ 2001(a) (the estate tax is imposed on every decedent "who is a citizen or *resident of* the United States") (emphasis supplied), 2501(a) (the gift tax is imposed on all individuals, both residents and nonresidents, with certain exceptions for nonresidents). Again, the generation-skipping transfer tax is imposed on those transfers that are otherwise subject to the estate or gift tax. *Id*. § 2612(c). For residency purposes, the extent of the U.S. is not as broad as it is for citizenship purposes. Instead, the "U.S." only extends to the fifty states and the District of Columbia. Regs. §§ 20.0-1(b)(1), 25.2501-1(b). The Code does not, however, provide a definition of "resident" for transfer tax purposes.

To learn what "resident" means, one must turn to the Regulations. A "resident" is a decedent who had his or her domicile in the U.S. at the time of death. Regs. § 20.0-1(b); *see also id*. § 25.2501-1(b) (providing similar definition in the context of the gift tax). A "nonresident" is the converse, that is, a person who has his or her domicile outside of the U.S. *Id*. § 20.0-1(b)(2), 25.2501-1(b) ("All other individuals [*i.e.*, those who are not 'residents'] are nonresidents.").

The Regulations under both the estate and gift taxes explain the term "domicile" in the same manner by describing how one acquires a domicile:

> A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.

Regs. §§ 20.0-1(b)(1), 25.2501-1(b). Domicile therefore has two elements: (i) an actual physical presence; and (ii) an intent "to remain indefinitely". *Id*. The brevity of a physical residence is not determinative because the physical presence is sufficient even if for a "brief period of time". *Id*. Similarly, the length of a physical residence also does not govern if there is no intent to remain indefinitely. *Id*. Once a domicile is established, a presumption exists that the domicile does not change until it is shown to have changed. *See Mitchell v. U.S.*, 88 U.S. 350 (1874) (determined in the context of the legality of contracts between residents of the Northern States and the Southern States during the Civil War); *Nienhuys v. Commissioner*, 17 T.C. 1149 (1952) (determined in the context of the estate tax). Note that the U.S. has a handful of bilateral transfer tax treaties with other nations that may weigh in on the determination of domicile. See Section III(C), below.

Ultimately, it seems one typically acquires a U.S. domicile by moving to the U.S. with no intent to leave after a period of time. Conversely, a non-citizen who moves to the U.S. may nevertheless avoid acquiring residency status for purposes of transfer taxes by having a present intention of returning home at some point in the future.

Residency under the transfer tax regime, which is subjective in nature, should be contrasted with residency under the income tax, which depends on much more objective factors. For all purposes of the Code, with the exception of transfer taxes, a person is considered to be a U.S. resident if: (i) he or she is a lawful permanent resident (regardless of actual residence); (ii) he or she meets the substantial presence test; or (iii) he or she makes an election under the Code. Code § 7701(b)(1). Whether one meets the substantial presence test requires a somewhat fact intensive analysis. In very general and simplistic terms, the substantial presence test is met if the person is present in the U.S. for 31 days in the tax year and has been present for 183 days over the current and the two preceding years. *See id*. § 7701(b)(3) (stating the substantial presence test in detail).

In the context of the recent and continuing violence in Ciudad Juarez, Nuevo Laredo and other locales along the U.S./Mexico border, the concept of residency and how one obtains it requires estate planners who are advising Mexican citizens who are contemplating removal or who have removed to the U.S. to escape such violence to address these issues in a meaningful way. Failure to do so could result in U.S. taxation of such persons' U.S. and Mexican assets. For all intents and purposes, the Mexican citizens who have fled the violence seem to be refugees, albeit privileged refugees (law abiding persons without means seem to be effectively excluded from seeking refuge on the north side of the river). Current U.S. policy seems to be ignoring the reality of the situation and, at least to the author's awareness, none are officially recognized as refugees. Instead, and on a purely anecdotal basis, most of those who have entered the U.S. legally have done so on either an investor's visa or a shopping visa (those who have entered on a shopping visa and stay are staying illegally).

The critical issue in the analysis (and in litigation) is the requisite intent. To avoid taxation, for example in the context of the Mexican elite escaping to the U.S., one must have an intent to return to Mexico. It is one thing simply to state such an intent. It is another to prove that intent. Myriad factors have been considered. The following is a list of factors, none of which are determinative, as compiled by Michael A. Heimos, 837-3rd T.M., *Non-Citizens—Estate, Gift and Generation-Skipping Taxation*, § III(C)(4).

- Immigration and Work Status – A person's immigration status can provide evidence as to intent. For example, a permanent resident probably would be found to have the requisite intent to be found a resident for transfer tax purposes. On the other hand, a person's status as a nonimmigrant with a temporary visa, for example, an H-1B visa which allows skilled workers to work temporarily in the U.S., would tend to provide evidence of the opposite intent. Applicants for such visas must declare an intent not to immigrate. Still, and despite such official declarations and legal requirements, the IRS may argue that the person's intent to stay changed while in the U.S. *See, e.g., Jack v. United States*, 54 Fed. Cl. 590 (2002) (question of fact as to intent existed despite nonimmigrant status of decedent); *Kahn v. Commissioner*, T.C. Memo 1998-22 (1998) (U.S. permanent resident who died in his native Pakistan ruled an RA after the IRS attempted to tax his estate as an NRA). The statements of the immigrant (or nonimmigrant) in official documents also must be taken into account. If he or she is declaring a U.S. residency or domicile, those facts will tend to outweigh evidence to the contrary.
- Location of Business and Property Interests – The location of one's business and investment interests tend to reveal one's intent as to domicile. If the decedent has no property interests in his or her country of origin, he or she likely has an intent to live indefinitely right where the residence is located. On the other hand, if the person has significant business and other property interests in the country of origin, the balance is tilted to suggesting an intent to return. For those Mexican citizens escaping drug violence, 100% investment in the U.S. would be a mistake if the goal is to avoid U.S. residency.
- Family Immigration History – The more one's family has immigrated to the U.S., the more likely a court will find the decedent had the same intent.
- Residential Property Comparisons – Many foreign nationals maintain homes in both the U.S. and the countries of their origin. A comparison of the relative physical characteristics and values of these residential structures may provide evidence of intent. Also important is whether the residence is rented, is associated with recreational opportunities, and is appropriate for year round living. Another factor to consider especially important along the border is the location where guests are entertained.
- Testimony and Statements of the Individual in Question – Careful attention should be paid to testimony, statements (especially written) and correspondence. Each may provide evidence one way or the other. To the extent a decedent obtains a domestic driver's license or a residential hunting license, for example, he or she is more likely a U.S. resident. Of course, many statements can be self-serving and sometimes do not carry much weight. On the other hand, it does not hurt to create such lasting evidence (as long as it is true).

- Motivations for Being Within the U.S. – A person's motivation for being in the U.S. can be very important in the analysis. For example, the decedent in *Niehuys v. Commissioner*, 17 T.C. 1139 (1952), had fled the Netherlands because of World War II. He had intended to return, but was prevented from doing so because of the war. In the meantime, he worked in the U.S. and acquired property. He was found to be a nonresident. Similarly, the decedent in *Paquette v. Commissioner*, T.C. Memo 1983-571, was found to have been a nonresident in part because he was in the U.S. for medical care. In the context of the current drug violence, establishing a motivation for being in the U.S. seems to be quite important.
- Travel and Duration of Stays in the U.S. – While the length of stay in the U.S. certainly is not determinative, the relative length and frequency of visits to the U.S. certainly provide some evidence of intent. *See* Regs. § 20.0-1(b) (length of residence not determinative).
- Community Affairs and Group Affiliations – A person's community involvement tends to establish domicile. The thought is that a person who has no intention of staying for the long term will not become involved in the community. While this argument may be fallacious, the courts certainly consider the factor.

3) <u>Non-Resident, Non-Citizen</u>

No special definition is required for NRAs as all persons who are not citizens and not residents of the U.S. are NRAs.

B. Federal Transfer Tax Consequences

A person's status as a citizen, RA or NRA bears a direct relation to the transfer tax consequences for his or her estate. The U.S. imposes the estate tax on all U.S. citizens and residents on his or her world wide property. Code §§ 2001 (estate tax imposed on citizens and residents), 2031 (the estate is composed of "all property, real or personal, tangible or intangible, wherever situated"). Similarly, the gift tax also is imposed on all U.S. citizens and residents (though making an exception for certain residents of U.S. territories). *Id*. § 2501(a) (gift tax imposed on any "transfer of property by gift").

The attorney also must ascertain the citizenship of the decedent's spouse, if any, to give proper advice. Regardless of the transferor's status, a transfer to a non-citizen spouse does not qualify for the marital deduction. Code §§ 2056(d)(1) (estate tax), 2523(i) (gift tax). The rule applies even if the non-citizen spouse is a U.S. resident.

In contrast to transfers by citizens and RAs, transfers by NRAs are subject to U.S. taxation only if the property has a U.S. situs. *Id*. §§ 2101(a) (estate tax imposed on NRAs), 2103 (on property situated in the U.S.), 2501(a) (gift tax imposed on NRA), 2511 (but excluding property not situated in the U.S.). Other rules also apply to NRAs with respect to U.S. situs property that, on the surface at least, would seem to discourage U.S. investment. Both the rules and some techniques designed to avoid their application also will be discussed below.

Finally, and depending on the circumstances, the practitioner also may be forced to consult a handful of bilateral treaties to determine the possible estate tax exposure for the estate, without respect to the decedent's status, if the decedent owned property located in more than one country. See Section III(C), below. Ultimately, the executor and the attorney may need to consult with competent counsel in the sister nation to come to a final conclusion.

1) <u>Transfers to Non-Citizen Spouses</u>

Transfers to non-citizen spouses, even if the spouse is nevertheless a resident, do not qualify for the marital deduction. Code §§ 2056(d)(1) (estate tax), 2523(i) (gift tax). Therefore, transfers to a non-citizen spouse must fall under some other exception to avoid taxation.

a) *Transfers at Death*

In the context of the estate tax and for taxable estates, there are only two options to defer taxation until the death of the non-citizen spouse. The first option, which likely may not be very practical, is for the non-citizen spouse to become a citizen before the day on which the decedent's estate tax return is due. *See* Code § 2056(d)(4) (defining time by which the surviving spouse must obtain citizenship to avoid application of the no marital deduction rule). The second and more practical option is for the transferor to establish a Qualified Domestic Trust ("QDOT") for the benefit of the surviving non-citizen spouse. *Id*. § 2056(d)(2). Of course, the QDOT also must meet the requirements of Code section 2056(b) for the marital deduction, such as being a qualified terminable interest property ("QTIP") trust as well. Regs. § 20.2056A-2(b).

Apparently in recognition that some folks mistakenly rely upon the marital deduction in their estate planning, the Code also allows post mortem planning to qualify for QDOT treatment. *Id*. §§ 2056(d)(2)(B), (d)(5). If the decedent, for example, established a QTIP trust for the surviving spouse that does not qualify as a QDOT trust, a reformation of the trust may be sought. *Id*. § 2056(d)(5). Such a reformation is timely if it is either accomplished or the state action seeking the reformation is filed before the due date (including extensions) of the decedent's estate tax return. *Id*. If the decedent did not establish a trust for the surviving non-citizen spouse, the spouse herself may establish the QDOT trust. *Id*. § 2056(d)(2)(B). In the later situation, the surviving non-citizen spouse must either actually transfer or irrevocably assign the property to the QDOT on or before the date the decedent's estate tax return is due. *Id*.

QDOTs have quite extensive requirements that are designed to ensure the non-citizen surviving spouse does not abscond from the U.S. with the QDOT property to avoid taxation. *See* Code § 2056A; Regs. § 20.2056A. The statutory requirements, in general, are as follows:

- U.S. Trustee – At least one of the QDOT's trustees must be either a U.S. citizen individual or a domestic corporation. Code § 2056A(a)(1)(A). For purposes of this section, a domestic corporation is one that is established under the laws of the U.S., one of its states or the District of Columbia. Regs. § 20.2056A-2(c).
- Withholding Right – The trust must provide that the U.S. trustee has the right to withhold from any distribution of principal the tax imposed by section 2056A (the "QDOT tax"). Code § 2056A(a)(1)(B).
- Regulatory Compliance – the trust must comply with applicable regulations. *Id*. § 2056A(a)(2).
- Election – the executor of the decedent's estate must have elected QDOT treatment for the trust. *Id*. § 2056A(a)(3).

The regulatory requirements, in general, are as follows:

- U.S. Trust – The trust must be governed by and administered under the law of one of the fifty states or the District of Columbia. Regs. § 20.2056A-2(a). To be administered under U.S. law, the trust must maintain its records (or copies) in the U.S. *Id*. The trust also must be an "ordinary trust" as defined in section 301.7701-4(a) of the Regulations, without regard to the type of property (for example, an active trade or business) being transferred to the trust. *Id*.
- Marital Deduction – The trust must otherwise qualify for the marital deduction if the property passed from the decedent to the QDOT. *Id*. § 20.2056A(b)(1). If the surviving spouse established the QDOT, the property with which the trust is funded must have been eligible to qualify for the marital deduction had it not been that she was not a U.S. citizen. *Id*. § 20.2056A(b)(2).
- Security Requirements – The trust must contain significant and detailed language giving the U.S. security in the trust's assets. *Id*. § 20.2056A(d)(1). The failure to include such language disqualifies the trust as a QDOT. The IRS has issued model language for use to satisfy this requirement. *See* Rev. Proc. 96-54. The model language is found below at Exhibit A.

The QDOT tax applies to almost all distributions of principal, whether made to the surviving spouse during life, or to the remaindermen at her death. Code § 2056A(b)(1), Regs. § 20.2056A-5(a). The only exception to the QDOT tax applying to distributions of principal to the surviving spouse during her lifetime are those made to the spouse "on account of hardship." Code § 2056A(b)(3)(B). The Regulations state that a distribution is made "on account of hardship" if it is made:

> in response to an immediate and substantial need relating to the spouse's health, maintenance, education, or support, or the health, maintenance, education, or support of any person that the surviving spouse is legally obligated to support.

Regs. § 20.2056A-5(c)(1). Distributions of income, however, are not subject to the QDOT tax. Code § 2056A(b)(3)(A).

QDOT trusts are taxed in a substantially different way than a simple QTIP trust that is included in the surviving spouse's gross estate either by virtue of Code Section 2044 or as a general power of appointment QTIP under Section 2056(b)(5). In contrast, QDOT trusts are taxed in the context of the grantor's estate. Code § 2056A(b)(2). Generally speaking, the tax for each taxable distribution is equal to:

- The tax that would have been imposed on the grantor's estate if it had been increased by the sum of:
    - The amount of the taxable distribution, plus
    - The aggregate amount of previous taxable distributions, less
- The tax on the aggregate amounts previously distributed.

Id.; *see also* Regs. 20.2056A-6(a). For a nice detailed description of how the QDOT tax is calculated, *See* Chapter 12, Michele A. Mobley, "QDOTs: Drafting and Administering Marital Trusts for Non-Citizens," 24th Annual Estate Planning and Probate Drafting Course (October 2013).

Taxes for lifetime distributions from QDOT trusts are due by April 15 of the year immediately following the year in which the lifetime distribution was made. Code § 2056A(b)(5)(A); Regs. § 20.2056A-11(a). The tax related to the death of the surviving spouse is due nine months after the surviving spouse's death. Code § 2056A(b)(5)(B); Regs. § 20.2056A-11(b). Certain extensions are available under both circumstances. Regs. § 20.2056A-11.

Given the stringent requirements of a QDOT and the manner in which they are taxed, one should avoid them if possible. Accordingly, provisions relating to QDOTs should be designed as flexible as possible. For example, they should be triggered only if necessary to avoid taxation, i.e., only if the surviving spouse does not become a citizen within the time and restrictions as found in Code section 2056(d)(4). To provide further flexibility, the plan could include an outright gift to the surviving spouse, who could then disclaim the gift into a QDOT. Relying on the surviving spouse's ability to establish the QDOT post mortem probably is not the safest approach from the planner's perspective because of the additional requirement of funding the QDOT before the return is filed. Because the QDOT is no longer necessary if the surviving spouse eventually becomes a U.S. citizen (even after the decedent's return is filed and the QDOT if funded), provisions should be included that allow the QDOT to be terminated (or at least the QDOT language if a QTIP is deemed nevertheless desirable). Model QDOT language can be found in the attached Exhibits as follows:

- Exhibit A – IRS Model Language for QDOTs. The relevant portion of Rev. Proc. 96-54 is reproduced here.
- Exhibit B – Sample Post Mortem QDOT. The sample language is from a QDOT established by an executor in an estate which did not include the necessary QDOT for the gift to the surviving non-citizen spouse. Provisions unrelated to the QDOT nature of the trust have been omitted.
- Exhibit C – Sample Irrevocable Assignment. The assignment is designed to comply with the irrevocable assignment requirement of Code section 2056(d)(2)(B) in connection with the post mortem creation of a QDOT.

b) *Gifts During Life*

The marital deduction also is not available for gifts to non-citizen spouses. Code § 2523(i). Instead, gifts to non-citizen spouses are eligible for an annual exclusion of sorts that is similar to the annual exclusion found in Code section 2503(b). *Id*. The amount is adjusted with inflation. For the 2014 tax year, the marital annual exclusion for gifts to non-citizen spouses is $145,000. Rev. Proc. 2013-35 § 3.34(2). Note that QDOTs are unavailable for lifetime transfers to non-citizen spouses. *See* Code § 2056A(a) (QDOTs are defined "with respect to any decedent").

The lack of a marital deduction for gifts to non-citizen spouse can create possible gift tax issues in the context of joint tenancies and tenancies by the entirety. Under Section 2523(i)(3), the gift of tax treatment applied to joint tenancies and tenancies by the entirety as found in former Sections 2515 and 2515A of the 1954 Code (which were repealed in 1981) still apply with respect to spouses who are not U.S. citizens. Under these former statutes, the creation and subsequent termination of such joint properties can be treated as a gift under certain circumstances and trigger use of the annual exclusion for gifts to non-U.S. citizen spouses and taxes if the annual exclusion is exhausted.

With respect to joint tenancies in real property created on or after July 14, 1988, no gift is made upon the mere creation of the joint tenancy. Code § 2523(i)(3); Regs. § 25.2523(i)-2(b)(1). A gift can be triggered upon termination of the joint tenancy, however, if the non-U.S. citizen spouse receives more than his or her share of the proceeds attributable to the total consideration he or she has furnished. Regs. § 25.2523(i)-2(b)(2). For example, if the U.S. citizen spouse contributed 100% of the purchase price for the property held as joint tenants, and that spouse and the non-citizen spouse split the proceeds upon sale, the citizen spouse made a taxable gift equal to the amount the non-citizen spouse received. If the value of the gift exceeds the annual exclusion for gifts to non-citizen spouses, then gift taxes would be owed. Note that different rules might apply for gifts made before July 14, 1988. *See* Siegler, 842-2nd T.M., *Transfers to Non Citizen Spouses*, § IX.B.2 (2011) for a detailed discussion of the prior and current rules relating to joint tenancies in real property and non-citizen spouses.

Joint tenancies with rights of survivorship in personal property present even greater potential gift tax liability when one spouse is not a U.S. citizen. For gifts on or after July 14, 1988, the creation of a joint tenancy with a non-citizen spouse in personal property generally is a taxable gift, unless both spouses contributed equal amounts to the joint tenancy. Code § 2523(i)(3); Regs. § 25.2523(i)-2(c)(1).

Fortunately, joint bank accounts and most typical joint brokerage accounts are treated slightly differently than other types of personal property. The mere creation of a joint bank account of which the contributor can unilaterally withdraw the funds does not result in a gift. Regs. § 25.2511-1(h)(4). On the other hand, each time the non-citizen spouse withdraws funds for his or her own benefit, a gift results. *Id.* The IRS applied the same rule to a joint brokerage account in which the securities were held in the name of a nominee of the brokerage firm. Rev. Rul. 69-148. Note, however, that the creation of a joint account in some instances can cause an automatic gift of up to one-half of the account to the non-citizen spouse. *See* Regs. § 25.2511-1(h)(5). Again, different rules may apply for gifts before July 14, 1988. *See* Siegler, 842-2nd T.M. § IX.B.2 for a detailed discussion.

Regardless, joint properties are a potential minefield where one of the spouses is a non-U.S. citizen.

The lack of a full marital deduction for lifetime gifts to non-citizen spouses also can affect planning related to attempted equalization of estates between a husband and wife with significant disparities in separate property. For spouses both of whom are citizens, it is common practice for the wealthier spouse simply to give assets to the other. If the less wealthy spouse is a non-citizen, however, any cumulative gifts in a single year that exceed (beginning in 2014) $145,000 will be taxable. Therefore, the planner must give extra thought as to how to accomplish estate equalization.

2) Portability

Estates of RAs may elect portability of the deceased spousal unused exclusion ("DSUE") amount. Code § 2010; Regs. § 20.2010-2T(a)(5). Estates of NRAs, however, are not eligible for portability. Regs. § 20.2010-2T(a)(5) ("an executor of the estate of a [NRA] at the time of death may not elect portability on behalf of that decedent, and the timely filing of such a decedent's estate tax return will not constitute the making of a portability election"). Also, the estate of an NRA who was the surviving spouse of a citizen or RA, whose estate had elected portability, nevertheless may not take advantage of the DSUE amount. *Id.* § 20.2010-3T(e).

Special rules also apply to the calculations of the DSUE amount when property passes to a QDOT. Regs. §§ 20.2010-2T(c)(4), 20.2010-3T(c)(2). Unlike the typical case, the DSUE amount in the context of a QDOT is redetermined when the QDOT tax is imposed under Code Section 2056A. *Id.* The temporary regulations provide an example of how to redetermine the DSUE amount. *Id.* § 20.2010-2T(c)(5), ex. 3. The general result takes into account that the QDOT tax under Section 2056A is calculated based upon the tax in effect when the deceased spouse died, but on the value of the QDOT taxable distribution. The details of the recalculation are beyond the scope of this article.

3) Property Situs

The situs of the decedent's property is especially important. Just because the property may be "located" in the U.S. does not mean the property has a U.S. situs, especially for purposes of the gift tax. The converse is true as well, property "located" in a foreign nation may be deemed to be situated in the U.S. To add to the complexity of the situation, the situs of some categories of property shifts depending on whether the transfer occurs during life or at death. Ultimately, if the property has a U.S. situs at the moment of transfer, it is potentially subject to taxation.

As a general statement, tangible personal and real property is deemed situated where it is physically located at the time of transfer. Code §§ 2104 (estate tax), 2511 (gift tax); Regs. §§ 20.2104(a) (estate tax), 25.2511-3(b)(1) (gift tax). For example, if an NRA purchases a valuable article of jewelry while making a trip to San Antonio, and then gives it to her daughter (whether a citizen, RA or NRA) before she returns to Monterrey, Mexico, the NRA has made a taxable gift of property situated in the U.S. In contrast, if she had waited until she returned to Mexico, the NRA would not have made a taxable gift, even if the daughter was a U.S. citizen.

U.S. currency (not deposits) is treated as tangible personal property for estate tax purposes. Regs. § 20.2104-1(a)(7)(ii); *see also* Rev. Rul. 55-143. On the other hand, there is no clear answer as to the situs of currency for gift tax purposes. The safe approach, therefore, is to treat cash as tangible personal property. Deposits, generally speaking, fall under the rules for intangible property.

The situs of intangible property would have been anyone's guess had Congress and the Treasury Department not given some guidance. For example, stock in a U.S. corporation is deemed situated in the U.S. for estate tax purposes despite that the stock certificate is located elsewhere. Regs. § 20.2104-1(a)(5). In stark contrast, and for gift tax purposes only, U.S. corporate stock is located outside the U.S. under the general rule for intangibles. Code § 2501(a)(2); Regs. § 25.2501-1(a)(3). The proceeds of life insurance are deemed situated outside the U.S. for estate tax purposes. Regs. § 20.2105-1(a)(5) (estate tax). The same holds true for deposits at U.S. financial institutions. Code §§ 2105(b) (estate tax), 2501(a)(2) (gift tax). Rather than attempt to provide a list in narrative form, the chart found at Exhibit D provides a quick reference for common types of property and their situs depending on whether the transfer is made during life or at death. Please note that the rules given are general rules. As is the case for any area of the law, there are exceptions.

Given the cavernous loophole under the gift tax for intangible property (i.e., gifts of intangibles by NRAs are not subject to gift tax regardless of the nature of the underlying obligation), any NRA who is contemplating a move to the U.S. should consider giving away intangible property before establishing U.S. residency.[2] Residency for gift tax purposes

[2] Note that U.S. persons who receive gifts with a value of $10,000 or more, as adjusted for inflation, from non-U.S. persons must report the receipt to the IRS under Code section 6039F(a). Beginning in 2014, the inflation adjusted amount is $15,358. Rev. Proc. 2013-35 § 3.38. *See* Section IV(A), below, for more information.

requires physical presence. If the NRA has a taxable estate, he or she could give away intangibles (even to U.S. citizens) before making the move with no transfer tax consequence.[3]

The distinction between tangible and intangibles also is important for estate tax planning purposes. The typical planning device for NRAs to avoid the application of estate tax for real property located in the U.S. is to establish a foreign corporation to purchase the property. Of course, the NRA must respect the corporate form or risk an attempt by the IRS to pierce the corporate veil. As in any gifting scenario for estate tax planning, the client should consider making the gift in trust. The advisor should, however, carefully consider whether the trust should be a foreign trust, or a U.S. trust. U.S. persons who are either treated as owners or beneficiaries of foreign trusts are subject to certain reporting requirements.[4] *See, e.g.*, Code §§ 6038D, 6048. Further, the NRA will run the risk of establishing a step transaction if he or she attempts to transfer previously owned real property to the foreign corporation.

Another significant risk of establishing a foreign owned corporation solely for purposes of owning U.S. real estate is similar to the risk of family limited partnerships and limited liability companies under Code sections 2036 through 2038. Code section 2104(b) specifically makes the concepts developed under Code sections 2036 through 2038 applicable to the situs rules. If the NRA has made a transfer within the meaning of these sections, the property will be considered situated in the U.S. if it was so situated at the time of the transfer or at the time of death. Code § 2104(b). Thus, even if the underlying real property had been sold and converted to real property in a foreign country before the NRA's death, the transferred property will be situated in the U.S. Therefore, any plan to utilize a foreign holding company needs to be analyzed in the same way one would approach a domestic family LP or LLC.

4) <u>NRA's Transfer Tax Exposure</u>

To the extent an NRA has an estate situated in the U.S. under the rules discussed in Section III(B)(2), above, that estate is subject to taxation in the same manner as for citizens and RAs with one major exception. Unlike citizens and RAs, the NRA is entitled to an estate tax credit of only $13,000 (which equates to an exemption of $60,000).[5] Code § 2102(b)(2)(A). The estate tax rates on an NRA's taxable estate are the same as those applicable to other estates. *Id*. § 2101(b). NRAs also are not eligible to take advantage of portability, even if the NRA was the surviving spouse of a person whose estate elected portability. Regs. § 20.2010-3T(e).

As an example, if an NRA has a U.S. taxable estate of $600,000, the tentative estate tax will be $192,800, based upon the current tables. This tentative estate tax will then be reduced by the $13,000 credit, resulting in an estate tax liability of $179,800 ($192,800 minus $13,000). On the other hand, if the decedent had been an RA, he would have been entitled to the $2,481,800 unified credit as adjusted for inflation in 2014 under current law. Of course, the RA's worldwide assets also would have been subject to taxation.

Because of the differences in tax credit available, an NRA whose worldwide estate consists mostly of U.S. property should consider establishing U.S. citizenship or residency for estate tax purposes. For example, if a person has a $4,000,000 worldwide estate, $3,000,000 of which is situated in the U.S., the RA would effectively have no U.S. taxable estate because the available exemption of $5,340,000 would swallow the entire estate. The NRA, on the other hand would have a U.S. taxable estate of $2,940,000 after application of the $60,000 exemption amount. Neither the citizen nor the RA would have to pay an estate tax, while the NRA would pay $1,145,800 in taxes.

The estate of an NRA also is entitled to the marital deduction for transfers to U.S. citizen spouses. Code § 2106(a)(3). Accordingly, a QTIP type of trust could be appropriate to defer taxes in the event the NRA is married to a U.S. citizen, or a QDOT trust if the spouse is a non-citizen.

With respect to the gift tax, NRAs are entitled to the annual exclusion in the same manner it is available to citizens and RAs. Code § 2503(b). NRAs also are eligible for the annual exclusion for gifts to non-citizen spouses of $145,000 per year (for 2014). *Id*. § 2523(i). NRAs may not, however, split gifts with a spouse. *Id*. § 2513(a)(1) (split gifts specifically limited to citizens and residents). Perhaps more significant, NRAs also

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[3] Respecting the corporate form usually means the foreign corporation should charge rent to anyone using the property, including the owner of the corporation and his or her family members. Charging rent raises other income tax issues that should be considered by the foreign owner. *See* Sanna, Dina K. and Stephen Ziobrowski, "Foreign-Owned U.S. Real Estate: To Rent or Not to Rent," Estate Planning, April 2014, for a nice discussion of the U.S. income tax implications arising out of such attempts to respect the corporate form.

[4] As stated when describing the scope of this paper, taxation issues related to foreign trusts are well outside the scope of this paper.

[5] Technically, an NRA could claim a credit up to $46,800. Code § 2102(b)(2)(B). The higher credit is virtually meaningless, however, because the NRA would be required to report his or her worldwide assets and most do not want to take this step. Further, at least 27.9% of the NRA's assets must be situated in the U.S. to claim more than the standard $13,000 credit.

are not entitled to the $5,340,000 lifetime exemption amount for taxable gifts. *See id*. § 2505(a) (credit is available only to citizens and residents). Accordingly, any gift of real or tangible property situated in the U.S. that exceeds the annual exclusion is subject to taxation and payment of tax, and regardless of whether the NRA has an otherwise taxable estate.

Transfers made by NRAs generally are subject to the GST tax to the extent the transfer also is subject to either the estate tax or the gift tax. *See* Code § 2601 (imposing tax on all generation-skipping transfers without distinction as to status of the transferor).

5) The Foreign Trust Tax Trap

Code Section 2104(b) interjects a significant tax trap for the unwary NRA (and his or her tax advisors). Under the section, any property with a U.S. situs transferred by the NRA during his or her life within the meaning of Sections 2035, 2036, 2037, or 2038, is deemed to have a U.S. situs at the time of death. Code § 2104(b). The subsection states:

> For purposes of this subchapter, any property of which the decedent has made a transfer, by trust or otherwise, within the meaning of Sections 2035 to 2038 inclusive, shall be deemed to be situated in the United States, if so situated *at the time of the transfer* or at the time of the decedent's death.

Id. (emphasis added). The consequence of this Section is that the NRA might die with some power or right over property with a foreign situs, but nevertheless be subject to U.S. estate taxation if the NRA originally had property with a U.S. situs. *See* TAM 9507044 (applying Section 2104(b) in this manner). For example, an NRA might transfer U.S. real property, which has a clear U.S. situs to a foreign revocable trust. Even if the foreign Trustee subsequently sells the property and acquires assets such as real estate in the NRA's domicile, which has a clear foreign situs, the foreign situs property is nevertheless deemed situated in the U.S. when the NRA dies. To avoid this result, the NRA must convert the U.S. situs property to a foreign situs before making a transfer within the meaning of Sections 2035 to 2038.

6) Charitable Deductions

In general, the estates of NRAs also are entitled to deductions for gifts for public, charitable and religious use. Code § 2106(a)(2). The deduction, however, is limited to the extent the property given to the charity was includable in the NRA's taxable estate. *Id*. § 2106(a)(2)(D). Further, the charitable gift must be to either a domestic non-profit corporation or a trust for use within the U.S. *Id*. § 2106(a)(2)(A).

C. Bilateral Transfer Tax Treaties

To add to the complexity of handling estates for RAs and NRAs, the U.S. has entered into bilateral treaties with a handful of other nations which impose property transfer taxes. Significantly, it has not entered a treaty with all such nations and persons with property in both the U.S. and such a country are at risk of double taxation. *See* Hauser, Barbara A., "Death Taxes Around the World in 2013," Trusts and Estates, November 2013, 56-64 (providing a survey of death taxes around the world). The existing treaties are with the following sovereigns:

- Australia;
- Austria;
- Canada (really part of the Income Tax Treaty);
- Denmark;
- Finland;
- France;
- Germany;
- Greece;
- Ireland;
- Italy;
- Japan;
- Netherlands;
- Norway;
- South Africa;
- Sweden[6];
- Switzerland; and
- The United Kingdom.

The details of these treaties are beyond the scope of this article. Suffice it to say that they may alter the situs rules and eligibility for credits, among other items. Significantly, the Code provides that the tax treaties do not automatically trump U.S. tax law, unless the treaty was in effect before August 16, 1954. Code § 7852(d). Instead, "neither the treaty nor the law shall have preferential status by reason of its being a treaty or law." *Id.* § 7852(d)(1). In advising the executor of an international estate with connections with any of the listed nations, the attorney is well advised to consult the applicable treaty. The treaties are available both on Lexis-Nexis and (the author assumes) Westlaw as well as appendices to Schoenblum, 851-2d T.M., *U.S. Estate and Gift Tax Treaties* (2012).

The U.S. has no transfer tax treaty with Mexico. Traditionally, Mexico has not imposed an inheritance tax. Effective January 1, 2014, however, Mexico now imposes an income tax on non-residents (regardless of citizenship) related to the inheritance of real property located in Mexico. (Mexican residents are not subject

[6] The treaty with Sweden was terminated effective January 1, 2008.

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to the tax until the property is sold.) The tax is 25% of the value of the inherited real property. The United States does have an income tax treaty with Mexico, which may address possible double taxation in this context. But it would seem there is no double taxation for the U.S. person because no taxable event has occurred in the U.S. upon mere inheritance. The several Mexican states and the Federal District (i.e., Mexico City) also impose a transfer tax upon the transfer of real property even if the transfer arises out of inheritance at rates of up to 4.5% of the value of the property.

D. Necessity of U. S. Executor.

Under Code Section 2203 and Regulation section 20.2203-1, if no executor has been appointed for the NRA's estate, the person in actual custody of the asset is deemed to be an "executor" under the Code. This means that a securities firm holding the NRA's investment account or the bank holding the NRA's deposits can be personally liable for estate taxes that are due. Code § 2002 (imposing liability for the tax upon the executor). It has been the author's experience that securities firms are reluctant to release possession of an NRA's securities, even into the hands of a U.S. executor, until an estate tax closing document or partial release of lien has been issued by the IRS, apparently for fear of this potential liability. To smooth the way for a successful administration, it may be necessary to appoint a U.S. executor.

III. TRAPS FOR THE UNWARY U.S. PERSON ACQUIRING PROPERTY THROUGH GIFTS OR INHERITANCES FROM ABROAD

A. Receipt of Gifts and Bequests from NRAs

U.S. persons who receive, in the aggregate, gifts and bequests with a value of $10,000 or more, as adjusted for inflation, from non-U.S. persons in any one tax year must report the receipt to the IRS. Code § 6039F(a). For purposes of this Section, a "U.S. person" is defined to include citizens, RAs, and domestic trusts. *Id.* § 7701(a)(30). Beginning in 2014, the inflation adjusted amount is $15,358. Rev. Proc. 2013-35 § 3.38. Significantly, the statute only requires such reporting "as the Secretary may prescribe regarding each foreign gift received." Code § 6039F(a). In Notice 97-34, the IRS addressed the reporting thresholds and indicated that U.S. persons would have to report gifts from NRAs or foreign estates only if the aggregate amount in the taxable year exceeds $100,000. Notice 97-34, 1997-25 I.R.B. 22, § VI(B)(1). On the other hand, purported gifts from foreign corporations or foreign partnerships would have to be reported at the statutory threshold. *Id.* § VI(B)(2). Failure to report the gift carries with it a potential penalty of 5.0% of the value of the unreported gift for each month the report is late, up to 25.0% of the gift. Code § 6039F(c).

Such gifts are reported on Form 3520. The reporting thresholds as reflected in the Instructions to Form 3520 and the Form itself are consistent with Notice 97-34. The Form is due to be filed on or before April 15 of the year following the receipt of the gift or bequest.

B. Gifts and Bequests from Certain Expatriates

Citizens and RAs who receive gifts or bequests from certain "covered expatriates" also must pay an inheritance tax on the value of the gift or bequest. *See* Code § 2801. A "covered expatriate" is, generally speaking, a person who has either lost his or her citizenship or legal residency status, and meets certain financial tests. *Id*. §§ 877(a)(2), 877A(g)(1). The financial tests include either an average annual net income tax for a 5 year period before becoming an expatriate of greater than $124,000, as adjusted for inflation, or a net worth of $2 million, with no adjustment for inflation, or more as of the date of expatriation. *Id*. § 877(a)(2). For 2014, the adjusted annual net income tax amount is $157,000. Rev. Proc. 2013-35 § 3.29. The inheritance tax applies to the extent the gift or bequest exceeds the annual gift tax exclusion amount in effect during the calendar year. Code § 2801(c). The tax rate is equal to the highest estate tax rate found in Code section 2001(c) effective on the date of the gift or bequest. *Id*. § 2801(a)(1). The U.S. person receiving the gift or inheritance is responsible for the tax. *Id*. § 2801(b). *See* Toce, Joseph H., Jr. and Joseph R. Kluemper, "Estate Planning for Expatriates Under Chapter 15(c)", Vol. 40, No. 1 Estate Planning 3-11 (January, 2013); and Liss, Stephen, "HEART-ache: Expatriation Under the New Inheritance Tax," Vol. 37, No. 4, Estate Planning 18-21 (April 2010) for two detailed articles regarding this inheritance tax.

A fairly common example of a covered expatriate might be a physician of foreign birth who practices in the U.S. for several years and then returns home. If the doctor had children while in the U.S., his or her children will be U.S. persons. Any gifts to the children over $14,000 (the current annual exclusion amount) after expatriation likely would be taxable if the financial tests are met.

The IRS has announced it intends to issue guidance under Section 2801 and promulgate a new Form 708 on which U.S. persons may report receipt of gifts or bequests from expatriates. Announcement 2009-57, 2009-29 I.R.B. 158. As of the date the author worked on this portion of the article (April 2014), however, neither the guidance nor the new form were available.

Exhibit A – IRS Model Language for QDOTs

From Rev. Proc. 96-54

SEC. 4. SAMPLE QUALIFIED DOMESTIC TRUST LANGUAGE THAT MAY BE USED TO SATISFY THE "GOVERNING INSTRUMENT" REQUIREMENTS OF § 20.2056A-2 (d) (1) (i) and (ii).

My trustee shall comply with the requirements for security arrangements for qualified domestic trusts as set forth in Treas. Reg. § 20.2056A-2 (d) (1) (i) or (ii), summarized as follows:

(a) *Trust in Excess of $2 Million.* If the fair market value of the assets passing to the trust (determined without reduction for any indebtedness thereon) exceeds $2 million on the relevant valuation date, then my Trustee must at all times during the term of the Trust either satisfy the U.S. Bank as Trustee requirement (see Treas. Reg. § 20.2056A-2 (d)-(1) (i) (A)), or furnish a bond that satisfies the requirements of Treas. Reg. § 20.2056A-2 (d) (1) (i) (B), or furnish an irrevocable letter of credit that satisfies the requirements of Treas. Reg. § 20.2056A-2 (d) (1) (i) (C), (hereinafter referred to as the U.S. Bank, Bond, or Letter of Credit Requirement). My Trustee may alternate between any of the security arrangements described in the preceding sentence provided that, at all times during the term of the trust, one of the arrangements is operative. If my Trustee elects to furnish a bond or letter of credit as security, then in the event the Internal Revenue Service draws on the instrument in accordance with its terms, neither my U.S. Trustee nor any other person will seek a return of any part of the remittance until after April 15th of the calendar year following the year in which the bond or letter of credit is drawn upon.

(b) *Trust of $2 Million or Less.* If the fair market value of the assets passing to the trust (determined without reduction for any indebtedness) is $2 million or less on the relevant valuation date, then my Trustee must comply with either the U.S. Bank, Bond, or Letter of Credit Requirement only if more than 35% of the fair market value of the trust assets, determined annually on the last day of the taxable year of the trust, consists of real property located outside the United States. For purposes of determining whether more than 35% of the trust assets consist of foreign real property, Treas. Reg. § 20.2056A-2 (d) (1)-(ii) (B) applies.

(c) *Determination of Value.* For purposes of determining whether the fair market value of the trust assets exceeds $2 million, my Trustee is authorized to make the election under Treas. Reg. § 20.2056A-2 (d) (1) (iv) (A) with respect to real property used as my spouse's personal residence.

(d) *Amount of Bond or Letter of Credit.* For purposes of determining the amount of the bond or letter of credit, my Trustee is authorized to make the election under Treas. Reg. § 20.2056A-2 (d) (1) (iv) (B) with respect to real property used as my spouse's personal residence.

(e) *Annual Statements.* My Trustee is directed to file any annual statements required under Treas. Reg. § 20.2056A-2 (d) (3).

(f) *General Conduct.* Notwithstanding anything contained herein to the contrary, my U.S. Trustee is hereby authorized to enter into alternative plans or arrangements with the Internal Revenue Service pursuant to Treas. Reg. § 20.2056A-2 (d) (4) to assure collection of the deferred estate tax, in lieu of the provisions contained herein.

(g) *References to Regulations.* All references to "Treas. Reg." in this document shall be references to regulations published under 26 CFR as in effect on the date of execution of this document, or, in the event that any such regulation is amended or superseded thereafter, to the regulation (or any successor regulation) as so amended.

(h) *Dollar Values.* The use of the dollar sign ($) shall indicate amounts stated in U.S. dollars

Exhibit B – Sample Post Mortem QDOT

THE _________________ QUALIFIED DOMESTIC TRUST

We, _________________, individually, joined by _______________ and ______________________, in their capacities as the Independent Co-Executors of the Will and Estate of _________________, Deceased, declare that we, as Grantors (hereinafter collectively referred to as "Grantor", unless otherwise specified), hereby establish this trust pursuant to the terms and provisions of this agreement, effective as of ___________, 20__. We have transferred to ________________ and _________________, as Co-Trustees, the property described in Schedule A attached hereto.

ARTICLE I
ESTABLISHMENT OF TRUST

1.1 Name of Trust. This trust shall be known as **THE _________________ QUALIFIED DOMESTIC TRUST** and shall be held and administered as set forth below.

1.2 Appointment of Trustees. Grantor appoints ________________ and _________________**(BANK)**, as initial Co-Trustees of the trust.

a. Appointment of Successor Co-Trustees. If __________________**(Individual Trustee)** ceases to serve as Trustee, Grantor appoints ____________________ to serve as the successor Co-Trustee of this trust to serve with ______________________**(Bank)**.

1.3 Revocation and Amendment. This trust is irrevocable. Except as specified in Article II, Paragraph 2.8(g), this trust also may not be amended.

ARTICLE II
TERMS AND CONDITIONS

2.1 Beneficiary. During her lifetime, _________________ (the "Primary Beneficiary") shall be the sole beneficiary of this trust.

2.2 Mandatory Distributions of Income. The Trustee shall distribute the entire net income of the trust to the Primary Beneficiary in monthly, quarterly, or other convenient installments, but at least annually. The Trustee also shall distribute to the Primary Beneficiary all income of any Retirement Benefit payable to the trust. To ensure the Primary Beneficiary's right to income, the Primary Beneficiary may direct the Trustee, in writing, to convert any non-income producing or unproductive trust assets into income producing assets within a reasonable time.

2.3 Discretionary Distributions of Principal. The Trustee also may distribute the trust principal for the Primary Beneficiary's health, education, maintenance and support at such times and in such amounts as the Trustee determines to be in the Primary Beneficiary's best interest. The Independent Trustee [only], if any, may distribute trust principal to the Primary Beneficiary at any time and from time to time when the Independent Trustee, in its sole discretion, determines that such a distribution is advisable or appropriate for any purpose and for any reason. The primary purpose of this trust is to provide adequate support and maintenance to the Primary Beneficiary and the distribution of the trust remainder to the remainder beneficiaries is only of secondary interest to the Grantors. The Trustee shall give priority to the Primary Beneficiary's health and support in that standard of living to which he or she was accustomed at the date of the death of the first Grantor to die.

2.4 Testamentary Power of Appointment. the Primary Beneficiary may appoint all or a portion of the trust remainder on termination of the trust to or among the class composed of the Grantors' descendants, but specifically excluding the Primary Beneficiary, his or her creditors, the Primary Beneficiary's estate and its creditors, upon such conditions and estates, outright or in trust, in such manner and in such amounts and proportions as the Primary Beneficiary may designate in his or her last Will. The Primary Beneficiary does not, however, have any power of appointment over any portion of the trust principal that was funded with property as a result of the Primary Beneficiary's qualified disclaimer of that property.

2.5 Sole Beneficiary. During his or her lifetime, the Primary Beneficiary shall be the sole beneficiary of this trust. No person, including but not limited to the Trustee and the Primary Beneficiary, has any power to appoint any of the trust property to any person other than the Primary Beneficiary.

2.6 Distribution of Trust Income and Assets on Death of Beneficiary. The Trustee shall distribute all accumulated income to the Primary Beneficiary's estate. Subject to the preceding provisions of this Article **and the Primary Beneficiary's power of appointment**, the Trustee shall distribute the trust principal and any income accumulated after the date of the Primary Beneficiary's death according to the provisions of Article IV of this agreement.

2.7 Marital Deduction Qualification. The Grantor intends that the property she transfers to this trust qualify for the marital deduction in the estate of _________________, deceased. To the extent that any term or condition in this agreement would cause the disqualification of the trust as such, that term or condition shall be void. The Trustee shall not accept any assets that do not qualify for the marital deduction in the estate of _________________, deceased.

2.8 Qualified Domestic Trust Provisions. At the time of this agreement, Grantor _________________ is not a United States citizen. Grantor intends this trust to qualify as a qualified domestic trust and therefore intends that the trust shall also be governed by the following provisions, notwithstanding any contrary provision in this agreement.

a. Special Trustee Provisions. **___________________(Bank)** shall serve as a Co-Trustee of this trust. In the event the named bank ceases to serve for any reason, the remaining Co-Trustee shall immediately appoint a replacement bank meeting the U. S. Bank as Trustee requirements, under applicable federal regulations.

b. U. S. Trustee. At least one Trustee shall always be either an individual United States citizen whose tax home is the United States or a corporation created or organized under the laws of the United States or under the laws of any state of the United States or the District of Columbia ("U. S. Trustee"). In the event that the Trustee is not a U. S. Trustee, the Trustee shall immediately appoint a Co-Trustee that meets the requirements of this subparagraph.

c. Withholding Requirement. The U. S. Trustee shall withhold any tax imposed by section 2056A of the Code from any distribution other than a distribution of income and pay such tax to the appropriate authority. The Trustee's selection of any assets to be sold to make payments pursuant to this subparagraph, and the tax effects thereof, shall not be subject to question by any beneficiary.

d. Trust Situs and Administration Requirements. The records of the trust or copies thereof must be kept in and administration of the trust must be governed by the laws of one of the United States or the District of Columbia.

e. Security Requirements. The Trustee shall comply with the requirements for security arrangements for qualified domestic trusts as set forth in TREAS. REG. § 20.2056A-2(d)(1)(i) or (ii), summarized as follows:

(1) Trust in Excess of $2 Million. If the fair market value of the assets passing to the trust (determined without reduction for any indebtedness thereon) exceeds $2 million on the relevant valuation date, then the Trustee must at all times during the term of the trust either satisfy the U. S. Bank as Trustee requirement (*see* TREAS. REG. § 20.2056A-2 (d)(1)(i)(A)), or furnish a bond that satisfies the requirements of TREAS. REG. § 20.2056A-2 (d)(1)(i)(B), or furnish an irrevocable letter of credit that satisfies the requirements of TREAS. REG. § 20.2056A-2(d)(1)(i)(C), (hereinafter referred to as the U. S. Bank, Bond, or Letter of Credit Requirement). The Trustee may alternate between any of the security arrangements described in the preceding sentence, provided that, at all times during the term of the trust, one of the arrangements is operative. If the Trustee elects to furnish a bond or letter of credit as security, then in the event the Internal Revenue Service draws on the instrument in accordance with its terms, neither the U. S. Trustee nor any other person will seek a return of any part of the remittance until after April 15th of the calendar year following the year in which the bond or letter of credit is drawn upon.

(2) <u>Trust of $2 Million or Less</u>. If the fair market value of the assets passing to the trust (determined without reduction for any indebtedness) is $2 million or less on the relevant valuation date, then the Trustee must comply with either the U. S. Bank, Bond, or Letter of Credit Requirement only if more than 35% of the fair market value of the trust assets, determined annually on the last day of the taxable year of the trust, consists of real property located outside the United States. For purposes of determining whether more than 35% of the trust assets consist of foreign real property, TREAS. REG. § 20.2056A-2(d)(1)(ii)(B) applies.

(3) <u>Determination of Value</u>. For purposes of determining whether the fair market value of the trust assets exceeds $2 million, the Trustee is authorized to make the election under TREAS. REG. § 20.2056A-2(d)(1)(iv)(A) with respect to real property used as the Grantor's personal residence. The "fair market value" of the trust assets shall be the fair market value of the assets passing, treated, or deemed to have passed to the trust, determined without reduction for any indebtedness with respect to the assets, as finally determined for federal estate tax purposes as of the date of death of the Grantor, or, if applicable, the alternate valuation date (adjusted as provided in the Treasury Regulations regarding the exclusion of a certain portion of the value of the Grantor's principal residence and related furnishings.)

(4) <u>Amount of Bond or Letter of Credit</u>. For purposes of determining the amount of the bond or letter of credit, the Trustee is authorized to make the election under TREAS. REG. § 20.2056A-2(d)(1)(vi)(B) with respect to real property used as the Grantor's personal residence.

(5) <u>Annual Statements</u>. The Trustee is directed to file any annual statements required under TREAS. REG. § 20.2056A-2(d)(3).

(6) <u>General Conduct</u>. Notwithstanding anything contained herein to the contrary, the U. S. Trustee is hereby authorized to enter into alternative plans or arrangements with the Internal Revenue Service pursuant to TREAS. REG. § 20.2056A-2(d)(4) to assure collection of the deferred estate tax, in lieu of the provisions contained herein.

(7) <u>References to Regulations</u>. All references to "Treas. Reg." in this document shall be references to regulations published under 26 CFR as in effect on the date of execution of this trust, or, in the event that any such regulation is amended or superseded thereafter, to the regulation (or any successor regulation) as so amended.

(8) <u>Dollar Values</u>. The use of the dollar sign ($) shall indicate amounts stated in U. S. dollars.

f. <u>QDOT Election</u>. Grantor intends that this trust qualify as a "qualified domestic trust" as that term is defined in section 2056A(a) of the Code. To the extent that any term or condition in this agreement would cause the disqualification of the trust as such, that term or condition shall be void. Subject to the provisions of section 2203 of the Code, the Trustee is hereby authorized, in the exercise of its discretion, to elect that the trust be treated as a "qualified domestic trust". The Trustee may make the election regardless of the respective interests of the income beneficiary and remaindermen of the trust and is hereby exonerated from any liability or responsibility as a result of its exercise or non-exercise of that election.

g. <u>Power to Amend for QDOT Treatment</u>. The Trustee shall have the power to amend this trust or any provisions of this agreement relating to such trust to assure its qualification as a qualified domestic trust. Further, the Trustee is authorized to amend any of the provisions of this agreement to meet any requirements for a qualified domestic trust that the Secretary of the Treasury may prescribe by regulations or otherwise. Any such amendment shall be by a written instrument which is signed, dated and notarized. The original amending instrument shall be kept with the trust records and may, in the Trustee's discretion, be recorded in the appropriate real property records. A copy of the amending instrument shall be delivered to the Grantor. No court action shall be necessary to effectuate any such amendment.

Appropriate termination, disposition and administrative provisions would follow.

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Exhibit C – Sample Assignment to QDOT Trust

IRREVOCABLE ASSIGNMENT

IRREVOCABLE ASSIGNMENT made effective the ______ day of _______, 20__, by and between _________________ (referred to herein as "Assignor") and _________________ and ___________________, as Co-Trustees of the _______________ QUALIFIED DOMESTIC TRUST, dated effective ___________, 20__ (collectively referred to herein as "Assignee").

RECITALS.

WHEREAS, __________________ is not a United States citizen, and she has established, as one of the Grantors, the ______________ QUALIFIED DOMESTIC TRUST, dated effective _____________, 20__, ("Trust") in accordance with 26 U.S.C. §§ 2056 and 2056A, and with the express intent and purpose such that certain assets passing to her by operation of the residuary clause of the Will of ________________, deceased, ("Decedent") qualify for the marital deduction for purposes of the United States estate tax; and

WHEREAS, in connection with the distribution of the assets of the estate of Decedent, and the funding of the Trust, Assignor desires to irrevocably transfer, assign, set over and deliver unto Assignee all of the assets which are listed on the attached Exhibit A; and

WHEREAS, Assignee desires to accept the assets listed on the attached Exhibit A upon the terms herein contained;

NOW, THEREFORE, it is agreed as follows:

1. Assignment of Interest. In partial distribution of the assets of the estate of Decedent, and to accomplish the funding of the Trust, Assignor does hereby irrevocably transfer, assign, set over and deliver unto Assignee all of the assets listed on the attached Exhibit A, together with all sums due or to become due to Assignor thereunder (the "Interest").

2. Assumption of Liabilities. Assignee hereby acknowledges and agrees that it is assuming all of Assignor's liabilities and obligations with respect to the Interest herein assigned.

3. Title. Assignor represents and warrants that it is the owner, free and clear of any encumbrances, of the Interest delivered by Assignor hereunder.

4. Benefits. All of the terms and provisions of this Assignment shall inure to and be binding upon Assignor and Assignee and their respective heirs, executors, administrators, successors and assigns.

Signatures to Follow

EXHIBIT D – Situs of NRA Property for Estate and Gift Tax Purposes (Generally Speaking)

Type of Property	Estate Tax Situs	Estate Tax Citation	Gift Tax Situs	Gift Tax Citation
Real property	Place of location	20.2104-1(a)(1), 20.2105-1(a)(1)	Place of location	25.2511-3(b)(1)
Tangible personal property	Place of location	20.2104-1(a)(2), 20.2105-1(a)(2)	Place of location	25.2511-3(b)(1)
Currency (not deposits)	Place of location	20.2104-1(a)(7)(ii), Rev. Rul. 55-143	To be safe - place of location	*See* 25.2511-3(b)(1)
Intangible personal property (the written evidence of which is not treated as the property itself)	U.S. (if enforceable against a U.S. person)	20.2104-1(a)(4)	Foreign situs	2501(a)(2), 25.2501-1(a)(3)
Intangible personal property (the written evidence of which is not treated as the property itself)	Foreign situs (only if not enforceable against a U.S. person)	20.2105-1(e)	Foreign situs	2501(a)(2), 25.2501-1(a)(3)
Domestic corporate stock	U.S.	2104(a), 20.2104-1(a)(5)	Foreign situs	2501(a)(2), 25.2501-1(a)(3)
Foreign corporate stock	Foreign situs	20.2105-1(f)	Foreign situs	2501(a)(2), 25.2501-1(a)(3)
Debt obligation of U.S. person	U.S.	2104(c)	Foreign situs	2501(a)(2), 25.2501-1(a)(3)
Deposits with U.S. banks (unless the deposit is associated with a trade or business in the U.S., or the NRA is a U.S. resident for income tax purposes)	Foreign situs	2105(b)	Foreign situs	2501(a)(2), 25.2501-1(a)(3)
Transfers with retained interests (Code §§ 2035-2038)	U.S. (if property situated in U.S. at time of transfer)	2104(b)	N/A	
Proceeds of life insurance on life of NRA	Foreign situs	2105(a)	N/A	
Domestic partnerships and other entities taxed as partnerships	Probably U.S.	*See* 2103; *cf.* 2105	Probably Foreign situs[7]	2501(a)(2), 25.2501-1(a)(3)
Beneficial interests in trusts & estates	The situs of the underlying asset	*See* Rev. Rul. 55-163	Probably situs of underlying asset	*See* Rev. Rul. 55-163
Commercial annuities issued by U.S. persons	Probably U.S.	2103, 2104(c), *cf.* 2105(a)	Foreign situs	2501(a)(2), 25.2501-1(a)(3)

[7] There seems to be a significant amount of debate as to whether an interest in a domestic partnership or other entity that is taxed as a partnership (like a limited liability company) has a foreign situs under Code Section 2501(a)(2). Many commentators believe the IRS will look to the nature of the underlying assets to determine the gift tax consequences, and ignore that a partnership interest, generally speaking, is intangible personal property the written evidence of which is not treated as the property itself under state law. Adding to the concern of some authors is the fact that the IRS will not ordinarily issue private letter rulings regarding "[w]hether a partnership is intangible property for purposes of § 2501(a)(2)". Rev. Proc. 2014-7 § 4.01(28). Unfortunately, the IRS has created a chilling effect on some estate planners because its stated reason for refusing to issue PLRs in this context is "either because issues are inherently factual *or for other reasons*." *Id.* § 2.01.

What If My Client's Settlement Agreement With The IRS Has A Mistake?

By Robert C. Morris and
Richard L. Hunn[1]

I. Everyone Makes Mistakes

In a recent presentation, a lawyer recounted a time when an IRS employee provided him with a settlement agreement that the lawyer believed contained an error. This purported error favored the taxpayer, and the lawyer chose to notify the IRS immediately of the possible error. The settlement agreement was then "corrected."

Everyone makes mistakes. The question is what actions, if any, do we take when we believe that the IRS may have made an error in a settlement agreement. How do we advise our clients, and what, if any, responsibilities do we have to the IRS? What if the roles are reversed and it is our client that has entered into a settlement agreement with the IRS that overstates the resulting adjustment or assessment?

This article first discusses the enforceability of settlement agreements with the IRS when one party to the agreement has made a mistake, and then explores some of the ethical issues lawyers face in these circumstances.[2]

II. Not Every Mistake Is Created Equal

A. Unilateral Conceptual Or Legal Mistakes In Settlement Agreements

The distinction between conceptual or legal errors on one hand, and clerical or arithmetic errors on the other, plays a large role in the enforceability of settlement agreements. Courts are reluctant to allow the IRS to correct its unilateral conceptual or legal errors so long as those errors were not based on the taxpayer's fraud, malfeasance, or misrepresentation of a material fact.[3] For example, in Stamm International Corp. v. Commissioner, 90 T.C. 315 (1988), the IRS and a taxpayer entered into a settlement agreement that resolved specific issues, but did not include the ultimate amount of tax deficiency. Although the settlement agreement provided that the taxpayer received a dividend from its controlled foreign corporation under Section 951, the settlement agreement did not specify (nor had the parties discussed) the effect of Section 959 (which may reduce the taxable amounts of dividends under Section 951) on the settlement. The

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IRS lawyer overlooked Section 959, and the taxpayer's counsel, although aware that Section 959 would significantly reduce the ultimate tax deficiency paid by the taxpayer, remained quiet. The IRS lawyer later learned that Section 959 had significantly reduced the amount of the ultimate tax deficiency and tried to set aside the settlement.

The Tax Court refused to set aside the settlement, finding that the taxpayer's counsel was not obligated to bring a legal error to the attention of the IRS. Others that have considered this issue, including the IRS, have also found that settlement agreements are enforceable even if the IRS made a conceptual or legal error in agreeing to the settlement. Haiduk v. Commissioner, 60 T.C.M. (CCH) 864 (1990) (settlement agreement that was predicated on IRS's mistaken belief that the taxpayer's earlier tax years were still open to disallowance of deductions and credits was enforceable); Phoenix Insurance Co. v. Commissioner, 29 B.T.A. 291 (1933) (court refused to set aside settlement agreement when IRS failed to detect error in taxpayer's return that resulted in an unauthorized deduction); Rev. Rul. 72-487, 1972-2 C.B. 645 (inspection of taxpayer's books and records "may disclose that errors were made in the computation of the tax liability and it may appear that the taxpayer should have paid a greater tax, but the agreement may not be set aside by the Service or by the courts unless there is a showing of fraud or malfeasance, or misrepresentation of a material fact.")

B. "What's Good For The Goose Is Good For The Gander"

Of course, the courts' refusal to set aside settlement agreements for unilateral conceptual or legal errors extends to errors made by taxpayers as well. Korangy v. Commissioner, 893 F.2d 69 (4th Cir. 1990) (court refused to set aside stipulation of agreed adjustments even though taxpayers contended that an item of income was mistakenly counted twice); Goss v. Commissioner, 93 T.C.M. (CCH) 705 (2007) (settlement agreement that may have double counted income enforced; "such a unilateral mistake is not a sufficient ground to set aside an otherwise enforceable settlement agreement"); Medkiff v. Commissioner, 94 T.C.M. (CCH) 451 (2007) (stipulation enforced even though a certain deduction may have been omitted from the settlement); see also Rev. Rul. 73-459, 1973-2 C.B. 415 (revenue agent's unintentional oversight in failing to include certain deductions in arriving at the result upon which the closing agreement was based did not constitute a misrepresentation that would justify setting aside the agreement).

Although the courts are reluctant to set aside settlement agreements when one party has made a conceptual or legal error, that same reluctance does not appear to be present in cases involving arithmetic or clerical errors.

C. Arithmetic Or Clerical Errors In Settlement Agreements

In Holland v. Commissioner, 64 T.C.M. (CCH) 1433 (1992), the IRS and taxpayer reached a settlement and filed a stipulation of the agreed settlement terms. The IRS computed the deficiency as $72,856.21 under the terms of the settlement, and provided its computation to the taxpayer. However, in the decision document later submitted to the court, the IRS entered $37,477.11 as the deficiency amount. The IRS later discovered this error, and moved to revise the decision document to reflect the larger deficiency of $72,856.21.

Although "reluctant to set aside a stipulated decision in the absence of fraud, mutual mistake, extraordinary circumstances, or other like case," the court permitted the correction because the use of $37,477.11 "was a mutual mistake," and merely a "clerical error." See also In re Catt, 96-2 U.S.T.C. (CCH) ¶50,422 (E.D. Wash. 1996) (court modified judgment to correct clerical error and enter the agreed $52,350.00 liability; judgment had incorrectly set forth liability of $52.35). We'll next consider the ethical responsibilities of lawyers when the IRS provides settlement documents containing errors.

III. Ethical Considerations Faced By Lawyers

A. Lawyers And Clients May Not Provide False Information To The IRS

As an initial matter, the lawyer and her client cannot give false or misleading information to the IRS. Circular 230 § 10.51(a)(4) provides that a lawyer may not give false or misleading information, or participate in any way in giving false or misleading information to the IRS.[4] Rule 8.4(c) of the ABA Model Rules further provides that lawyers may not engage in conduct involving dishonesty, fraud, deceit, or misrepresentation. Moreover, American Bar Association Committee on Professional Ethics Formal Opinion 314 (April 27, 1965) ("Formal Opinion 314") states that in negotiating administrative settlements, "the lawyer is under a duty not to mislead the Internal Revenue Service deliberately and affirmatively, even by misstatements or by silence or by permitting his client to mislead." These authorities leave no doubt that a lawyer may not lie to the IRS.

Taxpayers must also refrain from misleading the IRS, and Circular 230 § 10.22 requires the lawyer to advise the client of the potential consequences of misleading the IRS. There are statutes (such as 18 U.S.C. § 1001 and Section 7212) that prohibit a taxpayer from giving false or misleading information to the IRS. A lawyer may not need to scare her client by getting down to brass tacks and naming specific statutes, but a lawyer should advise the client of the potential consequences to the client for providing false or misleading information to the IRS when commenting on draft settlement documents. At least one ethics opinion has found that a lawyer may ultimately have to withdraw from the representation if a client misleads the IRS (discussed later in this article).

Often times, the client will decide to disclose the error. Otherwise, the only other alternative is for the client and the lawyer is to avoid commenting on the settlement documents. However, what if the IRS never provides the lawyer or client with draft settlement documents, and instead just sends final documents for signature that contain an error? What if the client is not even aware of the potential error?

B. Lawyers Should Inform Their Clients Of Potential Errors

There are strong arguments in favor of a lawyer's duty to inform a client of a possible error in an IRS settlement document. Circular 230 § 10.21 provides a practitioner who knows that the client has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States must advise the client promptly of the fact of such noncompliance, error, or omission and must advise the client of the consequences under the code and regulations. The Committee on Standards of Tax Practice of the American Bar Association concluded in Standards of Tax Practice Statement 1999-1, 53 Tax Lawyer 733 (2000) ("Statement 1999-1") that in non-docketed cases involving refunds or deficiencies, if the client refuses to consent to disclosure to the IRS of an error, counsel may have an obligation to withdraw from the matter depending on the type of error. Although Statement 1999-1 never directly states that the lawyer must inform the client of the IRS's error, it is implicit in Statement 1999-1 that a lawyer must inform the client of the error as a lawyer cannot ask his client for consent to disclose the error to the IRS without informing the client of the error.[5]

Two other ethics opinions located in this area did not address whether the lawyer had a duty to inform the client because the client was aware of the error in both of these opinions. See Chicago Bar Ass'n Prof. Resp. Comm., Opinion No. 86-4, ABA/BNA Lawyers' Manual on Professional Conduct, Ethics Opinions 1986-1990, 901:3201 (digest) ("Chicago Ethics Opinion") and Dallas Bar Ass'n Legal Ethics Comm. Opinion No. 1989-4, ABA/BNA Lawyers' Manual on Professional Conduct, Ethics Opinions 1986-1990, 901:8402 (digest) ("Dallas Ethics Opinion").

C. May The Lawyer Disclose The Error To The IRS Without Client Consent?

1. Again, All Errors Are Not Created Equal

Like the courts, the Committee in Statement 1999-1 draws a major distinction between arithmetic/clerical errors and conceptual errors. The Committee distinguishes conceptual errors because unlike arithmetic errors, conceptual errors depend on the application or interpretation of the tax law for which a reasonable dispute could exist.

Statement 1999-1 posits four hypotheticals involving IRS errors in non-docketed cases.[6] Three of these hypotheticals involve a common factual setting: the lawyer had actively been involved in negotiating a settlement with the IRS; the terms of the settlement had been agreed to in principle; the client had computed or estimated the amount of the resulting anticipated tax liability; but the IRS made an arithmetic or clerical error (for example, a misplaced decimal or a multiplication error) in computing the tax liability that favored the client. The Committee started with the assumption, based on American Bar Association Committee on Professional Ethics Informal Opinion 86-1518 (Feb. 9, 1986),[7] that implied authority to disclose an IRS error "will generally exist where the terms of a settlement have been reached and the Service then commits an unilateral arithmetic or clerical error in the computation of the tax, penalty, or interest owed, or refund due." Based on this assumption, the Committee concluded that the lawyer had implied authority to disclose the IRS's error in two of the hypotheticals. In these two hypotheticals, the terms of the settlements had been agreed to, the errors were clearly clerical or arithmetic, and the "corrected" tax amounts were in line with the client's expectations.

In contrast, the Committee concluded that, even when the error was arithmetic or clerical, the lawyer did not have implied authority to disclose the IRS's error where the client had estimated the tax to be $100,000, but the IRS erroneously determined the deficiency to be $125,000, when the correct revised deficiency was actually $150,000. The Committee determined the lawyer did not have implied authority to disclose because the "correct" amount was "not consistent with the client's stated expectation." The Committee concluded that the lawyer must seek the client's express consent to disclose the error on these facts, and must withdraw if the client refuses to consent.

The remaining hypothetical involved a conceptual error by the IRS. Here, the client and IRS had negotiated a settlement in which the client was entitled to a $100,000 deduction. The lawyer believed that the deduction was attributable to a passive activity and not currently deductible, but that issue was never raised and the IRS computations treated the deduction as non-passive.

The Committee distinguished this situation from the other hypotheticals because "the application of Section 469 to the settlement computation is highly factual and subject to some reasonable dispute." The Committee concluded that the lawyer did not have implied authority to disclose the error to the IRS, because the issue was not addressed in the settlement negotiations and there was "no meeting of the minds" on the issue of whether the deduction was subject to Section 469. See also Formal Opinion 314, which concluded that although a lawyer may not deliberately or affirmatively mislead the IRS in settlement negotiations, the lawyer need not disclose weaknesses in a client's case even if an unjust result occurs.

2. Must The Lawyer Disclose The Error To The IRS Or Withdraw?

If the error is a conceptual error, as opposed to an arithmetic/clerical error, no authority was located that advises (or even implies) that the lawyer is under a duty to disclose the error to the IRS. As explained earlier, Statement 1999-1 determined that lawyers are under no obligation to withdraw or disclose conceptual errors to the IRS and the authors of the Dallas Ethics Opinion concluded that the lawyer does not have a duty to disclose or withdraw even if the client refuses to correct an error.

However, the authorities are not consistent on whether a lawyer is required to disclose an arithmetic error, and the authors of the Chicago Ethics Opinion and Dallas Ethics Opinion appear not to distinguish between the types of error. The error discovered in the Dallas Ethics Opinion was a calculation error, and the authors concluded that the lawyer did not have a duty to disclose or withdraw from the representation. Likewise in the Chicago Ethics Opinion, the authors determined that the lawyer was not ethically required to disclose the error to the IRS unless the error was caused by the lawyer's own fraud. These views contrast with Statement 1999-1, in which the Committee concluded that a lawyer must withdraw if the client refuses to disclose the arithmetic/clerical error.

D. Issues With The Approach Of Statement 1999-1

One issue with the approach of Statement 1999-1 is that it is not always clear whether an error is conceptual or arithmetic/clerical. For example, the IRS will often prepare and send closing documents to the taxpayer without having previously exchanged calculations. Although lawyers and taxpayers may know that the computations on the closing documents do not match their own, they may not be able to pinpoint the reasons for the difference. Moreover, even if the reasons for the difference are identified, it may still be difficult to distinguish between a conceptual error and an arithmetic/clerical error.

For example, we once received a document from the IRS that appeared to have applied the wrong tax rate in computing the purported tax due. Was that a clerical/arithmetic error (multiplication) or a conceptual error (the choice to apply a different rate)? In the case of doubt, lawyers may wish to treat an error as conceptual and seek the client's consent to disclose. A lawyer who wrongly assumes she has implied authority to disclose the error may run the risks of her client's ire and a violation of the rules of professional conduct.

E. Lawyer Cannot Inform IRS Of Error If Client Does Not Consent

The ethics opinions located in the tax arena are in agreement that a lawyer cannot notify the IRS of the error if the client instructs the lawyer not to disclose. Statement 1999-1 ("When counsel learns that the Service has made a computational error of tax, penalty, or interest in the client's favor, the information gained is a client confidence under Rule 1.6(a), which generally may not be disclosed without the client's consent unless otherwise provided in the Rules or by other law."); Chicago Ethics Opinion (The lawyer's discovery of the IRS's error is a client "secret," and the lawyer is not permitted to disclose the information to the IRS unless the client consents to the disclosure or disclosure is required by law); Dallas Ethics Opinion (Lawyer not required to inform comptroller or judge that comptroller's calculation contained a significant error in client's favor. To do so, without the client's permission would violate rule of confidentiality).

IV. Conclusion

Everyone makes mistakes. Lawyers should first try to determine whether the mistake is a conceptual error (an error depending on the application or interpretation of the tax law) or an arithmetic/clerical error (for example, a misplaced decimal or multiplication error). The courts and at least one ethics opinion draw a major distinction between errors that are conceptual versus those that are arithmetic/clerical. The courts have been reluctant to set aside agreements containing conceptual errors, and none of the ethics opinions located placed a duty on the lawyer to inform the IRS of conceptual errors. In contrast, the courts appear less likely to enforce settlement agreements with arithmetic/clerical errors, and at least one ethics opinion determined that the lawyer may have implied authority to disclose (depending on the magnitude of the error) or may have to withdraw if the error is not disclosed.

Lawyers must approach these situations cautiously, as oftentimes it may be difficult to neatly categorize the error as conceptual or arithmetic/clerical. Moreover, in addition to the legal and ethical issues raised in this article, lawyers and taxpayers must also consider their ongoing relationship with the IRS when confronted with this situation.

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[1] Robert C. Morris and Richard L. Hunn are with Norton Rose Fulbright. The authors thank Nancy T. Bowen, a retired colleague, for her contributions to this article.

[2] This article is not intended to be an exhaustive analysis of these issues.

[3] Section 7121 allows the IRS to set aside a Closing Agreement "upon a showing of fraud or malfeasance or misrepresentation of a material fact." This article assumes that none of those circumstances is present. All "Section" references in this article are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[4] Circular 230 § 10.22 also requires a lawyer to exercise due diligence in preparing or assisting in preparing, approving and filing tax returns, documents, affidavits and <u>other papers</u> relating to IRS matters and in determining the correctness of oral or written representations to the IRS.

5 Although Statement 1999-1 was reviewed before issuance by the Council of the Section of Taxation, Statement 1999-1 "has not been approved by the Section or by the American Bar Association and should not be construed as policy of those entities."

6 The focus of this article is on settlements in non-docketed cases. Statement 1999-1 indicates that where an arithmetic or clerical error occurs in a docketed case, the lawyer must disclose regardless of whether the client consents, because counsel owes a greater duty to a tribunal.

7 Finding that the lawyer for one party had implied authority to notify the lawyer for the other party that an agreed upon clause was omitted from a contract.

Are Virtial Currencies Such as Bitcoin the Next Tool for Tax Evaders - The IRS is Watching and You Might Be Surprised What They See

Virtual Currencies, such as Bitcoin, are an incredible tool in the digital age. A virtual currency is a currency that exists only in cyberspace that is not backed by any government. The value can fluctuate by the hour and there is no coin or certificate to touch.

If one thinks these cyber or crypto currencies are only for sophisticated computer users, think again. Bitcoin is the most widely recognized of the virtual currencies. Bitcoin is accepted by Expedia and the United Way, among others. These entities accepting Bitcoin are broadcasting that Bitcoin is in the mainstream.

What would a potential tax evader believe he has to gain by using the cyber currency Bitcoin? The answer is simple, the same protections promised by so many tax shelter promoters from good old-fashioned barter tax shelters to offshore tax havens. Namely, secrecy and an obtuse trail of funds.

Unfortunately for would-be tax cheats, IRS Criminal Investigation has committed a team of IRS Criminal Special Agents to master Bitcoin and other virtual currencies. The IRS knows that to use Bitcoins, a user needs a virtual wallet along with private keys and public addresses. Unknown to many Bitcoin users is the fact that every Bitcoin transaction is included in a ledger called a block chain.

The IRS is simply accessing the block chain to review all Bitcoin transactions. From that point, the IRS works its way back to the public address that was used in the Bitcoin transaction. While the public address itself does not identify the user, the IRS has been very diligent in associating the public address with the identity of the Bitcoin user. Thus, Bitcoin and other cyber and crypto currencies do not provide anonymity, which is contrary to many popular beliefs.

When examining the IRS approach to the taxation of virtual currencies, the most basic question is whether they will be treated as currency or property. The IRS chose to treat virtual currency as property and opened the door for some detailed and voluminous accounting. Details of the IRS taxation scheme for the taxation of virtual currencies can be found in IRS Notice 2014-21.

Since virtual currencies are treated as property for federal income tax purposes, a good way to view them is to consider how bartering is taxed. When you work on a project and are paid with a washing machine as a barter, the value of the washing machine is compensation for services, which constitutes income. The amount recognized in income becomes the basis in the washing machine. The subsequent barter of the washing machine for something else, say, a barbeque smoker, is a realized taxable transaction.

Given the IRS treatment of virtual currency as property in IRS Notice 2014-21, the burning question will be how a taxpayer will maintain the adequate records to determine the correct amount of tax. Imagine having a cyber-wallet with Bitcoins from numerous transactions that presumably will all have a different basis, especially in light of the fluctuations in value

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experienced in Bitcoins. Accordingly, the amount of basis in each Bitcoin will vary widely. Will a taxpayer be able to specifically identify the Bitcoin they are using for basis purposes or will a FIFO, LIFO or another method be employed to correctly reflect basis?

Once we determine and account for basis correctly, then we have to examine the other side of the transaction, the value of purchases made with Bitcoins. An extreme example is to use Bitcoin to pay for a daily newspaper and cup of coffee. The accounting would be voluminous.

Besides the actual computation of tax, there are other IRS compliance issues to consider. For example, the IRS has not waived employment tax withholding and reporting obligations merely because a virtual currency is involved. With the gusto used by many employers who consider withholding and reporting as merely aspirational goals that may be complied with or not, paying employees in virtual currency to fly under the radar is expected if it is not already underway.

Ironically, a fraction of the super-computing techniques used to "mine" Bitcoins could be implemented to keep track of all Bitcoin basis and taxable realization events. Once that becomes common place, the accounting burden may become reasonable.

While the IRS has been focusing on the use of virtual currencies and crypto currencies in money laundering cases, the IRS has recently expanded inquiries to include the likelihood that some users are merely committing tax evasion and tax fraud with virtual currencies. This is especially true because large amounts of virtual currency can change hands anywhere in the world instantaneously. Used correctly, cyber and crypto currencies are additional financial tools in our ever-shrinking world. Used incorrectly, cyber and crypto currencies are very dangerous tools for those with a leaning towards and involved in illegal activities including tax evasion.

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The Comptroller's Franchise Tax Guidance Related to Depreciation Recapture Should Be Clarified

By: Brent C. Gardner, Tax Associate at Gardere Wynne Sewell, LLP

A "passive entity" is exempt from Texas franchise tax. An entity is a passive entity if (a) it is a certain type of entity, including general, limited, or limited liability partnerships; and (b) its federal gross income during the period on which the tax is based consists of at least 90% "passive income." *See* Tex. Tax Code § 171.0003.

Passive income includes "capital gains from the sale of real property," and other types of passive income *Id*.

I. The Comptroller's guidance broadly characterizes "depreciation recapture" as "ordinary income."

According to the Comptroller's current franchise tax guidance, gain on the sale of real property that constitutes "depreciation recapture" under IRC §§ 1245, 1250, or 1254 is "treated as ordinary income" for federal tax purposes, and "[a]s a result, the recapture is not considered passive income when computing the 90% [passive entity] test." *See* Tex. Policy Ltr. Rul. No. 201007720L (7/21/2010) and *Franchise Tax Frequently Asked Questions – Passive Entities* (02/01/2013), at question 7 (also available at http://www.window.state.tx.us/taxinfo/franchise/faq_pass_ent.html, as accessed on 10/07/2014).

But, as discussed below, not all depreciation recapture – specifically that under IRC § 1250 – is ordinary income for federal tax purposes. Thus, the Comptroller's guidance is potentially misleading, or at least confusing, and may cause some Texas taxpayers to overstate their franchise tax liabilities.

II. Not all Section 1250 depreciation recapture is ordinary income.

A taxpayer selling property for a gain may be required to "recapture" prior depreciation deductions taken with respect to the property. *See generally*, IRC §§ 1245, 1250 or 1254. Such recaptured depreciation is generally, but not always, taxed as ordinary income rather than capital gain. This discussion focuses on depreciation recapture under § 1250.

At the risk of oversimplifying, "Section 1250 property" – i.e., property to which Section 1250 applies –includes real property such as buildings and their structural components, improvements to land (such as a pipeline), and intangible real property (such as a leasehold).[1]

Until 1986, taxpayers could deduct accelerated depreciation (i.e., depreciation in excess of straight-line depreciation) with respect to certain Section 1250 property. For Section 1250

[1] The technical definition of "Section 1250 property" is "any real property (other than section 1245 property, as defined in section 1245(a)(3)) which is or has been property of a character subject to the allowance for depreciation provided in section 167." IRC § 1250(c).

property acquired after 1986, taxpayers are generally limited to straight-line depreciation for real property, including Section 1250 property.

When Section 1250 property is sold for a gain, a taxpayer is required to recapture some or all of the depreciation deductions taken with respect to the property. With respect to non-corporate taxpayers, any depreciation in excess of straight-line depreciation is treated as ordinary income up to the total amount of the gain. Any remaining gain will be treated as "25% capital gains" up to the amount of the depreciation that was or would have been allowed under the straight-line method. *See* IRC § 1(h)(6), – referring to such gains as "unrecaptured Section 1250 gain." Any additional gain above the "unrecaptured Section 1250 gain" is regular capital gains.

Consider the following simple example. Partnership A, having only individuals as partners, purchased Section 1250 property in 1985 for $1,000. The property had a useful life of 20 years, so straight-line depreciation was $50 per year. Partnership A was entitled to, and took, accelerated depreciation of $55 per year for the first five years and then took $50 of depreciation every year thereafter until the property was fully depreciated – i.e., a total of $25 of depreciation in excess of straight-line.[2] Taxpayer sold the property in 2005 for $700, realizing a $700 gain (because the property had been fully depreciated).

Although the entire gain in this example represents recapture of prior depreciation, only $25 is ordinary income under § 1250. The remaining $675 is "unrecaptured Section 1250 gain" that is taxed at 25% capital gains rates. For franchise tax purposes, the $25 of ordinary income is "active income," but the $675 of 25% capital gain should constitute passive income.

III. The Comptroller should reissue its franchise tax guidance and clarify that "unrecaptured Section 1250" gain should be treated as passive income.

The Comptroller's franchise tax guidance does not expressly address "unrecaptured section 1250 gain," but the guidance appears to characterize all depreciation recapture under Section 1250 as ordinary income. This is misleading and inconsistent with federal tax treatment of "unrecaptured Section 1250 gain," which is capital gain. The Comptroller should clarify its guidance accordingly.

Pursuant to recent conversations the author has had with personnel within the Comptroller's office, clarified guidance may be forthcoming. But even in the absence of new guidance, taxpayers should carefully consider whether they can treat unrecaptured Section 1250 gain as passive income for the passive entity test.

Any questions or comments about this article can be addressed to Brent C. Gardner at bgardner@gardere.com or (214) 999-4585.

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[2] This example is illustrative, but may not be technically consistent with the depreciation deductions that would actually have available for such property (for example, costs of real estate may typically be recovered over periods exceeding 20 years).

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THE TOP TWENTY-FIVE INSURANCE PLANNING MISTAKES AND HOW TO AVOID OR AT LEAST FIX THEM

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TEXAS TAX LAWYER - FALL 2014

THE TOP TWENTY-FIVE INSURANCE PLANNING MISTAKES AND HOW TO AVOID OR AT LEAST FIX THEM

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THE TOP TWENTY-FIVE INSURANCE PLANNING MISTAKES AND HOW TO AVOID OR AT LEAST FIX THEM

1. Creating Problems in the policy application.

A) Failure to properly plan for a successor owner of the policy, where the policy owner is an individual other than the insured.

If the owner of a policy is an individual other than the insured and there is no designated individual or entity as the successor owner, at the policy owner's death (before the insured), ownership of the policy passes under the default terms of the policy – usually to the <u>owner's</u> probate estate. Therefore, some level of probate proceedings (depending on the value of the policy and the owner's state of residence) would be required to transfer ownership of the policy to the successor owner under the owner's Will (or the intestacy laws of his or her state of domicile). In addition, the owner's legatee may not be someone the insured would want to own the policy on his or her life.

If under the policy owner's Will or applicable intestacy laws, the policy were to go to the insured, assuming he or she wished to give it away to keep the proceeds out of his or her estate for estate tax purposes, the transfer would be subject to the Section 2035 three-year rule, meaning the death proceeds would be includible in his or her estate, if he or she died within three years of the transfer. If the owner of the policy became to a trust for the insured, he or she could not safely be the trustee, since that would give the insured fiduciary incidents of ownership in the policy.[1/] Potentially, a power of appointment granted to the insured over the

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1/ Treas. Reg. §20.2042-1(c)(4); see Rev. Rul. 72-261, 1972-2 C.B. 276, revoked by Rev. Rul. 84-179, 1984-2 C.B. 195.

trust could create a risk of inclusion of the policy proceeds in the insured's estate under Section 2042, as well.

Finally, if the insured (not the owner's estate) is the default owner of the policy and if no alternate successor owner has been designated, then upon the insured's death prior to the death of the owner, there may be a risk that the insured would be treated as having a reversion in the policy, causing the proceeds to be included in his or her estate for estate tax purposes.[2/]

B) Naming an individual as the beneficiary of a policy, with no successor individual or trust beneficiary named.

Similarly, where an individual is named the beneficiary of the policy, with no successor individual, trust or other entity as the contingent beneficiary, and the named beneficiary predeceases the insured, the policy death proceeds will be payable in accordance with the default terms of the policy, usually to the estate of the insured. This problem can be solved by providing for a successor beneficiary in the policy application or by naming one after the primary beneficiary's death.

If this is the only asset of the insured, the omission of a successor beneficiary will necessitate opening a probate estate for the policy proceeds, and in any event, will expose the proceeds to claims of creditors and the delay and expense of probate.

[2/] I.R.C. §2042.

C) Naming a minor child (or any other incapacitated person) as the beneficiary of a policy.

If a minor is designated directly as a beneficiary of a policy, then any proceeds payable to that minor upon the insured's death would be required to be held in a court supervised guardianship or custodianship. Not only is this cumbersome and expensive, but guardianships and custodianships must terminate when the beneficiary reaches age 18 or, at best, age 21.

Accordingly, the insured's estate plan should contain provisions to create trusts for the minor, and the beneficiary designation should name the appropriate entity created (or to be created) under the insured's estate plan.

D) Naming multiple individual (such as the insured's children) as the owners of a life insurance policy.

With multiple individual owners, there is a risk that a gift of the policy to them, as a group, or direct payment of premiums by the insured to the insurer, won't qualify for the gift tax annual exclusion,[3] and problems will arise if one owner dies, divorces, goes bankrupt, or becomes incompetent before the insured's death or one owner merely decides not to contribute his or her share of the premium.

As an alternative, consider the creation of a partnership or LLC to own the policy; all of those issues can be dealt with in the partnership or LLC operating agreement.

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3 See Skouras v. Commissioner, 14 T.C. 523 (1950).

Note, however, the possibility of creating valuation discounts for interests in a policy which are gifted to multiple owners, based on the inability of any one owner to unilaterally exercise incidents of ownership in the policy.

E) Not naming an insurance trust which owns a policy as the revocable beneficiary.

The trustee of an ILIT owes a fiduciary duty to the beneficiaries to assure that the trust is both the owner <u>and</u> the beneficiary of its policy; if it weren't, could the <u>Goodman</u> case issue, discussed below, treat payment of the death proceeds as a gift by the trust beneficiaries?

2. The three-corner life insurance policy – a different owner, insured, and beneficiary – the <u>Goodman</u> problem.

In personal insurance planning, any time an insurance policy has three parties involved as owner, insured and beneficiary, there is a potential for an inadvertent gift by the policy owner of the entire policy proceeds at the insured's death.

In a typical situation, a husband might be the insured, his wife the owner, and their children the policy beneficiaries. Under the holding of the <u>Goodman</u> case,[4/] at the insured's death, in this situation, the wife would be considered to have made a gift of the entire policy death proceeds to the children – obviously an unanticipated and undesirable result. If the beneficiary were a trust in which the wife had an interest, the gift would be the actuarial value of the remainder, assuming the wife's retained interest was a "qualified interest" under Section

4/ <u>Goodman v. Commissioner</u>, 156 F.2d 218 (2nd Cir. 1946).

2702 of the Code; otherwise it would be a gift of the entire proceeds.[5/] If the beneficiary were a skip person from the wife's point of view, or a trust for skip persons, the wife would also have made a generation-skipping transfer at the insured's death.

The problem can be solved by being sure that if the policy owner is not the insured, the policy owner is always the policy beneficiary.

3. Creating phantom income by surrendering a policy (or letting a policy lapse) which was subject to an outstanding loan.

Any amount received in a single sum under a life insurance contract on its complete surrender, redemption, lapse, or maturity is includible in the gross income of the policy owner, as ordinary income[6] to the extent that that amount exceeds his or her "investment in the contract,[7/] a basis-like concept. Investment in the contract is the aggregate amount of premiums or other consideration paid for the contract, less any amount received under the contract, to the extent that amount was excludable from gross income (such as dividends received on a participating policy, so long as they don't exceed basis).[8/]

Accordingly, investment in the contract will be aggregate premiums paid by the taxpayer, reduced by any dividends, unrepaid loans, accumulated interest on loans, and any other

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5/ If she had a power of appointment over the trust, her gift would be incomplete, but a portion of the trust would be includible in her estate for estate tax purposes, under Section 2038.

6/ For the reasons discussed below.

7/ I.R.C. §72(e)(5)(a) and (3); Treas. Reg. §1.72-11(d)(1).

8/ I.R.C. §72(c)(1), 72(e)(6). Note that, unlike basis in a policy, there is no reduction in the investment in the policy for the cost of insurance protection provided under the policy (because it has already been deducted from cash surrender value); see Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, discussed below, dealing with basis in a policy sold in a life settlement transaction and requiring reducing that basis by the cost of insurance.

amounts received under the contract, such as withdrawals, which were not previously includible in gross income.[9/] If dividends are received in cash or are used to reduce premiums, they will reduce the investment in the contract; presumably, dividends used to purchase term riders will also reduce investment in the contract, but dividends used to purchase paid-up additions will not (since they will be retained inside the policy and its cash value). Any part of the premiums attributable to other benefits, such as a disability income benefit, also reduces investment in the contract.

The common mistake in surrendering a policy (or letting a policy lapse) is not taking account the effect of an outstanding policy loan on the taxation of the surrender or lapse. Under Regulation Section 1.1001-2(a), the amount realized from a sale or other disposition of property (including a life insurance policy) includes the amount of any nonrecourse liabilities from which the transferor is discharged (such as the policy loan) as a result of the sale or disposition. Accordingly, any policy loan will be a part of the consideration received by the taxpayer on a policy surrender or lapse, generating ordinary income[10/] – without generating any cash in the case of a lapse, or potentially not enough cash to pay the tax in the case of a surrender.

9/ Note the different issues raised on a sale of a policy, where, as discussed below, basis – not investment in the contract – is the relevant concept, under Rev. Rul. 2009-13, above.

10/ See the discussion regarding the capital gain treatment of a policy sale under Rev. Rul. 2009-13, above, and the possible application of Section 1234A to a policy lapse or surrender, discussed below.

See Barr v. CIR, T.C. Memo 2009-250, involving a surrender of a policy subject to a loan in which the Tax Court rejected the taxpayer's argument that gain on surrender should be capital. See also Reinert v. CIR, 2008-163 T.C. Summary Opinion, holding that gain on cancellation of a policy was ordinary.

But note Hunt v. CIR, a Tax Court Case which was settled, without an opinion, on the basis that gain on the lapse of a policy subject to a loan was capital under Section 1234A, discussed below.

4. Exchanging a policy under Section 1035, which is subject to a loan, for a new policy, not subject to a loan in the same amount.

Under Code Section 1035 and Regulation Section 1.1035-1, a life insurance policy can be exchanged for another policy without recognition of gain or loss, if the policies exchanged "relate to the same insured." If a policy with a loan on it is exchanged for another policy, the amount of the loan on the first policy which is discharged in the transaction will be treated as "boot," money or other property received in the exchange generating taxable income in an otherwise non-taxable exchange without generating any cash to pay the tax.[11/]

To avoid recognition of the gain in such a situation, the new policy has to be issued with a loan equal to the loan on the policy exchanged;[12/] alternatively, of course, the loan on the first policy could be repaid before the exchange.

5. Loans against or withdrawals from a modified endowment contract (a "MEC"), or using such a policy as collateral for a third party loan.

A modified endowment policy is any insurance policy issued after June 21, 1988, under which the cumulative premium payments in any of the first seven years exceeds the sum of net level premiums which would be have been paid to provide a paid-up policy after the payment of seven level annual premiums (the so-called seven pay test).[13/]

Distributions from modified endowment contracts are subject to the same rules as distributions from deferred annuity contracts – income rather than return of premiums comes out

11/ Treas. Reg. §1.1035-1, referring to Treas. Reg. §1.1031(b)-1(c) for the taxation of "boot" received in an otherwise tax-free exchange.

12/ PLRs 860433 and 8816015.

13/ I.R.C. §7702A. Once a policy becomes a MEC, no modification or exchange to another policy can change that result.

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first as a result of any withdrawal or distribution.[14/] In addition, loans against the cash value of a modified endowment contract are treated as distributions for this purpose.

Finally, there is a 10% penalty tax on any withdrawal from or loan against a MEC if the "taxpayer" – not necessarily the insured – is under 59-1/2. It is unclear as to who the taxpayer is in the case of a trust owned policy; if it is a grantor trust, presumably the taxpayer is the grantor (there isn't any direct authority for that, but it is the practice of carriers when issuing 1099s).

The use of a Modified Endowment Contract as collateral for a third party loan is, under the Conference Report to TAMRA 1988, treated as a loan against or withdrawal from the Modified Endowment Contract - to avoid an end-run around the policy loan or withdrawal provisions of Section 7702A, by merely using the policy as collateral for that third party loan.[15]

Accordingly, any time lifetime loans or withdrawals or using the policy as collateral for a loan are contemplated, or just to preserve flexibility to do so on an income tax-free basis, the policy should be designed to avoid MEC treatment.

14/ I.R.C. §72(e)(10).

15 Whether or not entering into a collateral assignment split-dollar arrangement with a Modified Endowment Contract and pledging it as collateral for the split-dollar advances would be treated as using the policy as collateral for a third party loan is not clear, but it appears that collateral assignment split-dollar is a different economic transaction, since no cash is received by the "borrower" at the time of the transaction.

Accordingly, many commentators feel that collateral assignment split-dollar should not be treated as a loan against or withdrawal from a Modified Endowment Contract (although there is no authority for either position). In any event, using the unsecured documentation method (where the policy is not assigned as collateral for the advances) should avoid this issue.

6. Borrowing against a policy in excess of the owner's income tax basis and then transferring the policy subject to the loan as a gift to a new owner.

In many cases, when an existing policy is to be transferred to a new owner, the insured will borrow against the policy to reduce its gift tax value on the subsequent transfer. Loans against policy cash values are normally income tax-free, even if in excess of basis, since they are not distributions under Section 72(e), so long as the policy isn't a MEC (as discussed above).

However, if the loan exceeds the insured's income tax basis in the policy[16/] – the transfer will be treated as a sale, with the loan proceeds treated as the amount realized.[17/] That will have two adverse income tax effects – there will be gain to report on the transfer, and, perhaps more importantly, the transfer will be subject to the transfer for value rules (discussed below) at the insured's death (since the normal exception for gift transfers from those rules – the carryover basis exception – will not be applicable, unless, as noted below, the transfer is to a grantor trust), or the transferee is otherwise exempt from the transfer fro value rule, as a "proper party" (as also discussed below). As an alternative, in a universal-type policy, the insured could withdraw from the policy, tax-free, up to investment in the contract,[18] to reduce the value of the policy prior to the gift, with no such concerns.

16/ Presumably, basis in a policy for purposes of determining gain on a withdrawal is not reduced by the cost of insurance protection under Rev. Rul. 2009-13, above, because the amount which can be withdrawn is based on cash surrender value, which has been reduced by the cost of insurance. Alternatively, perhaps it is investment in the contract under Section 72, rather than basis, which is relevant in this situation.

17/ Rev. Rul. 69-187, 1969-1 C.B. 45.

18 IRC §72(e)(5).

Finally, if the gift were to a grantor trust, any gain on the transfer would go unrecognized for income tax purposes,[19/] and, because of that, the carryover basis exception to the transfer for value rule would apply.[20/]

7. Surrendering a policy for its cash value without checking the life settlement market.

A policy owner who or which no longer wishes to continue a policy traditionally had one choice – to surrender the policy to the insurance carrier for the cash surrender value since there was only one buyer – the insurer – which offered only one standard price.

However, the advent of the life settlement market[21] has meant that, at least for older insureds (probably age 70 and above), with relatively large policies, where the insured's health has declined since he or she took out the policy, a life settlement company may be willing to pay more than the policy's cash surrender value to acquire the policy during the insured's lifetime.[22/]

Accordingly, advisors need to be careful that their older, less healthy clients don't inadvertently surrender a policy which is no longer needed without checking the availability of a life settlement, assuming the insured is comfortable with a third party owning a policy on his or

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19/ Rev. Rul. 85-13, 1985-1 C.B. 184.

20/ Section 101(a)(2)(B). In addition, the transfer would be treated as an exempt transfer to the insured under the transfer for value rule. See Rev. Rul. 2007-13, 2007-1 C.B. 684.

21 Which grew out of the viatical settlement market for terminally or chronically ill insureds.

22/ The policy may be worth more to a life settlement company than to the insurance carrier because the life settlement company will be able to get updated medical information about the insured in order to evaluate the policy, and to obtain a life expectancy study, estimating the insured's likely expectancy, while the insurance carrier won't.

her life,[23] the risk of a death shortly after the sale, and the fact that the sold policy will "count" against his or her ability to acquire additional insurance – this is sometimes referred to as a sale of future insurability.

8. Calculating the amount and character of the gain on a policy sale in the settlement market.

A life insurance policy is a capital asset (since it is not expressly excluded from the Section 1221 definition of a capital asset). As noted above, if a policy is cancelled or surrendered to the insurance carrier in exchange for cash surrender value, any gain on the policy is ordinary income, despite the fact that the policy is a capital asset, because the transaction does not qualify as a "sale or exchange" of the policy.[24/]

However, if the policy is sold in the life settlement market (and perhaps in other sale transactions), since it is a capital asset and since the sale would qualify as a sale or exchange, any gain on the sale, in excess of basis, should be capital. Note, however, that based on the substitution of income theory of cases such as CIR v. P.G. Lake, Inc. [25/], gain above basis up to the policy's cash surrender value at the time of the sale is ordinary, since it is, in effect, a

23/ Arguably, not an irrational concern.

24/ But note the argument that Section 1234A (which eliminates the sale or exchange requirement for cancellation of a right relating to a capital asset to get capital gain treatment) applies to a policy surrender, (which is a cancellation of a right with respect to capital gain property) and would arguably eliminate the requirement for a sale or exchange to support capital gain treatment.

Rev. Rul. 2009-13, above, without citing any authority, said it did not apply; see also TAM 200452033, to the same effect. Note again, the settlement reached in Hunt v. Cir., described above.

25/ 356 U.S. 260 (1958).

payment in lieu of interest earned on policy cash values.[26] Accordingly, under Rev. Rul. 2009-13, above, gain on a sale of a policy in the life settlement market over basis up to cash value is ordinary income and any gain over cash value is capital. [27/]

In Rev. Rul. 2009-13, above, the IRS also – controversially – held that in a policy sale in the life settlement market, [28/] basis (as opposed to investment in the contract, discussed above) was reduced by the cost of insurance protection provided to the insured (without guidance on how to measure it). [29/]

26/ Rev. Rul. 2009-13, above. Query as to the effect of the policy sold being a variable policy – there, any gain is not attributable to interest but to capital value increases – should that produce a different result?

27/ It had been widely assumed that basis was premiums paid minus non-taxable dividends (in participating whole life policies). In PLR 9443020, the IRS took the position, without citing any authority, that basis was also reduced by the "value" of the death benefit provided; but see Gallun v. CIR, in which the court calculated basis on a policy sale without any such reduction. In the PLR, the IRS assumed that, absent other proof, the value of the death benefit was measured by the difference between premiums paid and cash surrender value – that difference, of course, is made up of more than just the cost of insurance.

28/ Query as to whether the basis reduction rule of Rev. Rul. 2009-13 applies to sales or deemed sales outside the life settlement market – such as intra-family sales or sales to trusts – or to deemed sales of policies purchased by a grantor trust when grantor trust status terminates (if the trust has any outstanding liabilities) – or to withdrawals in excess of basis – or to loans in excess of basis where the policy is thereafter transferred. See PLR 200945032, extending the reduction of basis by cost of insurance rule to policies surrendered (not sold) at a loss.

29/ See Section 7702(g)(1)(D), for one possible statutory definition of that cost – the lesser of the Table 1 cost (determined under the group term Table, Treas. Reg. §1.79-(3)(d)(2)) or the mortality charge stated in the contract; in whole life policies, that charge is not separately stated (and may be hard to obtain).

9. A transfer of a new life insurance policy to an irrevocable insurance trust or other third party owner after its acquisition by the insured – the Section 2035 three year transfer rule.

Under the present version of Section 2035 (the "three-year transfer" rule), if the insured has transferred as a gift any interest in a policy to a third party owner (such as a trust) within three years of his or her death, then even if he or she no longer holds any incident of ownership in the policy, the policy proceeds will be included in the insured's estate for estate tax purposes.[30/] Even momentary ownership of a policy by the insured transferred by gift within three years of his or her death will require inclusion of the full policy proceeds in his or her estate for estate tax purposes.

The only safe way to avoid this rule is to be sure that the insured never owned incidents of ownership in the policy on his or her life – even for an instant, – by having the desired third party owner be the initial applicant and owner of the policy (even if done with the insured's gifted funds).

10. Techniques to attempt to avoid the Section 2035 three-year transfer rule – such as the "oral trust," the "disappearing" application, and a full value sale to a grantor trust.

As noted above, the safest way to avoid the three-year transfer rule is being sure that the initial applicant and owner of the policy is the intended third party owner. Whether any techniques short of having the third party as the original applicant and owner of the policy would work isn't clear.

30/ IRC §2035.

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One sometimes suggested technique is to have the insured create a state law valid oral trust as the initial owner and applicant, which would later be memorialized. The issues raised by this technique are that the trust may not be valid under state law and/or that the trust was not truly irrevocable as long as it was merely oral.

Another suggested technique is to issue the policy to, for example, a child or the spouse of the insured, and have him or her gift it to the intended third party owner. This will obviously involve a gift from the donee to the trust, might be ignored under the step transaction[31/] doctrine , and if the third party is a trust in which he or she has an interest, at least some portion of the trust will be included in his or her estate for estate tax purposes.[32/]

Another suggestion is applying for insurance in the name of the insured as owner, and once the trust is created, "withdrawing" the first application and "replacing" it with an application showing the trust as owner. So long as the first application was not accompanied by consideration, it would not have created a binding contract under state law and, therefore, should not be treated as giving the insured any incident of ownership in the policy.[33/] If it had been accompanied by consideration, the insurer would have been on the risk, the insured would have had an ownership interest in the policy and the three-year rule of Section 2035 will apply.

Any such "tricks" should never be planned for; they should only be used as a last resort in the event that, for some valid reason, the intended third party owner cannot be the initial applicant and owner of the policy.

31/ One way to help avoid the step transaction argument might be to have the insured sell the policy to the spouse, income tax free under Section 1041, who then, without any pre-arrangement, gifted it to the trust.

32/ See Stavroudis v. CIR, 27 T.C. 583 (1956).

33/ See TAM 933002.

If a policy in which the insured held an incident of ownership is to be transferred to a third party owner, the safest technique to consider to avoid the Section 2035 three year transfer rule may be a full value sale of the policy by the insured to an insurance trust which is a grantor trust for income tax purposes. The full value sale would be exempt from the Section 2035 three year rule[34/] and the sale to a grantor trust would be ignored for income tax purposes[35/] and, therefore, would be exempt from the transfer for value rule under the carryover basis exception, or as a transfer to "the insured," or as a non-transfer, since the sale wasn't recognized for income tax purposes.[36/] Of course, any such sale would have to have economic substance – a gift of the purchase price, which was returned to the donor/seller would likely not be respected for this purpose.

34/ I.R.C. §2035(d), which exempts sales for full and adequate consideration from the scope of Section 2035.

Note the issue of what the policy's value is in this context – its gift tax value under the Section 2512 Regulations, or the amount needed to replace the value of the policy in the insured's estate for estate tax purposes under Section 2035?

Compare TAM 8806004 (dealing with a single life policy and holding the value required was the amount needed to replace the amount includable in the insured's estate for estate tax purposes) with PLR 9413045 (dealing with a survivorship policy, and holding it was the gift tax value, if the insureds weren't "near death"); that difference may be explainable because Section 2035 would not apply in the second situation at the first death (since Section 2035 won't apply unless Section 2042 would).

<u>Query</u> as to the application of the holding of the TAM to a sale by the insured to a life settlement company within three years of death – would the life settlement sale price qualify as full and adequate consideration for this purpose? If not, Section 2035 would include the policy proceeds – received by the settlement company – in the insured's estate for estate tax purposes.

35/ Rev. Rul. 85-13, above.

36/ I.R.C. §101(a)(2)(A). See Rev. Rul. 2007-13, above.

11. Transferring a policy from the insured to a third-party owner (such as an ILIT) without obtaining the policy's gift tax value from the carrier, in advance.

Under the Section 2512 Regulations,[37] the gift tax value of a policy transferred during the insured's lifetime is determined by its "replacement" cost, the cost of a "comparable policy". However, the Regulations recognize that for a policy that has been in force for sometime (an undefined term) on which future premiums are due, obtaining the cost of a comparable policy would be difficult; accordingly, the Regulations provide that, in this situation, the cost of a comparable policy <u>may</u> be (not <u>must</u> be)[38] approximated by the so-called interpolated terminal reserve formula – the policy's interpolated terminated reserve plus any prepaid premiums.[39]

While technically only traditional whole life policies allow for the calculation of an interpolated terminal reserve (because only they have stated cash values which increase at stated rates and fixed premiums), the ITR formula is used by carriers in reporting the gift tax values of policies transferred during the insured's lifetime, on a Form 712, for universal and variable policies (which don't have fixed premiums or stated cash values which increase at stated rates).

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37 Reg. Sec. 25.2512-6.

38 Accordingly, in an appropriate case, consideration should be given to obtaining an appraisal to determine a policy's fair market value, based on a willing buyer/willing seller analysis.

39 Policy loans are deducted from that result; surprisingly, the Regulations don't provide for that deduction, but Form 712 contains a line showing the deduction of policy loans from the ITR value.

Historically, carriers reported a policy's ITR value as its gift tax value on a Form 712, when requested to do so. More recently, some carriers have begun to report a series of possible values for a policy transferred during the insured's lifetime, including the policy's cash or accumulation value, its cash surrender value, its interpolated terminal reserve value and its PERC value (a calculation required for transfers of policies in some income tax situations by the 2005 regulations issued under Section 83).[40] Most carriers have determined that a policy's "fair market value" is a legal issue to be determined by counsel for the policy owner and its only role is to provide the range of values for counsel.

The warning here is that the fair market value of a policy for gift tax purposes may be significantly higher than its cash surrender value – for example, a no-lapse guarantee universal life policy may literally have a zero cash surrender value but a very large ITR value[41] – and the only way to know what the policy's potential gift tax value is to request a Form 712 from the issuing carrier, <u>before</u> the policy is transferred.[42]

12. Transferring a policy during the insured's lifetime without considering the transfer for value rule and its exceptions.

Under Section 101(a), the general rule is that life insurance proceeds received "by reason of death of the insured" are excluded from the beneficiary's gross income (even if the policy is a MEC).

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40 They don't, of course, report a policy's possible life settlement value (since they won't know it), but that value may be the best measure of its fair market value.

41 As is true with many level term policies.

42 It may be possible to discuss the issuance of the Form 712 in advance with the carrier's legal department, since there are several possible reserves which can be used to value a policy, and the effect of a withdrawal or a loan prior to the transfer on the reserve value could be discussed.

There is, however, an exception to that general rule for transfers of the policy for value during the insured's lifetime. If a policy is transferred for value during the insured's lifetime, unless one of the exceptions to the transfer for value rule (described below) applies, the only portion of the death proceed which will be excludable from the beneficiary's gross income are equal to the amount paid by the transferee for the policy plus any future premiums paid by the transferee. The "value" for a transfer which might subject it to the transfer for value rule need not be a cash payment – the mutuality of a contractual agreement to transfer the policy has been held to be enough to support the application for the transfer for value rule.[43]

Fortunately, there are a number of helpful exceptions to the transfer for value rule applicable in an estate planning context.[44] Those exceptions include transfers to one of the four "proper party" transferees:

1. A transfer to the insured (including, for this purpose, a transfer to a trust which is a wholly grantor trust from the point of the insured);[45/]

2. A transfer to a partner of the insured;

3. A transfer to a partnership in which the insured is a partner (including for this purpose an LLC taxed as a partnership); and

4. A transfer to a corporation in which the insured is an officer or a shareholder.

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43 See, e.g., Monroe v. Patterson, 197 F. Supp. 146 (N.D. Ala. 1961) and Ltr. Rul. 7734048.

44 I.R.C. §101(a)(2).

45/ See Rev. Rul. 2007-13, above.

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In addition, a transfer in which the transferee's basis is determined, in whole or in part, by the transferor's basis (including, for this purpose a transfer to the insured's spouse, or former spouse, if incident to a divorce), is also exempt from the rule.[46]

The warning here is that, any time a policy is transferred during the insured's lifetime, caution must be exercised to consider whether the transfer for value rule might apply to the transfer, and if so, whether one of the exceptions to its application would be available.

13. Post-Final Regulation loan regime split-dollar arrangements which are treated as term loans, especially those involving gift term loans.

Under the Final Split-Dollar Regulations, other than donor/donee or employer/employee non-equity split-dollar arrangements, collateral assignment arrangements (where the policy is not owned by the premium provider) must be treated under the loan regime, governed by Section 7872, rather than the economic benefit regime, governed by Section 61.[47]

Under Section 7872, both the determination as to which applicable Federal rate must be used and, more importantly, when the interest imputed under the arrangement is treated as received by the lender, is determined by whether the loan is classified as a demand loan, a term loan, or a hybrid loan. Under a demand loan, the interest rate is based on the short term AFR, and is treated as received on an annual basis. Under a hybrid loan, the interest rate is determined based on the term of the loan, but the interest is treated as received on an annual basis.[48/] Importantly, in a term loan, the interest rate is based on the term of the loan, but all of the interest during the expected term of the loan, discounted back to present value, is treated as

46 I.R.C. §1041(b)(2).

47 Reg Sec. 1.61-22(b)(3).

48/ But only for income tax, not gift tax, purposes.

received in the year the loan is entered into (bunching all of that income in the first year of the transaction).

If a term loan has gift tax consequences, because, for instance, it is between an employer and an employee's trust or is between a donor and his or her trust, the same bunching rule applies for gift tax purposes (as well as generation-skipping tax purposes, if applicable).

14. Related party premium financing arrangements which violate provisions of the Final Split-Dollar Regulations.

Under the Final Split-Dollar Regulations, a premium financing transaction (a loan with interest paid or accrued at the AFR) will meet the very broad definition of a "split-dollar arrangement," because it is a transaction in which one party advances money to a second party to acquire a life insurance policy, and the loan is either repayable out of the policy cash value or its death proceeds (or both) or is secured by the policy.[49]

There are a number of provisions of the final Split-Dollar Regulations which, when applied to premium financing transactions between related parties, can pose special problems.

In the first place, if the arrangement is "non-recourse" (an undefined term in the Regulations), unless each of the parties to the premium financing transaction attaches to his, her, or its income tax return in each year a loan is made under the arrangement, a statement that a "reasonable person" would expect the loan to be repaid, the loan is treated as if it provided for

[49] Reg. Sec. 1.61-22(b).

contingent interest, meaning that merely paying or accruing the applicable Federal rate will not avoid the application of Section 7872 to a portion of the loan.[50]

Secondly, if the lender were to ever forgive any interest due on the loan, that forgiveness would be treated as income or a gift (depending on the relationship of the parties), plus, unless the statement described above is filed, there would be a penalty equal to three percentage points over the interest rate provided for underpayments of Federal tax.

Next, if the lender is "to pay" the borrower the interest due under the loan, then, despite the borrower's actual payment of interest to the lender, the loan is treated as if it were a Section 7872 loan.[51/] There is no formal definition of the phrase "to pay", so that any time there is an arrangement (explicit or implicit) that the lender will provide the borrower with funds to pay the interest, that provision would apply. As an example, in a donor/donee premium financing arrangement that required the payment of interest on an annual basis, the donor's annual gift of the amount of the interest to the donee would presumably qualify as a "to pay" transaction.[52/]

Finally, the Regulations provide strict "ordering" rules for the application of loan repayments – they must be repaid in the order they were made.

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50 There are two unrelated benefits to filing those statements – the Regulations provide such a loan will be respected for tax purposes (even if it wouldn't otherwise be respected under general tax principles, because, for instance, the policy cash value is less than the amount loaned in the early years) and the penalty described below would not apply if the interest charged were less than the appropriate AFR.

51/ It's unclear what the effect of this provision is – do we ignore the actual payment of interest and treat this as a Section 7872 transaction, or is the payment recognized and then Section 7872 applied as well?

52/ How "un-related" the gifts and the interest payments have to be to avoid this rule isn't clear.

15. Large premium financing arrangements using a variable policy as collateral, potentially violating Federal Reserve Regulation U.

A variable life policy is, by definition, a security for Federal securities law purposes (since the funds underlying the policy are securities). Accordingly, a premium financing transaction involving a minimum of $200,000 in any one loan or $500,000 in cumulative loans to finance a variable policy will be a margin loan, subject to Regulation U, if (but apparently only if) the policy is used as collateral for the loan.[53/]

The practical effect of the margin loan rules applying to such a transaction would be to limit the amount that could be loaned to the margin rules of 50% of the value of security acquired with the loan (presumably based upon the policy's cash surrender value). Accordingly, premium financing with a variable policy will not generally be economically effective if the policy must be pledged as collateral.[54/]

16. Not restricting a collateral assignment of a policy taken back by the insured (or one of the insureds) who advances money to pay policy premiums under a private premium financing or split-dollar arrangement.

An insured (or one of the insureds in a survivorship policy) may advance money to a third party owner (like a trust) to pay premiums on a policy on his or her life, under a private split-dollar or private premium financing arrangement. Usually, he or she will take back the policy as security for those advances, under a collateral assignment document.

53/ Staff Opinion T-917.191 (1985).

54/ In private premium financing transactions, not securing the loan with the policy (an unsecured arrangement) would appear to avoid the issue. Query as to taking a security interest only in the death benefit (not the cash value) of a variable policy.

If the standard American Bankers form is used, the insured will have extremely broad rights in the policy under that assignment, which will constitute incidents of ownership in the policy for Section 2042 purposes.[55/]

Use of either a "restricted" assignment form (in which the lender's only right is to be repaid its advances at the end of the term of the loan) or not taking back the policy as security (an "unsecured arrangement") will avoid the issue.

17. Terminating a private pre-Final Regulation split-dollar arrangement without considering the risk that any policy equity on termination would be a transfer for transfer tax purposes.

A private pre-Final Regulation split-dollar arrangement which hasn't been "materially modified" (as discussed below) after the effective date of the Regulations, is governed by Notice 2002-8.[56]

Under Notice 2002-8, so long as the arrangement is in effect and the parties are reporting or paying the economic benefit costs, there will be no other transfer tax consequences of the arrangement, even if policy values owned by the policy owner exceed the donor's advances. However, under that Notice, by negative inference, on termination of the arrangement during the insured's life, the IRS will take the position that any such policy equity was a gift by the donor to the owner, subject to the Notice's so-called "no inference" provision. Under that provision, the IRS will not be able to assert those policy values were transferred for transfer tax purposes based on the Notice or the Proposed or Final Split-Dollar Regulations. It, however,

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55/ Presumably, giving up these rights would be subject to the Section 2035 three year rule.

56/ 2002-1 C.B. 398.

isn't clear that the IRS wouldn't attempt to do so under prior law;[57] accordingly, any such termination has to take that possibility into account.[58/]

18. Entering into a post-Final Regulation private split-dollar arrangement or a premium financing arrangement for a single life policy without checking the other as an alternative, or, in either case, without having an exit strategy.

Whether premium financing (a loan with interest, either paid or accrued at the applicable Federal rate) or a split-dollar arrangement using the economic benefit regime makes the most sense in a given post-Final Regulation private premium funding transaction depends upon whether the policy is a single life or a survivorship policy, and, if it is a single life policy, both the age of the insured and the relative level of interest rates.

In general, for survivorship policies, private, non-equity split-dollar arrangements using the economic benefit regime will continue to make sense, because the extremely low economic benefit for survivorship policies (at least while both insureds are alive).[59]

With a single life policy (or a survivorship policy after the first death), private premium financing may make more sense if the insured is older, if interest rates are relatively low, and if the insurance carrier does not have alternative term rates which qualify to be used in lieu of the Table 2001 rates. Such a loan may make even more sense if all (or a substantial

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57 Best practices would indicate making full disclosure of the termination on any applicable income and/or gift tax returns(s) to start the respective statute(s) of limitations and avoid any potential penalties.

58/ What if the policy value on termination were <u>less than</u> what was owed the premium provider; is there any forgiveness of indebtedness issue?

59 Although there is a gift involved (even though small, unless the economic benefit is contributed); however, in an AFR interest-accrued private premium financing arrangement, there is no gift at all.

portion) of the premiums can be loaned to the owner at the outset, to lock in the interest rate for the term of the loan (perhaps even if the lender has to borrow from a third party to lend those premiums). The amount loaned can create the side fund, out of which premiums are paid as due.

In either case, entering into such an arrangement without an effective exit strategy to unwind the arrangement during the insured's lifetime is problematic. Over time, economic benefits continue to increase as the insured ages; in a survivorship policy, at the first death, the attractive term rates are no longer available; and a loan arrangements get increasingly expensive as more premiums are advanced and more interest is due on those advances (especially if interest is accrued). In any such case, the longer the arrangement continues, the smaller the death benefit which will remain payable to the policy beneficiary, unless the policy death beneficiary can be planned to increase to track the advances or loans (perhaps including accrued interest).[60]

Exit strategy planning contemplates creating a side fund to be owned by the policy owner, which can, over time, be used to repay the premium advances under the split-dollar arrangement or the premium loans under the premium financing transaction. If the owner is an irrevocable trust, creating the side fund needs to be done on a transfer tax leveraged basis, perhaps including additional policy loans to the trust (with interest paid or accrued at the AFR), having the trust become the residuary beneficiary of a grantor retained annuity trust (if the insurance trust does not have generation skipping implications) or the purchaser in an installment sale.[61/] In addition, as noted above, consideration should be given to arranging for the policy

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60 Of course, that extra death benefit requires additional underwriting capability and an additional premium.

61/ For loans or installment sales, the insurance trust should be an intentional grantor trust, so that any gain on the sale and any interest on the deferred payments or the loan would be ignored for income tax purposes under Rev. Rul. 85-13, above.

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death benefit to increase, to keep the proceeds payable to the owner constant (for an additional premium).

19. Not considering using a private split-dollar arrangement to fund a survivorship policy to use the low survivorship economic benefit rates (while both insureds are alive).

The issuance of the Final Split-Dollar Regulations in late 2003, effective for transactions entered into or "materially modified" after the effective date of the Regulations, as noted in several places above, has eliminated many – but not all – uses of split-dollar. While some commentators have taken the position that the Final Regulations "killed" split-dollar going forward, one place where an economic benefit regime split-dollar arrangement still makes sense is when the policy acquired with the split-dollar advances is a survivorship policy. There, while both insureds are alive, the measure of the economic benefit is derived from Table 2001, to measure the actuarial risk of both insureds dying in the same year (a very small risk).

That special measure of the economic benefit provided to the policy beneficiary for survivorship policies makes them the most attractive kind of policy with which to consider creating new private, non-equity split-dollar arrangements. Those arrangements would need to be donor/donee "non-equity" arrangements, where the insured/premium provider was entitled to the greater of the premiums advanced or the policy cash values (determined without regard to surrender charges).

Accordingly, although it is true that split-dollar arrangements may not make as much sense as they did prior to the issuance of the Final Regulations, they will often make sense from a tax point of view in funding survivorship policies (while both insureds are alive); after the first death, the economic benefit reverts to the traditional economic benefit measure for any single life policy – the lower of the Table 2001 rates or the insurance carrier's qualifying alternative term rates.[62/]

20. Not checking the availability of the insurer's alternative term rate (in lieu of the Table 2001 rate) for private post-Final Regulation split-dollar arrangements for a single life policy.

At least until the IRS publishes what the Final Regulations call "uniform term rates" for determining the measure of the economic benefit in private, non-equity post-Final Regulation split-dollar arrangements, the economic benefit can be measured by the lower of the Table 2001 rates or the insurance company's "qualifying" alternative term rates.[63/] For post-January 28, 2002 arrangements, under Notice 2002-8,[64] qualifying term rates must be published, generally available rates for one year term insurance, which must be made known to proposed insureds who are sold insurance through the carrier's normal distribution channels and must be "regularly sold by the carrier" (an undefined term).

While some carriers take the position that their term rates do not qualify under these more stringent rules, some (although a limited number) carriers have taken the position that their rates continue to qualify, and some carriers (an increasing number) have taken the position that this has become a legal issue and all they can do is provide the proposed insured and his or her advisors with the facts, but that the decision about whether their rate qualifies has to be made by legal counsel.

62/ Note that even with low term rates, there is a gift being made (unless the economic benefit is contributed by the trust) – in AFR interest accrued premium financing, there is no gift.

63/ Otherwise, there is nothing in the Final Regulations dealing with (nor restricting) the use of alternative term rates that otherwise qualify under Notice 2002-8, above.

64 Above.

21. Changing a pre-Final Regulation private split-dollar arrangement without considering whether it could be considered a "material modification" of the arrangement.

As noted above, a private pre-Final Regulation split-dollar arrangement which hasn't been "materially modified" after the effective date of the Regulations, is governed by Notice 2002-8.[65] Conversely, a private pre-Final Regulation arrangement which has been "materially modified" after the effective date of the Final Regulations will no longer be governed by Notice 2002-8, but by the generally less favorable rules of the Final Regulations.

The Final Regulations do not contain a helpful definition of the phrase "materially modified" – they contain a so-called "angel list", a non-exclusive list of non-material modifications.[66] In addition, the IRS has indicated that this is an area in which they will not issue private letter rulings.[67]

Accordingly, any change to a private pre-Final Regulation split-dollar agreement, the terms of the economic "deal" between the parties, or even a change to the underlying policy needs to be approached as a potential material modification to the arrangement, subjecting the arrangement to the rules of the Final Split-Dollar Regulations from the date of the change. Since most pre-Final Regulation private arrangements were equity, collateral assignment arrangements (where the premium provider was only entitled to recover his or her premium advances), applying the rules of the Final Regulations to that arrangement would require that it be treated under the loan regime (measuring tax consequences of the arrangement by the foregone interest

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65 Above.

66 Reg. Sec. 1.61-22(j)(2).

67 See Rev. Proc. 2011-3 §3.01(2), 2011-1 I.R.B. 110.

under Section 7872, as described above) rather than the economic benefit regime (measuring the benefit by the term costs, under Section 61).[68] In addition, this "switch" would likely be treated as a termination of the arrangement under Notice 2002-8, treating any policy equity as having been transferred, subject to its no inference provision.

Accordingly, where it is important for a non-tax reason to change the arrangement or the underlying policy and it is important to be able to continue to be able to use term cost to measure the benefit of the arrangement, the agreement would need to be amended to convert it into a non-equity arrangement (where the premium provider would be entitled to the greater of his or her advances or policy cash values), which would then qualify for one of the very narrow exceptions to the general rule of the Final Regulations that collateral assignment arrangements must use the loan regime to measure the benefit.[69]

22. Not planning for the disposition of the split-dollar receivable or premium financing note in the estate of the insured in a private premium funding arrangement.

In a private premium funding arrangement, the insured (or one of the insureds – or both of the insureds – in a survivorship policy arrangement) is either advancing premiums to a third party owner (such as an ILIT) under a split-dollar arrangement or is loaning money to the third-party owner under a premium financing arrangement, with interest either paid or accrued at the applicable federal rate. As noted above, a private premium funding arrangement is used to reduce the gift (and potential GST) consequences of funding an irrevocable life insurance trust –

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68 Reg. Sec. 1.61-22(b)(3).

69 But note that each change requires the policyowner (normally an ILIT) to give up any existing or future cash value interest in the policy, which would pose fiduciary duty issues for an ILIT trustee.

reducing the gift required from the full policy premium to the economic benefit of the arrangement (with split-dollar) or to any interest required to be gifted to the trust (in a premium financing arrangement).

The down-side of reducing or eliminating the gift otherwise created by having to fund policy premiums is that an increasing part of the death benefit of the policy will be returned to the insured or his or her successor in interest (either his or her revocable trust or his or her probate estate). That concern is heightened in both a post-Final Regulation private split-dollar arrangement (since the premium provider must get back the greater of premium advanced or the then policy cash value), and in an interest accrued premium financing transaction. The concern is that an increasing portion of the death benefit will be returned to the donor's successor in interest and an ever decreasing portion will be left in the irrevocable life insurance trust, unless the policy can be structured so that the death benefit grows either as cash value grows (in a split-dollar arrangement) or can grow to track premiums advanced (and perhaps accrued interest).

In any event, disposition of the receivable or the note in the insured's estate plan by specific bequest should be considered. The receivable or the note might be bequeathed to a surviving spouse, a charity, or even back to the trust which owns the policy.[70]

70 In the latter case, it would be extinguished by operation of law, with no tax consequences, under Section 102, but might also be treated as a transfer of the policy itself, rather than the receivable, under the Final Regulations.

23. Creating an "old style" equity, collateral assignment private split-dollar arrangement after the Final Split-Dollar Regulations without recognizing the effect of those Regulations.

As noted above, any equity collateral assignment split-dollar arrangement entered into (or materially modified) after the Final Regulations will be required to use the loan regime, governed by Section 7872, rather than the economic benefit regime, governed by Section 61. Accordingly, the measure of the benefit will be determined by the interest imputed rather than term costs.

Private (donor/donee) collateral assignment arrangements entered into after the Final Regulations can use the economic benefit regime only if they are non-equity – that is, the premium provider must be entitled to receive the greater of the premiums advanced or the policy cash values (determined without regard to surrender charges).[71]

[71] Reg. Sec. 1.61-22(b)(3)(ii)(B).

THE TOP TEN ISSUES ENCOUNTERED AT THE (UNAVOIDABLE) INTERSECTION OF A CLIENT'S BUSINESS AND PERSONAL LIFE

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INTRODUCTION

The purpose of this outline is to explore a variety of issues that may arise when working on estate planning for families owning various types of businesses. Many of the issues are legal in nature, while others are of a "softer" variety because they are rooted in family dynamics. Almost every topic covered in this outline has, at one time or another, been confronted by the author while working on a client engagement. It is hoped that an estate planner's perspective on these issues will bring helpful insights to attorneys not regularly representing clients with respect to estate planning matters.

I. CONTROLLING THE LIST OF OWNERS

In the context of a family-owned business (as well as many of today's energy-related start-ups which may not be strictly "family owned"), controlling who may (and more importantly, who may not) become an equity owner is at or near the top of the list of issues that must be addressed at the intersection of a client's business and personal life. For a family-owned business, the goal is often to keep the equity of the business within the bloodline of the family so that non-blood relatives (many times including spouses) are kept outside the business. For a non-family owned business, the goal is often to keep the spouses of business partners outside of the business. In addition to including restrictions on who can become an equity owner, often times the entity documents are engineered to assure the individual who is part of the "deal" is required to keep absolute control over decisions concerning the equity in the entity – even if approved estate transfers are allowed to members of the owner's family.

A. Valuation Provisions in Shareholder Restrictions

Provisions designed to control the list of shareholders should always include mechanisms under which the interests are to change hands if an authorized disposition is attempted or completed. From the perspective of the estate, gift and generation-skipping transfer taxes, a threshold question for consideration is whether the valuation aspects of the provisions will be respected under Section 2703 of the Internal Revenue Code of 1986, as amended (the "Code"), and related Treasury Regulations thereto. Section 2703 of the Code is part of the so-called "Chapter 14" of the Code, which on its face is applicable to certain interests in corporations, limited partnerships and general partnerships and is effective for agreements, options, rights, or restrictions entered into after October 8, 1990.

Section 2703 of the Code provides that in valuing property for estate, gift and generation-skipping transfer tax purposes, the value of an interest in the entity is determined without regard to options or agreements to acquire the property at less than fair market value unless the agreement: (i) is a bona fide business arrangement; (ii) 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; and (iii) has terms comparable to similar arrangements entered into by persons in arms-length transactions. The Treasury Regulations are clear that **each** of these three prongs must be satisfied in order to avoid the impact of Section 2703 (resulting in the valuation being disregarded for transfer tax purposes). *See* Treasury Regulation §25.2703-1(b)(2).

Treasury Regulation §25.2703-1(b)(4) provides that a provision is similar to an arms-length transaction if it is one which could have been obtained in a fair bargain among unrelated parties in the same business. A "fair bargain" is defined as one which "conforms with the general practice" of unrelated parties in negotiated agreements. *Id.*

Notwithstanding the foregoing, Treasury Regulation §25.2703-1(b)(3) provides an exception from treatment under Section 2703 if more than 50% of the value of the property subject to the right or restriction is owned directly or indirectly by individuals who are not members of the transferor's family. But, the definition of "members of the transferor's family" for these purposes is not as definitive as one might wish. The definition specifically includes the transferor, the transferor's spouse, any ancestor of the transferor or the transferor's spouse, the spouse of any ancestor, any lineal descendants of the parents of the transferor or the transferor's spouse and "**any individual who is a natural object of the transferor's bounty**" (emphasis added). It is the last part of the definition that introduces an open-ended inquiry and reduces certainty about the scope of the potential "family."

Thus, if the entity in question is one that falls within the scope of Section 2703, you must take care to assure the provisions addressing valuation under a buy-sell agreement do not introduce transfer tax complications. One way to avoid the implications raised by Chapter 14 is to require that any triggering event requiring the purchase or sale of shares be priced at an appraised fair market value as of the date of the event in question (rather than based on something like the book value of the interests in question).

B. Transfer Restrictions

1. Corporations. In the case of corporations, there are several ways to graft provisions relating to control over who may become a shareholder into the entity documents. The most common approaches include (i) inclusion of share transfer provisions in the Bylaws of the corporation; (ii) adoption of a separate, stand-alone Shareholder Agreement; or (iii) inclusion of share transfer provisions in the Certificate of Formation of the entity which are filed with the relevant state's secretary of state. The approach chosen is largely based on the preferences of the attorney drafting the entity formation documents because all can accomplish the same goal - restricting the list of persons who are eligible holders of the shares.

Interests in corporations are generally covered by Chapter 14 if immediately before a transfer in question, the transferor and applicable family members hold (including attribution of certain indirect holdings) control of the entity, defined as at least 50 percent (by vote or value) of the stock of the corporation. *See* §2701(b) of the Code. "Applicable family members" are defined to include any lineal descendants of any parent of the transferor or the transferor's spouse. *See* §2701(b)(2)(C) of the Code.

2. Partnerships. Any partnership with any level of sophistication is likely to contain transfer restrictions that govern the right to transfer ownership interests and dictate the identity of permissible owners. Such provisions are generally aimed at allowing for transfers of interests in entities to (i) other existing owners, (ii) members of a

defined group of families, or (iii) trusts or entities owned by or for the benefit of the foregoing.

The provisions of a partnership agreement that govern the forced transfer of interests must be considered in light of Chapter 14 if (i) in the case of a general partnership, the client owns at least 50% of the capital or profits interest in the partnership, or (ii) in the case of a limited partnership ("LP"), the client owns any interest as a general partner. If the partnership satisfies either of these two tests, any buy-sell provisions in the partnership agreement should be addressed as described above in the case of a corporation.

3. Limited Liability Companies. Given that Chapter 14 of the Code was added before the proliferation of limited liability companies ("LLCs"), its provisions do not expressly mention LLCs nor which types of limited liability companies, if any, may be subject to the provisions of Chapter 14. However, it seems likely that Chapter 14 does apply to LLCs.[1] As a result, some commentators suggest the following approach:

Treat LLCs that are manager-managed as limited partnerships. If the client is a manager or part of a board of managers, analyze the impact of Chapter 14 on the LLC as if the structure is an LP and the client holds his or her interest as a general partner. If the client is a member, but not a manager, Chapter 14 may not apply unless the client owns sufficient membership interests in the LLC to replace the manager at any time with himself or herself.

Treat member-managed LLCs as a general partnership. Analyze the impact of Chapter 14 on the LLC from the perspective of whether the client owns at least 50% of the economic rights to the LLC. If the answer is "yes," treat the LLC as if Chapter 14 would apply. *See* Mezzullo, 835-4th T.M., *Transfers of Interests in Family Entities Under Chapter 14*: Sections 2701, 2702, 2703 & 2704, at 11, B.

C. Cases Where Valuation of Interests Has Been At Issue

Two significant and well-known families that own family businesses have dealt with issues pertaining to valuation of stock under a buy-sell formula, both involving facts that predate Section 2703 of the Code. The Joseph and Estee Lauder family, owners of the Lauder cosmetic empire, is one of those families. In *Estate of Joseph Lauder v. Commissioner*, T.C. Memo 1992-736 (1992), the Lauder family failed in its effort to enforce the buy-sell price (based on book value of the shares) because the Tax Court found the formula to be a disguised testamentary disposition rather than a price reflecting an arms' length approach to determining share value such as would be used by unrelated parties. In *Lauder*, the court considered the following principles to determine whether the price formula was reasonable:

1. The offering price must be fixed and determinable under the agreement.

2. The agreement must be binding during life and at death.

[1] *See* Structuring Estate Freezes: Analysis with Forms, Part 1, Chapter 2, ¶ 2.02 [1][a].

3. The restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for a testamentary disposition.

Although the case pre-dates Chapter 14, the seeds of the principles of Chapter 14 can easily be seen if you compare the principles above to Section 2703 of the Code.

The Hall family, owners of Hallmark Cards, has also dealt with issues pertaining to the valuation of stock under a buy sell formula. In *Estate of Joyce Hall v. Commissioner*, 92 T.C. 312 (1989), the family fared better and was successful in establishing that an adjusted book value approach did fairly establish fair market value for estate tax purposes. In *Hall*, shares were subject to a buy-sell provision based on the "adjusted book value" of the stock. Experts were hired to ascertain whether the adjusted book value was a reasonable proxy for fair market value. The IRS believed that it was not, but the Tax Court sided with the valuation experts for the estate who had concluded that the adjusted book value method adopted by company agreements was in fact a reasonable proxy for fair market value.

Although *Lauder* and *Hall* were both decided before Section 2703 was enacted, they were both decided under Section 2031 and related Treasury Regulations thereunder which also deal with valuation for estate tax purposes. At the end of the day, much of the analysis under Section 2703 and Section 2031 is very similar and ultimately revolves around whether the provisions are reasonable and are similar to what other parties might contract for in a bona fide negotiation.

D. <u>Other Issues Related to Restrictions on Disposition</u>

In addition to valuation issues under Chapter 14, it is often the case that issues involving transfer restrictions arise because the provisions have not been fully thought through in terms of accommodating "estate planning" transactions. Generally speaking, most agreements will seek to introduce some type of "permitted transfer" under the agreement, but the language can raise subtle legal issues when it comes time to implement a transfer. For example, the following transfer provisions presented challenges in the recent past:

> <u>Example</u>: An LLC agreement provided in pertinent part as follows:
>
> "Family Member" includes a spouse, lineal ancestor or descendant, legally adopted child, brother or sister of a Member, or a lineal descendant or legally adopted child of a brother or sister of such Member.
>
> "Permitted Transferee" includes (i) any other Member; (ii) a Family Member of any Member; or (iii) a trust or other Person whose sole and exclusive beneficiaries are Members and/or Family Members of Members.
>
> "Person" includes natural persons, corporations, limited partnership, limited liability companies, general partnerships, joint ventures, associations, estates, trusts, trustees, executors, and administrators.

> The LLC agreement further provided that a transfer is only possible by a Member if the Member retains voting control over any entity or trust to which the equity is transferred, and to control further dispositions in the interests of any such transferee entity or trust, it further provided as follows: "No Member may make any further dispositions of interests in any entity to which a Membership Interest is disposed of under the transfer provisions of this Company Agreement."
>
> Query: To comply with the "thou shalt maintain control over thy Membership Interest at all times" rule, this Member must first transfer his or her membership interest in the LLC to a new "family LP" structure. Thereafter, if he or she wishes to make a gift of equity in the LP to trusts for his or her children, can he or she do so?

The answer appears to be yes, if you can get comfortable that when the definition of "Permitted Transferee" provides that an "other Person whose sole and exclusive ***beneficiaries*** are . . (emphasis added)" that "beneficiaries" mean, as to an LP, other "owners". But you must also pay attention to a follow-along transfer of an LP interest in the family LP to, for example, new irrevocable trusts for the Member's descendants. Looking at the definition of "Permitted Transferee," those irrevocable trusts would seem to be anticipated as "Permitted Transferees," but the "no further disposition" prohibition would defeat the ultimate desired estate planning disposition. Some might argue the possibility of a secondary transfer in the equity of the family LP was contemplated, but in a situation where an unauthorized transfer both triggers rights of other owners to acquire the interest following a disposition that is not strictly permitted under the LLC Agreement, and also triggers additional issues in debt covenants for the LLC, it would not be worth taking the risk. The fix would be to amend the LLC to allow for further dispositions as long as the intended recipient would have otherwise qualified as a "Permitted Transferee." However, that detail needed to be addressed before any disposition was made to avoid triggering the rights of other owners to acquire the interest as a result of a disposition that is not strictly permitted under the LLC Agreement as well as causing problems with credit agreements.

There are an unlimited number of variations on the theme of this example as each LLC/LP structure is different. LPs generally contain transfer restrictions on the interests in the partnership which are substantially similar to the examples above, both of which were contained in LLCs.

E. Special Considerations for S Corporations

If an entity has elected to be treated as an S corporation under Section 1362(a) of the Code, it has a compelling interest in assuring that the shareholders never include a disqualified owner of S corporation stock as a permissible owner. Accordingly, a special subset of shareholder "restrictions" apply in the case of an S corporation. These restrictions are commonly made binding on the holders of stock in the S corporation in one of the following ways: (i) as a part of the Articles of Incorporation of the entity (hopefully making it less likely that the provisions "disappear" in a revision of the

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Bylaws), (ii) as part of the Bylaws of the corporation, or (iii) as a separate Shareholder's Agreement. Generally, the provisions are designed to address the following points:

1. A prohibition on exceeding the number of shareholders permitted for S corporations under Section 1361(b) of the Code, as amended from time to time;

2. A prohibition on transferring shares to anyone other than (i) an individual (other than a nonresident alien), (ii) an estate; (iii) a Qualified Subchapter S Trust as defined in Section 1361(d) of the Code (a "QSST"), or (iv) a trust described in Section 1361(c)(2) of the Code (an "ESBT").

3. In addition, there are generally covenants that (i) prohibit individual shareholders from renouncing United States citizenship; and (ii) require Trustees of revocable trusts make to assurances that following the termination of grantor trust status the trust will timely elect to be either a QSST or an ESBT for tax purposes.

4. Violations are generally deemed to result in a sale of shares back to the Corporation at the fair market value of the shares as determined by a qualified independent appraiser (or sometimes at the average of several qualified appraisals, if the stakes are high enough).

II. TRANSFER TAX ISSUES RADIATING FROM CONTROL

A. Section 2036(b)

Section 2036(b) of the Code, which if applicable, results in estate tax inclusion of assets in a decedent's taxable gross estate, is among the most fruitful ground for challenges by the Internal Revenue Service with respect to family limited partnerships. On its face, Section 2036(b) provides that retention of the right to vote (directly or indirectly) shares of stock in a "controlled corporation" is considered retention of the enjoyment of such property under Section 2036(a)(1) of the Code. Section 2036(a)(1) of the Code provides that the value of the gross estate of a decedent includes the value of all property over which the decedent retained the right to control enjoyment. Thus, retained voting rights (direct or indirect over controlled corporation stock) results in gross estate inclusion under Section 2036(b).

For purposes of Section 2036(b) a "controlled corporation" includes a corporation in which, after a transfer and within 3 years of death, the decedent owned (with the application of Section 318) or had the right (either alone or in conjunction with any person) to vote stock possessing at least 20% of the combined total voting power of all classes of stock.

Section 2036(b) was enacted in response to the IRS's loss in the case of *U.S. v. Byrum*, 408 U.S. 125 (1972). In the facts of the *Byrum* case, the decedent had transferred some of his holdings in three different closely-held corporations to trusts over which he retained the right to vote the stock, but had transferred income rights to his children. The question that was litigated was whether the retained ability to vote the stock through the position of trustee was tantamount to a retained right to control the enjoyment of the income of the stock through control over dividend decisions. The IRS lost the case and Section 2036(b) was born in response.

Thus, any time a transfer of the common stock of a closely held corporation that could fall within the scope of Section 2036(b) is contemplated, you must take care to assure the transferor does not retain (directly or indirectly) the power to continue to control the vote of the stock. If the transferor gives up all rights over the shares, the transfer can be made subject to 2036(b) without fear of continuing estate inclusion.

One clever taxpayer even tested whether a properly structured transaction could be "busted" under Section 2036(b) where estate inclusion was desired (because the stock had declined in value). However, because the transferor had given up the requisite right to continue to control the stock by giving the shares in trust and appointing a third party as trustee, the IRS refused to allow the taxpayer to use 2036(b) to his advantage. *See* Technical Advice Memorandum ("TAM") 9515003. Thus, TAM 9515003 illustrates that proper planning can be done.

The IRS has also litigated the "direct or indirect" retention of voting rights. In the facts of TAM 199938005, controlled corporation stock was first transferred to a family limited partnership in which the original stockholder possessed some of the control over the general partner. The IRS held that the partnership could not serve as a "blocker" entity to insulate the original shareholder if he or she retained voting rights as a general partner.

One proposed solution to the issue raised in TAM 199938005 is to specially pass out voting rights in Section 2036(b) stock to someone besides the general partner if the general partner was the original owner of the voting shares. An example of a provision designed to accomplish this result is as follows:

> "<u>Right to Vote Stock of Certain Controlled Corporations</u>. Notwithstanding Section __ or any other provision of this Agreement, the right to vote any Contributed Property which constitutes stock of a "controlled corporation" within the meaning of section 2036(b)(2) of the Code ("Section 2036 Stock") as to any Partner shall not be held or exercisable by the General Partner; instead such right to vote shall be held or exercisable by those Limited Partners to which such stock does not constitute Section 2036 Stock, with such Limited Partners holding the power to vote such stock in proportion with the Sharing Ratios of such Limited Partners (determined without regard to the Sharing Ratio of the Limited Partner(s) as to which such stock constitutes Section 2036 Stock). Should there be no Limited Partner entitled to vote the Section 2036 Stock under the conditions of this Section ___, such stock shall instead be voted by ____ on behalf of the Partnership. In the event that ___________________________________ is unable or unwilling to vote such Section 2036 Stock, then _________________________________ shall hold the power to vote such stock."

The failure to plan for the application of Section 2036(b) could have significant impact on a client's estate tax exposure. If a Section 2036 issue exists, resolving the issue more than three (3) years from the death of the shareholder will neutralize the Section 2036 issue. *See* Section 2035 of the Code.

B. Estate Freeze Transactions

One of the primary motivating factors for the passage of Chapter 14 was to eliminate the ability to effectuate a "preferred stock freeze" for a family corporation. Under this arrangement the senior generation was left with a preferred class of equity that had a stated rate of return and the common equity was passed to younger family members who thereafter possessed all equity appreciation potential which escaped transfer tax – at least most probably for an extended period of time.

A full treatment of the provisions of Chapter 14 which limit this type of planning is beyond the scope of this outline. However, the general approach taken under Chapter 14 is to supply special rules that are required to be used when calculating the value of any "applicable retained interests" (interests the transferor keeps) to arrive at the value of the transferred interest. An "applicable retained interest" means an interest in an entity with respect to which there is a distribution, liquidation, put, call, or conversion right if, immediately before the transfer, the transferor and "applicable family members" hold control of the entity. *See* Section 2701(b)(1) of the Code.

As stated above, for a corporation "control" means holding at least 50% (by vote or value) of the stock of the corporation, and for a general partnership, holding at least 50% of the capital or profits interest in the partnership, or in the case of a LP, holding any interest as a general partner. *See* Section 2701(b)(2) of the Code. For purposes of Section 2701 of the Code, "applicable family members" means with respect to the transferor, (i) the transferor's spouse, (ii) an ancestor of the transferor or the transferor's spouse, and (iii) the spouse of any such ancestor. *See* Section 2701(e)(2) of the Code.

Under the approach of Chapter 14, the value of any "applicable retained interests" (anything akin to a preferred stock interest) is ignored (valued at zero) unless the right pertains to a cumulative payment right on the retained shares which can be attributed value in the process of determining the value of the "applicable retained interest." Accordingly, extreme care is required when dealing with interests in a corporation or partnership to which Chapter 14 may apply to avoid significant transfer tax issues under Chapter 14. What is clear is that traditional estate freeze transactions with common and preferred stock are prohibited post-Chapter 14.

C. Common Approaches to Address Potential Issues

1. Recapitalization to Avoid 2036(b). The outcome under Section 2036(b) if the IRS were to establish that voting stock was transferred by a decedent under an arrangement where he or she retained voting power is draconian in nature. One approach to avoid this result is to recapitalize the company to have two classes of stock – both voting and non-voting stock – and to enter into estate planning transactions with the non-

voting equity. Generally, any such recapitalization would be designed to be tax-free under other provisions of the Code (namely, Section 354(a)(1) of the Code, Section 368(a)(1)(E) of the Code).

Further, Chapter 14 should not be a concern as long as the provisions of Treasury Regulation §25.2701-1(b)(3)(i) apply, namely, that (i) the transferor, (ii) each applicable family member and (iii) each member of the transferor's family hold substantially the same interests after the recapitalization as before. Note that the cited Treasury Regulation provides that "common stock with nonlapsing voting rights and nonvoting common stock are interests that are substantially the same." *See* Treasury Regulation §25.2701-1(b)(3)(i).

Following a recapitalization to create nonvoting stock, transfers of a client's nonvoting holdings can be made without fear of triggering the provisions of Section 2036(b). This makes such a recapitalization an attractive safe harbor approach to solving a potentially problematic situation.

Notwithstanding the foregoing, for some clients and in some situations a recapitalization may not be viable. This may be the case where a client exceeds the threshold of "controlled corporation stock" under Section 2036(b) but is far from possessing effective control over the business. In this instance, stock with voting rights can be transferred, but extreme care must be taken to assure that no direct or indirect voting control continues to exist (such as through retained powers over a trust to which the stock is transferred.

There is very little guidance on Section 2036(b) but there are proposed Treasury Regulations that were issued on August 3, 1983 but have never been finalized. *See* Prop. Reg. §20.2036-2. A few interesting points from the proposed Treasury Regulations are as follows:

a. Transfer of nonvoting shares with the retention of voting shares does not create a problem with respect to the transferred shares.

b. Stock that possesses voting rights only in extraordinary situations (like a merger or liquidation) "shall be subject to this section" (Section 2036(b)) unless the retention of the power to vote the shares is only in a fiduciary capacity.

c. However, retained voting power over stock in a fiduciary power for "normal' voting does present a problem.

d. The fact that a relative of the decedent is the trustee with power to vote shares is not itself evidence of an indirect right to vote the shares . . . however the record should be clear that the decedent did not continue to possesses a power to control the vote of the shares.

2. Vertical Slice to Avoid Chapter 14 Issues. Given the special approach to valuation employed in Chapter 14 (attributing zero value to the value of any "applicable retained interests"), caution is required when the client owns more than one class of equity in a particular enterprise. If the client makes a transfer of any equity but retains an

"applicable retained interest," the impact of the valuation methodology for transfers causes the client to be deemed to have made a transfer of all of the client's equity in the business for transfer tax purposes. Therefore, if a client owns more than one class of equity, the generally accepted "safe harbor" approach is to make a transfer of what is referred to as a vertical slice of all that the client owns in the enterprise. This makes it necessary for the client to transfer and retain proportionally the same interests as contemplated by Treasury Regulation §25.2701-1(c)(4) which provides as follows: "Section 2701 does not apply to a transfer by an individual to a member of the individual's family or equity interests to the extent that the transfer by that individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer."

It is not necessarily the case that by transferring only one class of equity without invoking the "vertical slice" exception that a transfer tax complication will arise. However, the practical issue is that few clients want to turn their transfer tax attorney loose to consider whether a transfer of a given class of equity to a family member could result in the retention of an "applicable retained interest" putting the client squarely in the middle of Chapter 14 issues. Accordingly, given that the "vertical slice" provides reasonable insurance against such a problem, clients who choose to inform themselves about the issues that exist with respect to the transfer of interests in their entities are now becoming familiar with the term "vertical slice!"

Some practitioners advocate for a "derivative contract" approach as an effective and less cumbersome alternative to the "vertical slice." In the "derivative contract" approach, a derivative contract "mimicking" the class of equity to be transferred is created that grants the owner the financial rights associated with the class of equity to be transferred and, thereafter, the contract rights are transferred by gift rather than the actual equity.[2]

III. LIQUIDITY NEEDS FOR THE OWNERS

A. The Business or its Owners?

Potentially the most "classic" issue arising in the context of estate planning for the interests of business owners is the continual struggle between leaving liquidity inside the business to permit ongoing operations, to fund future growth, or to maintain covenants on existing debt of the business, and taking liquidity outside the business either in the form of salary, dividends or other distributions to equity owners. In the author's experience, it is far more likely to find individuals who have built businesses willing to sacrifice their own personal needs rather than impose hardships on the business.

That being said, unless the plan is for an eventual exit through a sale of the business, which generates substantial liquidity for the owner, it is prudent to raise awareness on the part of the client about the impact that a long-term pattern of keeping all capital invested inside the business is likely to have on the business owner's family. Raising that awareness is best started long before a difficult situation presents itself so there is

[2] David Handler and Angelo Tiese, *Using Derivatives to "Transfer" Carried Interests in Private Equity, LBO and Venture Capital Funds,"* National Venture Capital Association and Ernst & Young LLP, Issue 17 (Spring 2006).

adequate time to address the issue. This topic is discussed further in Section IV of this outline.

B. Capital Calls for New (Transferee) Owners

When a business is not self-sustaining additional capital calls are required to allow the enterprise to execute its business plan. This can cause liquidity issues when transferees of an interest in the business are called upon to participate in additional capital calls proportionately with the other owners of the business but lack the financial ability to do so.

Take as an example a start-up oil and gas operation to which the proposed transferor has made a substantial capital commitment that is not fully funded at the time of the desired gift planning. Assume that in order for the owner to transfer his or her equity in the business, he must first establish a family partnership into which the equity in the business must be transferred so as not to violate the requirements of the deal documents. After establishing the family partnership, the client wishes to give away some of his equity in the family partnership, consisting of limited partnership interests, as is permitted under the terms of this particular structure. If future capital call requirements are ignored, issues will develop for the family members or the trusts for the benefit of family members to which the limited partnership interests would ultimately be transferred. What solutions exist to allow the client to transfer his or her equity to family members or trusts for their benefit assuming the transferees will not be in a position to respond to capital calls in the future?

One solution is for the client to give a sufficient amount of cash to the transferees to allow them to make their proportionate capital contributions when necessary. Depending on the relative size of the capital call requirements, it is possible that annual exclusion gifts under Section 2503(b) of the Code may be sufficient to allow the transferor to make continuing gifts to the transferees for the purpose of providing them with sufficient liquidity to meet their obligations to make future capital calls. If this is the case, this may be a relatively efficient method to handle the issue of future capital calls.

If annual exclusions will not suffice or are not an available option for other reasons, another solution might be to anticipate the need during the formation of the family partnership and to fund sufficient liquid assets into the family partnership to allow it to meet its obligations on behalf of all of its owners. This seems to be a conservative approach to the issue if significant capital calls are expected as the value of any gifts of interests in the family partnership would be calculated to include the liquid reserves transferred to the partnership before gifts are made – thereby including a portion of the liquidity in the valuation of the gifts.

Another option might be for the original owner to lend funds to be used for capital calls to either the partnership or to the transferees of the interests in the family partnership. In each instance, the loan and the interest rate thereon must be such that there are no imputed gift consequences on the loan (such as through the charging of an insufficient rate of interest under Section 7872 of the Code and the principles of *Dickman v. Commissioner*, 435 S.C. 330 (1984)) and there is a viable plan under which the loans could be expected to be repaid.

C. Income-Only Trusts When Dividends Are Not Paid

Upon occasion you may encounter trusts as shareholders of closely-held businesses that have been designed as "income only" trusts – meaning that distributions of principal are not permitted or allowed by the terms of the trust. What is the impact on such a trust if the closely held business does not pay dividends to its owners on a recurring basis for some valid reason, such as all cash is needed to finance growth?

Assuming the trust is governed by traditional common law rules applicable to trusts, including rules incorporating the provisions of the Uniform Principal and Income Act,[3] if the only asset of the trust is the stock in the closely-held business, the trust will not have any income for state law purposes in the absence of a dividend. *See* Section 116.151 of the Texas Property Code which provides in pertinent part that money received from a business (not as part of a distribution in exchange for part or all of the trust's interest in the entity or as a partial or total liquidation of the entity) is allocated to income of the trust. The impact of the provisions of Section 116.151 of the Texas Property Code is to provide that recurring cash dividends are allocated to trust income. However, if recurring dividends are not paid, no income arises for the trust over which the Trustee has discretion to make distributions to trust beneficiaries.

What options exist for the trustee of an income-only trust when no recurring income is available to the trustee for distribution? Probably the most notable provision potentially available to the Trustee is Section 116.005 of the Texas Property Code entitled "Trustee's Power to Adjust," commonly known as "equitable adjustment." Under Section 116.005 of the Texas Property Code, the "trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in Section 116.004(a), that the trustee is unable to comply with Section 116.004(b)."

Section 116.004(b) of the Texas Property Code requires that the trustee administer the trust "based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may factor one or more of the beneficiaries." *See* Section 116.004(b) of the Texas Property Code.

The practical impact of the power to adjust under the Texas Property Code is to permit certain trustees to consider the trust's principal value as part of the available "resources" for distribution to beneficiaries. A general rule of thumb is that an adjustment in the

[3] Texas adopted its own version of the Uniform Principal & Income Act effective January 1, 2004 which is codified in Chapter 116 of the Texas Property Code.

range of 3% to 5% of the trust's total value is reasonable. *See* Section 116.007(b) of the Texas Property Code concerning non-charitable unitrusts.

If the trust contains assets other than the business interests, the power to equitably adjust can really "save the day" because the trustee has other assets to consider as income available for distribution. If, however, the only asset of the trust is the business interests, the trustee must carefully consider the impact of an "equitable adjustment" approach if dividend income is unlikely over an extended period of time. This is because the decision to adjust could eventually give rise to a need to dispose of the corpus of the trust in order to manage the impact of the plan to make trust distributions. Additionally, the trustee will have to have a plan to translate the deemed "resources" of the trust into liquid assets, potentially through a loan to the trust which will itself have to be settled at some point in the future.

Note there are certain limitations on the power to adjust, the most notable of which is the fact that the power is not available if the trustee is also a beneficiary of the trust. *See* Section 116.005(c)(6) of the Texas Property Code.

IV. ILLIQUIDITY AND THE BUSINESS AS AN ESTATE ASSET

One of the most significant questions that arises in planning for the estates of clients who own significant, illiquid businesses is how to address the eventual need for estate tax liquidity at the death of the owner, or if married, potentially not until the death of the second spouse to die. Planning for estate liquidity when a substantial business is involved can become very complex. This is especially true if age and health are factors for the owners because life insurance is often on the list of tools to generate estate tax liquidity. A detailed coverage of all relevant issues in the area of estate tax liquidity is beyond the scope of this outline. However, below are some of the primary approaches and topics for consideration.

A. Life Insurance to Address Estate Tax Liquidity

Although some clients have a negative opinion of life insurance, life insurance should generally always be considered when attempting to address an estate tax liquidity issue for business owners. That being said, if the business is of substantial value and the client controls the business, it is important to properly structure ownership of the life insurance so as to not exacerbate the issue for the owner by having the proceeds paid at death included in his or her estate.

From an estate planner's perspective, life insurance is most efficiently owned in a manner that does not expose the proceeds to estate tax in the client's estate. Of course, any insurance owned directly by the client (regardless of who receives the proceeds as the designated beneficiary) will be included in the client's taxable gross estate. That being said, if the client is married and the spouse is the outright beneficiary of the life insurance the proceeds should qualify for the estate tax marital deduction. However, any part of the proceeds that remain on hand at the surviving spouse's death will then be subject to the estate tax.

In the case of a client who controls a business, estate tax inclusion of life insurance proceeds is an even more complicated issue. When determining the value of the business for estate tax purposes, the value of the business at the decedent/owner's date of death is inclusive of the face value of life insurance on the decedent/owner's life if the business is named as the designated beneficiary of the proceeds. *See* Treasury Regulation § 20.2042-1(c)(6). If the business is the owner of a policy but the proceeds of the policy are payable to a third party (such as members of the decedent's family), the policy is still includable in the decedent's estate if the decedent is the sole shareholder/owner under the theory that the decedent possesses, through the control over the business, incidents of ownership over the life insurance policy. *Id*.

Accordingly, it is preferable in any situation where life insurance is being used to generate liquidity to structure ownership of the life insurance in such a manner as to mitigate estate tax exposure. Generally speaking, the best approach is to acquire the insurance through an irrevocable life insurance trust over which the owner/insured possesses no incidents of ownership.

Many times insurance premiums can be well in excess of the cumulative lifetime gift tax exemption available to the client (see Exhibit A). So, in instances where the amount of insurance required is large, the practical issue generally becomes how to finance payment of the premiums. The larger the value of the business, the less likely that a traditional approach involving gifts of cash into a life insurance trust by the client/insured, which in turn acquires and pays for insurance on the insured business owner's life, will be possible.

One viable approach to structure the acquisition of life insurance in instances where a large amount of insurance is required and the business interest is illiquid is to create a trust that is capable of owning an interest in the business itself. Assuming the owner possesses the power to make that interest productive of income for the trust (through dividend or distributions, depending on the type of business interest involved), once the trust owns an interest in the business, the trust is able to receive proportional distributions on its equity and that liquidity can then be employed in the acquisition of insurance on the owner's life as long as the trust was structured in a manner that anticipated that outcome.

Another option, potentially used in combination with a trust that also owns a portion of the business (assumed to be productive of income as described in the preceding paragraph), is to explore the possibility of a split dollar life insurance plan. Split dollar life insurance planning is a complex and specialized process now governed by final Treasury Regulations issued on September 12, 2003, effective on September 18, 2003.[4]

However, you must take care in selecting the correct form of split dollar planning for the particular circumstances. Only certain split dollar arrangements are appropriate for a situation where the insured is the controlling shareholder of the business. Generally speaking, the structure would include a split dollar agreement between a life insurance

[4] Treasury Regulations §§1.61-22, 1.83-3(e), 1.83-6(a)(5), 1.301-1(q) and 1.7872-15.

trust and the business whereby the client's business would advance the funds for the life insurance from company assets, subject to an agreement whereby the company would be repaid the greater of the following: (i) cumulative premiums advanced by the company, net of any prior reimbursements or repayments the company received, or (ii) the cash value of the policy immediately before the death of the insured (or the death of the second insured to die if a joint life policy). Other than the repayment obligation to the company, the life insurance trust would be the sole and absolute owner of the insurance contract and hold all "incidents of ownership" as described in Treasury Regulation §20.2042-1(c) of the Code. There are imputed tax consequences to the shareholder and to the trust if the trust lacks sufficient liquidity to pay the current cost of the insurance protection. More specifically, the amount of policy cash value to which the non-owner has current access and any other economic benefits that are provided to the non-owner must be treated as deemed gifts to the trust. *See* Treasury Regulation §1.61-22(d)(2)(i)-(iii) and 1.61-22(d)(3)(i). A detailed discussion of split dollar planning is beyond the scope of this outline but such planning is worth of exploration where estate tax liquidity issues exist along with a family business.

B. <u>Section 6166</u>

Assuming that life insurance liquidity planning is not an option or is not sufficient to offset all of the estate tax liability that may arise at the death of a key shareholder/owner, what are the other options? One of the options is invoking the provisions of Section 6166 of the Code to provide for an extended period of time to pay the estate tax finally determined to be due on the shareholder's estate. It is important to understand that Section 6166 in no way lowers the estate's overall tax obligation – it merely "buys time" for the estate's personal representative to pay the tax obligation due.

For relief under Section 6166 to be available, the shareholder's interest in the closely-held business must exceed 35% of his adjusted gross estate. *See* Section 6166(a)(1) of the Code. The "adjusted gross estate" is calculated based on the decedent's gross estate value less certain types of deductions (deductions allowable under Section 2053 and Section 2054). If the estate meets this threshold test, the estate tax that may be deferred is the portion of the estate tax (compared to the total estate tax) which the closely-held business interest "qualifying" the estate for Section 6166 bears to the value of the entire adjusted gross estate. *See* Section 6166(a)(2). Thus, Section 6166 is designed to alleviate the estate's liquidity problem with respect to the closely-held business interest not with respect to all other estate assets.

How much time does qualifying for treatment under Section 6166 "buy" for an estate? Section 6166(a)(1) allows the executor to pay the principal of the tax in 2 or more installments, but not to exceed 10 installments. Section 6166(a)(3) provides that the due date of the first installment is not more than 5 years after the date prescribed for the payment of the tax, and thereafter on each 1 year anniversary until the expiration of the 10 year period.

What happens during the first 5 years? Section 6166(f) provides that interest on the deferred estate tax obligation is payable annually during the first 5 years. The amount of interest an estate is required to pay is itself a complicated calculation under Section 6166, but in short, interest is paid at a 2% rate on the first $580,000 of tax (for 2014, but changes annually), and thereafter at 45% of the then prevailing federal underpayment rate. *See generally* Section 6601(j).

In certain situations, the provisions of Section 6166 can provide meaningful relief to a liquidity-strapped estate. That being said, you must take care to assure both that the type of business interest held by the estate qualifies under Section 6166 and that the decedent has done nothing to "disqualify" the estate from the election.

C. <u>Section 303</u>

Another option potentially available to the estates of owners of closely held business interests is found in Subchapter C, Part I of the Code. More specifically, Section 303 of the Code entitled "Distributions in Redemption of Stock to Pay Estate Taxes" provides another potential path for liquidity-strapped estates to gain access to liquidity for estate tax payments. Section 303 requires a distribution of property[5] to a shareholder, that such distribution be in partial or full redemption of the shareholder's stock, and that stock so redeemed be included in the gross estate of a decedent.

The theory under Section 303 of the Code is to give an estate the opportunity to benefit from sale or exchange treatment for stock in a closely-held corporation (avoiding ordinary income treatment that would likely otherwise fall out of a combination of Section 302 of the Code and the family attribution rules of Section 318 of the Code) where liquidity "inside" a closely-held corporation could be helpful for estate tax purposes.

However, the potential utility of Section 303 of the Code is constrained by the fact its provisions only apply to redemptions necessary to cover (i) estate and inheritances taxes (plus interest) and (ii) funeral and administration expenses allowable as deductions to the estate. *See* Section 303(a) of the Code. As is the case for Section 6166 above, there is a threshold test to determine whether Section 303 of the Code is available to a particular estate. Specifically, the value of the stock of the corporation must exceed 35% of the excess of the value of the gross estate of the decedent over the sum of amounts allowable as deductions for Section 2053 and Section 2054 of the Code. *See* Section 303(b)(2) of the Code. Note that the rules allow for the aggregation of interests in more than just a single corporation for the purposes of qualifying for Section 303 treatment as long as the decedent owned 20% or more of the value of the stock in each entity to be so aggregated for the purposes of meeting the 35% threshold test. *See* Section 303(b)(2)(B) of the Code.

Another favorable aspect of Section 303 is the fact there is substantial flexibility in determining when the redemption takes place. Specifically, the Code provides that a Section 303 redemption may take place any time during the period of limitations under

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[5] For Section 303 purposes, "property" is defined under Section 317 of the Code to include "money, securities, and any other property, except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

Section 6501(a) for the assessment of the federal estate tax, or within 90 days after the expiration of that period. *See* Section 303(b)(1) of the Code. Further, if an election under Section 6166 is in place for the estate, the period during which a redemption under Section 303 may be made is extended to the period for the extended payment of estate taxes under Section 6166 of the Code.

A more detailed discussion of the provisions of Section 303 is beyond the scope of this outline, including its application to certain types of business, but if applicable, Section 303 allows for access to liquidity for certain estates where liquidity exists "inside" a business but not in the hands of a deceased shareholder personally.

D. P.S. – Nothing Makes Up for Proactive Planning

Notwithstanding the fact there are "tools in the tool box" that can be used to help deal with liquidity issues at the level of an individual shareholder's estate, in many instances, there is nothing that can fully erase the impact of failing to do proactive planning on the front-end. Once closely-held businesses become items of significant value in the hands of a shareholder, the planning must focus on mitigating the impact of the eventual estate tax assuming that the client's goal is to hold onto the business and pass its ownership to succeeding generations. Therefore, it is critical to consider – sooner rather than later – the idea of transferring equity to succeeding generations (likely in trust) as soon as the shareholder can get comfortable with doing so. As long as the trust vehicle to which the ownership will be transferred is drafted in a manner to be flexible in the future for additional planning (sales by the senior generation of additional equity; acquisition of life insurance on the life or lives of the senior generation; etc.) transferring equity and allowing the appreciation to occur outside of the senior generation's estate is a powerful approach to planning for the mitigation of estate tax illiquidity that should not be overlooked.

E. P.S. (Again) – Think about What Proactive Planning is Undertaken

Notwithstanding what is stated above concerning proactive planning, it is also true that some planning can end up at cross purposes with other helpful provisions of the Code (such as Section 6166 and Section 303). For example, a substantial sale of interests in a client's closely-held business that would have otherwise qualified the estate for either Section 6166, Section 303, or maybe both, can take those options off the table in certain circumstances. Specifically, if the decedent prior to death "trades" his or her interest in a qualifying closely-held business in exchange for a long-term promissory note (perhaps in an effort to insulate the decedent from further appreciation in value in the interest), the sale could reduce the estate's ownership of the closely-held business interest to such a level so as to disqualify the estate from treatment under Section 6166 or Section 303. Any value gained from the sale could easily be erased if the sale removes Section 6166 or Section 303, or both, as options for the decedent's estate when the time comes to pay the estate tax.

V. PHILANTHROPIC PLANNING AND THE BUSINESS

As most client's wealth grows, so generally does the client's desire to do something "bigger" than simply benefitting his or her own family. The most common response to a desire to do something "bigger" is the setting-aside of funds for philanthropic endeavors. Because the client must become educated about the mechanics of philanthropic giving in a tax-advantaged manner, this type of planning can become complicated. This is especially true if the client is an owner of a closely-held businesses.

A. Public Charity vs. Private Foundation

A key fork lying in the road of philanthropic planning involving a closely-held business interest is the level of control the client desires to have over the recipient of the gift. Generally speaking, clients who are used to controlling their businesses are attracted to the level of control offered by a private foundation. Specifically, the client can continue to "call the shots" on how the board or trusteeship structure is formulated, to have control over where funds are given, etc. However, private foundations – and entities subject to private foundation excise tax rules under Subchapter A of Chapter 42 of the Code (Section 4940 through Section 4946 of the Code) – can pose special problems when the planning includes a client's interest in a closely-held business. A detailed treatment of the so-called private foundation excise tax rules is beyond the scope of this outline, but a few key issues of particular concern are discussed below. On the other hand, if a client is content to give an interest in the business to a charitable entity the client does not in fact control (a public charity or an entity which is treated as a public charity for tax purposes), it is possible to avoid many of the issues discussed in this section.

One of the key differences between dealing with a gift to a public charity as opposed to a gift to a private foundation, which the client will quickly come to understand, is the amount of charitable deduction available to the client for federal income tax purposes. Given that an interest in a closely-held business is long-term capital gain property, if the gift is made to a private foundation, the donor's charitable income tax deduction is limited to the income tax basis of the property (not its fair market value) at the time of the gift. *See* Section 170(b)(1)(C)(iii) of the Code. On the other hand, if a gift of the same interest is made to an entity that qualifies as a public charity, the gift is deductible at fair market value up to 30% of the donor's adjusted gross income. *See* Section 170(b)(1)(C). Since in most situations, a client's income tax basis in a closely-held business interest is significantly lower than the fair market value of the interest, it is often of critical importance for the prospective donor to understand that gifts to private foundations and gifts to public charities (or organizations treated as public charities) produce substantially different results in many instances.

B. Excess Business Holdings for Private Foundations

The excess business holdings rules under Section 4943 of the Code present one of the chief issues to be dealt with by a client who wishes to make a disposition of a business interest to a private foundation. Stated in a straightforward manner, under the provisions of Section 4943 of the Code, a private foundation is treated as having an "excess business holding" if the interest the foundation owns, when added to the interests owned by all disqualified persons, exceeds 20% of the voting stock of the corporation. The test is specifically stated as follows: "the permitted holdings of any private foundation in an incorporated business enterprise are (i) 20 percent of the voting stock, reduced by (ii) the percentage of voting stock owned by all disqualified persons." *See* Section 4943(c)(2) of the Code. If "it is established to the satisfaction of the Secretary that effective control of the corporation is in one or more persons who are not disqualified persons with respect to the foundation," the 20 percent limitation is replaced by a 35 percent limitation for the purposes of the excess business holdings rule. *See* Section 4943(c)(2)(B) of the Code. Note there are provisions that extend the rule which is applicable to corporations to partnerships or joint ventures for the purposes of Section 4943. *See* Section 4943(c)(3) of the Code.

The test to determine whether an excess business holding exists requires the aggregation of all interests held by "disqualified persons" as provided above. The inclusion of interests held by "disqualified persons" greatly expands the universe of interests that must be considered when determining whether an excess business holding exists. For these purposes, a disqualified person is deemed to include, among others: (i) a "substantial contributor"[6] to the foundation; (ii) a foundation manager; (iii) an owner of more than 20 percent of the total combined voting power of a corporation, the profits interest of a partnership or the beneficial interests of a trust or unincorporated enterprise which is a substantial contributor to the foundation; (iv) a member of the family of any individual described in (i), (ii) or (iii); (v) a corporation of which persons described in (i), (ii), (iii), or (iv) own more than 35% of the combined voting power; (vi) a partnership on of which persons described in (i), (ii), (iii), or (iv) own more than 35% of the profits interest; or (vii) a trust or estate of which persons described in (i), (ii), (iii), or (iv) own more than 35% of the beneficial interest; or (viii) for the purposes of Section 4943, a private foundation which is effectively controlled (directly or indirectly) by the same person or persons in question, or substantially all of the contributions to which were made (directly or indirectly) by the same person or persons described in (i),(ii) or (iii) or members of their families.

If a holding constitutes an "excess business holding" within the meaning of Section 4943 of the Code, significant excess tax penalties apply to the value of the holdings under Section 4943(a) of the Code and more significantly under Section 4943(b) of the Code if a timely disposition of the interest does not occur. However, a private foundation generally has five years to dispose of a gift or bequest of a holding that constitutes an "excess business holding" and can request an extension of time from the IRS to make the disposition. *See* Section 4943(c)(6) and Section 4943(c)(7) of the Code. A private foundation must take care to assure the proposed disposition does not violate any other private foundation excise tax provisions, most notably the prohibition against self-dealing transactions.

[6] For these purposes, Section 507 of the Code provides that a substantial contributor is one whose contributions total more than $5,000 if that total exceeds 2% of all contributions received by the foundation from its creation through the close of the year in which the donation is received. *See* Section 507(d)(2)(A) of the Code.

C. Watch for Donor Advised Funds and Certain Supporting Organizations

Effective for tax years beginning after August 17, 2006, the Pension Protection Act of 2006 (P.L. 109-286) amended Section 4943 of the Code to extend the rules concerning excess business holdings to apply to "donor advised funds" and Type III Supporting Organizations (other than a functionally integrated Type III supporting organization) or an organization which meets the requirements of subparagraph (A) and (C) Section 509(a)(3) and which is supervised or controlled in connection with one or more organizations described in paragraph (1) or (2) of Section 509(a), but only if such organization accepts any gift or contribution from any person described in Section 509(f)(2)(B). *See* Section 4943(f)(3) of the Code. The impact of these changes is to extend the excess business holdings rules to donor advised funds, to "grant-making" Type III Supporting Organizations (but not to Type III "functionally integrated" Supporting Organizations and to Type II Supporting Organizations which accept gifts from persons in direct or indirect control of a supported charity. The rules do NOT apply to Type I Supporting Organizations (ones which are "operated, supervised or controlled by" the supported organization). Prior to the 2006 changes, structuring through a community foundation was a "straightforward" fix. This is no longer the case.

D. Self-Dealing

Another critical area of concern at the intersection of closely-held businesses and philanthropic planning is the possibility of self-dealing that arises from the provisions of Section 4943 of the Code. Generally speaking, the self-dealing rules are intended to proscribe certain types of transactions involving private foundations and disqualified persons as to the private foundation. See the definition of who constitutes a "disqualified person" as to a private foundation as set forth above in the discussion concerning the excess business holdings rules.

The self-dealing rules under Section 4941 of the Code prohibit direct or indirect transactions including, among others:

a. Sale or exchange, or leasing, of property between a private foundation and a disqualified person;

b. Lending of money or other extension of credit between a private foundation and a disqualified person;

c. Furnishing of goods, services, or facilities between a private foundation and a disqualified person;

d. Payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; and

e. Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

See Section 4941(d)(1) of the Code. The Treasury Regulations provide insight as to when certain types of transactions would not be considered to be indirect acts of self-dealing. *See* Treasury Regulation §53.4941(d)(1).

However, Section 4941(d)(2) also provides a list of transactions that will not be considered to constitute acts of self-dealing, including:

a. The lending of money by a disqualified person to a private foundation if the loan is without interest or other charge;

b. The furnishing of goods, services or facilities by a disqualified person to a private foundation if without charge and the use is for purposes specified in Section 501(c)(3) of the Code;

c. The furnishing of goods, services or facilities by a private foundation to a disqualified person if on a basis no more favorable than that on which such goods, services or facilities are made available to the general public;

d. Except in the case of a "government official," the payment of compensation (or reimbursement of expenses) by a private foundation to a disqualified person for personal services necessary to carry out the exempt purposes of the private foundation; and

e. Any transaction between a private foundation and a corporation which is a disqualified person pursuant to any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization or reorganization if all the securities of the same class as that held by the private foundation are subject to the same terms and the terms provide that the foundation receive no less than fair market value.

Given that closely-held businesses which are either 20% or 35% owned or controlled by disqualified persons in turn constitute "disqualified persons" as to a private foundation, most family-owned businesses will fall within the ambit of Section 4941 of the Code. Given the scope of the transactions prohibited by the self-dealing rules, many transactions that one might expect would be available options are actually prohibited if the self-dealing rules are applicable.

E. <u>Interface of Excess Business Holdings and Self-Dealing</u>

It is also important to note the intersection of the excess business holding "problem" and prohibited actions under the self-dealing rules. Many obvious solutions to cure an excess business holding are in fact prohibited acts of self-dealing.

As in the case of an "excess business holding," significant excess tax penalties apply to acts of self-dealing. In the case of self-dealing, the excess tax applies both on the part of the self-dealer as well as foundation managers who were involved. If the act of self-dealing is not corrected on a timely basis, the self-dealing excess tax penalties are compounded. *See generally* Sections 4941(a)-(c) of the Code for the rules concerning the excess tax of self-dealing.

The bottom line is that before any action is undertaken involving the owner of a closely-held business interest, the business itself and a private foundation, careful and detailed analysis must be performed concerning the action contemplated, the relationship of the parties and the interactions involved to determine if the action could result in a prohibited act of self-dealing.

F. Community Foundation Solutions

Despite the changes as a result of the Pension Protection Act of 2006 (P.L. 109-286), certain types of supporting organizations (specifically, "Type I" Organizations which are "operated, supervised or controlled by" the supported organization) can still prove helpful in charitable planning which includes a client's closely-held business and philanthropy. When formulating an approach to deal with the interface of a client's business and philanthropic desires, consider whether a solution involving a community foundation is a prudent step in the planning process.

VI. THE DECISION TO SELL OR HOLD

One of the most important overall discussions an advisor has with a client who owns a closely-held business starts with the following question: "What do you see as the endgame for the business you have built?" The reason this question is of such importance is that it guides many of the steps that follow in the process of planning for the transfer of the business to the founder/controlling shareholder's family and/or philanthropies. This may be the hardest question for the client to answer. In the author's experience, there are many reasons that account for the difficulty a client may experience when asked to commit to an answer to this question. Nonetheless, it is vitally important to seek client input on this topic due to the pervasive nature of the response on the approach to planning. Outlined below are a few of the key areas that will likely cause the client to struggle with his or her response to this critical question.

A. Business May Equal Identity

One of the first key obstacles to receiving a thoughtful answer to the "sell or hold" question is that the business may well equal identity for the client. For the founder of a business, at some deep psychological level the business may well have become synonymous in the founder's mind with whom he or she "is," and who the family "is." That phenomenon certainly complicates the process of helping the client make an objective decision about whether to "sell or hold" the business. Given that most of us are not professionally trained to counsel clients concerning such matters, perhaps the best we can do is to realize it is an issue and seek to help the client express how much that issue colors his or her ability to provide feedback.

Some clients might actually realize the extraordinary importance of answering the question in order to get the plan right and be willing to enlist the help of outside consultants to explore the question as applied to the client's family to help guide them through the decision-making process. There are a number of well-qualified firms and individuals who specialize in helping clients explore such issues with an eye to bringing objectivity to the equation and the cost of such assistance may well be worth it to the client in the long-run.

B. Focus on Accretion of Value

In almost every case, the reason a business has become a valuable asset is that the founder has made every key decision with the goal of building the value of the business. Whether it is a key contract, a new line of business, a change of branding identity, or entering into a new credit agreement to facilitate further expansion, the founder has become used to analyzing all decisions in terms of what impact it might have on building additional value. Many founders are also "eternal optimists" when it comes to the value of their business and many spend their effort focusing on what factors must come together to create that next round of value. These are all good things, unless that focus becomes so myopic the founder is unable to honestly assess whether the time is approaching to monetize the value of the business through a sale.

In the author's experience, many founders are also of a mindset that if "x" or "y" will just transpire, that event will have such an impact on valuation of the business that then it will be time to think about selling. Sometimes, that event occurs and the founder is able to say "sell" because they realize the time is right. However, other founders are not as capable of realizing when the time is right. It may take someone who is willing to challenge the business founder in his or her thinking about what it would take to sell the business to bring this issue to light. Sometimes the entry to the topic comes in the form of some other goal the client expresses an interest in pursuing.

C. Founder Syndrome

Another obstacle that sometimes lies at the root of a client's difficulty in deciding the answer to the "sell or hold" question is a phenomenon known as "founder syndrome." Wikipedia defines "founder syndrome" in part as follows: "a difficulty faced by many organizations where one or more of the founders maintain disproportionate power and influence . . . leading to a wide range of problems for both the organization and those involved in it." "*Founder Syndrome*." Wikipedia: The Free Encyclopedia.

Founder syndrome is many times associated with non-profit organizations but is also equally applicable to for-profit organizations. The issue it raises arises because the business founder, even if surrounded by people who could provide valuable input and analysis, refuses to accept their input. This issue can certainly impact the ability to critically think about the "sell or hold" decision for the company. More often than not, the founder is less likely – for the reason outlined in the section immediately above – to think that disposing of the business should be evaluated as a realistic alternative. Thus, no appropriate process is allowed to be initiated to consider the pros and cons of a "sell" decision; rather, all energy continues to be focused on operating and expanding the business. This may, or may not, be the best decision, but if "founder syndrome" is at work, it may be the only decision considered.

If "founder syndrome" is at play, it may take an outside professional who specializes in in helping clients explore such issues to identify and help work through the issues.

D. Honest Assessment of the Next Generation

A final factor that is sometimes missing from an appropriate "sell or hold" analysis is an honest assessment of the ability of the second generation to run the business into the future. To truly keep the business "in the family," many times it is of critical importance that there is a succession plan in place that involves bringing a member of the next generation along as the leader of the family business. More than any other, this topic likely requires professional guidance since client family relationships are involved.

In the author's experience, there is no predicting whether a founder's view of the issue of the next generation's readiness/capability is correct. Some founders get it right as it is obvious that one or more of their children wants to be involved in running the business, has committed to the task, and is succeeding. In other cases, the founder may have formed an opinion that the next generation (does or does not) possess the right skills, aptitudes and interests totally in a vacuum and without involving members of the next generation in the process. Approaching the decision in a vacuum and without involving the family members in the process is almost always a mistake because the founder is relying on his or her own judgment in isolation to make the determination. It may be that a decision to hold on to the business is made under the faulty assumption that a member of the next generation will gladly give up his or her own path to come join the family business at the "right time," or that a decision to sell is made without involving members of the next generation who have been sitting by waiting for an invitation to step into the business and learn to lead it. Either way, the right decision may be sacrificed because the proper information is not gathered. Thus, challenging the founder/owner in his or her approach to thinking about the issue of whether the next generation has an interest or capability to run the business in the future is an important role for advisors to the family if the proper outcome is to be achieved.

VII. OTHER EMOTIONAL ISSUES RELATED TO THE BUSINESS

In addition to the other "soft" issues related to a client's business previously discussed, there are other emotional issues that may become part of the landscape when planning for an interest in a closely-held business. A few of the other emotional issues frequently encountered are discussed in this section.

A. Differences in Participant v. Non-Participant Owners

One key "emotional" issue lies in the differences that often exist in how family members who are equity owners in the business, but not active participants in the business, feel about the "equities" of the overall situation as compared to how family members who are both equity owners and active participants in the family business may feel. Specifically, it is the author's experience that family members who are not active in the family business may well feel like they are treated unfairly because of their passive role as compared to family members with active positions in the business. This can be true even when the non-participant members recognize that the family members who have chosen to participate in the management of the business by devoting their time and efforts to the business should be compensated for that commitment.

It could be the non-participant family member feels the compensation paid to the participant family member is unfairly high. One solution to that issue might be to hire outside compensation consultants to fairly appraise the duties and responsibilities of the participant family member and to offer suggestions about the appropriate range of compensation. This offers a fairly objective manner to deal with this type of perceived inequity which hopefully satisfies both participant and non-participant family members.

But what if the perceived inequity arises from a less obvious source, such as the prestige associated with the reputation of the family business afforded to family members who have decided to participate? That type of perceived inequality is much more difficult to address than adjusting compensation, although there are solutions. For example, some families consider the adoption of a family board structure to give members who are not active participants in the day-to-day business a forum to be involved in the business at a strategic level. This type of approach allows the non-participant to offer input and to communicate to third parties that the family member does in fact have a role in the business, etc.

Another issue that could create perceived differences between participant and non-participant family members are issues surrounding "access" to perks of the family business. One of the most notable differences may be access to a private jet owned by the family business.

If the structure is such that family members who participate in the business gain access to the jet for company business (and extended weekends while travelling for business), while other family members who are non-participants in the business do not, it is highly likely that sharp differences of opinion will arise about who benefits from the family's wealth.

Certainly, access to a jet to efficiently conduct corporate business is often essential in the fast-paced business world, but in family settings, private jets can end up serving dual purposes. Nothing can fuel a perceived difference in treatment of family members faster than a difference in access to a private jet, so consideration should be given to structures that avoid such issues. For example, with the assistance of experienced legal counsel familiar with FAA rules and associated tax issues, implementation of a structure under which extended family members who are not active in the business also have prescribed access to the private jet when not in use for business purposes. In addition, it is advisable to adopt a formal set of rules and policies concerning how usage of the jet must be scheduled if disputes concerning the mechanics of the process are to be minimized.

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B. Deeper Issues Involving the Family Business

Another "emotional" issue related to the family business that might present itself when dealing with family members is of a decidedly deeper nature – that is, what happens when there is a strong negative association of family members to the business as a result of the choice of the founder to build the business rather than spend time with the family. This issue can cause hidden, and sometimes not so hidden, issues for spouses and descendants of the family member, making planning for the transfer of the interests a challenge. If the business is negatively associated with its founder in the sense that the family views that it has been short-changed from a relational perspective by the founder, it is hard to predict what issues will arise when trying to plan for the transfer of the family business or the transition of control, and in some cases, in how to deal with the management of the family business in the wake of an unexpected death of the founder. If you perceive these issues might be at play, as previously mentioned, there are professionals who specialize in helping clients explore such issues with an eye to bringing objectivity to the equation and the cost of such assistance may well be worth it to the client in the long-run.

VIII. SPOUSAL ISSUES AND THE BUSINESS

Another issue for consideration when dealing with planning for the families of owners of family businesses is how to plan for the protection of the spouse from a financial perspective. Generally speaking, the ownership in family businesses follows family bloodlines – but where does that leave those who marry into the family in terms of providing for the financial security they become accustomed to as a member of the family by marriage? Addressing spousal issues in a fair and equitable manner many times drives the dynamics of planning for the owners of a family business whether recognized or not.

A. Owning Up to the Financial Realities

Like it or not, many times it is absolutely essential to realize that a spouse of a family member has become accustomed to enjoying the benefits associated with ownership of a stake in the family business. Depending on the facts, it may be the case that the spouse owns a legal interest in the business through community property laws based on the facts surrounding the formation of the business (this is likely the case when the business was started with community funds during the course of the marriage of the spouses). In other cases, the spouse may have married into the family after the business was formed, resulting in no actual ownership by the spouse in the business. Regardless of which case is applicable, from the spouse's perspective, if the founder/shareholder/family member by blood dies first, real financial concerns may develop for the surviving spouse that should be considered and addressed to avoid later issues for the family. The key issue is how to anticipate and plan for the spouse's security if the business is to continue uninterrupted.

B. Shareholder Restrictions and the Surviving Spouse

One of the common ways to address keeping a family business "in the family" is to assure that restrictions exist on the right to transfer interests in the business that preclude existing shareholders from transferring their interests – directly or indirectly at death – to persons not related to the founders of the business by blood. As discussed in Section I above, such restrictions can take the form of buy-sell provisions in the underlying entity documents or can take the form of a shareholder's agreement. In some cases, the restrictions on spousal benefits are also grafted into the structure of trust agreements which have become the owners of the equity interests in the family business. Either way, in addressing estate planning for a member of a family and his or her spouse where prohibitions exist on spousal interests in the business, attention must be paid to the manner in which the spouse is provided for financially. In some situations, this may give rise to a legal conflict for the attorney seeking to represent both spouses.

For example, what if the underlying organic documents for the family business provide a buy-sell provision that states that if the shareholder owner dies, his or her shares are sold back to the company at a discounted value and you are engaged to represent both spouses? It may be the case that, after explaining the provisions to your clients, the spouse would like to modify the formula provision for the share repurchase to assure that the he or she ends up with a payment that more closely resembles fair market value.

It is also possible the spouse would not be satisfied with the terms under which his or her payment will be made. For example, the underlying agreements may provide that the repurchase of the interest to prevent a required repurchase allow the company or other shareholders to pay out the purchase price over an extended period of time, interest-only to start. That payment structure might not leave sufficient resources for the surviving spouse to live on following the death of the family member who was the equity owner.

Depending on the receptivity of the broader family, there may be structural solutions to assist with these issues. For example, some shareholder restrictions are tightly written such that a disposition other than directly to members of the founder's family by blood or to trusts exclusively for their benefit is all that is allowed for under the agreements. In such a case, consideration could be given to liberalizing the types of trusts to which the interests could pass. For example, what about allowing for traditional "bypass" trusts (which typically involve the surviving spouse as a beneficiary) to be equity owners along with blood descendants of the family during the lifetime of any surviving spouse, as long as the remainder is fixed in the bloodline of the business founder? Such a modification would allow for the surviving spouse's interests to be provided for during his or her life (assuming the business makes distributions of cash to its equity owners) and yet assure that the interests remain in the family. Such a trust could even be drafted to require a descendant of the founder of the business to serve as the trustee if that would make the family more comfortable with the approach.

C. Other Solutions for the Surviving Spouse

Family members/shareholders who are serious about ensuring their spouses are provided for should address the issue proactively. If there is not support in the family to change provisions in the agreement for the family business to provide more comfort that spouses will be provided for, it may become necessary for other planning to be implemented to supplement or replace what the surviving spouse will be entitled to at the death of the member/shareholder, such as through the purchase of wealth replacement life insurance. Since the economics of life insurance is always dependent on the insurability of the life involved, it is critical to start down the life insurance path sooner rather than later.

In some estate planning structures, beneficiaries are given relatively broad powers of appointment over trusts allowing the beneficiary to redirect the assets at their death. Another potential source of financial security for a surviving spouse who is not entitled to be the owner of an interest in a family business could be the redirection of the financial assets of other trust assets through the exercise of a power of appointment, if an available option. However, this planning does not occur by default under estate planning documents but instead requires the beneficiary to specifically trigger the exercise by written action, generally in the member/shareholder's Last Will. If the power of appointment is broad enough to allow for appointment to a spouse, taking advantage of the ability to redirect assets to the spouse in this manner could be an important part of providing financial security to the spouse in the event the member/shareholder dies first.

D. Other Potential Issues Involving Spouses

Other remedies existing for surviving spouses whose interests have not been adequately addressed during the planning phase and such remedies may well appear after the death of the shareholder/member in the form of claims that may arise under Texas law. The type of claim that may arise depends on the facts of the particular situation and whether the spouse had a community property ownership interest that was subjected to a forced disposition in which he or she was not represented or a situation in which the interest was the separate property of the deceased spouse.

In the case of a community property interest that was disposed of against the surviving spouse's wishes and without the surviving spouse's consent and joinder, the surviving spouse may be entitled to bring a claim for fraud on the community against the estate of the first spouse to die. *See Massey v. Massey*, 807 S.W.2d 391 (Tex. App.-Houston [1st Dist.] 1991, *writ dismissed*. Section 3.102 of the Texas Family Code grants a spouse the sole right to manage, control and dispose of personal earnings, revenue from separate property, recoveries from personal injuries and the increase and mutations from all property subject to the spouse's sole management, control and disposition.

Old Texas case law also recognizes that some property may be held in only one spouse's name, and therefore under that spouse's control, but managed for the benefit of both spouses. *See Howard v. Commonwealth Building and Loan* Association, 94 S.W.2d 144 (Commission of Appeals 1937). Given that one spouse may manage community property for the benefit of both spouses, it is possible the managerial spouse could decide to make a disposition of the asset deemed by the non-managing spouse to be detrimental to his or her interests. This is the basis of a recovery for fraud on the community. Based on the author's personal experience, such a cause of action, if applicable, can be very costly to the estate of the spouse against whom the claim is brought – making it highly advisable to consider the results of such a course of action.

Section 3.402 of the Texas Family Code also recognizes recoveries for claims for reimbursement where certain factors can be established by which the separate property of one spouse has been enriched at the expense of the community estate. One of the situations in which a claim for reimbursement may exist involves "inadequate compensation for the time, toil, talent and effort" of one spouse at the expense of the community estate. Thus, under certain facts, a surviving spouse could bring a claim against the estate of a deceased spouse if the facts indicate a pattern of taking less than appropriate compensation for efforts of the deceased spouse in running the family business. It would not be unusual to find situations where compensation is artificially low to enable the business to meet its cash flow and growth objectives. In such a case, the executor of the estate of the deceased member/shareholder spouse should not be surprised to be presented with such a claim by a disappointed surviving spouse.

IX. SPECIAL CONSIDERATIONS WHEN THE BUSINESS IS PUBLIC

In some instances, the "family business" becomes far more than just a business controlled by members of one or two families so the business can "go to the next level." When the family business becomes a public business, most of the concern about estate tax liquidity is mitigated because there is a public market for the shares. That being said, many of the challenges of planning for transfers of interests in privately held family businesses remain and a few additional challenges are introduced. The purpose of this section is to highlight a few issues encountered in estate planning engagements involving key owners of public companies.

A. The Optics of a Sale or Other Disposition

One of the main recurring themes encountered in estate planning for owners of public companies whose relationship with the company and knowledge about it are unique for some reason (Founder; Chairman or Chief Executive Officer; and insiders for the purposes of securities laws) is the optics around a sale or other disposition of the stock. In some cases, the concern about making a disposition is justifiable, such as in the case of lock-up restrictions or federal security law constraints, but in other cases the reticence may simply arise from a culture at the company that "requires" insiders to hold on to their shares. Either way, the constraints placed on the ability to plan can be significant when there is inertia regarding the transfer of shares. However, if individuals with a real or imagined bias against transferring shares might get comfortable with any disposition, it generally will be in making a disposition to members of the individual's family or to trusts for the benefit of members of the individual's family.

B. Legal Restrictions on the Disposition of Shares

A detailed treatment of the relevant legal restrictions on the disposition of shares in a public company context is beyond the scope of this outline. However, a few of the key legal restrictions are as follows:

1. Rule 10b-5. Rule 10b5 and Rule 10b5-1 of the Securities Exchange Act of 1934 are aimed at keeping insiders of public companies from benefitting from being in the possession of material, non-public information about the company. *See* C.F.R. §§240.10b-5; 240.10b5-1. For these purposes, an "insider" is generally an officer, director, employee of the company, or someone who receives information from such a person. The rule requires that an insider must disgorge profits gained from any trades made on the basis of inside information. To reduce the risk of having the rule apply to insiders, many companies have adopted trading "windows" in which such individuals can trade shares following a public release of information. In addition, sales plans (so called "10b5-1 plans") are also a useful tool to establish a sales program under a pre-arranged methodology that can be implemented on a recurring basis, even when the "window" is otherwise closed.

2. Rule 144. Rule 144 of the Securities Act of 1933 both restricts the volume of sales and requires disclosure of sales for certain shareholders. *See* 17 C.F.R. §230.144. Rule 144 can impact two different types of shareholders: (officers, directors, large shareholders (including shares owned by attribution), and "control persons" and persons who did not acquire their shares in the public market – i.e., holders of "restricted" or "letter" stock). The restrictions under Rule 144 vary depending on the type of stock involved. For example, if the stock is "restricted stock" for Rule 144, it cannot be disposed of for at least one year. *See* 17 C.F.R. §230.144(d). The amount of stock that can be sold if subject to Rule 144 is also limited under the so called "volume limitation" rules. There are many nuances to Rule 144 and the various categories of stock to which its rules pertain, so it is important to work with competent securities counsel to properly consider the exact facts of any proposed transfer.

3. Section 16. Section 16 of the Securities Exchange Act of 1934 also impacts insiders of public companies. Under Section 16(a), officers, directors and shareholders owning more than 10% are required to file notices of changes in their holdings with the Securities and Exchange Commission. *See* 17 C.R.F. §240-16a. In addition, Section 16(b) requires those subject to the provisions of Section 16 to disgorge any profits obtained from trades in the stock by "matching" purchases and sales within any 6 month period (both in forwards matching and "reverse" matching calculations). *See* 17 C.F.R. 240.16b.

4. Section 13. Section 13 of the Securities Exchange Act of 1934 requires reporting related to persons or groups of persons who together beneficially own more than 5% of public equity in a particular company. *See* 17 C.F.R. §240-13d.

The Section 13 rules contain reporting requirements for any changes in the holdings of persons whose stock is subject to its provisions.

If the shares involved are subject to any of the foregoing rules, care must be taken to assure that competent securities law counsel has reviewed and signed off on any planning that is contemplated and that the planning does not violate any applicable law governing the shares in question.

C. Planning to Benefit Family

Despite the complicated rules that apply to shares owned by insiders in public companies, many insiders want to engage in estate planning using shares in the company even *after* the liquidity event has already taken place for the family. In many situations, restricted shares are the only asset of any significant value to use for estate planning purposes.

One estate planning technique that is frequently used to transfer future appreciation in public company stock is a Grantor Retained Annuity Trust (GRAT). GRATs can be powerful wealth transfer tools if the equity transferred to the GRAT appreciates in value well-beyond the Section 7520 Rate that is applicable to the GRAT in question. GRATs are popular because they effectively eliminate any economic and tax risk if structured properly, yet also provide an opportunity to transfer significant wealth estate and gift tax free. A detailed discussion of the use of a GRAT for these purposes is outside the scope of this outline, but any planning for the owner of a public company should include consideration of a GRAT. However, prior to implementation, the structure of any GRAT that is to own shares owned by an insider should be reviewed in detail with securities law counsel so the client fully understands the implications of the GRAT from a securities law perspective and the reporting required.

X. SPECIAL ISSUES WHEN THE BUSINESS IS A FARM OR RANCH

When the family business is a ranch, or more frequently, when the family business has produced the ability to acquire a farm or ranch, issues can arise in developing an appropriate estate plan that takes into consideration the interests of the various stakeholders in the farm or ranch, both economically and "emotionally." The purpose of this section is to highlight a few issues that are commonly encountered when estate planning involves interests in a farm or ranch.

A. Keeping It in the Family

A farm or ranch is sometimes more important than any other asset to the family's "identity" which magnifies the importance of keeping its ownership in the bloodline. If keeping the farm or ranch in the family is the goal, the question is how is to accomplish that goal to the satisfaction of the patriarchs of the family?

Sometimes, the farm or ranch is already owned inside of an LLC or LP, which makes it easy to control the class of "permitted distributees" as has been previously discussed. If that is not the case, a desire to control disposition of a farm or ranch within the bloodline of the family may be most easily accomplished by forming an LLC or LP to own, control and manage the farm and ranch and to accomplish the objective of keeping the property within the family. An LLC or LP also accomplishes another objective, namely, protection against further fractionalization of interests in the property. By centralizing the ownership in an entity, the title to the property remains in the name of the entity despite the introduction of many new owners as the property passes down through per stirpital estate planning dispositions.

If for some reason an LLC or LP structure is not desired, another way the author has seen control over the disposition of interests in a farm or ranch accomplished is through the use of restrictive covenants in deeds. However, this approach is not recommended unless constrained to specific applications as described in subsection X.C. below.

B. Managing the Farm or Ranch into the Next Generation

Another key issue concerning the ownership of a farm or ranch, especially one with active operations, is the determination of who in the family will actually oversee the business of the farm or ranch. The greater the significance of the farm or ranch to the identity of the family, the greater the likelihood that this will be an area that requires special structuring.

In some families, management of the farm or ranch as an asset has an "easy answer" in the sense that one member of the next generation has such a passion for the asset that he or she has already emerged as the manager to the mutual satisfaction of other family members. That is certainly an ideal result for everyone involved. In fact, it may even allow the family to benefit from special use valuation under Section 2032A of the Code when the ranch is valued for estate tax purposes in the estates of the patriarchs. However, this solution is not available to every family as a result of a variety of factors.

When this solution is not available, another approach to management of the farm or ranch may need to be developed, such as a farm or ranch "board of directors" with broader family membership to oversee the operations (or those who conducted them). The "board" may take the form of a group of managers who oversees the operations of an LLC that is the owner or the general partner of an LP that is, in turn, the owner of the farm or ranch. In situations where one family member is not an acceptable solution to the oversight of the family farm or ranch, in all likelihood, the "board of directors" approach is the next best alternative.

However, even the democratic approach of having a board with oversight over family farm or ranch operations is not a magic answer for all issues if the family has difficulty seeing eye-to-eye on how much to invest in the operations of the farm or ranch. In the author's experience, sometimes the management of dynamics of a board with oversight of a family farm or ranch can become "political" within a family that struggles to be cooperative with one another. Depending on the severity of the relational issues and the impact on the ability to conduct operations at the farm or ranch, the family may have to resort to third party management or even to a negotiated segregation of who operates the property for the benefit of the other owners.

C. Sharing Enjoyment of the Property

Perhaps the most important "emotional" issue concerning a farm or ranch is the ability of all parts of the family to enjoy the use of the property as they desire. Almost always central to the ability of the family to enjoy the use of the farm or ranch is the right to use and enjoy a residence on the property. In many families, a single, central residence can easily be shared by various members of the family according to some sign up process where usage rights rotate within the family.

However, in other situations, the family may need for each branch of the family to have its own residence under the sole control of a particular family member and subject to usage only by that family member and his or her descendants. In such situations, a question that may arise is how to give the various branches the right to choose a location, construct a residence, and most importantly to finalize the costs (both capital and operating) of the residence. An entire article could be written on this particular topic, but for purposes of this outline, the short answer is through careful negotiations. One solution the author has seen where various branches of the family need their own "space" is to physically survey out property for each branch of the family to construct a private residence so that the family building the residence is the sole owner of the residence and the land on which it is constructed. Further, thereafter, the operating costs of the residences can be separately tracked and paid for by the family member who owns the residence.

If separate parcels are set aside for various family members, the author has seen the deeds for the land drafted to include covenants running with the land that constrain the ability to convey the property outside a defined set of takers. If such an approach is taken, then the control over what is built in terms of a residence, the budget for the residence, etc. is under the control of the family member who has been provided the "lot" for the residence and the consequences of violating a covenant concerning who can become a future owner of the residence falls on the family member in question.

If the issues surrounding the residences are resolved, additional issues may exist with regard to the right to enjoy the ranch, as a whole, especially if hunting is a shared activity. However, these issues can generally be fairly addressed through the development of uniform usage rules, much like in the case of a family-owned jet.

D. Financial Issues

Numerous financial issues can develop in the context of planning for the ownership and operation of a family farm or ranch. It is generally rare for the property to produce a sufficient level of cash flow (outside of oil and gas revenues associated with the property) to sustain the property. As a result, any planning involving interests in a farm or ranch must contemplate the handling of the operating costs associated with the property. This is another area in which differences of opinion are likely to surface from different branches of a family given that all members of the family are unlikely to see eye-to-eye on all issues.

Exhibit A

Estate, Gift and GST Exclusions

	Basic Exclusion Amount*	Top Marginal Tax Rate
Estate Tax **	$5,000,000 **	40%
Gift Tax **	$5,000,000 **	40%
GST Tax	$5,000,000	40%

* The estate, gift and GST Tax exemptions are indexed for inflation since 2011. Thus, the exemptions are $5.34 million in 2014.

** The estate and gift tax basic exclusion amounts could be increased through the DSUE of a deceased spouse.

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Recent Developments in Transfer Pricing Administration

TEI Dallas Chapter Technical Session and Dinner Meeting

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September 16, 2014

Agenda

- IRS Transfer Pricing Audit Roadmap
- IBC-TPP Rules of Engagement Memorandum
- Notice 2013-78 - IRS Proposed Competent Authority Revenue Procedure
- OECD Transfer Pricing Documentation Project and cbc Reporting

IRS TRANSFER PRICING AUDIT "ROADMAP"

Transfer Pricing Audit "Roadmap"
Basic Principles

- On February 14, 2014, the IRS released its long-awaited Transfer Pricing Audit "Roadmap."
- The Roadmap is labeled as a "work in process" and a ***toolkit not a template*** for examiners to use in developing transfer pricing issues.
- Roadmap reiterates public statements that IRS officials have been making over the past several years that have emphasized the need for Exam teams to focus more effectively on ***upfront planning, factual development and risk assessment***.
  - Correspondingly less emphasis is placed on the role of legal and economic analysis.
  - The Roadmap represents a conscious break from approaches that the IRS took in the past that have relied on more standardized analyses grounded in legal and/or economic theory, e.g., the Cost Sharing Buy-In Coordinated Issue Paper (CIP).

Transfer Pricing Audit "Roadmap"
Basic Principles - continued

- In emphasizing the paramount role of the facts, the Roadmap explains on the first page that:

> *Transfer pricing cases are usually won and lost on the facts.* The key in transfer pricing cases is to put together a compelling story of what drives the taxpayer's financial success, based on a thorough analysis of functions, assets, and risks, and an accurate understanding of the relevant financial information. Fact development is the "bread and butter" of our exam teams – it's what they are trained for and good at. . . .

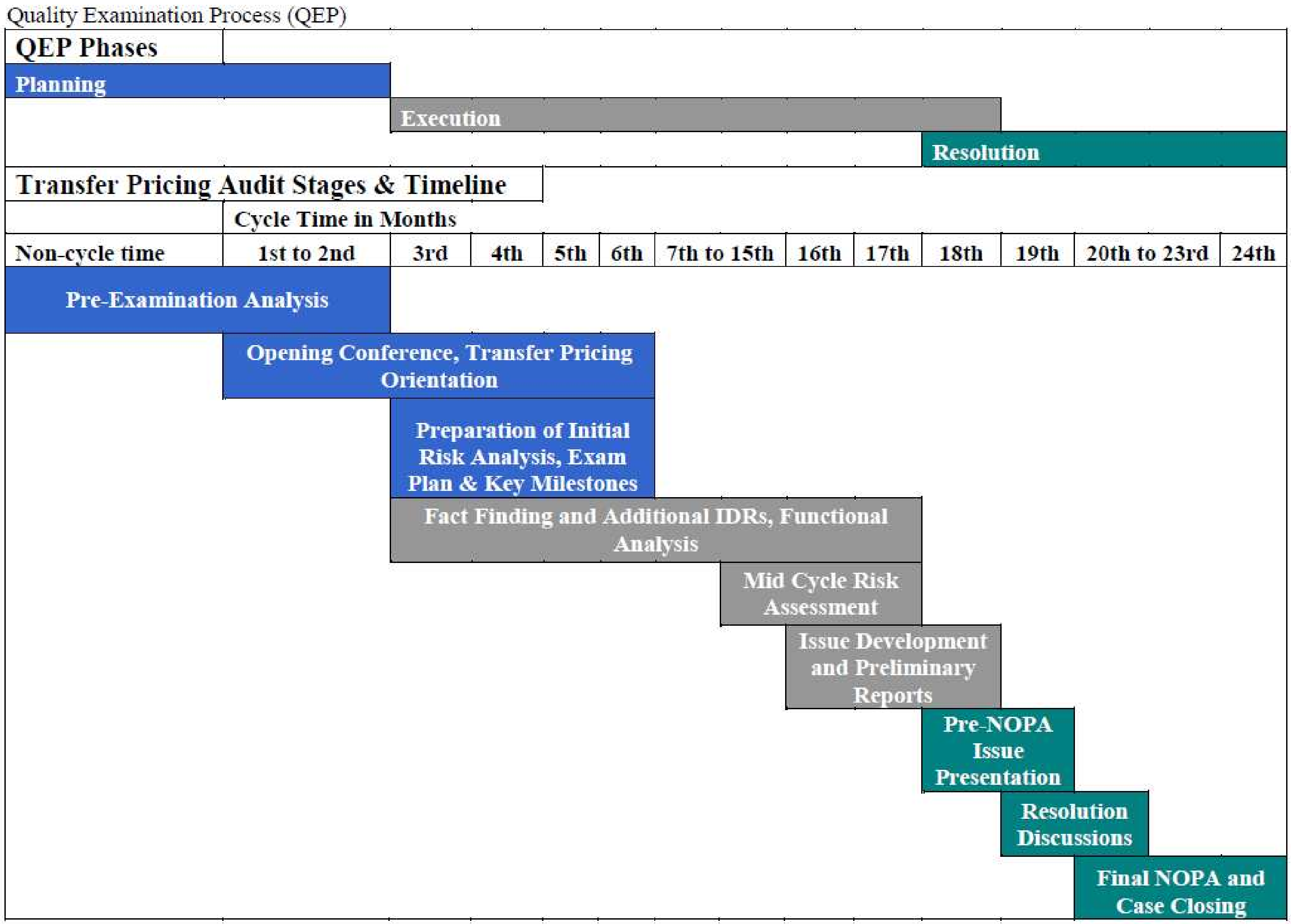
- The Roadmap instructs agents to develop a "working hypothesis" ("WH") [referred to previously as an "elevator speech"] to guide the factual development but to keep an open mind to adjusting or even discarding the working hypothesis depending on the new facts that are developed.
  - For example, an initial WH might be: Company B (a U.S. subsidiary of Company A) shifted profits by paying Company A excessive prices for goods and services in order to lower the Company A group's worldwide ETR.
  - An adjusted WH might be: Company B's below-range results are partly attributable to a decreased demand for Company A products, partly attributable to mispricing between Company A and Company B.

Transfer Pricing Audit "Roadmap" Phases Overview

- The Roadmap divides the lifecycle of a transfer pricing audit into three distinct phases:
  - Planning Phase (up to a 6-month process)
  - Execution Phase (up to a 14-month process)
  - Resolution Phase (up to a 6-month process)
- Consistent with the Roadmap's emphasis on upfront planning, the Roadmap provides the most detailed guidance on the first phase, planning.
- The Roadmap also notes the specific IRS team members that are expected to be involved in each phase (and stage within each phases), e.g., IEs, TPP, economists, Counsel, computer specialists.
  - While transparent in noting who the potential players are at each stage, notably absent is clear guidance regarding which IRS personnel are the decision-makers.
    - The IBC-TPP Rules of Engagement (released to the public after but issued internally prior to the Roadmap) confirm the lack of bright line rules regarding the authority over an audit.
- A detailed diagram of these three phases copied directly from the Roadmap follows on the next slide.
  - Note that IRS officials have since clarified that the specific timeframes provided in the Roadmap are merely illustrative; actual audit plans can be longer or shorter than 24 months.

Transfer Pricing Audit “Roadmap” Phases Overview - continued

TRANSFER PRICING AUDIT ROADMAP



Transfer Pricing Audit "Roadmap"
Planning Phase

- **Planning Phase**
  - Reflecting the key importance of this phase, 12 of the 26 pages of the Roadmap are dedicated to providing examiners with detailed guidance on how to complete the planning phase.
  - The planning phase consists of the following stages:
    (1) Pre-Examination Analysis (does not count towards running of the clock on the audit cycle)

    (2) Opening Conference (starts the clock on the audit cycle)

    (3) Taxpayer Orientation

    (4) Preparation of Initial Risk Analysis and Examination Plan

Transfer Pricing Audit "Roadmap"
Planning Phase - continued

- **Pre-Examination Analysis Stage**
  - The Pre-Examination Analysis consists of the risk assessment and initial factual development tasks that Examiners are expected to perform *before* the opening conference. These tasks include an upfront financial ratio analysis for risk assessment purposes.
  - Specifically, examiners are instructed to:
    - "Use tax return information and available research tools to compute the key financial ratio analysis for multiple years, make industry comparisons and consider whether cross border income shifting is occurring."
  - This is similar to the risk assessment contemplated in the OECD Transfer Pricing Document Discussion Draft, albeit without the country-by-country reporting element.
  - Despite warnings that financial ratio analyses "do not provide a definitive indication of the arm's length nature of a taxpayer's controlled transactions" and that the team "nonetheless needs to complete rigorous development of the issue facts and circumstances," is there a legitimate concern that these analyses could take on a life of their own (e.g., that these analyses could give rise to non-arm's length "short-cut" approaches)?
  - While newly re-emphasized, this guidance to examiners is not entirely new. The current Internal Revenue Manual instructed examiners to do similar analysis. *See* IRM 4.61.3.4.1 (6) (05-01-2006).

Transfer Pricing Audit "Roadmap" Planning Phase - continued

- **Pre-Examination Analysis Stage – cont.**
  - Other tasks conducted at the Pre-Examination Analysis stage of the planning phase include:
    - Research of Taxpayer Background, history and core business operations
    - Analysis of statute of limitations on both income tax return and related returns (e.g., Form 1042)
    - Issuance of mandatory IDR for I.R.C. §6662(e) documentation
    - Issue IDR for accounting records
    - Issue IDR to request a "financial statement orientation" meeting with Taxpayer to be provided within 30 days of opening conference [see discussion below]
    - Consider whether and the means of obtaining information or foreign-based documentation from Treaty partners
    - Develop and outline preliminary WH and transfer pricing risk assessment, and begin to outline a "fact statement"
    - Evaluate the need for specialists
    - Review and analyze the I.R.C. §6662(e) documentation
    - Conduct preliminary planning meeting(s) with Taxpayer
    - ***If a Treaty partner is involved, notify APMA***
      - Early involvement of APMA also contemplated in Notice 2013-78 (the proposed competent authority revenue procedure), which would effectively provide APMA with an early seat at the table in any (and every) transfer pricing examination involving a Treaty partner.

Transfer Pricing Audit "Roadmap" Planning Phase - continued

- **Opening Conference Stage**
  - Relatively little change appears to be contemplated from existing opening conference procedures, though opening conferences would now also be used to plan further meetings to be held during the Taxpayer Orientation Stage described below.
  - Opening conference starts the running of the "clock" on the audit cycle.
- **Taxpayer Orientation Stage**
  - This Stage begins with three key meetings:
    - Financial Statement Orientation – meeting with taxpayer
    - Transfer Pricing Orientation – meeting with taxpayer
    - Reassessment Meeting – internal IRS meeting
  - <u>Financial Statement Orientation</u>
    - Exam will be requesting that this meeting cover, in addition to financial statements and books and records, the taxpayer's organizational charts and functional organizational charts.

Transfer Pricing Audit "Roadmap" Planning Phase - continued

- **Taxpayer Orientation Stage – cont.**
  - Transfer Pricing Orientation Meeting
    - The IRS's stated objectives for this meeting are to:
      - Gain understanding of the taxpayer's rationale for entering into the transactions
      - Gain understanding of the taxpayer's value chain(s) associated with the intangible, services and/or tangible goods
      - Gain understanding whether the intercompany transaction is associated with the transfer of an income stream, or contribution to the value, of any intangible
    - The emphasis on the Taxpayer's value chain echoes Notice 2013-78 and Notice 2013-79 (the IRS's proposed APA and competent authority revenue procedures) and the OECD Transfer Pricing Documentation Discussion Draft.
      - While this focus reflects the current trend among tax administrators, it should be borne in mind that current U.S. law (e.g., the I.R.C. §6662(e) documentation regulations) takes narrower, transaction-based approach, focusing on whether the prices of specific transactions between specific related parties are arm's length.
    - Also of significance, the Roadmap also states that in order to understand the transfer pricing study, the IRS should "request supporting documents (interview notes, minutes)" at this stage.

Transfer Pricing Audit “Roadmap”
Planning Phase - continued

- **Taxpayer Orientation Stage – cont.**
  - Taxpayer Reassessment Meeting – This is an internal meeting that the IE, economist, TPP, Field counsel and their first level managers are to hold *after* the Transfer Pricing Orientation meeting.
  - Among other objectives, the team is to use this meeting to:
    - “Determine which transaction(s) need(s) further development, which transactions may be closed or which transaction(s) need(s) to be eliminated from further analysis.”
    - **If** this works as intended, the result could be narrower, more focused audits, and/or transfer pricing issues being eliminated altogether.
  - Also at this meeting, the IRS team:
    - Assesses level and scope of TPP and Counsel involvement;
    - Discusses and reassesses/adjusts the “working hypothesis”
    - Begins “best method” analysis, including assessment of the Taxpayer’s method.

Transfer Pricing Audit "Roadmap" Planning Phase - continued

- **Taxpayer Orientation Stage – cont.**
  - Risk Assessment and Audit Plan
    - After reassessment meeting, Exam team prepares initial "risk assessment" and audit plan for approval by International Team Manager, Territory Manager and Economist Manager.
    - Upon approval, both risk assessment and audit plan are to be shared with the Taxpayer.
    - The Roadmap makes clear that the risk assessment may need to change over the cycle: "Risk assessment is an iterative process that will take throughout the audit and updated and documented at different stages."
    - Audit plan is to include a detailed timeline including key milestone dates.
    - See Slide 6 for the illustration of a 24-month audit timeline included in the Roadmap.

Transfer Pricing Audit "Roadmap"
Execution Phase

- **Execution Phase** includes two stages:
  - Fact Finding Stage; and
  - Issue Development Stage
- The <u>Fact Finding Stage</u> consists of:
  - *Additional IDRs* - Not surprisingly, examiners are specifically instructed to follow the new IDR Enforcement Directive when responses are delinquent.
  - *Functional Analysis* – Guidance largely incorporates existing IRM guidance, but emphasizes working cooperatively with the taxpayer to:
    - identify personnel to interview
    - plan site visits
    - develop factual statement
  - *Updated Mid-Cycle Risk Assessment*
    - Risk assessment and working hypothesis to be updated based on functional analysis.
    - Updated risk assessment to be shared with taxpayer after management approval.

Transfer Pricing Audit "Roadmap" Execution Phase - continued

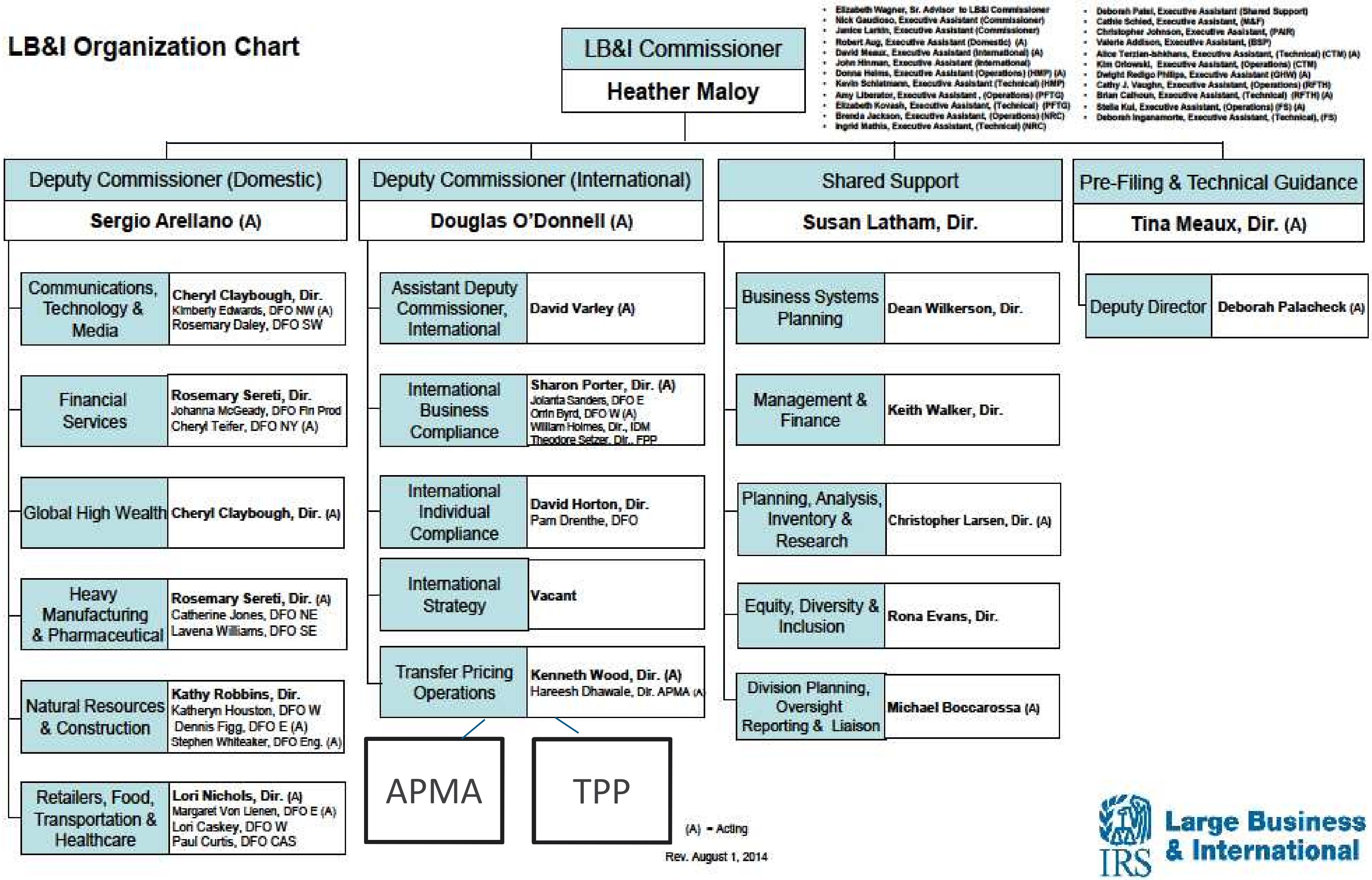
- The Issue Development Stage consists of:
  - *Economic Analysis* – Notably, Exam teams are instructed to:
    - Conduct a robust analysis of why the taxpayer's method is or is not the best method; determine best method, as applicable
    - Consider its usability for resolution purposes
    - Coordinate with APMA on any country-specific considerations
      - Reflects earlier involvement of APMA contemplated by Notice 2013-78.
  - *Preliminary Report and Findings*
    - Draft economist's report and NOPA are to be shared with the taxpayer for input.
    - "Iterative process" of revisions based on Taxpayer input envisioned.

Transfer Pricing Audit "Roadmap"
Resolution Phase

- The Resolution Phase consists of:
  - *Issue Presentation*
    - Meeting with Taxpayer before issuance of final NOPA
    - Exam team is instructed to "assess strength of positions, risks associated with taking the issue forward, and the best approach for issue presentation."
  - *Issue Resolution*
    - Resolution meeting with Taxpayer
    - Final NOPA
    - If issue is agreed, availability of Rev. Proc. 99-32 relief is discussed with Taxpayer
    - In resolving issues, Exam Teams are instructed to "[m]ake certain any agreement reached is clear as to the transactions and years to which the agreement applies. Clarify with the taxpayer any implication of the resolution on subsequent years."
  - *Case Closing/RAR*
    - RAR/30-day letter issued
    - Exam Teams warned that "If the Protest contains new factual information, raises new factual disputes or presents new economic or legal theories, consider re-engaging examination processes. Re-evaluate the timeline and reset the milestone dates as appropriate."
    - Reflects intent to get Appeals out of fact-finding and make its role more "quasi-judicial."

IBC–TPP RULES OF ENGAGEMENT MEMORANDUM

IRS Organizational Chart LB&I



IBC - TPP Rules of Engagement - Background

- In 2012, LB&I launched its Transfer Pricing Practice (TPP), comprised of approximately 60 economists and tax law specialists organized into three groups in various locations throughout the country.
  - TPP has been described by the media as the IRS's Transfer Pricing "**A Team**."
- Although formed to fill what the IRS viewed as a critical need to "up its game" in the area of transfer pricing, the practice lacks the resources required to run or even be involved in most transfer pricing audits.
- Therefore, International Business Compliance (IBC) retains an important (and in most cases, the primary) role in transfer pricing examinations.
- However, the exact role of TPP and IBC in transfer pricing examinations has not always been entirely clear, either internally within the IRS or externally.
- The "Rules of Engagement," released internally during September 2013 and to the public during August 2014 provide some general guidelines for the role of each organization, but stop short of providing hard and fast rules.

IBC - TPP Rules of Engagement – General Principles

- "The specific roles of the team members and level of engagement of each should be established by the IBC and TPP managers as the team forms, risk is assessed and early audit planning activities proceed. It is understood that the TPP must determine whether it has sufficient resources in any given circumstance. The roles and levels of engagement need to be flexible and dynamic to adjust to the circumstances of the audit, which may change over time."
- In most cases in which the TPP is involved, it is envisioned that the TPP team member, the IE, the economist, other internal experts, and the other members of the examination team will work "shoulder-to-shoulder" to perform the core work.
  - No team member "owns" the transfer pricing issue, and the participation of an economist or TPP practitioner does not mean that the other team members have no role in the case.
- Level of TPP involvement can range depending on the assessment of the case. The memo provides three specific levels of TPP involvement: **Extensive, Moderate, Limited**.

IBC - TPP Rules of Engagement - Extensive Involvement

- Extensive involvement is a direct, continuing and significant role in the day to day management and execution of the exam.
- TPP will participate directly in:
    - Identifying transfer pricing issues selected for examination
    - All discussions and negotiations with the taxpayer
    - Preparing audit plan and initial and mid-cycle risk analyses
    - Developing and meeting timelines, milestones and ECD
    - Functional and economic analyses, drafting IDRs and evaluating responses
    - Developing the "working hypothesis" of how to approach the case
    - Coordinating the preparation and conduct of taxpayer interviews
    - Assisting in the selection of, and working with, outside experts
    - Drafting, reviewing and presenting the NOPA and rebuttal
    - Preparing and participating in Appeals conferences and alternative resolution processes

IBC - TPP Rules of Engagement - Moderate Involvement

- Moderate involvement may entail regular interaction between IBC and TPP members of the team.
- TPP will participate in substantive interactions with the taxpayer and in significant strategic decisions, such as whether to engage outside experts.
- Specific areas TPP may actively assist include:
    - Advising on preparation of the audit plan and initial and mid-cycle risk analyses
    - Developing the ‘working hypothesis’ for the issue
    - Developing the functional and economic analyses
    - Participating in the selection of outside experts
    - Drafting, reviewing and presenting the NOPA and rebuttal
    - Participating in issue resolution discussions with the taxpayer
    - Supporting the exam team throughout the Protest, Rebuttal, pre-Appeals and Appeals process

IBC - TPP Rules of Engagement - Limited Involvement

- Occasional or periodic interaction in the nature of advisory services.
    - The exam team may contact TPP for assistance on an ad hoc basis.
- Limited or no taxpayer engagement by TPP.
- Areas of assistance could include:
    - Providing initial feedback on the taxpayer's transfer pricing results and analytic approach
    - Assessing the viability of a challenge to taxpayer's position (a "sanity check")
    - Consulting at critical junctures on facts needed to be developed; what transfer pricing method might be most appropriate; the reasonableness of any potential resolution, and the like
    - Providing feedback/ assistance on draft NOPAs and other written presentations

For Moderate and Extensive TPP Involvement

- For cases with moderate or extensive TPP involvement the memo details the roles for TPP and IBC in the following:
  - Estimated Completion Date
    - IBC and TPP should be fully engaged in establishing the ECD.
  - Issue Management
    - International team must ensure both TPP and IBC personnel participate at the outset of exam, if not before.
  - IDR Management
    - IBC and TPP will participate in IDR progress meeting and must be involved in taxpayer discussions when IDR requests are delinquent.
  - Quarterly/Status meetings with taxpayer
    - TPP and IBC team members, TMs, and the appropriate Territory Managers will participate in all meetings.
  - International Penalties
    - TPP and IBC managers will decide whether to assert transfer pricing penalties.
  - CAP taxpayers with transfer pricing issues
    - TPP and IBC managers will confer with and provide comments to the Industry TM when documenting taxpayer cooperation and transparency on transfer pricing issues.

For Moderate and Extensive TPP Involvement (cont)

- APA and Competent Authority
  - TPP, IBC, and APMA will collaborate to determine appropriate staffing.
- Fast Track
  - All TPP and IBC team members and managers will participate in Fast Track proceedings that include transfer pricing issues.
- Closing Agreement/Form 906
  - Transfer pricing issues on Form 906 must be reviewed by TPP, counsel and IBC.
- Appeals
  - TPP and IBC will collaborate and concur on any Appeals matters. This includes pre-appeals meetings and related planning sessions, post-appeals conferences, decision regarding return cases from Appeals for further development and review of ACMs.
- Outside Experts
  - TPP and IBC territory managers will decide on whether to engage an outside expert.

Notice 2013-78

PROPOSED IRS COMPETENT AUTHORITY REVENUE PROCEDURE

Notice 2013-78
Overview of Proposed Revenue Procedure

- On November 22, 2013, the IRS issued Notice 2013-78, which contains a draft revenue procedure for requesting competent authority assistance under tax treaties.
  - When finalized, the proposed revenue procedure would replace Revenue Procedure 2006-54.
- At the same time, the IRS also issued Notice 2013-79, which contains a draft revenue procedure for requesting advance pricing agreements.
  - When finalized, this proposed revenue procedure would replace Revenue Procedure 2006-9.
- The main impetus for the new revenue procedures is the IRS's 2012 restructuring that combined most of the U.S. competent authority office (previously under LB&I) with the Advance Pricing Agreement ("APA") Program (previously under ACCI).
  - The new combined program, called the Advance Pricing and Mutual Agreement ("APMA") Program, is a part of the IRS's Transfer Pricing Operations ("TPO") within LB&I.
  - The old revenue procedures were designed for the predecessor organizations and have become outdated.
  - They also do not reflect the best practices that APMA has adopted and the efficiency gains that it has been making since its inception.

Notice 2013-78
Competent Authority Background

- By way of background, a "request for competent authority assistance" is a request made by a taxpayer for the U.S. competent authority to address actions of the U.S., a treaty country, or both that the taxpayer considers to be inconsistent with the provisions of an income tax treaty.
- Such requests are made pursuant to the Mutual Agreement Procedure ("MAP") article contained in most tax treaties, but the U.S. procedural rules are governed by Rev. Proc. 2006-54.
- The most typical grounds for competent authority assistance are U.S. or foreign initiated transfer pricing adjustments that result in economic double taxation.
- However, competent authority assistance is available to address a host of other international tax issues within the scope of tax treaties, including permanent establishment, limitations on benefits (LOB) and residence issues.
  - Notice 2013-78 now expressly provides that FTC issues are eligible.
  - The Treaty Assistance and Interpretation Team ("TAIT"), an LB&I office separate from APMA, now handles non-allocation (i.e., issues other than TP, PE profits attribution) cases.
- The following slides focus primarily on competent authority assistance in the transfer pricing context.

Notice 2013-78
Accessing Competent Authority Assistance – in General

- The procedures and timing for requesting competent authority assistance depend on whether the transfer pricing adjustment is:
  - Foreign-initiated;
  - U.S.-initiated; or
  - Self-initiated (e.g., pursuant to Treas. Reg. §1.482-1(a)(3))
- Notice 2013-78 proposes:
  - Relatively minor changes to the procedures applicable to foreign-initiated adjustments;
  - Very significant changes to the procedures applicable to U.S.-initiated adjustments;
  - Newly allowing competent authority assistance with respect to self-initiated adjustments in certain cases.
    - The IRS administrative practice under Rev. Proc. 2006-54 was to *not* grant competent authority assistance with respect to self-initiated adjustments.

Rev. Proc. 2006-54 and Notice 2013-78
Foreign-Initiated Adjustments

- Under Rev. Proc. 2006-54, a U.S. taxpayer can request competent authority assistance with respect to a foreign-initiated adjustment "as soon as the taxpayer believes such filing is warranted based on the actions of the country proposing the adjustment." Taxpayer must also be able to "establish that there is a probability of double taxation."
  - While the plain language suggests a very liberal standard for granting competent authority assistance with respect to a foreign-initiated adjustment, in practice the IRS typically requires some written communication of the adjustment potential from the foreign government.
- Notice 2013-78 proposes a similarly broad standard – A Taxpayer may request assistance with respect to a foreign-initiated adjustment "as soon as it reasonably believes that a MAP issue exists or is likely to arise."
- However, Notice 2013-78 proposes a new requirement that a Taxpayer submit a mandatory pre-filing memorandum, and if requested by the IRS, attend a pre-filing conference, if the amount of the foreign initiated adjustment is greater than $10 million.

Rev. Proc. 2006-54
U.S. Initiated Adjustments

- Under Rev. Proc. 2006-54, taxpayers generally have flexibility (subject to certain exceptions) to request competent authority assistance with respect to a U.S.-initiated adjustment any time:
  - *After* the NOPA is issued; and
  - *Before* a Closing Agreement or Form 870-AD settlement is entered into or a judicial decision is rendered.
    - But even in these situations, Taxpayers can request *correlative relief* – that is, for the U.S. competent authority to try to convince the foreign competent authority to allow a deduction in the amount of the U.S. adjustment, without reconsidering the agreed adjustment amount.
- This means that currently, a taxpayer facing an IRS transfer pricing adjustment involving a treaty country that wishes to retain the right to competent authority assistance may:
  - Take an unagreed NOPA directly to competent authority without filing a Protest with Appeals.
  - Resolve the issue with Exam, then request competent authority assistance if the resolution results in double taxation.
  - File a Protest with Appeals seeking unilateral withdrawal of the U.S.-initiated adjustment, then request competent authority assistance subsequently if Appeals does not withdraw the entire adjustment.
  - Utilize the Simultaneous Appeals / Competent Authority Procedure.
- Competent authority consideration of issues in litigation require a joint taxpayer/IRS motion to sever and the consent of ACCI.

Notice 2013-78
U.S. Initiated Adjustments

- Rev. Proc. 2013-78 would *significantly* alter the rules for accessing competent authority assistance in the case of a U.S.-initiated adjustment.
- Generally, these changes provide for an earlier and stronger role for APMA (competent authority) and allow fewer procedural options.
- For cases at the Exam level (i.e., not yet in Appeals):
  - A NOPA would continue to serve as the "ticket" that most taxpayers need to get into MAP.
    - However, APMA would have new authority to require Exam position to be withdrawn or modified.
  - Cases agreed at the Exam level are only eligible for competent authority assistance if APMA approved the resolution.
  - Fast Track cases only eligible if APMA participated in the settlement proceedings.
- In contrast to the early and robust role for APMA at the Exam-level contemplated by Notice 2013-78, APMA (competent authority) generally has *no role* at the Exam-level under current procedures.
  - Although Notice 2013-78 is not yet effective, the Transfer Pricing Audit Roadmap (which is effective) contemplates similar engagement (though not necessarily decision-making) by APMA at the Exam-level.

Notice 2013-78
U.S. Initiated Adjustments - continued

- Taxpayers would no longer have the option to go to Appeals first to seek a unilateral withdrawal of an adjustment before seeking competent authority assistance.
  - The Simultaneous Appeals Procedure ("SAP") would be the only way that taxpayers could have Appeals review a U.S.-initiated adjustment and still obtain correlative relief.
  - A taxpayer in regular Appeals must request competent authority assistance within 30-days of the Appeals opening conference or forever be foreclosed from MAP. Upon filing such a request, the transfer pricing issue is severed from any other issues covered by Protest.
  - Cases considered in Appeals Mediation or Arbitration generally not eligible.
- Additional restrictions are imposed on seeking competent authority assistance with respect to cases in litigation.
  - No assistance available if case was *ever* in Appeals.
  - Cases designated for litigation not eligible.

Rev. Proc. 2006-54 and Notice 2013-78
U.S.-Initiated Adjustment Procedures Compared

	Rev. Proc. 2006-54		Notice 2013-78	
Procedural Stage	**Unrestricted**	**Correlative only**	**Unrestricted**	**Correlative only**
Exam – Unagreed NOPA	Yes	N/A	Yes; APMA has authority to require Exam to modify or withdraw adjustment	N/A
Exam – Form 870	Yes	N/A	Only if APMA consented to resolution	N/A
Regular Appeals – Protest filed; No settlement	Yes	N/A	Only if MAP request filed or SAP invoked within 30 days of opening conference; issue must be severed.	N/A
Regular Appeals – Settlement in Form 870-AD or Closing Agreement	No	Yes	No	No
Simultaneous Appeals Procedure (SAP)	Yes	No	Yes; SAP must be initiated within 60 days of request for comp. authority assistance	N/A
Pending Litigation	Only (i) if ACCI consents, (ii) IRS and Taxpayer file joint motion to sever or stay.	N/A	Only if (i) ACCI consents; (ii) joint motion to sever or stay; (iii) case not designated for litigation; and (iv) case *never* in Appeals	N/A
Judicial Decision	No	Yes	No	Yes

Notice 2013-78
Self-Initiated Adjustments

- Notice 2013-78 acknowledges that “MAP issues can also arise as a consequence of taxpayer-initiated positions,” e.g., a self-adjustment pursuant to Treas. Reg. §1.482-1(a)(3).
  - Requests for assistance with respect to self-initiated adjustments are conditioned on the taxpayers following mandatory pre-filing procedures, which include submitting a pre-filing memorandum and attending a pre-filing conference if requested by the IRS.
  - Such requests may be rejected “if the request evinces after-the-fact tax planning or fiscal evasion or is otherwise inconsistent with sound tax administration.”
- This is a significant, and generally taxpayer favorable development.
  - While the IRS is concerned about the potential for abuse stemming from “after-the-fact tax planning,” the likely effect may be more compliance not less.
  - Taxpayers may be more willing to self-assess adjustments that increase U.S. taxable income if relief from double-taxation through MAP is available.

Notice 2013-78
Other Contemplated Changes

- Notice 2013-78 contemplates a number of other changes that have the effect of expanding the role and power of APMA. For example, APMA would now have the power to:
  - Initiate new MAP requests in the absence of such a request
  - Expand an existing MAP request to cover additional issues and countries
  - Mandate use of the Accelerated Competent Authority Procedures ("ACAP") to cover other filed but unexamined tax years
  - Encourage (but not require) an APA to cover unfiled current and future years on a consistent basis.
- These changes are motivated in large part by efficiency and resource concerns. APMA would rather deal with as many issues and years at once in a single proceeding than revisit the same or related issues in cycle-after-cycle.
- Notice 2013-78 also clarifies that APMA and TAIT are available to provide informal oral advice on MAP issues, including whether the payment of a foreign tax would be considered non-compulsory under Treas. Reg. §1.901-2(e)(5).

Notice 2013-78
Other Contemplated Changes - continued

- Notice 2013-78, consistent with the Transfer Pricing Audit Roadmap and the OECD's recent work in the transfer pricing documentation area, strongly emphasizes upfront planning, factual development and risk assessment.
- The new pre-filing procedures (requiring a detailed memorandum and conference at the discretion of the IRS) must be followed if the request involves any of the following:
  - (a) a foreign-initiated adjustment in which the total adjustments exceed $10 million for all MAP years combined;
  - (b) a taxpayer-initiated position;
  - (c) the license or other transfer of intangibles in connection with, or the development of intangibles under, an intangible development arrangement;
  - (d) any arrangement that qualifies as a global trading arrangement;
  - (e) unincorporated branches, pass-through entities, hybrid entities, or entities disregarded for U.S. tax purposes;
  - (f) a request for discretionary LOB relief; or
  - (g) other circumstances in which the taxpayer believes a MAP issue has arisen outside the context of an examination, such as in cases involving withholding taxes or guidance issued by a foreign tax authority.
- From the IRS's perspective, these are the more significant types of cases from a *risk assessment* perspective. More routine cases, such as outbound management fees or distribution cases, do not require these upfront procedures.

Notice 2013-78
Other Contemplated Changes - continued

- Notice 2013-78 would also require much more extensive information to be submitted upfront in MAP requests.
  - Information requested focuses on the multinational enterprise's overall "value chain," not just the local taxpayer's specific transactions under review.
  - This is again consistent with recent trends in tax administration, e.g., the Roadmap and the OECD's work in the documentation area.
- The Pre-filing procedures and information requirements for APA requests contemplated in Notice 2013-79 closely track those required for MAP requests in Notice 2013-78.
  - This consistency is intentional and reflects the APA and competent authority functions coming under "one roof" in the APMA Program.
  - Requesting an APA under Rev. Proc. 2013-79 will require more effort and a more substantial submission than requesting an APA under Rev. Proc. 2006-9. However, the burdens associated with *not* having an APA (i.e., the costs and efforts associated with defending against an adjustment at Exam, followed possibly by MAP) are clearly increasing too.
- Comments on the proposed revenue procedures were due on March 10.

OECD TRANSFER PRICING DOCUMENTATION DISCUSSION DRAFT

OECD Transfer Pricing Documentation Discussion Draft Background

- Item 13 of the OECD's BEPS Action Plan calls for enhanced rules for transfer pricing documentation, including rules for the so-called "country-by-country" (cbc) reporting, or reporting of the "global allocation of the income, economic activity and taxes paid among countries according to a common template."
- Item 13 was scheduled to be completed by September 2014.
  - Cbc template anticipated to be released September 16, but other aspects of project may now be deferred to 2015.
- As an initial step in the process, the OECD released a White Paper on Transfer Pricing Documentation in July 2013.
  - White Paper endorsed a two-tier approach to transfer pricing that would require both a "Master File" (big picture information on the MNE as a whole) and a "Country File" (focused analysis of the specific transactions of a local affiliate).
- Public comments were due in October. The comments received focused heavily on concerns regarding administrative burdens and confidentiality.
- The OECD held a public consultation on November 12-13, 2013.

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OECD Transfer Pricing Documentation Discussion Draft Objectives and Proposals

- The OECD released a Discussion Draft on Transfer Pricing Documentation and Country-by-Country Reporting (the "Discussion Draft") on January 30, 2014.
  - Release of the Discussion Draft was expedited in light of the ambitious timeframe contemplated for BEPS Action Plan item 13.
  - The introductory paragraphs indicate that the Discussion Draft does not necessarily reflect a consensus of the Committee on Fiscal Affairs (CFA) or of Working Party n°6.
- The Discussion Draft both adopted the two-tier approach of the White Paper as follows.
  - <u>Master File</u> – A "blueprint" of the MNE group and contains relevant information that can be grouped in five categories:
    - a) the MNE group's organisational structure;
    - b) a description of the MNE's business or businesses;
    - c) the MNE's intangibles;
    - d) the MNE's intercompany financial activities; and
    - (e) the MNE's financial and tax positions.
  - <u>Local File</u> – "focuses on information relevant to the transfer pricing analysis related to transactions taking place between a local country affiliate and associated enterprises in different countries and which are material in the context of the local country's tax system."

OECD Transfer Pricing Documentation Discussion Draft CBC Reporting

- The "Local File" is similar to traditional transfer pricing documentation, *e.g.*, documentation pursuant to I.R.C. §6662(e), but the Master File goes beyond what is generally currently required.
  - The EU Joint Transfer Pricing Forum ("EU JTPF") has adopted its own version of a Two-Tier approach for EU MNEs
- In addition, the Discussion Draft proposes a "Model Template" for cbc reporting, as contemplated by item 13 of the BEPS Action Plan.
- The cbc Model Template would require disclosure of information such as number of employees, tangible assets, local sales and taxes paid by each entity in the MNE group.
  - The Discussion Draft left open for comment whether:
    - the Model Template would be required to be included in the Master File or if it would be a separate document; and
    - the Master File and the Model Template would be provided by local affiliates directly to their tax authorities or if it would be provided only to the parent country and exchanged government-to-government under the Exchange of Information procedures.
- One of the key purposes for requiring cbc reporting is to enable governments to do better *risk assessment*.
- The Model Template as it appears in the Discussion Draft follows on the next slide.

OECD Transfer Pricing Documentation Discussion Draft
CBC Reporting - continued

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Annex III to Chapter V: A Model Template of Country-by-Country Reporting

Overview of allocation of income, taxes and business activities on a country-by-country basis

Country	Constituent Entities Organised in the Country	Place of Effective Management	Important business activity code(s)	Revenues	Earnings Before Income Tax	Income Tax Paid (on Cash Basis)		Total Withholding Tax Paid	Stated capital and accumulated earnings	Number of Employees	Total Employee Expense	Tangible Assets other than Cash and Cash Equivalents	Royalties Paid to Constituent Entities	Royalties Received from Constituent Entities	Interest Paid to Constituent Entities	Interest Received from Constituent Entities	Service Fees Paid to Constituent Entities	Service Fees Received from Constituent Entities
						(a) To Country of Organisation	(b) To All Other Countries											
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OECD Transfer Pricing Documentation Discussion Draft CBC Reporting - continued

- Three of the primary concerns raised by MNEs with respect to cbc reporting are:
  - Administrative burdens – MNEs simply do not maintain or have systems capable of producing all of the cbc data in the format contemplate by the template.
  - Confidentiality – The information that would be required to be provided is highly sensitive, and there are legitimate concerns both about leaks as well as the possibility that public disclosure could be required by local law or regulation.
  - Misuse – Despite language in the Discussion Draft that reinforces the primacy of the arm's length standard, there is legitimate concern that the data could be misused for formulary apportionment or other "short-cut" non-arm's length approaches.

April 2, 2014 Update on BEPS Project

- Public comments on the Discussion Draft were discussed by Working Party n°6 in March 2014.
  - Developing countries consulted during the Annual Meeting of the Global Forum on Transfer Pricing in March 2014.
- In an April 2, 2014 webcast, the OECD announced the following tentative decisions by Working Party n°6:
  - Eliminate transactional reporting in cbc template (last six columns) – limit transactional reporting to local file
  - Retain reporting of activity measures on a country basis - number of employees, tangible assets, capital and retained earnings
  - Require country level financial data for all countries but not entity-by-entity reporting
  - Include a list of entities and PE's included in each country with numbers / activity codes for each

April 2, 2014 Update on BEPS Project - continued

- Provide flexibility regarding sources of financial data provided a consistent approach is followed for entire group and from year to year
- cbc template is to be a separate document rather than a part of the master file
- Clarify that the master file is supposed to be a high level overview
- Flexibility as to whether master file should be prepared on a group–wide basis or by line of business
- Eliminate proposal to include information on the top 25 highest paid employees in the master file

Proposed Changes to Model Template

CONFIDENTIAL CTPA/CFA/NOE2(2014)4/REV1/CONF

Annex III to Chapter V: A Model Template of Country-by-Country Reporting

Overview of allocation of income, taxes and business activities on a country-by-country basis

Country	Constituent Entities Organised in the Country	Place of Effective Management	Important business activity code(s)	Revenues	Earnings Before Income Tax	Income Tax Paid (on Cash Basis)		Total Withholding Tax Paid	Stated capital and accumulated earnings	Number of Employees	Total Employee Expense	Tangible Assets other than Cash and Cash Equivalents	Royalties Paid to Constituent Entities	Royalties Received from Constituent Entities	Interest Paid to Constituent Entities	Interest Received from Constituent Entities	Service Fees Paid to Constituent Entities	Service Fees Received from Constituent Entities
						(a) To Country of Organisation	(b) To All Other Countries											
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May 26, 2014 Update on BEPS Project

- The OECD held public consultations in May 2014.
- Working Party n°6 discussions on May 20-23, 2014:
  - Consensus in WP6 that the new approach will greatly improve the access for governments to relevant information for transfer pricing purposes
  - Agreement on a three tier approach (cbc template, Masterfile and Local File)
  - Agreement that a monitoring mechanism is needed to assess the effectiveness and efficiency of the tools
  - Broad recognition within WP6 that a structured and careful implementation is necessary to ensure:
    - consistency in the approaches by governments
    - that the relevant information is available to governments for which it is relevant on a timely basis
    - that commercially sensitive information is treated confidentially
    - that the costs for both taxpayers and tax administrations are balanced
    - to secure that the information is used as intended

Issues still under discussion following May OECD meetings

- Filing and sharing process for cbc template and for master file.
  - Best way to file and share the cbc report.
    - Issue is how to balance competing interests of safeguarding confidentiality and ensuring the timely distribution of the information to all stakeholder countries.
  - One approach discussed for filing and sharing the cbc template is to share under a tax treaty.
    - Parent company files with its domestic tax authority.
    - Subsidiaries' countries could request the cbc template under the Exchange of Information article.
  - Another approach would be to require direct filing with each local tax authority.
    - No consensus on how to ensure the information remains confidential.
  - Alternative approach discussed was for full public disclosure.
    - Approach favored by some NGOs.
- Guidance on language.

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OECD Transfer Pricing Documentation Discussion Draft CBC Reporting - outlook

- Predictions for final cbc template and discussion draft to be released on September 16:
  - Final cbc template unlikely to delete any columns beyond those that the OECD announced would be deleted in April.
  - Final guidance on implementation, filing and sharing of the cbc template to be deferred for another six months.
- What is in the September 16 deliverable?
- Were the prior predictions correct?

Model Template CBC Reporting

Annex III to Chapter V

A model template for the Country-by-Country Report

Table 1. Overview of allocation of income, taxes and business activities by tax jurisdiction

Name of the MNE group: Fiscal year concerned:										
Tax Jurisdiction	Revenues			Profit (Loss) Before Income Tax	Income Tax Paid (on cash basis)	Income Tax Accrued – Current Year	Stated capital	Accumulated earnings	Number of Employees	Tangible Assets other than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							

GUIDANCE ON TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING © OECD 2014

Model Template CBC Reporting – Table 2

Table 2. List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction

Name of the MNE group: Fiscal year concerned:															
Tax Jurisdiction	Constituent Entities resident in the Tax Jurisdiction	Tax Jurisdiction of organisation or incorporation if different from Tax Jurisdiction of Residence	Main business activity(ies)												
			Research and Development	Holding or Managing intellectual property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or Distribution	Administrative, Management or Support Services	Provision of Services to unrelated parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding shares or other equity instruments	Dormant	Other[2]
	1.														
	2.														
	3.														
	1.														
	2.														
	3.														

[2] Please specify the nature of the activity of the Constituent Entity in the "Additional Information" section.

Model Template CBC Reporting – Table 3

Table 3. Additional Information

Name of the MNE group: Fiscal year concerned:
Please include any further brief information or explanation you consider necessary or that would facilitate the understanding of the compulsory information provided in the country-by-country report.

Model Template CBC Reporting Summary

- Cbc reporting generated the most comments by stakeholders and changes were made in response to comments received. Many of the changes are the same as previously announced.
- The model template includes reporting of;

  By jurisdiction:

  – Revenues (related party / unrelated);
  – Profit (loss) before income tax;
  – Income tax paid (cash basis) and accrued;
  – Stated capital and accumulated earnings;
  – Number of employees;
  – Tangible assets other than cash/ cash equivalents.

  By entity:

  – Country of organization / incorporation;
  – Main business activity.

- Cbc reporting is intended to be a risk assessment tool and nothing more.

Model Template CBC Reporting Summary – continued

- The information required to be reported is agreed to but more discussion is needed on implementation and dissemination, the scope of the obligation (which companies are required to report) and possibly a phase in period.
- Source of data used for providing the information does not matter as much as consistency.
  - The same sources of data should be used consistently from year to year.
- The language of the transfer pricing documentation should be established under local laws.
  - Countries are encouraged to permit filing of transfer pricing documentation in commonly used languages. If translation of documents is necessary specific requests should be made.

OECD Transfer Pricing Documentation Discussion Draft CBC Reporting - outlook

- It should also be borne in mind that the finalization of the OECD's work in this area will not change the actual documentation rules in the U.S. and other countries.
  - Treasury officials have indicated their belief that the U.S. can implement cbc by issuing regulations under section 6038.
  - Currently, there is no project on Treasury's and IRS's business plan for regulations to implement cbc.
  - While the IRS clearly cannot require cbc reporting without changes to the regulations (if not to a statute), the IRS would presumably be able to request by IDR any cbc reports produced for other countries.
    - Moreover, while stopping short of requiring cbc reporting, the type of information that the IRS now expects to be provided early in an audit (see Transfer Pricing Audit Roadmap) or in connection with a request for competent authority assistance or an APA (see Notices 2013-78 and 79) is not dissimilar to what would be required to be included in the "Master File."

Recent Developments in Transfer Pricing – Trends and Common Themes

- The recent IRS and OECD developments all point to greater emphasis by the tax authorities on:
  - **Transparency**
  - Upfront **risk assessment** by the tax authorities
  - The **value chain** of the multinational enterprise rather than specific related party transactions
  - An enhanced role for **competent authority**

ALLEN v. UNITED STATES, 2014-1 U.S.T.C. (CCH) ¶50,300 (N.D. CAL. 2014)

Knowledgeable tax counsel and real estate investors appreciate that the federal income tax consequences of a real estate activity differ greatly depending on whether the owner primarily holds the real estate (i) for sale to customers in the ordinary course of a trade or business or (ii) for productive use in a trade or business or as an investment. Tax counsel commonly refer to real estate held primarily for sale to customers in the ordinary course of a trade or business as "dealer property," while the term "investor property" is often used to describe real estate held for productive use in a trade or business or as an investment.

The distinction between investor property versus dealer property is significant since "dealer" property is not eligible for (i) long term capital gain treatment, (ii) depreciation, (iii) like-kind exchange treatment under Code §1031, or (iv) installment sale treatment under Code §453. In addition, gain from dealer realty may be subject to (i) self-employment tax under Code §1401, (ii) in the case of tax-exempt organizations or qualified plans, unrelated business income tax under Code §511, or (iii) in the case of real estate investment trusts, the 100% prohibited transactions tax under Code §857(b)(6).

For long term capital gain treatment, Code §1221(a) defines a "capital" asset as property held by the taxpayer (whether or not connected with the taxpayer's trade or business), but specifically excludes *". . . property held by the taxpayer primarily for sale to customers in the ordinary course of his or her trade or business"*. Similarly, Code §1231(a)(3)(A) says "section 1231 gain" includes any recognized gain on the sale or exchange of *property used in the trade or business,* and Code §1231(b)(1), in defining "property used in the trade or business," excludes *property of a kind which would properly be included in inventory of the taxpayer . . . .*"

For like-kind exchange eligibility, Code §1031(a) requires that both the real estate transferred and the real estate received must be held by the taxpayer either "for productive use in a trade or business or for investment." However, Code §1031(a)(2)(A) specifically excludes *"stock in trade or other property held primarily for sale"*. The phrases "held for investment" and "held for use in a trade or business" are essential to qualifying an exchange as a tax-free exchange under Code §1031, but unfortunately, these phrases are not defined in Code §1031 or the income tax regulations under Code §1031. However, these phrases may have the same meaning as "used in the trade or business" employed in both Code §§167 and 1231.

As noted above, the key definitional language is "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" or "property . . . properly . . . included in inventory." Whether a taxpayer intends to hold a property for resale, or to hold for investment, is the critical issue. This analysis is commonly known as the "dealer versus investor test", and requires numerous factual determinations, none of which are controlling.

It is the taxpayer's intent at the time of sale which is determinative. *Cottle v. Commissioner*, 89 T.C. 467, 487 (1987). A taxpayer's intent in holding a property is a question of fact. See *Austin v. Commissioner*, 263 F.2d 460, 461 (1959). Often, it is the taxpayer's initial intent which suggests the intent at the time of sale. *Neal T. Baker Enters. v. Commissioner*, 76 T.C.M. 301 (1998). However, taxpayers have frequently demonstrated a changed intent, from being a "dealer" to begin an "investor" at the time of sale. Proving intent can be difficult. As a general rule, taxpayers tend to be more successful in proving a change in intent where they can demonstrate the change took place for a suitable period prior to the sale rather than on the eve of sale. See *Tibbals v. U.S.*, 362 F.2d 266, 273 (1966); *Eline Realty Co. v. Commissioner*, 35 T.C. 1, 5 (1960). Further, the Fifth Circuit has stated that, where unanticipated, externally induced factors or events occur, changed intent will be more convincing. See *Biedenharn Realty Co. v. U.S.*, 526 F.2d 409, 421 (5th Cir. 1976).

In *Suburban Realty Co. v. United States*, the Fifth Circuit developed a framework for determining whether sales of land are considered sales of a capital asset or sales of property held for sale to customers in the ordinary course of a taxpayer's business. 615 F.2d 171 (5th Cir. 1980). The three principal questions to be considered are:

1. Was the taxpayer engaged in a trade or business, and if so, what business?

2. Was the taxpayer holding the property for sale in that business?

3. Were the sales contemplated by the taxpayer "ordinary" in the course of that business?

In *Suburban Realty*, the Fifth Circuit looked to the earlier Fifth Circuit decision in *Biedenharn Realty Co. v. U.S.*, *supra*, for seven factors which should be considered when answering these three questions. These seven factors include:

1. the nature and purpose of the acquisition of the property and the duration of the ownership;

2. the extent and nature of the taxpayer's efforts to sell the property;

3. the number, extent, continuity and substantiality of the sales;

4. the extent of the subdividing, developing, and advertising to increase sales (i.e., what was the extent of advertising and other active efforts used in soliciting buyers for the sale of the property, and was the property listed with brokers?);

5. the use of a business office for the sale of the property;

6. the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and

7. the time and effort the taxpayer habitually devoted to the sales.

See also *U.S. v. Winthrop*, 417 F.2d 905, 910 (5th Cir. 1969). The frequency and substantiality of sales is the most important factor, although no one factor alone is decisive. *Suburban Realty*, 615 F.2d at 176; *Biedenharn*, 526 F.2d at 416. The extent of development activity and improvements also carries significant weight. The holding in *Suburban Realty* has led many advisors, especially those who practice within the Fifth Circuit, to believe that, since the frequency and substantiality of sales are important factors, realty held for a significant period of

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time and sold in one "bulk" sale will be safe from being characterized as dealer property – a so-called "one bite" rule. Advisors have felt even more comfortable with a "one bite" assessment where there have been no significant marketing activities (such as maintaining a sales office, general publication of promotional sales advisements or hiring of sales personnel) or physical improvements. *Compare with Cottle v. Commissioner*, 89 T.C. 467, 488 (1987); *S & H, Inc. v. Commissioner*, 78 T.C. 234, 244 (1982). See also *Goldberg v. Commissioner*, 223 F.2nd 1314 (5th Cir. 1955) (in which houses sold were not advertised, no "for sale" signs were used, no salesmen were hired, and no commissions were paid on sale).

Accordingly, the result reached in the recent case of *Allen v. United States*, 2014-1 U.S.T.C. (CCH) ¶50,300 (N.D. Cal. 2014), is notable. The taxpayer in *Allen* (a construction engineer by trade) admitted to originally acquiring the subject realty for the purpose of developing and reselling it. He argued, though, that over time he decided not to develop the property, but continued to hold it "for investment" until he could sell all of the realty, which finally occurred twelve years later. As a first impression, one might assume that realty held for more than a decade would not constitute dealer property. However, as shown in *Allen*, the taxpayer's initial intent proved more important than the length of the holding period.

The court in *Allen* granted summary judgment in favor of the IRS and found that the taxpayer originally acquired the property for development and resale, and that the taxpayer failed to adequately prove he changed his intent to "holding the property for investment." In deciding for the IRS, the court focused on the following facts: (i) from 1987 to 1995, the taxpayer attempted to develop the property on his own; (ii) the taxpayer admitted his initial intention to develop the property on his own, and searched for partners to help in the property's development; (iii) from 1995 to 1999, the taxpayer brought in partners who contributed capital for development; (iv) in 1999, the taxpayer sold the property to a developer; and (v) the taxpayer made significant efforts to develop the property over many years and failed to substantiate when his actions changed with regard to the property. The court noted ten engineering studies were prepared in respect to the subject realty. When the taxpayer sold the property in one conveyance, he received a lump sum (used to pay-off encumbering debt and prior partners), along with 22% of the buyer's profits and a set fee per developed lot sold.

It is interesting to note that there was no mention of whether the taxpayer ever engaged in any marketing activities for the realty at issue or made any physical improvements. It is this lack of marketing activity and physical improvements in *Allen* which concerns some tax observers. It seems the court in *Allen* was too easily convinced that the taxpayer was a dealer without completing the analysis and considering the rest of the seven factors discussed above. In this regard, remember that the taxpayer in Allen lost on summary judgment, which means the court must have determined there was no fact in controversy relating to the change in intent that could have been decided in the taxpayer's favor.

The result in *Allen* may not have been the same if decided by or in the Fifth Circuit, given the precedence of *Suburban Realty* and given (i) Allen's twelve year holding period, (ii) no prior sales, (iii) lack of physical improvements, (iv) minimal if any marketing activities, and (v) that the taxpayer in Allen appears to have decided to simply liquidate the investment (alla *Goldberg*, *supra*).

Perhaps *Allen* is an anomaly, or perhaps *Allen* can simply be read as a "failure to prove" case in respect to when, how or why the taxpayer's intent changed. *Allen* demonstrates the need for solid evidence and documentation establishing clear facts and circumstances whenever a taxpayer asserts a change in intent from an "intent to sell" to an "intent to hold for investment." Planners should anticipate that, upon audit or litigation, evidence will be required to support the taxpayer's assertion of their change of intent, and in this regard, planners should assist taxpayers in documenting and collecting evidence which establishes such a change in intent.

TAX SECTION
State Bar of Texas

September 16, 2014

VIA U.S. MAIL & FEDERAL eRULEMAKING PORTAL
HTTP://WWW.REGULATIONS.GOV

Mr. John Koskinen
Commissioner
CC:PA:LPD:PR (REG-121542-14)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

RE: Comments on Proposed Regulations Under Section 7602

Dear Commissioner Koskinen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS" or the "Service") in the notice of proposed rulemaking, REG-121542-14, for comments concerning the proposed regulations regarding participation of a person described in Section 6103(n) in a summons interview under Section 7602(a)(2) of the Internal Revenue Code (the "Proposed Regulations").

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Andrius R. Kontrimas
Chair, Tax Section
The State Bar of Texas

cc: Mark J. Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury

William J. Wilkins
Chief Counsel
Internal Revenue Service

Emily S. McMahon
Deputy Assistant Secretary (Tax Policy)
Department of the Treasury

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COMMENTS ON PROPOSED REGULATIONS REGARDING PARTICIPATION OF A PERSON DESCRIBED IN SECTION 6103(n) IN A SUMMONS INTERVIEW UNDER SECTION 7602(a)(2) OF THE INTERNAL REVENUE CODE

These comments on the Proposed Regulations ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. Principal responsibility for drafting these Comments was exercised by Richard L. Hunn. Robert C. Morris reviewed and provided substantive suggestions. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Robert Probasco, Chair of COGS, reviewed these Comments. Mary McNulty also reviewed the comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Person: Richard L. Hunn
richard.hunn@nortonrosefulbright.com
(713) 651-5293

Date: September 16, 2014

These Comments are provided in response to the request of the IRS and Treasury for comments concerning the notice of proposed rulemaking, REG-121542-14, regarding participation of a person described in Section 6103(n) in a summons interview under Section 7602(a)(2)[1] (the "Proposed Regulations"). The Tax Section applauds Treasury and the IRS for their efforts to improve the summons interview process and offer the following comments.

Recommendation

We believe that the Proposed Regulations are helpful in clarifying that a person who is authorized to receive returns and return information under Section 6103(n) and Treas. Reg. § 301.6103(n)-1(a) may receive and examine books, papers, records or other data produced in compliance with a summons, that such person may be present during a summons interview, and that such person may, in the course of a summons interview, receive, review and use summoned books, papers, records, or other data. We believe it would also be appropriate for such person to advise and consult with IRS officers or employees during the course of a summons interview. However, we respectfully suggest that Treasury and the IRS consider removing the provision permitting such person to question the witness under oath or to ask the witness's representative to clarify an objection or assertion of privilege, for the reasons discussed below.

Revised wording for Prop. Treas. Reg. § 301.7602-1(b)(3), based on this suggestion, might be as follows:

> (b)(3) *Participation of a person described in section 6103(n).* For purposes of this paragraph (b), a person authorized to receive returns or return information under section 6103(n) and § 301.6103(n)-1(a) of the regulations may receive and examine books, papers, records, or other data produced in compliance with the summons and, in the presence and under the guidance of an IRS officer or employee, participate in the interview of the witness summoned by the IRS to provide testimony under oath. Participating in such an interview means receipt, review and use of summoned books, papers, records, or other data, being present during the summons interview, taking notes during the summons interview, and advising and consulting with an IRS officer or employee regarding the IRS officer or employee's questioning of the witness.

Discussion

We recognize that the IRS may have particular reasons for including this provision, but we have prudential concerns about how it would operate in practice. Turning the questioning of a witness over to a third party contractor, as well as allowing the contractor to question the witness's representative regarding objections or assertions of privilege, may cause the IRS officer or employee in charge of the interview to lose control of the interview. Moreover, having multiple persons on the record—the IRS officer or employee, the private contractor, the witness, and the witness's representative—may lead to a cluttered, incomprehensible transcript of the interview.

We believe that the analogous practice at trial and deposition may be instructive. In a trial (or deposition), if examining counsel wishes to confer with co-counsel or a consultant, he or she may ask the court (or court reporter) for leave for a brief consultation. When counsel is ready, he or she will typically announce to the court (or court reporter) that he or she is ready to proceed, the court goes back on the record, and the examination continues.

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[1] Unless otherwise specified, all references to "Section" are to the Internal Revenue Code of 1986, as amended (the "Code"), all references to "Treas. Reg. §" are to the Treasury Regulations promulgated thereunder, and all references to "Prop. Treas. Reg. §" are to the Proposed Regulations.

We suggest that a similar process be followed in a summons interview. During the summons interview, the IRS officer or employee examining the witness would simply announce to the court reporter that he or she needs a moment to confer with the private contractor and then confer with that contractor. After the consultation, the IRS officer or employee would announce they were ready to go back on the record, and the examination of the witness would continue. Proceeding in this manner would, we believe, result in a more orderly proceeding and a cleaner, more comprehensible transcript of the interview.

Our suggestion also would avoid the unsettled question of whether a private contractor has the legal authority to examine a witness. In the context of an IRS examination and summons interview, a person authorized under Section 6103(n) and Treas. Reg. § 301.6103(n)-1(a) to receive returns and return information will typically be an expert consultant with whom the IRS has contracted to provide services. Consequently, that person is a private contractor rather than an officer or employee of the IRS.

The Proposed Regulations allowing a private contractor to question a witness during a summons interview may exceed the scope of the statute that authorizes summons interviews. Specifically, Section 7602(a) provides in pertinent part that "the Secretary is authorized—

> . . .
>
> (3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry."

Section 7701(a)(11) defines "Secretary" to mean "the Secretary of the Treasury or his delegate." Section 7701(a)(12)(A) in turn defines "or his delegate" in pertinent part as follows:

> . . . when used with reference to the Secretary of the Treasury, means any officer, employee, or agency of the Treasury Department duly authorized by the Secretary of the Treasury directly, or indirectly by one or more redelegations of authority, to perform the function mentioned or described in the context . . .

Section 7602(a), by its express terms, authorizes only an officer, employee or agency of the Treasury Department to take testimony of witnesses. The substance of the language in Section 7701(a)(12)(A) can be traced all the way back to the Internal Revenue Code of 1954. *See* I.R.C. § 7701(a)(12) (1954); H.R. Rep. No. 83-1337, at A437 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4586; S. Rep. No. 83-1622, at 619 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 5270.

Since the enactment of the Internal Revenue Code of 1954, we have not located any construction of the term "agency of the Treasury Department" to mean anything other than a bureau or branch of the Department. If the term were meant to refer to a third party agent, presumably it would have been framed as "agent of the Treasury Department." Historically, delegations by regulation, delegation orders and redelegation orders have been used to delegate authority only to officers and employees of the Treasury Department, and that has been the case with respect to delegations of authority to take testimony pursuant to a summons. *See* Treas. Reg. § 301.7701-9; Treasury Order No. 150-10; Delegation Order 1-23 (formerly DO-193, Rev. 6) at I.R.M. § 1.2.40.21(2) and (3); Delegation Order 25-1 (formerly DO-4, Rev. 23) at I.R.M. § 1.2.52.2, which include delegations and redelegations of authority to various officers and employees of the Treasury Department to take testimony under oath of the person summoned. We are unaware of such regulations or orders previously being used to delegate authority to third party contractors. This suggests that statutory authorization may be required for such delegation. For example, when the IRS was authorized to hire private contractors to perform tax collection functions in 2004, Congress enacted a statute specifically authorizing it. *See* I.R.C. § 6306, which was enacted by the American Jobs Creation Act of 2004, P.L. 108-357, § 881(a)(1).

The preamble to the temporary regulations[2] notes that allowing a private contractor to question summoned witnesses is consistent with Treas. Reg. § 301.7602-2(c)(1)(i)(B) and (c)(1)(ii) Example 2. That regulation, for purposes of notice of third party contacts by the IRS under Section 7602(c), treats private contractors as if they were IRS employees. However, that regulation also specifically provides, "No inference about the employment or contractual relationship of such other persons [i.e., private contractors] with the IRS may be drawn from this regulation for any purpose other than the requirements of section 7602(c)." Treas. Reg. § 301.7602-2(c)(1)(i)(B). Thus, that regulation apparently would not provide the necessary authorization for the Proposed Regulations.

Because the Proposed Regulations arguably exceed the statutory authority under Section 7602(a) by allowing a private contractor to examine a witness under oath, we respectfully request that this provision be removed. Including this provision in the final Treasury regulations would result in litigation and the expenditure of substantial time and resources by the IRS, taxpayers, third party witnesses and the courts. These costs would outweigh the potential benefits from allowing a private contractor to examine a witness under oath, rather than simply consult with the IRS agent questioning the witness.

We appreciate the opportunity to provide these Comments to the Proposed Regulations.

[2] T.D. 9669, incorporated in the Proposed Regulations by reference.

TAX SECTION
State Bar of Texas

June 26, 2014

Via U.S. Mail

Mr. John Koskinen, Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20024

Ms. Karen L. Hawkins, Director
Office of Professional Responsibility
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20024

RE: Proposed Revision to Circular 230

Dear Commissioner Koskinen and Director Hawkins:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed proposal for a revision to 31 Code of Federal Regulations, Subtitle A, Part 10, Regulations Governing Practice Before the Internal Revenue Service ("Circular 230"). The Circular 230 rules for written advice were changed in final regulations (T.D. 9668) issued on June 9, 2014. Our proposal here is not related to those June 9th changes to Circular 230.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

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THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We appreciate the opportunity to provide input on how best to regulate practice before the Service and we appreciate your consideration of our recommendation.

Respectfully submitted,

Elizabeth Copeland

Elizabeth Copeland
Chair, Tax Section
The State Bar of Texas

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PROPOSED REVISION TO CIRCULAR 230

This proposed revision to Circular 230 is submitted on behalf of the Tax Section of the State Bar of Texas. Principal responsibility for drafting these comments was exercised by Robert D. Probasco and Dustin Whittenburg. Richard L. Hunn, the Chair of the Tax Controversy Committee, reviewed the comments and made substantive suggestions. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. David Colmenero reviewed the comments and made substantive suggestions on behalf of COGS. Stephanie Schroepfer, the Co-Chair of COGS, also reviewed the comments on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: June 26, 2014

Section 10.27(b)(1) of Circular 230 prohibits, with certain exceptions, charging a contingent fee for services rendered in connection with any matter before the Internal Revenue Service (the "Service"). The "audit exception," in Section 10.27(b)(2), allows a practitioner to charge a contingent fee for services rendered in connection with the Service's examination of, or challenge to, either an original tax return or an amended return (or claim for refund or credit) filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to, the original tax return.

We understand the Service's concerns with respect to the use of contingent fees in representing a taxpayer before the Service. We appreciate the exceptions included in Section 10.27(b), allowing the use of contingent fees for situations less likely to involve the Service's concerns. We believe, however, that it would be appropriate to expand the scope of Section 10.27(b)(2) slightly.

We understand the audit exception as justified by two factors, which are often not applicable to other representation before the Service. First, the audit exception only applies when the Service is already examining the tax return. Charging a contingent fee for pre-filing advice or preparing a return might encourage a taxpayer to take overly aggressive positions. For services rendered in connection with an audit, however, there is no question of playing the "audit lottery." Second, audits and Appeals hearings are by their nature adversarial proceedings for which professional assistance is important. Taxpayers may be ill-equipped to participate in such proceedings without the assistance of a qualified professional. Without the possibility of a contingent fee arrangement, the taxpayer may find it more difficult to arrange competent representation. For these reasons, the audit exception to the prohibition against contingent fees is well justified. However, those two factors that justify the audit exception also apply in other circumstances that are not clearly covered by the literal language of Section 10.27(b)(2), because the Service is not examining or challenging the tax liability on the tax return.

For example, examinations to determine whether to impose the trust fund recovery penalty of Internal Revenue Code ("Code") Section 6672 on a responsible person, whether to impose transferee liability under Code Section 6901, or whether to extend Code Section 6015 innocent spouse relief from joint and several liability, normally are not examinations of or challenges to the tax liability reflected on the return. The Service is merely determining against whom it will collect that tax liability.

Similarly, services rendered in connection with a collection due process ("CDP") hearing under Code Section 6320 or 6330 do not fall clearly within the scope of any of the exceptions to the prohibition against contingent fees. CDP hearings may involve challenges to the liability, for items that the taxpayer has not previously had an opportunity to contest such as assessable penalties or interest. In such situations, the CDP hearing is a limited post-assessment, pre-payment alternative to a claim for credit or refund with respect to penalties or interest. But because the CDP hearing is post-assessment and pre-payment, it is not clear whether it falls within the literal language of "in connection with the Service's examination of, or challenge to" a return, in Section 10.27(b)(2), or a refund claim for penalties and interest, in Section 10.27(b)(3). Allowing a contingent fee for representing the taxpayer in a CDP hearing, when the taxpayer is disputing liability for the amount owed, would be helpful to taxpayers who are not in the financial position to pay these amounts and then file a refund claim.

For all of these examples, the Service should already be aware of the tax issues involved, so there is no reliance on the audit lottery. Further, these are adversarial proceedings for which the assistance of a competent representative is important. Therefore, we respectfully suggest that Section 10.27(b)(2) be revised to allow additional contingent fees situations.

A revision to Section 10.27(b), taking into account the considerations detailed in the paragraphs above, might read as follows:

(2) A practitioner may charge a contingent fee for services rendered in connection with –

(i) The Service's examination of, or challenge to –

(a) An original tax return; or

(b) An amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to, the original tax return;

(ii) The Service's determination of whether to impose a penalty under Section 6672 of the Internal Revenue Code ("Code"), whether to impose transferee liability under Section 6901 of the Code, or whether to provide relief from joint and several liability under Section 6015 of the Code; or

(iii) A collection due process hearing under Section 6320 or 6330 of the Code, to the extent that the taxpayer disputes liability.

Thank you in advance for your consideration of this recommendation.

TAX SECTION
State Bar of Texas

June 25, 2014

Via U.S. Mail

CC:PA:LPD:PR Notice 2014-5
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Comments on Internal Revenue Service Notice 2014-5 Discrimination Testing Standards Applicable to Softly Frozen Defined Benefit Pension Plans

Dear Sirs and Madams:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Internal Revenue Service in Notice 2014-5, for comments concerning discrimination testing standards applicable to softly frozen defined benefit pension plans (the "*Notice*").

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THESE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED FOR THESE COMMENTS AND THESE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Service for the time and thought that has been put into preparing the Notice, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Elizabeth Copeland

Elizabeth A. Copeland
Chair, Tax Section
The State Bar of Texas

COMMENTS REGARDING NOTICE 2014 DISCRIMINATION TESTING STANDARDS APPLICABLE TO SOFTLY FROZEN DEFINED BENEFIT PENSION PLANS.

The principal drafters of these comments are Stephanie Schroepfer and Henry Talavera. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these comments. Robert Probasco, the Co-Chair of COGS, reviewed these comments. Felicia Finston also reviewed these comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing, reviewing and approving these comments have clients who would be affected by the principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: June 25, 2014

These comments are provided in response to the request by the Internal Revenue Service (the "*IRS*") in IRS Notice 2014-5 (the "*Notice*") for comments concerning what discrimination testing standards should apply to softly frozen defined benefit plans under regulations issued by the IRS under Sections 401(a)(4) and 410(b) of the Internal Revenue Code of 1986, as amended.[1]

We applaud the efforts of the Treasury and the IRS to address the discrimination testing qualification challenges that threaten the viability of softly frozen traditional defined benefit pension plans.

Although as a technical legal matter employers are free to prospectively change, freeze or terminate at any time their traditional single-employer defined benefit pension plans that are subject to Title IV of ERISA ("defined benefit plans"), many employers feel that they have established social bargains with their long-service employees that the employers wish to fulfill. Presumably, all stakeholders involved, employers, long-service employees and the government agree that it is important for employers to be permitted to fulfill their social bargains with employees by delivering anticipated benefits under long-standing defined benefit plan pension formulas.

Under many traditional defined benefit plans (such as "final average pay pension plans")[2] long-service employees have worked for years for the same employers and expect to receive pension benefits under the same pension formulas that applied to them in their younger years. Many of these long-service employees will suffer significant diminutions in their anticipated retirement benefits if employers completely freeze their benefit accruals. In order to retain long-service employees and to comply with qualification requirements under Section 411 of the Code, many traditional defined benefit plans have back-end loaded accruals in which employees' largest accruals are designed to occur at the ends of their careers. Long-service employees have fulfilled their parts of the social bargains with employers – they have worked 15 or more years under the same pension formulas and are now poised to earn their highest accruals (the back-end loaded part). The idea of depriving long-service employees of these accruals is noxious to many employers who wish to fulfill their parts of the social bargains (as evidenced by the fact that they chose to engage in soft freezes rather than hard freezes of their defined benefit plans).[3]

While we appreciate the IRS' stated concern that employers may be incented to softly freeze their traditional defined benefit pension plans in order to avoid discrimination testing if the discrimination testing rules are relaxed for softly frozen plans, in our experience, employers that opt to engage in soft freezes (rather than hard freezes) of traditional defined benefit plans are doing so primarily to fulfill their social obligations with long-service employees.

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[1] Unless otherwise specified, all references to "Section" are to the Internal Revenue Code of 1986, as amended (the "Code"), all references to "Treas. Reg. §" are to the Treasury Regulations promulgated thereunder.

[2] A final average pay formula is typically based upon the employee's years of service multiplied by a percentage of the average of the employee's most recent annual compensation during a specified period of years.

[3] A "soft freeze" involves the cessation of accruals for new hires whereas a "hard freeze" involves the complete cessation of accruals for all persons. We use the term "soft" as synonymous with the term "closed," which the IRS defines with respect to a defined benefit plan as plans "that provide ongoing accruals but that have been amended to limit those accruals to some or all of the employees who participated in the plan on a specified date.

Over the past 25 to 30 years, traditional defined benefit plans have been dying. This is a reality, as evidenced by widely publicized demographic data. In the early 1990s, there were about 100,000 single-employer defined benefit plans sponsored by private employers; today, the number of such plans is about 26,000.[4]

Unfortunately, absent unforeseen circumstances, we believe that traditional defined benefit plans are on a path to extinction. During the past 25 years many employers have determined to completely freeze or terminate their traditional defined benefit pension plans for a variety of reasons, including mitigating volatility of required minimum contributions and expenses on their financial statements, frustration with what employers perceive to be unpredictable tax qualification statutes enacted with inconsistent goals, complex regulations, and increasing costs (including as a result of repeated increases in PBGC premiums).

We respectfully suggest that the IRS consider taking as pragmatic a position as possible in presiding over the apparently inevitable demise of most, if not all, traditional defined benefit plans in an orderly manner that encourages and enables employers to satisfy their social bargains with long-service employees.

In our experience, employers that have softly frozen their traditional defined benefit plan typically have engaged actuaries, lawyers and consultants to estimate the durations of the limited life expectancies of such plans due to the inevitable inability to comply with even the most sophisticated, complex discrimination testing rules presently available. The discrimination testing rules in their present form will cause an acceleration of hard freezes of traditional defined benefit pension plans. Many employers have waited as long as they can without jeopardizing the qualified status of their traditional defined benefit plans. We suggest that time is running out for the IRS to issue meaningful relief to avoid accelerating the pace of hard freezes of traditional defined benefit plan accruals.

Below we propose certain preliminary recommendations. We would be happy to consult with the IRS concerning the recommendations.

Recommendations

<u>Alternative 1</u>: <u>Completely Exempt Softly Frozen Traditional Defined Benefit Plans From Discrimination Testing</u>.

We respectfully suggest that the IRS consider completely exempting softly frozen defined benefit plans from nondiscrimination testing rules (for periods following the dates on which the plans are softly frozen) so long as no new highly compensated employees ("HCEs") are allowed to participate in the plan.

If the IRS deems it appropriate, the IRS may wish to consider limiting this exemption to mature softly frozen defined benefit plans that have provided accruals for at least ten[5] full years.

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[4] Pension Benefit Guaranty Corporation ("PBGC") website: http://www.pbgc.gov/about/who-we-are.html.

[5] A ten-year threshold would be consistent with the minimum period of time during which a pension plan must be maintained (as a general rule) in order to satisfy the qualification rule known as the permanency requirement.

Alternative 2: Apply Alternative Discrimination Testing Standards for Softly Frozen Traditional Defined Benefit Plans.

If the IRS believes that it is necessary to apply some discrimination testing standards to softly frozen traditional defined benefit plans (even though at some point the plans may not satisfy the alternative rules) we suggest that the IRS consider drafting nondiscrimination testing rules that are lenient enough for the lives of the plans to be extended for meaningful periods of time.

As the IRS noted in the Notice, frozen defined benefit plans frequently satisfy the coverage test of Section 410(b) and the nondiscrimination test of Section 401(a)(4) by aggregating the plan with a defined contribution plan (called a "DB/DC plan" in Treas. Reg. § 1.401(a)(4)-9(b)), converting certain employer contributions under the defined contribution plan to actuarially equivalent benefits, and testing the aggregated DB/DC plan for nondiscrimination on a "benefits" basis (rather than on the basis of contributions). This testing methodology has enabled many defined benefit plans to satisfy the discrimination testing rules. However, as the IRS noted in the Notice, this testing methodology is generally available only in limited situations outlined in Treas. Reg. § 1.401(a)(4)-9(b)(2)(v). The methodology is available if the DB/DC plan satisfies the "primarily defined benefit in character" or "broadly available separate plans" thresholds specified in Treas. Reg. § 1.401(a)(4)-9(b)(2)(v). Over time, a DB/DC plan that includes a softly frozen defined benefit plan will inevitably have difficulty satisfying these thresholds for being able to test for nondiscrimination on a "benefits basis".

We respectfully suggest that the IRS consider amending Treas. Reg. § 1.401(a)(4)-9(b) to include special rules for DB/DC plans that include softly frozen defined benefit plans. We suggest that additional thresholds for being able to test for nondiscrimination on a "benefits basis" be added that are modeled after the rules set forth in Treas. Reg. § 1.401(a)(4)-9(b)(2)(v) but with certain modifications that improve the likelihood the thresholds may be satisfied by aging softly frozen defined benefit plans.

We suggest that the primarily defined benefit in character threshold specified in Treas. Reg. § 1.401(a)(4)-9(b)(2)(v) be modified by substituting 5% for 50% in the case of a DB/DC plan that consists of a softly frozen defined benefit plan and does not include active defined benefit plans[6]. We believe that a 5% threshold is sufficient for demonstrating that the defined benefit plan covers a meaningful number of employees who are not HCES (NHCEs). In our experience, and the experience of other commentators, mature softly frozen defined benefit plans are not maintained by employers with any intention to discriminate against NHCEs or in favor of HCEs. Rather, they are maintained primarily to fulfill social bargains with long-service employees (many of whom were NHCEs earlier in their careers).

We suggest that the broadly available separate plans threshold be modified by removing the problematic requirement that a softly frozen defined benefit plan separately satisfy the coverage test of Section 410(b) of the Code.

Under our proposal, Treas. Reg. § Section 1.401(a)(4)-9(b) would be modified by adding the following new Paragraph (4):

[6] In our view, it is reasonable for the IRS to expect an active defined benefit plan to satisfy (either alone or on a basis that involves aggregation with another plan) to satisfy the existing coverage and nondiscrimination tests of Sections 410(b) and 401(a)(4) of the Code.

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(4) *Special rules for DB/DC Plan that includes softly frozen DB Plan.*

(i) *General.* The following alternative rules specified in Subparagraphs (ii) through (iv) may be applied (at the option of the employer) in the case of a DB/DC plan that includes one or more softly frozen defined benefit plans but no other defined benefit plan.

(ii) *Primarily defined benefit in character.* A DB/DC plan that includes one or more softly frozen defined benefit plans, but no other defined benefit plan, is deemed to be primarily defined benefit in character for purposes of Paragraph (b)(2)(v) of this Section if, for at least 5% of the NHCEs benefitting under the DB/DC Plan, the normal accrual rate for the NHCE attributable to benefits provided under the defined benefit plans that are part of the DB/DC plan exceeds the equivalent accrual rate for the NHCE attributable to contributions under defined contribution plans that are part of the DB/DC plan.

(iii) *Broadly available separate plans.* A DB/DC Plan that includes one or more softly frozen defined benefit plans, but no other defined benefit plan, consists of broadly available separate plans for purposes of Paragraph (b)(2)(v) of this Section if: (1) the defined contribution plans and the defined benefit plans that are part of the DB/DC plan each would satisfy the nondiscrimination in amount requirement of § 1.401(a)(4)-1(b)(2) if each plan were tested separately and assuming that the average benefit percentage test of § 1.410(b)-5 were satisfied and (2) the defined contribution plan that is part of the DB/DC plan would satisfy the requirements of Section 410(b) if it was tested separately. For these purposes, all defined contribution plans that are part of the DB/DC plan are treated as a single defined contribution plan and all defined benefit plans that are part of the DB/DC plan are treated as a single defined benefit plan. In addition, if permitted disparity is used for an employee for purposes of satisfying the separate testing requirement of this Paragraph (b)(2)(v)(C) for plans of one type, it may not be used in satisfying the separate testing requirement for plans of the other type for the employee.

(iv) *Alternative definition of HCE.* For purposes of this Paragraph (4), the determination of whether an individual is an HCE or an NHCE shall be made by applying the applicable dollar threshold in effect under Section 401(a)(17) of the Code for the plan year rather than the dollar limitation under Section 414(q) of the Code.

We suggest that the IRS consider amending Treas. Reg. § 1.401(a)(4)-12 by adding the following new definition:

Softly frozen defined benefit plan means a defined benefit plan that provides accruals only for a specific group of employees who are identified as of a specific date. A *softly frozen defined benefit plan* may include a defined benefit plan that specifies employees who are rehired or otherwise return to service after a specified date may accrue benefits under the defined benefit plan so long as the employees are within the specific group of employees who are identified as of a specific date.

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In addition to the foregoing recommendations, we wish to articulate our strong support for the IRS' proposal to modify the discrimination testing standards by permitting matching employer contributions to be taken into account for purposes of demonstrating that a DB/DC Plan satisfies the nondiscrimination in amount requirement of Treas. Reg. § 1.401(a)(4)-1(b)(2) on the basis of benefits. We believe it would be rationale to permit employers to take into account matching contributions for testing discrimination in the amounts of benefits under a DB/DC Plan and that excluding matching contributions from the test may result in testing failures for common and benign plan designs.

We appreciate the opportunity to provide these comments concerning the Notice.

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TAX SECTION
State Bar of Texas

June 20, 2014

Via U.S. Mail

Mr. John Koskinen, Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20024

CC:PA:LPD:PR (REG-119305-11)
Courier's Desk
Internal Revenue Service
1111 Constitution Av,e NW
Washington, DC 20044

RE: Comments on Proposed Regulations Regarding Disguised Sales and the Allocation of Liabilities

Dear Commissioner Koskinen:

On January 29, 2014, the Department of the Treasury ("***Treasury***") and the Internal Revenue Service (the "***Service***") published proposed Treasury regulations (the "***Proposed Regulations***") under Sections 707 and 752 of the Internal Revenue Code [REG-119305-11] and requested comments on the proposed rules. On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the following comments on the Proposed Regulations.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

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We commend Treasury and the Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Elizabeth Copeland

Elizabeth Copeland
Chair, Tax Section
State Bar of Texas

COMMENTS ON PROPOSED TREASURY REGULATIONS SECTION 1.707-4, AS PUBLISHED IN THE FEDERAL REGISTER ON JANUARY 29, 2014

Principal responsibility for drafting these comments was exercised by David S. Peck and Gary R. Huffman. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these comments. Robert Phillpott reviewed the comments and made substantive suggestions on behalf of COGS. Robert Probasco, the Co-Chair of COGS, also reviewed the comments on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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The Proposed Regulations address a number of deficiencies and technical ambiguities in the existing regulations under Section 707(a)(2)(B)[1] (relating to disguised sales of property to or by a partnership) and under Section 752 (relating to the treatment of partnership liabilities). These preliminary comments are limited to recommending expansion of the guidance provided in the Proposed Regulations concerning the reimbursements of certain preformation capital expenditures (the "**exception for preformation capital expenditures**"). This should not be construed as implying that we agree with other aspects of the Proposed Regulations. The Tax Section of the State Bar of Texas anticipates submitting comments regarding the treatment of partnership liabilities at a later date.

We respectfully recommend that final regulations include (1) specific guidance regarding the application of the exception for preformation capital expenditures in certain common circumstances involving tiered partnerships and (2) additional guidance regarding the meaning of the term "property" for purposes of the exception for preformation capital expenditures. Each recommendation is discussed in detail below.

I. Application of the Exception for Preformation Capital Expenditures in Tiered Partnership Transactions.

A. Recommended Clarification

We respectfully recommend that final regulations include specific guidance regarding the application of the exception for preformation capital expenditures in two common circumstances involving tiered partnership structures. First, we recommend that any final regulations clarify that if a partner (the "***Contributing Partner***") makes capital expenditures (as defined in the Proposed Regulations) with respect to property that is contributed to a partnership ("***Upper Tier Partnership***") and the Upper Tier Partnership subsequently contributes that property to another partnership ("***Lower Tier Partnership***"), that the Upper Tier Partnership can receive a distribution from the Lower Tier Partnership that qualifies for the exception for preformation capital expenditures to the same extent that a distribution from the Upper Tier Partnership to the Contributing Partner would qualify for the exception.

For example, assume that Contributing Partner owns Property X, which has a fair market value of $1,000 and a tax basis of $200. Contributing Partner has made capital expenditures of $100 with respect to Property X within the past two years. Contributing Partner contributes Property X to Upper Tier Partnership ("***Upper Tier Contribution***"), which then contributes Property X to Lower Tier Partnership ("***Lower Tier Contribution***"). Lower Tier Partnership makes a $100 transfer to Upper Tier Partnership, which then makes a $100 transfer to Contributing Partner as a reimbursement of preformation capital expenditures with respect to Property X.

Absent the recommended clarification, there would be a question regarding whether the $100 transfer received by Upper Tier Partnership from Lower Tier Partnership in the Lower Tier Contribution is treated as disguised sale proceeds or a distribution under the exception for

[1] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "***Code***"), or a section of the Treasury Regulations, unless otherwise indicated.

preformation capital expenditures. If the $100 transfer were treated as disguised sales proceeds, Contributing Partner would be allocated the resulting gain by the Upper Tier Partnership under Section 704(c) even though the Upper Tier Contribution would qualify for the exception for preformation capital expenditures.

Similarly, we recommend that any final regulations clarify that if a Contributing Partner makes capital expenditures (as defined in the Proposed Regulations) with respect to property contributed to a Lower Tier Partnership and the Contributing Partner subsequently contributes her interest in Lower Tier Partnership to Upper Tier Partnership, that the Contributing Partner can receive a distribution from the Upper Tier Partnership that qualifies for the exception for preformation capital expenditures to the same extent that a distribution from the Lower Tier Partnership to the Contributing Partner would have qualified for the exception.

For example, assume that Contributing Partner owns Property X, which has a fair market value of $1,000 and a tax basis of $200. Contributing Partner has made capital expenditures of $100 with respect to Property X within the past two years. Contributing Partner contributes Property X to Lower Tier Partnership in exchange for an interest therein. Contributing Partner then contributes her interest in Lower Tier Partnership to Upper Tier Partnership in exchange for a partnership interest plus a transfer of $100.

Absent the recommended clarification, there would be a question regarding whether the $100 transfer by Upper Tier Partnership to Contributing Partner qualifies for the exception for preformation capital expenditures.

B. Background and Analysis

Section 1.707-4(d) of the existing regulations provides that a transfer of money or other consideration by a partnership to a partner is not treated as part of a sale of property by the partner to the partnership under Section 1.707-3(a) to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that—

> (1) Are incurred during the two-year period preceding the transfer by the partner to the partnership; and
>
> (2) Are incurred by the partner with respect to—
>
> > (i) Partnership organization and syndication costs described in Section 709; or
> >
> > (ii) Property contributed to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20% of the fair market value of such property at the time of the contribution. However, the 20% of fair market value limitation of this Paragraph (d)(2)(ii) does not apply if the fair market value of the contributed property does not exceed 120% of the partner's adjusted basis in the contributed property at the time of contribution.

The preamble to the Proposed Regulations states that "the purpose of the exception for preformation capital expenditures is to permit a partnership to reimburse a contributing partner for expenditures incurred with respect to contributed property."

There are several authorities, including the Proposed Regulations, that address the application of other exceptions to the disguised sale rules in tiered partnership transactions. However, there are no authorities that address the application of the exception for preformation capital expenditures in circumstances involving tiered partnerships. Our recommended clarifications are consistent with the purpose of the exception for preformation capital expenditures and also consistent with authorities, including the Proposed Regulations, which address the application of other exceptions to the disguised sale rules in tiered partnership and other circumstances. These authorities are described briefly below.

Treasury Regulation Section 1.707-5(e) provides that if a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the characterization as qualified or nonqualified that it had in the upper-tier partnership.

The Proposed Regulations would clarify that the debt-financed distribution exception of Treasury Regulation Section 1.707-5(b) applies in a tiered partnership setting by providing that "an upper-tier partnership's share of the liabilities of a lower-tier partnership that are treated as a liability of the upper-tier partnership under Section 1.752-4(a) shall be treated as a liability of the upper-tier partnership incurred on the same day the liability was incurred by the lower-tier partnership." Similarly, the Proposed Regulations adopt an aggregate approach for purposes of determining whether (in a contribution of an interest in a lower-tier partnership to an upper-tier partnership) the contributing partner's share of the liabilities of the lower-tier partnership are qualified liabilities.

In Rev. Rul. 2000-44,[2] a corporation incurred capital expenditures to acquire property and subsequently liquidated into its corporate parent in a transaction which met the requirements of Section 332. Within two years of the time the liquidating corporation had made its capital expenditures on the property, the parent corporation contributed such property in exchange for partnership interests and a reimbursement for preformation expenditures in an amount equal to the capital expenditures made by the liquidating corporation. The Service observed that:

> Where a corporation incurs preformation expenses or undertakes a borrowing, and another corporation acquires assets of the corporation in a Section 381 transaction, the transfer does not alter the circumstances under which the expenditures or indebtedness were originally incurred <u>or otherwise raise concerns that would justify not treating the transferee corporation as having incurred the expenditures or undertaken the liabilities at the time they were incurred or undertaken by the predecessor corporation</u>.[3]

The theme of the authorities applying exceptions to the disguised sale rules to persons other than a partner directly incurring a liability or expenditure is that the rules should be extended to cases where application is consistent with the underlying purpose of the exception

[2] 2000-2 C.B. 336.
[3] Emphasis added.

and does not raise concern regarding abuse. The clarifications recommended above are consistent with the policy underlying the exception for preformation capital expenditures and provide little (if any) opportunity for abuse. Because these types of tiered partnership transactions occur with some frequency, we recommend that final regulations include our proposal.

II. Definition of "Property" for Purposes of the Exception for Preformation Capital Expenditures under Section 1.707-4(d).

A. Recommended Clarification

We respectfully recommend that any final regulations include a flexible standard regarding the term "property" for purposes of applying the exception for preformation capital expenditures. Specifically, for the reasons discussed below, we recommend that final regulations state that in appropriate circumstances, the term "property" is broader than each separate capitalized asset contributed by a partner.

B. Background and Analysis

The Proposed Regulations clarify that the references in the exception for preformation capital expenditures to "such property" and "contributed property" are intended to refer "to the single property for which the expenditures were made." The preamble to the Proposed Regulations states that "in the case of multiple property contributions, the proposed regulations provide that the determination of whether the fair market value limitation and the exception to the fair market value limitation apply to the reimbursements of capital expenditures is made separately for each property that qualifies for the exception."

Under this clarified rule, the meaning of each separate "property" is critical. The Proposed Regulations, however, do not provide a definition. In order to eliminate potential disputes between taxpayers and the Service over the meaning of "property" for this purpose, and in recognition of the practical difficulties inherent in valuing various components of integrated facilities, we recommend that final regulations acknowledge that the term "property" has, in appropriate circumstances, a broader meaning than each separate capitalized asset.

The issue is best illustrated by example. Suppose that a taxpayer owns and operates an oil refinery. A refinery consists of various components that perform different parts of the refining process (e.g., a distillation unit, catalytic cracker, separator, pumps, condensers, alkylation units, etc.). Even though each of the individual components is part of a larger facility designed to accomplish the refining of crude oil, each component may constitute a separate depreciable asset under Section 167. For example, assume that a taxpayer constructs a refinery and places it in service in 2008. In 2014, the taxpayer has to replace the catalytic cracker and is required to treat the new catalytic cracker as a separately depreciable asset.[4] If the taxpayer contributes the refinery to a partnership in 2015, the question is whether, in applying the

[4] *See, e.g.*, Treas. Reg. §§ 1.162-4, 1.263(a)-3. Pursuant to those regulations, the taxpayer may have to account for the catalytic cracker as a separate capital expenditure and depreciate it separately from the refinery.

exception for preformation capital expenditures, the "property" is the refinery as a whole, or instead, whether the new catalytic cracker must be treated as separate "property."

Viewing the catalytic cracker as a separate property poses difficulties arising principally from the fact that it is part of a functionally integrated facility. As such, it will be difficult, as a practical matter, and unusual, as a factual matter, to determine a separate fair market value for the catalytic cracker.

We understand that providing a highly specific and comprehensive definition of "property" by regulation may be difficult. However, we believe that guidance should be provided clarifying that the definition of "property" for purposes of the exception for preformation capital expenditures will not necessarily correspond to the determination of whether a property is a separate asset for depreciation purposes. We believe such guidance would help to avoid unnecessary disputes and prevent the imposition of limitations on the exception for preformation capital expenditures that would render it useless as a practical matter in many common cases involving contributions of integrated property consisting of multiple properties.

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