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FICPA

2010 Florida Institute on Federal Taxation® Conference

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Wednesday, November 3, 2010

8:00-8:45 a.m. — **Registration and Continental Breakfast**

8:45-9:00 a.m. — **Introduction and Opening Remarks**
Larry J. Herring
Committee Chair

9:00-10:40 a.m. — **Federal Tax Update 1**
Katherine Breaks
Director / KPMG LLP

10:40-10:55 a.m. — **Break**

10:55-11:45 a.m. — **Tax Preparer Penalties/Regulations 39**
Charles P. Sparano, CPA, MBA, MST
Tax Director / RSM McGladrey

11:45a.m. – 12:35p.m. — **Tax Controversies 62**
Samuel C. Ullman
Partner / Bilzin Sumberg Baena Price & Axelrod LLP

12:35-1:25 p.m. — **Lunch**

1:25-3:05 p.m. — **Hot Topics in Entity Planning 64**
Richard B. Comiter, JD, LLM
Senior Partner/Comiter, Singer & Baseman, LLP
and
Domenick R. Lioce, Esq, CPA
Attorney/Nason, Yeager, Gerson, White & Lioce, PA

3:05-3:15 p.m. — **Break**

3:15-4:05 p.m. — **Federal Credits and Incentives 86**
Karen A. Lake, CPA
Tax Manager / Berkowitz Dick Pollack & Brant CPAs & Consultants, LLP

4:05-4:55 p.m. — **Post Mortem Tax Planning 102**
Mary Lee Mosley
Tax Director, Private Client Advisors / Deloitte Tax, LLP

Thursday, November 4, 2010

7:30-8:00 a.m.	**Continental Breakfast**
8:00-9:40 a.m.	**Real Estate Hot Topics .... 118** Charles H. Egerton, Esq. Shareholder Dean, Mead, Egerton, Bloodworth, Capouano & Bozarth, P.A. and Christine Weingart Associate / Dean, Mead, Egerton, Bloodworth, Capouano & Bozarth, P.A.
9:40-9:55 a.m.	**Break**
9:55-10:45 a.m.	**Foreign Trusts – Dancing Through the Minefield .... 140** Charles Rubin Managing Partner Gutter Chaves Josepher Rubin Forman Fleisher P.A.
10:45-11:35 a.m.	**C Corps .... 142** Gary D. Jenkins, CPA Managing Director / RSM McGladrey, Inc.
11:35 a.m.-12:55 p.m.	**Lunch Presentation: A Reader's Digest Version of the Patient Protection Act of 2010 .... 176** Keith N. Faust, CPA, EA, CFF Keith N. Faust, CPA
12:55-1:10 p.m.	**Break**
1:10-2:00 p.m.	**Employment Tax Issues .... 180** John G. DeLancett, Esq. Attorney / Law Offices of John DeLancett, PL
2:00-2:50 p.m.	**State & Local Tax Issues .... 193** Mark R. Arrigo, CPA, MBA Partner Tax Services, State & Local Tax / Grant Thornton LLP
2:50-3:05 p.m.	**Break**
3:05-4:45 p.m.	**Current Issues Affecting S Corporations, Partnerships and LLCs .... 194.** Christopher R. D'Amico Shareholder Dean, Mead, Egerton, Bloodworth, Capouano & Bozarth, P.A. and Stephen R. Looney, Esq. Shareholder Dean, Mead, Egerton, Bloodworth, Capouano & Bozarth, P.A.

Friday, November 5, 2010

7:30-8:00 a.m.	**Continental Breakfast**
8:00-9:40 a.m.	**Asset Protection & Estate Planning: Why Not Have Both?** **Hot Topics in Estate Planning and Asset Protection ....358** Barry A. Nelson, Esq. Attorney / Nelson & Nelson, P.A.
9:40-9:55 a.m.	**Break**
9:55-11:35 a.m.	**Planning to Declare Bankruptcy ....400** R. Lawrence Heinkel, Esq. Attorney – Tax & Bankruptcy / Heinkel Law Group, P.L.
11:35 a.m.-12:20 p.m.	**Lunch**
12:20-1:10 p.m.	**Not-for-Profit Entities ....429** David C. Moja, CPA National Director of Not-for-Profit Tax Services / CapinCrouse LLP
1:10-2:50 p.m.	**Tax Planning for Millionaires ....462** Alan D. Campbell, PhD, CPA, CMA, CFP® Associate Professor of Accounting Troy University – Sorrell College of Business

Federal Tax Update

Katherine Breaks

Katherine M. Breaks

Director/Washington National Tax Practice
KPMG LLP

Ms. Breaks is a director in KPMG's Washington National Tax practice. She joined KPMG in 1998.

Katherine works in the Legislative and Regulatory Services (LRS) practice within Washington National Tax. As a member of the LRS practice, she provides advice to clients on federal tax policy developments and represents taxpayers before the National Office of the Internal Revenue Service, the U.S. Treasury Department, and the U.S. Congress. She speaks and writes frequently on federal tax legislative and regulatory matters.

Publications

Katherine has written a number of articles on tax legislation and regulations.

- Katherine provided commentary in CCH's *Law, Explanation and Analysis on the American Recovery and Reinvestment Act of 2009*
- Katherine authored *Comparison of House, Senate Energy Tax Legislation*, which was published August 14, 2007 in the *Daily Tax Report*.
- Katherine provided commentary in CCH's *Law, Explanation and Analysis on the Energy Tax Incentives Act of 2005.*
- Katherine co-authored *Practice Considerations in Implementing the Section 199 Regulations*, which appeared in the August 2006 edition of the *Journal of Taxation*.
- Katherine co-authored *Do the Section 199 Proposed Regulations Clarify or Complicate the Domestic Production Deduction?,* which appeared in the January 2006 edition of the *Journal of Taxation*
- Katherine co-authored *The Domestic Manufacturing Deduction: Treasury and IRS Fill in the Gaps*, which appeared in the April 2005 edition of the *Journal of Taxation*
- She also co-authored, *The Tax Man Giveth!*, discussing the 2004 tax act, which appeared in the January 2005 edition of *Hart Energy Markets*.

A KPMG LLP TAXWATCH EVENT

Federal Tax Legislative Update

TAX

Katherine M. Breaks
Director, Tax
Washington National Tax
November 3, 2010

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Agenda

- **Enacted Legislation**
  - Hiring Incentives to Restore Employment (HIRE) Act (enacted March 18, 2010)
  - Health care reform (enacted March 23 and March 30, 2010)
  - An Act providing funding to the states (enacted August 10, 2010)
  - Small Business Jobs Act of 2010 (enacted September 27, 2010)
- **Provisions expiring in 2010**
  - Planning ideas for higher tax burdens
- **Election**

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Enacted Legislation

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HIRE Act

- **Payroll Tax Forgiveness for Hiring Unemployed Workers**
  - Provides that a qualified employer is not required to pay the employer share of OASDI on wages paid to a qualified employee for the remainder of 2010
    - Effective for employees hired after 02/03/2010 and who begin work prior to 1/1/2011
    - Must be a new job, cannot be replacing another worker unless the prior worker resigned or was terminated for cause
    - Applies to wages paid after date of enactment (March 18) and prior to 1/1/2011
  - Worker must certify by signed affidavit under penalties of perjury that he/she was employed for a total of 40 hours or less during the 60-day period prior to the date employment begins
  - Can't claim the WOTC for the worker during the one-year period beginning on the hiring date of the individual

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HIRE Act

- **Hiring Incentives to Restore Employment Act**
  - Business Credit for Retention of Certain Newly Hired Individuals in 2010
    - Provides a GBC of up to $1,000 to an employer for each worker who would be a qualified individual for purposes of the payroll tax forgiveness provision of the Act, but only if the employee has continued to be employed by the employer for at least 52 consecutive weeks.
    - Credit is allowed at the end of the retention period
    - Wages for employment during the last 26 weeks of such period must be at least 80% of the wages during the first 26 weeks of the period
    - Credit is limited to 6.2% of wages paid in the period
      - Would need to pay wages of at least $16,129 in the 52-week period for the employer to receive the full $1,000

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HIRE Act

- **Small business expensing**
  - Increases the dollar limit for 2010 to $250,000
    - Under prior law, dollar limit would have been $134,000
  - Increases investment limit for 2010 to $800,000
    - Under prior law, investment limit would have been $530,000
  - As under prior law, the dollar limit is scheduled to be $25,000, and the investment limit is scheduled to be $200,000 in tax years beginning in 2011 and thereafter

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HIRE Act

- **Foreign Account Tax Compliance Act (FATCA)**
  - New 30% withholding tax on: (i) payments of U.S.-source FDAP and (ii) gross proceeds from the sale or disposition of property that can produce U.S.-source interest or dividends,
    - when payment is made to a foreign financial institution unless the foreign financial institution agrees to adhere to certain reporting requirements with respect to U.S. account holders
  - Effective for payments made after 2012

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HIRE Act

- **Foreign Account Tax Compliance Act**
  - 30% withholding on any “withholdable payment” made to a foreign financial institution (FFI) unless FFI enters into an agreement with the IRS
  - The agreement will require FFI to identify U.S. accounts and to report these to the IRS on an annual basis
  - Previously only required to look-through flow-through entities such as partnerships and certain trusts
  - Will be required to look through all entity types with limited exceptions
    - Includes corporations with more than 10% owner who is a specified U.S. person

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Health Care Reform Legislation: Individual Mandate

- **Penalty on individuals without adequate health insurance coverage**
  - Individual who fail to maintain minimum essential coverage in 2016 are subject to a penalty equal to the greater of:
    - 2.5% of household income in excess of the threshold amount of income required to trigger an income tax return filing requirement for that taxpayer, or
    - $695 per uninsured adult in the household.
      - The fee for uninsured individuals under 18 is ½ of the adult fee
      - Total household penalty may not exceed 300% of the per adult penalty ($2,085)
    - Beginning in 2017, the penalty is indexed to CPI-U
    - Penalty phases in beginning in 2014; $95 for 2014 and 1% of household income; $325 and 2% of income for 2015
    - Penalty accrues ratably on a monthly basis
  - Note the need to determine “household income,” which could include the income of children if a personal exemption is claimed; it includes tax-exempt interest

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Health Care Reform Legislation: Individual Mandate

- **Penalty on individuals without adequate health insurance coverage**
  - Penalty may not exceed the national average annual premium for bronze level health plan offered through the exchange that year for the household size
  - No civil or criminal penalties for failure to pay
  - Interest does not accrue on unpaid amounts
  - IRS cannot impose liens or levies to collect the tax
    - Note the absence of conventional collection remedies

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Health Care Reform Legislation: Individual Made

- **Penalty on individuals without adequate health insurance coverage**
  - Exemptions from the penalty are allowed for:
    - Individuals where the full premium of the lowest cost bronze plan in the exchange (net of subsidies and employer contributions, if any) exceeds eight percent of their household income in 2013
      - This income limit is indexed to the excess of premium growth over income growth beginning in 2015
    - Individuals whose required contributions to employer provided coverage exceeds 8% of their household income in 2013
      - This income limit is indexed to the excess of premium growth over income growth beginning in 2015
    - Individuals below the income tax filing threshold
    - Individuals for whom obtaining coverage would be a hardship
    - Individuals who are members of Indian tribe
    - Individuals who are incarcerated, who are not legally present in the U.S., or who maintain religious exemptions

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Health Care Reform Legislation: Employer Mandate

- **Employers with:**
  - 50 employees or more must:
    - offer their full-time employees health insurance,
    - fund that insurance at a specific level and
    - provide insurance that is “affordable” to all its employees,
  - otherwise, penalties may apply.
- **Effective in 2014**

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Health Care Reform Legislation: Employer Mandate

- **Funding level**
  - Plan’s share of the total allowed cost of benefits must be at least 60%
- **Number of employees**
  - Must employ an average of at least 50 full-time employees during the preceding calendar year (special rules for seasonal workers)
  - Full-time employees are those working an average of at least 30 hours per week
  - Part-time employees are counted on a pro-rata basis, using 30 hours per week as full-time
  - Aggregation rules apply

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Health Care Reform Legislation: Employer Mandate

- **"Unaffordable" coverage**
  - Requires the worker to pay a premium that is more than 9.5% of the employee's household income
    - This percentage is indexed to the per capita growth in premiums for the insured market
- **Penalties (two-tiers)**
  - Employers that don't offer coverage
  - Employers that don't offer affordable coverage that covers 60% of the costs

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Health Care Reform Legislation: Employer Mandate

- **Penalties**
  - Employers that don't offer coverage
    - If at least one of its full-time employees is certified as having enrolled in health insurance coverage purchased through a state exchange AND that worker receives a premium tax credit or cost-sharing reduction:
      - An excise tax is imposed, each month, equal to: (i) number of full-time employees over a 30-employee threshold during the applicable month times (ii) 1/12th of $2,000.
      - The penalty is calculated based on all employees, not the number that receive premium tax credits or cost-sharing reductions
      - Thus, the penalty is a maximum of $2,000 per employee, per year, over the 30-worker threshold
  - Effective in 2014

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Health Care Reform Legislation: Employer Mandate

- **Penalties**
  - Employers that do not offer coverage at the 60% level or do not offer coverage that is "affordable" to a worker
    - These workers are eligible for a premium tax credit and cost sharing reductions through other provisions in the bill, but only if the worker declines to enroll in employer-provided coverage and purchases coverage through an exchange instead

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Health Care Reform Legislation: Employer Mandate

- **Penalties**
  - Employers that do not offer coverage at the 60% level or do not offer coverage that is "affordable" to a worker
    - For each full-time employee who receives a premium tax credit or cost-sharing reduction for health insurance purchased through an exchange for any month, the employer is required to pay an amount equal to 1/12th of $3,000.
      - Penalty, in any month, is capped at an amount equal to what would be owed if the employer did not offer any coverage at all (i.e., full-time employees minus 30 times $2,000)
    - Beginning in 2015, the $3,000 and $2,000 dollar amounts are increased by the percentage (if any) by which average per capita premiums for health insurance coverage in the U.S. for the preceding calendar year exceeds the average per capital premium for 2013

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Health Care Reform Legislation: Employer Mandate

- **Business considerations**
  - How many additional employees will sign-up for employer-provided health insurance as a result of the new individual mandate?
    - How much will the additional employer contributions for these new participants cost the company?
  - How can an employer be sure that it is providing "affordable" coverage given expected employee turnover rates and the fact that affordable coverage is determined based on the income of the worker's entire household?

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Health Care Reform Legislation: Health-Related Tax Benefits

- **Tax credit for small businesses that provide health insurance**
  - Fully phased out if the employer has more than 25 employees
- **Qualifying Therapeutic Discovery Project Credit**
  - 50% nonrefundable tax credit for eligible R&D expenditures incurred in 2009 and 2010
  - Taxpayers can request a grant in lieu of the tax credit
  - Statute authorizes $1 billion in tax credits and credits are to be allocated under a competitive application process
    - Application period expected to begin May 21st
  - Must have no more than 250 employees to qualify
  - Definition of a qualifying project is broad enough to include a wide array of biotech companies
- **Individual tax credit for the purchase of health insurance through an exchange**
  - Refundable and payable in advance to the insurer

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Health Care Reform Legislation: Health-Related Revenue Raisers

- **Additional hospital insurance tax on high-income taxpayers**
  - .9% of wages/self-employment income (as defined in FICA/SECA) paid in excess of $200,000 ($250,000 in the case of a joint return)
  - Imposed on employee portion, not employer portion
  - Withholding based on wages paid to worker without regard to spouse's wages
  - Effective for tax years beginning after 2012

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Health Care Reform Legislation: Health-Related Revenue Raisers

- **HI tax expansion**
  - Addition 3.8% imposed on net investment income
    - Effective for tax years beginning after 2012
  - Tax is imposed on lesser of: (i) net investment income or (ii) the excess (if any) of modified AGI over a threshold amount
    - Threshold amount is $200k for singles, and $250k for joint filers

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Health Care Reform Legislation: Health-Related Revenue Raisers

- **HI tax expansion**
  - Net investment income means excess (if any) of:
    - Sum of:
      - gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business,
      - gross income derived in the ordinary course of a trade or business if:
        - such business is a passive activity with respect to the taxpayer or
        - such business is engaged in trading in financial instruments or commodities, and
      - net gain attributable to the disposition of property other than property held in a trade or business, less
    - Deductions allowed by the Code which are properly allocable to such gross income or net gain

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Health Care Reform Legislation: Health-Related Revenue Raisers

- **HI tax expansion**
  - Example
    - Couple filing jointly has modified AGI of $1 million in 2013. Of that amount:
      - $500,000 consists of wages from employment
      - $200,000 is net income from an investment in commercial real estate that is a passive activity
      - $100,000 is from the sale of a residential home that was rented and held for the production of income and not in a trade or business, and
      - $200,000 is gain from the sale of a partnership interest, and the property of the partnership consisted entirely of property that was property held in a trade or business, and the couple was passive with respect to the activity

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Health Care Reform Legislation: Health-Related Revenue Raisers

- **HI tax expansion**
  - Example (cont.)
    - Couple pays .9% on wages in excess of $250,000, or $2,250.
    - Modified AGI over the threshold amount is $750,000, so taxable base on net investment income is capped by that amount.
      - $200,000 in net income from investment in commercial real estate is included because it is a passive activity
      - $100,000 from sale of the rental home is included because the sale relates to property that was held for the production of income and not in the ordinary course of a trade or business
      - $200,000 gain from the sale of the partnership interest is included because the taxpayer is passive with respect to the activity (suggests advantages of classifying such activity as active)
    - $19,000 + $2,250 - $21, 250

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Health Care Reform Legislation: Health-Related Revenue Raisers

- **Excise tax imposed on insurance companies that offer "gold plated" plans**
  - 40% of the aggregate value that exceeds a threshold amount
  - For 2018, the threshold amounts are $10,200 for individual coverage and $27,500 for family coverage
    - Thresholds adjusted for health cost adjustment percentage and age and gender adjusted excess premium amount
  - Imposed pro rata on the issuers of insurance (i.e., medical, dental, FSA)
    - Excess of total premiums over threshold amount is the amount subject to tax
    - Through new employer reporting requirements, the liability is allocated to each insurance provider in proportion to the percentage of total premiums

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Health Care Reform Legislation: Health-Related Revenue Raisers

- **Excise tax imposed on insurance companies that offer "gold plated" plans**
  - Health cost adjustment percentage
    - Designed to increase the thresholds in the event that the actual growth in the cost of U.S. health care between 2010 and 2018 exceeds projected growth
      - 100% + the excess (if any) that: (per employee cost of Blue Cross/Blue Shield plan offered by FEHBP for plan year 2018 – per employee cost of same plan for plan year 2010) - 55%.
      - In 2019, the threshold amounts are indexed to CPI-U plus one percentage point
  - Age and gender adjusted excess premium amount
    - Designed to adjust for the fact that employers with older workforces and a higher proportion of female employees have higher average premiums
      - The excess (if any): (1) premium cost of standard FEHBP coverage for the type of coverage provided to the individual if priced for the actual characteristics of the employer's labor force over (2) the premium cost for that coverage if priced for the age and gender characteristics of the national workforce

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Health Care Reform Legislation: Health-Related Revenue Raisers

- **Excise tax imposed on insurance companies that offer "gold plated" plans**
  - Special rules
    - In case of self-insured group health plan or FSA, excise tax is paid by plan administrator
      - If employer acts as plan administrator, the employer pays the tax
    - In the case of employees covered by a multiemployer plan, the family threshold applies regardless of whether the individual maintains individual or family coverage.
    - Threshold amount is increased $1,650 for individuals and $3,450 for families in 2018, if former worker is over 55, is retired, but not Medicare-eligible
      - In 2019, the thresholds are indexed to CPI-U plus one percentage point.
    - Threshold amount is increased by the same amount for "high risk" professions. Term is broadly defined to include police officers, firefighters, emergency medical technicians, agricultural workers, longshoremen, construction workers, forestry workers, mining workers , fisherman, and individuals employed to repair electrical or telecommunications lines
      - A retiree with at least 20 years of employment in a high risk profession is also eligible for the increased threshold

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Health Care Reform Legislation: Health-Related Revenue Raisers

- **Excise tax imposed on insurance companies that offer "gold plated" plans**
  - Special rules
    - Excise tax is not deductible for federal income tax purposes
  - Example
    - Worker A is covered by a FSA plan ($1,000 per year), and a medical insurance plan ($10,000 per year)
    - Assume that there is no health cost adjustment percentage and age and gender adjusted excess premium amount
    - The excise tax is $320 (($11,000 - $10,200)) * .4)
      - 1/11ths is paid by the plan administrator for the FSA plan
      - 10/11ths is paid by the medical insurer

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Health Care Reform Legislation: Health-Related Revenue Raisers

- **Limit deductibility of remuneration paid by health insurance providers**
  - Under current law, section 162(m) generally caps the deduction for employment compensation paid to covered employees to $1 million
    - The provision applies only to the CEO, the CFO and the three most highly compensated officers (other than the CEO and CFO) for the tax year
    - There are a few exceptions, for instance, special rules permit certain performance-based compensation in excess of the $1 million limit to be deductible
    - The only other requirement is that, in order to be deductible under section 162(a), compensation must be "reasonable"
      - In recent years, the IRS and the courts have rarely litigated the question of "reasonable" compensation

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Health Care Reform Legislation: Health-Related Revenue Raisers

- **Limit deductibility of remuneration paid by health insurance providers**
  - As part of the TARP program, new restrictions were placed on the deductibility of employment compensation paid to recipient of TARP funds
    - Those rules, generally limited deductible compensation to $500,000, and did not provide an exception for performance-based compensation or commissions
    - Special rules applied to ensure that deferred compensation paid in a later year was subject to the cap

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Health Care Reform Legislation: Health-Related Revenue Raisers

- **Limit deductibility of remuneration paid by health insurance providers**
  - In the case of health insurance providers (including providers that are not publicly-held), the deduction for compensation for services would be limited to $500,000 per employee or service provider
    - The provision would apply to all employees, not just the CEO, CFO and the three most highly compensated officers for the tax year
    - As with the TARP program, the special rules for performance-based compensation and commissions would not be available
    - Applies to independent contractors
    - Same rules designed to incorporate deferred compensation apply
  - Effective for remuneration paid in tax years beginning after 2012, with respect to services performed after 2009

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Health Care Reform Legislation: Health Related Revenue Raisers

- **Reduces health flexible spending account maximum to $2,500**
- **Increases penalty for nonqualified distributions from HSA's**
- **Imposes tax on medical devices (beginning 2013)**
- **Imposes tax on indoor tanning services (beginning after July 1, 2010)**
- **Imposes annual fee on manufacturers and importers of "branded" prescription drugs (beginning 2011)**
- **Imposes annual fee on health insurance providers (beginning 2014)**
- **Eliminates deduction for Medicare Part D subsidy (beginning 2013)**

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Health Care Reform Legislation: Non-Health Related Revenue Raisers

- **Codification of economic substance**
  - In any case where the economic substance doctrine is relevant to a transaction, the economic substance doctrine would be satisfied only if:
    - The transaction changes in a meaningful way (apart from the federal income tax consequences) the taxpayer's economic position, and
    - The taxpayer has a substantial non-federal tax purpose for entering into the transaction.
  - Does not provide standards to assist a court in determining when the doctrine is relevant
  - The provision applies only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

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Health Care Reform Legislation: Non-Health Related Revenue Raisers

- **Codification of economic substance**
  - Any state or local income tax effect which is related to a federal income tax effect is treated in the same manner as a federal income tax effect
  - Achieving a financial accounting benefit is not taken into account in determining whether the purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of federal income tax

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Health Care Reform Legislation: Non-Health Related Revenue Raisers

- **Codification of economic substance**
  - Profit potential – In any transaction where the taxpayer relies on a potential for profit in satisfying either prong of the test, the taxpayer must show that the present value of the reasonably expected pre-tax profit from the transaction is "substantial" in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.
    - Fees and other transaction expenses as well as foreign taxes would be taken into account as expenses in determining pre-tax profit.
  - Strict liability penalty for transactions that lack economic substance

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Health Care Reform Legislation: Non-Health Related Revenue Raisers

- Codification of economic substance
  - The penalty rate would be 20% (increased to 40% if the taxpayer did not adequately disclose the relevant facts affecting the tax treatment).
  - Outside opinions or in-house analysis would not protect a taxpayer from imposition of a penalty if it were determined that the transaction lacked economic substance or failed to meet the requirements of any similar rule of law
  - The provision would apply to transactions entered into after the date of enactment

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Health Care Reform Legislation: Non-Health Related Revenue Raisers

- **Require information reporting on payments to corporations and payments for goods**
  - Very generally, the provision requires a Form 1099's to be prepared if payments aggregate $600 or more in a calendar year to a single corporation (other than a tax-exempt corporation)
  - In addition, very generally, the provision extends Form 1099 reporting to payments paid in consideration for property. Thus, Form 1099's would need to be prepared if payments for goods or property aggregate $600 more in a calendar year to a single business (other than a tax-exempt corporation)
    - The rule applies to all types of taxpayers, including corporations
  - Effective for payments made after 2011

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An Act providing funding to the states (enacted August 10, 2010)

- **Rules to prevent splitting of foreign tax credits from the income to which they relate**
- **Denial of foreign tax credit with respect to income not subject to U.S. taxation by reason of covered asset acquisitions**
- **Separate application of foreign tax credit limitation to items resourced under treaties**
- **Limitation on the amount of foreign taxes deemed paid with respect to section 956 inclusions**
- **Special rule with respect to certain redemptions by foreign subsidiaries**
- **Modification of affiliation rules for purposes of rules allocating interest expense**
- **Termination of special rules for interest and dividends received from persons meeting the 80% foreign business requirements**
- **Technical correction to the statute of limitations provision in the HIRE Act**

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Small Business Jobs Act

- **Bonus depreciation**
  - One-year extension
    - Now available for qualified property purchased and placed in service on or after January 1, 2008 and before January 1, 2011
      - Qualified property
        - Property subject to Modified Accelerated Cost Recovery System (MACRS) with a recovery period of 20 years or less
        - Water utility property
        - Computer software
        - Qualified leasehold improvement property

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Small Business Jobs Act

- **Bonus depreciation**
  - One-year extension
    - Extended placed-in-service date (to December 31, 2011)
      - One-year extended-placed-in-service deadline would apply to certain property ("extended placed-in-service property") with a 10-year or more recovery period or transportation property that:
        - Has an estimated production period exceeding one year, and
        - A cost exceeding $1 million
      - However, bonus depreciation is only available for capitalized costs incurred prior to January 1, 2011
    - Also, an extended placed-in-service date for certain aircraft contracted for prior to January 1, 2011

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Small Business Jobs Act

- **Bonus Depreciation and Revenue Recognition on Long-Term Contracts**
  - Generally, the amount of income recognized in any tax year on a long-term contract, under the percentage of completion method, is the percentage of total costs of the contract (including depreciation deductions) incurred during the tax year
  - Thus, bonus depreciation deductions can accelerate income recognition
  - The Act provides that in applying this formula, depreciation deductions on property with a recovery period of 7 years or less are computed without any bonus depreciation
  - Effective for property placed in service after 2009

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Small Business Jobs Act

- **Section 179 Expensing**
  - Dollar limit for 2010 and 2011 increased to $500,000
    - Without this change, the limit would have been $250,000 for 2010
  - Investment limit for 2010 and 2011 increased to $2 million
  - Section 179 expensing is available for qualified real property
    - Capped at $250,000
    - Qualified real property is: (i) leasehold improvement property, (ii) restaurant property, and (iii) retail improvement property
    - If trade or business income limit applies to 179 deduction for qualified real property, taxpayer can only carryforward unused deduction to year that the rule is available

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Small Business Jobs Act

- **Example**

Taxpayer is a service business and undertakes substantial renovations of its business location. Assume the taxpayer leases the space and the renovations constitute qualified leasehold improvement property. Total section 179 property placed in service for the year is $2.0 million, with $1 million associated with the renovations. Assume the remaining section 179 property is MACRS property with a recovery period of 20 years or less.

Taxpayer can claim $250,000 179 expensing on the leasehold improvement property (as well as up to $250,000 of expensing on the other section 179 property). The leasehold property It has a remaining basis of $1.75 million. It can claim 50% bonus depreciation on the rest, or $875,000. The remaining basis of the leasehold property of $875,000 can be depreciated under the regular depreciation rules. The total deduction for 2010 for the leasehold improvement property would be $1.125 million plus regular depreciation on the remaining basis.

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Small Business Jobs Act

- **Temporary exclusion of gain from sale of small business stock**
  - There is a 50% exclusion for gain on the sale of small business stock
    - The excluded gain is a preference item under AMT
  - Under the Act, for stock acquired after the date of enactment and before 2011, the exclusion is increased to 100% and the gain is not a preference item under AMT
    - Other limitations and requirements remain, including the requirement that the stock be held at least 5 years

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Small Business Jobs Act

- **5-year NOL carryback of GBCs of eligible small business**
  - Under general rules, general business tax credits (GBCs) that cannot be used in the year they are generated are carried back one year and carried forward 20 years
  - Under the Act, excess GBCs of eligible small businesses that are determined in the taxpayer's first tax year beginning after 2009 are carried back 5 years

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Small Business Jobs Act

- **5-year NOL carryback of GBCs of eligible small business**
  - An eligible small business is:
    - A corporation whose stock is not publicly traded
    - A partnership, or
    - A sole proprietorship,
  - But only if the entity or business has average annual gross receipts over the preceding three tax years of no more than $50 million
  - In the case of partnerships and S corporations, the gross receipts test must be satisfied by the partner or S corporation shareholder as well as at the entity level

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Small Business Jobs Act

- **Permit GBCs of eligible small business to offset AMT**
  - In general, most GBCs are subject to the GBC limit under section 38(c)
  - The credit for any tax year may not exceed the excess (if any) of the taxpayer's net income tax over the greater of:
    - Tentative minimum tax for the tax year, or
    - 25% of so much of the taxpayer's net regular tax liability as exceeds $25,000
  - The Act provides that, in the case of an eligible small business, tentative minimum tax is treated as "zero"
    - An eligible small business is defined in the same manner as for the special GBC carryback rule
    - The rule is available only for credits generated in the taxpayer's first tax year beginning after 2009, and to carrybacks of such credits

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Small Business Jobs Act

- **Example**

Taxpayer is a corporation and an eligible small business. In 2010, it generates $100,000 of tentative minimum tax (TMT) and $50,000 of regular tax, and pays $50,000 of AMT. In addition, taxpayer generates a $50,000 GBC in 2010 that is not a "specified credit." There were no GBCs in earlier years.

Under prior law, taxpayer could not claim any GBC in the current year, because of the TMT limitation. The GBC could generally be carried back one year and forward 20 years. Under the Act, the taxpayer can claim the GBC in full in the current year.

If the GBC for 2010 was $150,000, $93,750 could be used in 2010.

Calculation: net income tax of $100,000. 25% of so much of the taxpayer's regular tax as exceeds $25,000 is $6,250. Current-year limit = $100,000 - $6,250 = $93,750.

The excess GBC of $56,250 is carried back 5 years, and can be used with the same TMT = zero limitation in the carryback years.

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Small Business Jobs Act

- **Example**

Taxpayer is a partnership with 50-50 partners, A and B. The partnership is an eligible small business, and A is an eligible small business. B does not satisfy the rule. Partnership AB, A, and B are all calendar year taxpayers. Partnership AB generates a $100,000 GBC in 2010 that is not a "specified credit."

The law does not change the result for B. B is allocated $50,000 of the GBC. Its ability to claim that credit is limited by the general GBC rules of section 38(c).

The law does change for A. A is allocated $50,000 of the GBC. A can claim the GBC in 2010 without the TMT limitation. Any excess GBC is carried back by A 5 years and used without the TMT limitation in the carryback years.

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Small Business Jobs Act

- **Temporary reduction in recognition period for S corporation built-in gains tax**
  - Generally, a C corporation that elects S corporation status is subject to an entity-level tax if it sells any of the assets that it owned at the time of the election in an amount equal to the inherent gain in that asset at the time of the election
  - This is known as the "built-in gain" tax.
  - The built-in gain tax applies only for a 10-year period after the election
    - Special rules enacted last year eliminated any tax for 2009 or 2010 if the seventh year in the recognition period had already occurred.
  - The Act eliminates any tax for the tax year beginning in 2011 if the fifth tax year in the recognition period had already occurred.
  - Effective for tax years beginning after 2010

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Small Business Jobs Act

- **Increase in amount allowed as deduction for start-up expenditures**
  - Under prior law, up to $5,000 in capitalized start-up expenditures could be immediately deducted as of the date that the taxpayer began its trade or business
    - The balance is amortized over 15 years
    - The $5,000 deduction phases out dollar-for-dollar to the extent start-up expenditures exceed $50,000
  - The Act increases the deduction to $10,000 and the phase out threshold to $60,000
  - Effective for tax years beginning after 2009

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Small Business Jobs Act

- **Remove cellular phones and similar telecommunications equipment from definition of listed property**
  - Taxpayers can not deduct the costs of “listed” property unless they meet heightened substantiation requirements for the expense and business usage of the property
    - Listed property included telecommunications equipment
  - As a result of this rule, many employees had to include the value of their cell phone plan in income, or pick up a portion of the cost of such cell phone plans that was deemed to be personal
  - The Act provides that telecommunications equipment is not listed property
  - Effective for tax years ending after 2009

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Small Business Jobs Act

- **Temporary deduction for health insurance costs in computing self-employment income**
  - Health insurance premiums for a self-employed person and his/her family are deductible for income tax purposes
  - The Act permits these costs to be deductible also for purposes of the self-employment tax
    - The provision applies only for the first tax year beginning after 2009.

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Small Business Jobs Act

- **Limitation on penalty for failure to disclose reportable transactions**
  - Under prior law, there was a penalty for failing to disclose a reportable transaction or listed transaction.
    - For reportable transactions other than a listed transaction, the penalty was $10,000 for individuals and $50,000 in all other cases
    - For reportable transactions that were listed transactions, the penalty was $100,000 for individuals and $200,000 in all other cases
    - The Act provides that the penalty is the lesser of: (i) penalty under prior law, or (ii) 75% of the reduction in tax reported on the taxpayer's tax return as a result of participating in the transaction or that would result if the transaction were respected for federal tax purposes
    - Imposes a new minimum penalty of $5,000 for individuals and $10,000 for all others
  - Applies to penalties assessed after 2006

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Small Business Jobs Act

- **Information reporting for rental property expense payments**
  - Subjects recipients of rental income from real estate generally to the same information reporting requirements as taxpayers engaged in a trade or business
  - Thus, rental income recipients making payments aggregating at least $600 in a tax year to a service provider (such as a plumber, painter, or accountant) in the course of earning rental income are required to file an information return (typically a Form 1099-MISC) to the IRS and to the service provider
  - Effective for payments made after 2010
  - Beginning in 2012, information reporting on Form 1099-MISC is expanded to include: (i) payments to corporations (other than tax-exempt corporations), and (ii) payments for goods

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Small Business Jobs Act

- **Increase in information return penalties**
  - Increases the penalty for failing to timely file correct information returns (such as Forms 1099, W-2, 1042-S) with the IRS and the related penalty for failing to timely furnish correct payee statements
    - Generally, the penalty for each reporting failure is increased from $50 to $100
    - The maximum annual combined penalty for unintentional failures is increased from $350,000 to $3 million
    - The minimum penalty for intentional disregard of the reporting requirements is increased from $100 to $250
    - The penalties are indexed for inflation every five years
  - Applies to information returns required to be filed after 2010 – that is, for reporting related to 2010 activity

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Small Business Jobs Act

- **Sourcing rules for income from guarantees**
  - Provides that income from sources within the United States includes amounts received, directly or indirectly from:
    - A non-corporate U.S. resident or domestic corporation for providing that person a guarantee of indebtedness or
    - Any foreign person for providing that person a guarantee of indebtedness if such amount is connected with income effectively connected with the conduct of a U.S. trade or business
  - The provision legislatively overrides Container Corporation v. Commissioner (February 17, 2010) in which the court found that fees paid by a U.S. corporation to its foreign parent in connection with guarantees issued by the parent for the debts of the corporation were analogous to compensation for services, and that the source was to be determined by reference to the residence of the foreign-parent guarantor
  - Effective for guarantees issued after the date of enactment

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Small Business Jobs Act

- **Allow participants in government section 457 plans to treat elective deferrals as Roth contributions**
  - Employees participating in 401(k) or 403(b) plans could make post-tax contributions and exclude qualified distributions from gross income, instead of making pre-tax contributions and paying income tax on the qualified distributions
  - Those legislative changes did not apply to government section 457 plans
  - Effective for tax years beginning after 2010

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Small Business Jobs Act

- **Allow rollovers from elective deferral plans to Roth designated accounts**
  - Allows a plan that includes a designated Roth 401(k) or 403(b) program may allow employees (and surviving spouses) to make a “rollover” contribution from the tax-deferred contributions to a designated Roth account within the plan
  - The rollover is taxable when executed, but the early withdrawal penalty does not apply
  - If the contribution is rolled over in 2010, the taxpayer could elect to be taxed ratably over a 2-year period beginning in 2011
  - The IRS is given authority to provide employers with a remedial amendment period, allowing them to make the option available to employees for rollovers in 2010
  - Effective for distributions made after the date of enactment

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Small Business Jobs Act

- **Permit partial annuitization of a nonqualified annuity contract**
  - Permits a portion of an annuity, endowment, or life insurance contract to be annuitized while the balance is not annuitized, provided that the annuitized period is for at least 10 years, or is for the lives of one or more individuals
    - The annuity portion is treated as a separate contract for purposes of section 72
  - Effective for amounts received in tax years after 2010

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Small Business Jobs Act

- **Time for payment of estimated taxes**
  - The required corporate estimated tax payments due in July, August, and September 2015 for corporations with assets of at least $1 billion is increased by 36 percentage points to 159.25% of the payment otherwise due

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Other Recently Enacted Legislation

- Worker, Homeownership, and Business Assistance Act of 2009
  - Preparers must use electronic filing
    - Mandates that the Secretary require electronic filing by specified tax return preparers. “Specified tax return preparers” are all return preparers except those who neither prepare nor reasonably expect to prepare ten or more individual income tax returns in a calendar year.
      - The term “individual income tax return” is defined to include returns for estates and trusts as well as individuals.
    - Effective for tax returns filed after 2010

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Other Recently Enacted Legislation

- Worker, Homeownership, and Business Assistance Act of 2009
  - Increase in failure to file partnership and S corporation returns in a timely manner
  - Under the provision, the base amount on which a penalty is computed for a failure with respect to filing either a partnership or S corporation return is increased to $195 per partner or shareholder
    - Effective for tax years beginning after 2009

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Other Recently Enacted Legislation

- Worker, Homeownership, and Business Assistance Act of 2009
  - Homebuyer tax credit
    - Needed a contract by May 1, 2010
    - Needed to close by June 30, 2010
    - Must attach evidence of ownership
- Tax Increase Prevention and Reconciliation Act of 2006
  - Taxpayer can elect to rollover “traditional” IRAs into Roth IRAs regardless of income

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Provisions Expiring in 2010

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Provisions expiring in 2010

- **Individual income tax rates**
  - Current brackets are: 35%, 33%, 28%, 25%, 15%, 10%
  - Brackets will increase to: 39.6%, 36%, 31%, 28%, 15%
  - 10% tax rate bracket expires
  - In 2010, 35% rate bracket applies to taxable income of married couples in excess of $373,650; 33% rate bracket applies to taxable income of married couples in excess of $209,250 and below the 35% rate bracket
- **Reduced rate on dividend income**
  - Currently, 15% maximum rate (taxed at capital gains rates)
  - Increases to ordinary income tax rates in 2011
- **Capital gains tax rate**
  - Currently, 15% maximum rate
  - Increases to 20% in 2011
  - Beginning in 2011, increased rate even if sale or exchange closed in 2010 and payment is received in 2011

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Provisions expiring in 2010

- **Child credit**
  - Currently $1,000 per qualifying child
  - Reduced to $500 in 2011
- **Marriage penalty relief**
  - Currently, size of 15% rate bracket and standard deduction is 200% of singles
  - Reinstate to pre-2001 levels
- **Reinstate personal exemption phaseout and phaseout for itemized deductions**
- **Estate tax relief**
  - Currently, no estate tax
  - Exemption amount scheduled to be $1 million in 2011
  - Maximum estate tax rate of 55% in 2011

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Planning ideas for higher tax burdens

- **Rollover traditional IRA into a Roth IRA**
  - General rule is that traditional IRA cannot be rolled into a Roth IRA if the taxpayer has AGI in excess of $100,000
  - In 2010, AGI limit is removed
  - For taxpayers making the election in 2010, tax on unrealized gains are paid 50% with 2011 return and 50% with 2012 return
  - No minimum distribution rules apply at retirement
  - If tax rate at retirement is higher than in 2010, the increment is free of tax
  - Consider the timing of the rollover election to maximize the benefit
  - Additional considerations apply

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Election

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Tax Preparer Penalties/Regulations

Charles P. Sparano, CPA, MBA, MST

Charles Sparano, CPA, MBA

Tax Director

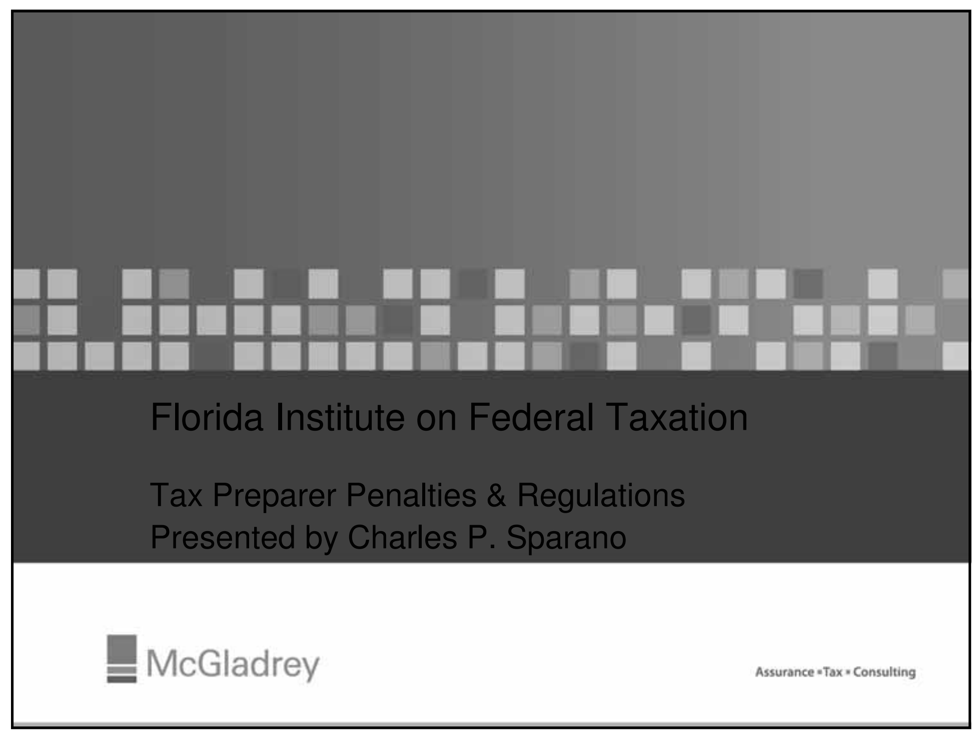
RSM McGladrey

Charles leads our Florida financial services tax practice and provides high level tax accounting and tax consulting services to both public and privately held corporations, S corporations, partnerships and limited liability companies. Charles spends the majority of his time serving the financial sector and coordinates multiple firm resources to serve the varying needs of his financial institution clients.

Prior to joining RSM McGladrey, Charles spent eleven years servicing clients in the financial services, healthcare and corporate tax areas in a Big 4 accounting firm. Among his clients were Genworth Financial Services, American Bankers Life Insurance Company, AMCOMP, Inc., Province Healthcare Company, Pediatrix Medical Group, Cross Country Healthcare and Amvescap PLC. Since joining RSM McGladrey, Charles has worked with the following clients:

Charles is a member of the American Institute of Certified Public Accountants. Additionally he is a member of the New York State Society of Certified Public Accountants, New Jersey Society of Certified Public Accountants and the Florida Institute of Certified Public Accountants. Charles holds active CPA licenses in each of those states. Charles is also a member of the Humane Society of Broward County Planned Giving Sub-committee.

Charles earned his Master in Business Administration in Accounting from Long Island University in Brooklyn, New York and earned his Master of Science -Tax from Seton Hall in New Jersey.



Agenda

- Preparer Defined
- Due Diligence and Evaluating Authorities
- Preparer Obligations for Non Tax Shelter Positions
- Preparer Obligations for Tax Shelter Positions
- Signing Returns and Other Preparer Obligations
- Confidentiality Obligations Under §7216
- Proposed changes to Circular 230
- Final regulations on PTIN Enrollment and User Fees

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Who is a Tax Return Preparer?

- A person who prepares for compensation (or who employs another who prepares for compensation) all or a substantial portion of a tax return
  - A firm is a "preparer" subject to penalties and obligations
- Includes signing preparers and those who advise concerning tax reporting when all events have occurred
- Substantial portion of a return
  - Preparer knows or reasonably should know the position is significant
  - Significance of position relative to the entire return
  - Safe harbor amounts in the §7701 regulations
  - Substantial portion concept does not apply to signing preparers

Who is a Tax Return Preparer?

- Preparers of information returns and other schedules may be preparers of the recipient's return if substantial portion test is met
- Exceptions
  - Officers, general partners, fiduciaries and employees of the taxpayer
  - Person who prepares without compensation (small gifts o.k.)
  - Persons who provide mechanical or clerical assistance
  - VITA and low income tax clinics

Rev. Proc. 2009-11 – Three Categories of "Returns"

- Returns reporting a tax liability
  - §6694 penalty and disclosure rules apply
  - *E.g.*, 990T, 1040 series, 1041, 1120 series, 706, 709, 941, 943, 944
- Information returns and other documents
  - §6694 penalty and disclosure rules apply if item is a "substantial portion"
  - *E.g.,* 1042-S, 1065, 1120S, 5500, 8038
- Other information returns and documents
  - §6694 penalty does not apply unless willful evasion or reckless or intentional disregard of rules or regulations
  - *E.g.,* 1099, W-2, 990, estimated tax returns

Fact Due Diligence

- Due diligence required by §6694(a) and Circular 230 §10.22
  - Not a uniform process; professional judgment as to diligence required
- Reliance on client information
  - Good faith, cannot ignore inconsistencies, obligation to follow up
  - Avoid SALY, SALY is not your friend
  - No materiality exception; immaterial positions known to be without reasonable basis will be penalized, but see the preparer's obligations
  - Final regulations change regarding legal conclusions
  - Exercise and document your professional judgment
- Reliance on other preparers and third parties
  - Is the third party qualified?

Determining Level of Assurance

- Three relevant levels of assurance
  - Reasonable Basis – 20% to 25%
  - Substantial Authority – 40% to 45%
  - More likely than not - >50%
- Process for evaluating level of assurance
  - Gather and evaluate facts
  - Research and evaluate supporting authority and contrary authority
  - Apply the law to the facts
  - Exercise professional judgment
  - Higher levels of assurance generally require more work

Evaluating Authority *Treas. Reg. §1.6694-2(b)(2) and §1.6662-4(d)(3)(iii)*

- What is the source of the authority?
- How old is the authority?
  - Shepardize / CCH Citator
  - Intervening statutory or regulatory changes
- How close are the authority's facts to the client's situation?
- How well-reasoned is the authority?
- What is the relative weight of contrary authority?
- Treatises and periodicals are <u>not</u> authority
- Exercise <u>and document</u> your professional judgment.

Signing Preparer Obligations - Non Tax Shelter Items

- Positions at less than reasonable basis
  - Cannot prepare or sign return, including draft returns
- Position with reasonable basis but less than substantial authority
  - Attach Form 8275 / 8275-R to return or comply with annual Rev. Proc.
  - No penalty if client removes the form, but no "wink, wink, nudge, nudge"
  - For returns subject to §6662 penalties other than substantial understatement, advise the client of the §6662 penalty standards and document the advice in the file

Non-signing Preparer Obligations - Non Tax Shelter Items

- Cannot advise a taxpayer to take a position without a reasonable basis
- Position with a reasonable basis but less than substantial authority
  - Adequate return disclosure (*e.g.*, 8275 / 8275-R avoids the penalty)
  - Advise taxpayer of the §6662 penalty standards and opportunity to avoid penalties via disclosure; must document the advice in the file
  - Advise another preparer that adequate return disclosure may be required and document the advice in the file

Preparer Obligations - Tax Shelter Items

- "Tax Shelter" defined as a partnership or other entity, investment plan or arrangement, or any other plan or arrangement having a "significant purpose" of avoiding or evading Federal income tax
- Neither existing §6662 regulations nor the new interim guidance define "significant purpose"
- Old §6111 "confidential corporate tax shelter" regulations
  - Existence of IRS guidance
  - Tax benefits are an "important part" of intended results
  - Presented to more than one taxpayer
  - Transaction in ordinary course of taxpayer's business
  - Reasonable basis for denying tax benefits

Preparer Obligations - Tax Shelter Items

- Notice 2009-5 interim guidance
- Must have substantial authority for the position
- Advise taxpayer of penalty standards applicable to the taxpayer in the event the transaction is deemed a "tax shelter"
  - Must be substantial authority for the position
  - Taxpayer must reasonably believe position is more likely than not correct
  - Adequate disclosure does not avoid the §6662(d) penalty
- Contemporaneously document advice in the file

Revenue Procedure 2010-15

- Identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under section 6662(d) (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the tax return preparer penalty under section 6694(a) (relating to understatements due to unreasonable positions) with respect to income tax returns.
- This revenue procedure applies to any income tax return filed on 2009 tax forms for a taxable year beginning in 2009, and to any income tax return filed on 2009 tax forms in 2010 for short taxable years beginning in 2010.

Revenue Procedure 2010-15

- For purposes of this revenue procedure, the taxpayer must furnish all required information in accordance with the applicable forms and instructions, and the money amounts entered on these forms must be verifiable.
- When the amount of an item is shown on a line that does not have a preprinted description identifying that item (such as on an unnamed line under an "Other Expense" category) the taxpayer must clearly identify the item by including the description on that line. For example, to disclose a bad debt for a sole proprietorship, the words "bad debt" must be written or typed on the line of Schedule C that shows the amount of the bad debt. Also, for Schedule M-3 (Form 1120), Part II, line 25, Other income (loss) items with differences, or Part III, line 35, Other expense/deduction items with differences, the entry must provide descriptive language; for example, "Cost of non-compete agreement deductible not capitalizable." If space limitations on a form do not allow for an adequate description, the description must be continued on an attachment.

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Revenue Procedure 2010-15

- Although a taxpayer may literally meet the disclosure requirements of this revenue procedure, the disclosure will have no effect for purposes of the section 6662 accuracy-related penalty if the item or position on the return: (1) Does not have a reasonable basis as defined in Treas. Reg. § 1.6662-3(b)(3); (2) Is attributable to a tax shelter item as defined in section 6662(d)(2); or (3) Is not properly substantiated or the taxpayer failed to keep adequate books and records with respect to the item or position.
- Disclosure also will have no effect for purposes of the section 6694(a) penalty as applicable to tax return preparers if the position is with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies.

Preparer Obligations – Reportable Transactions

- Positions attributable to transactions described in §6662A(b)(2) –
  - Listed transactions – Notice 2009-59 (7/15/2009)
  - Transactions of interest – Notice 2009-55 (7/15/2009)
- Tax return preparer must reasonably believe position is more likely than not correct
- Potential for conflicts with clients
  - Can a reportable transaction not have a "significant purpose" of tax avoidance?
  - Definition of "transaction"? "substantially similar"?

One Preper Per Position Per Firm Rule

- §6694 penalty will apply to only one person per firm per position
  - Old rule was one person per firm per return; AICPA advocated change
- Signing preparer may rely on others within the same firm to avoid the §6694 penalty
  - Signer is presumed responsible, but other evidence can shift burden
  - Others need not be §7701 preparers, *e.g.*, pre-transaction planning
- File documentation of responsibility is important
- Aggregate penalty (based on revenues) will not exceed statutory limit

Signing Returns

- Final regulations modify the definition of "signing preparer"
  - Individual practitioner with primary responsibility for the overall accuracy of the return
  - Old rule applied the "primary responsibility" test only when there was more than one paid preparer
- Implications of being the signing preparer
  - *Prima facie* responsibility for all positions on the return
  - Responsibility for particular positions may shift to others within the firm, but documentation of the consultation is critical
  - Other signing preparer responsibilities under the Code

Signing Returns

- Regulations require the signer to conduct a substantive review
  - Extent of review depends on complexity of the return
  - Document your review
  - Don't sign if you're not comfortable with a position
- Tax return review engagements raise specific issues
  - Scope of service? Must reviewer sign the return?
  - Appropriate only when taxpayer sufficiently sophisticated to prepare return
  - Akin to "agreed upon procedures;" consider negative assurance letter with the results of the review (*i.e.*, nothing has come to our attention…)
  - Positive assurance requires compliance with Circular 230 §10.37 standards for tax advice

Circular 230 §10.34

- §10.34(a) - "Reserved" pending revisions to reflect new §6694
  - Former (and future) rule as the corollary to §6694 standards
  - Old rule - No substantial portion or pre-transaction exceptions
- §10.34(c) - Practitioners must advise client of penalties reasonably likely to apply
  - Corollary to Treas. Reg. §1.6694-2(d)(3)
- §10.34(d) – Reliance on client information
  - Corollary to Treas. Reg. §1.6694-1(e)
- Circular 230 standards for discipline in §10.51 and §10.52

Other Preparer Obligations

- Expansion of the §7701 definition of preparer expanded the returns subject to other preparer obligations
- Employers of signing tax return preparers must maintain a list of the names, TINs, and locations of its signing preparers
- Signing preparer must furnish a copy of return to the taxpayer
  - Electronic copy is o.k. if the taxpayer agrees

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Other Preparer Obligations

- Employers of signing tax return preparers must retain a copy or a list of returns prepared and signed by employees
- Signing preparer must furnish i.d. no. on the filed return
  - Protect your identity, use a PTIN
  - I.d. not required on the client copy, but client sees the filed copy
- Ban on negotiating taxpayer refund checks
  - Affixing stamp and depositing in the taxpayer's account is o.k.

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Confidentiality Obligations and §7216

- §7216 regulations amended effective January 1, 2009
  - Applies to all taxpayers, not just individuals
- Client consent is required for disclosure or use of any information obtained in income tax return preparation
  - Client contact information is restricted
  - Disclosure to related parties is restricted
- Form of client consent specified in Rev. Proc. 2008-35
  - Taxpayer must sign and date the consent – an email is not sufficient
  - Specific disclosures are required, minimum paper and font sizes
  - Consent limited to one year unless otherwise specified
  - Cannot disclose SS No. outside the U.S., even with taxpayer consent

Confidentiality Obligations and §7216

- Key exceptions to the consent requirement
  - Accountants offering or providing accounting or tax services
  - Information that preparer can show was obtained from another source
- Handling a client request
  - Explain, then obtain the signed consent
  - Provide the information directly to the client, and the client can deliver to the third party
  - Signed letter may be required from the third party (*e.g.*, successor accountants seeking workpaper access)
- Mailing lists – Identify the source of the data

Proposed Changes to Circular 230

- On August 20, 2010 the IRS issued proposed regulations modifying Circular 230 rules that govern the practice before the IRS
  - IRS estimates that there will be 650,000 registered tax return preparers and 2,250 continuing education providers who will be affected by the collection of information requirements of the proposed regulations
  - The IRS and Treasury have estimated the total annual costs resulting from the requirements in the proposed regulations to be $9,880,000 for all affected practitioners and $38,632,500 for all affected continuing education providers.
- Many proposed changes to Circular 230 are a result of the findings and recommendations reported in Publication 4832, “Return Preparer Review” published on January 4, 2010.

Proposed Changes to Circular 230

- Circular 230 regulations were last amended on September 26, 2007 however those regulations did not finalize the standards with respect to tax returns under §10.34(a) and the definitions under §10.34(e).
- Proposed regulations also provide new rules governing the oversight of tax return preparers.
  - Establishes “registered tax return preparers” as a new class of practitioners
  - §10.3-§10.6 of proposed regulations describe process for becoming a registered tax return preparer and the limitations for practicing before the IRS.
- Proposed regulations do not change the existing authority of attorneys, CPA’s and enrolled agents to practice before the IRS under Circular 230. These regulations also to not alter or supplant ethical standards that might otherwise be applicable to practitioners.

Proposed Changes to Circular 230

- Registered Tax Return Preparers - §10.3(f)
  - Practice is limited to preparing tax returns, claims for refund, and any other documents for submission to the IRS
  - Not permitted to represent taxpayers, regardless of the circumstances requiring representation, before appeals officers, revenue officers, Counsel or similar officers or employees of the IRS or Treasury
  - Can only provide tax advice in the context of preparing a tax return, claim for refund or other document intended to be submitted to the IRS.
  - Must pass a minimum competency examination and possess a current or otherwise valid PTIN or other prescribed identifying number.

Proposed Changes to Circular 230

- Registered Tax Return Preparers (continued)
  - Examination will be administered by, or administered under the oversight of, the IRS similar to the enrolled agents exams.
  - Will be subject to suitability checks to determine whether the tax return preparer has engaged in disreputable conduct which can result in suspension or disbarment under Circular 230
  - No exemption from taking exam because of prior work experience.
  - Must successfully complete exams before becoming a registered tax return preparer and obtaining a PTIN.

Proposed Changes to Circular 230

- Registered Tax Return Preparers (continued)
  - IRS can deny application if:
    - Fails competency examination
    - Fails a tax compliance check
    - Fails a suitability check
  - If approved applicant will be issued a registration card or certificate which will be valid for a stated period.
  - Must have both a current and valid registration card or certificate and a current and valid PTIN to practice before the IRS.

Proposed Changes to Circular 230

- Registered Tax Return Preparers (continued)
  - To renew, must complete 15 hours of CPE during each registration year
    - 3 hours of federal tax law updates
    - 2 hours of tax related ethics
    - 10 hours of federal tax law topics
  - Required to maintain records to prove the CPE and must self certify completion of CPE at time of renewal.
  - May not use a designation such as “certified”
  - Acceptable language is “designated as a registered tax return preparer with the IRS”

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Proposed Changes to Circular 230

- Proposed changes to CPE-§10.6(f)
  - Proposed regulations would change the maximum amount of credit awarded for hours as an instructor, discussion leader, or speaker at an education program from 50% of CPE for current enrollment cycle to no more than 4 hours annually.
  - Proposed regulations would change maximum amount of credit awarded for hours authoring articles, books and other publications from 50% to 0%

Proposed Changes to Circular 230

- IRS and Treasury concluded that professional standards in §10.34(a) generally should be consistent with the civil penalty standards in §6694 for tax return preparers. Therefore sections of §10.34 are being re-proposed.
  - §10.34(a)(1)(i) would now state that a practitioner may not willfully, recklessly or through gross incompetence, sign a return or claim for refund that the practitioner knows or reasonably should know contains a position that (A) lacks a reasonable basis; (B) is an unreasonable position as described in §6694(a)(2) (including the related regulations and other published guidance); or (C) is a willful attempt to understate the liability for tax or a reckless or intentional disregard of rules and regulations as described in §6694(b)(2) (including the related regulations and other published guidance)

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Proposed Changes to Circular 230

- §10.34(a)(1)(ii) would now state that a practitioner may not willfully, recklessly or through gross incompetence advise a client to take a position on a tax return or claim for refund, or prepare a portion of a return or claim for refund that takes a position that the practitioner knows or reasonably should know contains a position that (A) lacks a reasonable basis; (B) is an unreasonable position as described in §6694(a)(2) (including the related regulations and other published guidance); or (C) is a willful attempt to understate the liability for tax or a reckless or intentional disregard of rules and regulations as described in §6694(b)(2) (including the related regulations and other published guidance)
- Proposed regulations specifically provide that a position on a return or claim for refund must always meet the minimum threshold standard of reasonable basis

Proposed Changes to Circular 230

- Proposed regulations provide no exception to §10.34(a) merely because there is a final determination that no understatement of liability for tax exists. This differs from §6694(d) which provides that the IRS must abate (or refund) a preparer penalty any time there is a final determination or a final judicial decision that there was no understatement of liability by the taxpayer.
- Practitioner can still be subject to discipline under §10.34(a) for a position even if other positions eliminate the understatement of liability

Proposed Changes to Circular 230

- Practitioner subject to discipline under §10.34(a) only after willful, reckless or grossly incompetent conduct. Differs from §6694 where a single, unintentional error that is not willful, reckless or grossly incompetent may result in a §6694(a) penalty.
- Multiple practitioners from the same firm may be disciplined in connection with the same act or acts. Under the §6694 regulations only one person per firm is subject to penalty
- §10.34(a)(2) of proposed regulations expressly provides that a pattern of conduct is a factor that will be taken into account to determine willful, reckless or gross incompetence. Under §6694 a single act can impose a penalty.

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Proposed Changes to Circular 230

- Under new paragraph §10.51(a)(16) disreputable conduct will include willfully failing to file on magnetic or other electronic media a tax return that the practitioner is required to do so under federal tax laws.
- Under §10.51(a)(17) disreputable conduct will include not having a current and valid PTIN or other prescribed identifying number and preparing or substantially preparing all of, or signing as a compensated tax return preparer, a tax return or claim for refund.

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Final Regulations on Process for Furnishing PTINs

- §6109(a)(4) requires tax return preparer's to furnish on tax returns and claims for refund an identifying number, as prescribed to ensure proper identification of the preparer, the preparer's employer or both.
- §6109(c) authorizes the Secretary to require such information as may be necessary to assign an identifying number to any person.
- On September 30, 2010 the IRS issued final regulations under §6109 regarding the process for furnishing PTINs to practitioners.
- Much of the final regulations are a result of Publication 4832, "Return Preparer Review" which issued findings and made recommendations as a result of the IRS conducting a comprehensive review of tax return preparers.

Final Regulations on Process for Furnishing PTINs

- Final regulations adopt the proposed amendments to §1.6109-2, which provide that for tax returns or refund claims filed after December 31, 2010, the tax return preparer must obtain and exclusively use the identifying number (PTIN) prescribed by the IRS as the identifying number to be included with the tax return preparer's signature on a tax return or claim for refund.
- Must have primary responsibility for the overall substantive accuracy of the return or refund claim.
- If signing preparer has an employment arrangement or association with another person, then the other person's EIN must also be included on the tax return or refund claim.
- Failure to include a PTIN is subject to a penalty under §6695(c), unless reasonable cause and not due to willful neglect.

Final Regulations on Process for Furnishing PTINs

- Final regulation §1.6109-2(g) defines a tax return preparer as an individual who prepares for compensation, or assists in preparing, all or substantially all of a tax return or refund claim.
  - There is no exemption for staff at firms that may substantially prepare the work papers and tax return but who do not sign the returns as requested by many commentators.
  - This component of the proposed regulations created a great deal of comments from the AICPA , other associations and practitioners that wanted staff at accounting firms to be exempt from the definition of tax return preparer.
- Final regulations do not include any exemption for state based licensure, length of experience or tax return prepared.
- Volunteers and other unpaid tax return preparers listed in §301.7701-15(f) will not be required to obtain a PTIN.
- Final regulations adopt the proposed provisions under which the IRS may prescribe requirements to apply for or renew a PTIN, including the payment of a user fee. According to the IRS a user fee is necessary to recover the costs to implement and administer the process to apply for and renew a PTIN

Final Regulations on PTIN Enrollment, User Fees

- Final regulations are effective September 30, 2010.
- Creates new §300.9 to part 300 of title 26 of the Code of federal Regulations which establishes a $50 user fee to apply for or renew a PTIN.
- Applicable to all tax return preparers.
- Fee is meant to recover the full cost to the IRS for administering the PTIN application and renewal program.
- Final regulations also adopt the reorganized effective date provisions under §§300.0-300.8

Final Regulations on PTIN Enrollment, User Fees

- The IRS will use a third party vendor who will charge $14.25 per application or renewal of PTIN. This is in addition to the $50 user fee.
- Vendor will face significant consequences for the unauthorized inspection or disclosure of confidential tax information
  - civil damages
  - Civil or criminal sanctions
  - penalties

Announcement 2010-81

- Issued on October 15, 2010 to delay, until further notice, the renewal period under §10.6(d) of Circular 230 for enrolled agents with social security numbers or PTINs ending in 4, 5 or 6.
- Enrolled agents generally must renew every 3 years and agents with 4,5 or 6 SS#s or PTINs would be required to renew from November 1, 2010-January 31, 2011.
- Delayed as a result of implementation of the recommendations in Publication 4832.
- Delayed to ensure that the revised user fee to renew enrollment as an enrolled agent is effective before the start of the next renewal period.

Tax Controversies

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Hot Topics in Entity Planning

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Author: "Partnership of P.A.'s" (1980); "The New Incentive Stock Option Created under the Economic Recovery act of 1982; "Dealer vs. Investor Status" (1985); "The 1986 Tax Reform Act" (1986); "Contesting Commercial Property Assessments" published in the Palm Beach Post and the South Florida Business Journal, 1991; "Don't be a "C" if you can help it". Co-author, "Partnership Law Update" published in Fall 1994; "Partnership Law Update" (1995); "The Florida Revised Uniform Partnership Act" (1995); "Disregarded Entities" (2001); "New Tax Rules Remove Roadblock to Limiting Liability" (2001); "It's Time to Convert!" (from C Corporation to S Corporation) (2002); "Unreasonable Low Compensations: The Story of the Three Little Pigs" (2003); "Choice of Entity" Florida Bar Tax Certification Exam Outline, updated February, 2009.

CURRENT DEVELOPMENTS UPDATE

TO

CHOICE OF BUSINESS ENTITY OUTLINE

Presented to the

Florida Institute of Certified Public Accountants
2010 Florida Institute on Federal Taxation Conference

Hilton in Walt Disney World Resort in Orlando

November 3, 2010

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CURRENT DEVELOPMENTS UPDATE TO CHOICE OF ENTITY OUTLINE

I. PIERRE I - UPHOLDS THE APPLICATION OF VALUATION DISCOUNTS TO GIFTS OF INTERESTS IN A DISREGARDED ENTITY.

In *Pierre, Suzanne J.*, (2009) 133 TC No 2 ("Pierre I"), a divided Tax Court held that the "check the box" regulations do not require that a single member limited liability company (LLC) be disregarded in determining the value of an interest in the LLC for gift tax purposes. Thus, gifts of interests in a single member LLC had to be valued as gifts of interests in the LLC, and not as gifts of a proportionate share of the underlying assets of the LLC.

The facts were as follows: The donor organized a single member LLC that was validly formed under state (New York) law. The donor did not elect to treat the LLC as a corporation for federal tax purposes. Thus, under Reg. Section 301.7701 3(b)(1)(ii) of the check the box Regs., the LLC was disregarded as an entity separate from the donor. The donor funded the LLC by transferring $4.25 million in cash and marketable securities to the LLC. Twelve days after funding the LLC, the donor transferred her entire interest in the LLC to two trusts (one for her son, and another for her granddaughter). The donor first gave a 9.5% membership interest in the LLC to each trust, and then (on the same day) sold a 40.5% membership interest to each trust, in exchange for a secured promissory note. The face amount of each note was equal to 40.5% of the value of the LLC's assets, reduced by a 36.55% discount (10% for lack of control and 30% for lack of marketability, for a cumulative 36.55% discount). The donor filed a gift tax return on which she reported the gift of a 9.5% LLC interest to each trust. The value of the gift to each trust was reported on the gift tax return as an amount equal to 9.5% of the LLC's underlying assets, reduced by a 36.55% discount.

The Tax Court held, as a matter of law, that the donor's transfers to the trusts should be valued for federal gift tax purposes as transfers of interests in the LLC, and not as transfers of a proportionate share of the underlying assets of the LLC. The court said that it would address, in a separate opinion, the issues of (1) whether the step transaction doctrine (which treats separate steps that are the integrated parts of a single scheme as a single transaction) applied to collapse the separate transfers to the trusts, and (2) the appropriate valuation discount, if any.

II. PIERRE II - APPLICATION OF THE STEP-TRANSACTION DOCTRINE TO ESTATE PLANNING STRATEGIES.

In Pierre, Suzanne J., (2010) TC Memo 2010 106 ("Pierre II"), a later decision involving the same transactions that were involved in Pierre I, the Tax Court addressed the issues it had reserved in its first decision: (1) whether the gift transfers (i.e., the gifts of a 9.5% LLC interest to each trust) and the sale transfers (i.e., the sale of a 40.5% LLC interest to each trust) should be collapsed into transfers of a 50% LLC interest to each trust, under the step transaction doctrine, and (2) if so, whether the lack of control and marketability discounts claimed by the donor had to be reduced.

In Pierre II, the Tax Court held that the gift transfers and the sale transfers had to be collapsed into a single transfer because the transfers were planned as a single transaction, and the multiple steps were used solely for tax purposes. The transfers all occurred on the same day, and the donor gave away her entire interest in the LLC in the time it took for four documents (two gift documents and two sale documents) to be signed. The donor had primarily tax motivated reasons for structuring the transfers as she did: she intended to transfer two 50% LLC interests to the trusts, but first gave small (9.5%) interests to the trusts to use a portion of her then available unified credit and GST exemption, and then sold her remaining LLC interests to the trusts in exchange for promissory notes that were significantly discounted, using the 36.55% valuation discount. As a result, the donor transferred $4.25 million of assets within the LLC without paying any gift tax. Because the Tax Court found that the gift transfers and the sale transfers had to be collapsed into a single transaction under the step transaction doctrine, the court held that the donor made a gift to each trust of a 50% LLC interest, to the extent the value of the interest exceeded the value of the promissory note executed by the trust.

In determining the valuation discounts allowable for a 50% LLC interest, the court reduced the lack of control discount from the 10% that had been determined by the donor's appraiser to 8%, but found that the 30% lack of marketability discount determined by the donor's appraiser was appropriate.

A. Step Transaction Doctrine.

1. Increasingly being used by the Court and the IRS.

2. Becoming more and more prevalent in estate and gift tax cases.

3. Broad application, basically applies whenever an individual has intent to transfer assets to children while minimizing transfer taxes.

4. For example, the Step Transaction Doctrine might be applied if you annually gift money to kids in order for them to purchase an LLC interest.

5. The court gave four (4) reasons for applying the Step Transaction Doctrine:

a. Same day transactions;
b. No lapse of time between gift and sale transactions;
c. taxpayer's intent (other than gift tax); and
d. Poor documentation.

B. Gift/Sale Transactions Can Be Structured to Avoid Aggregation for Valuation Purposes.

1. Wait enough time so there is arguably a real risk of change in economic value between the date of funding and the date of the transfer of interests in the entity.

2. Plan time between the gift and sale transactions to avoid argument that you only had the intent of making the transfers without gift taxes.

3. Document intent of client for other reasons besides avoiding gift taxes, e.g., for economic reasons (parents may be willing to gift outright a certain value but want payment in return for additional transfers).

4. If possible, give and sell different assets. No aggregation if different assets are being gifted and sold.

5. Focus on the economics of the separate sale transaction, and implement the sale transaction (e.g., make principal payments on the note over time, do not have the seller immediately turn around and make gifts of the principal note payments back to purchaser, do not refer to the gift as a "seed" gift, etc).

6. Give a "Sliver Gift" of an asset over a period of years rather than all at once.

III. ***HOLMAN* FAMILY BUY SELL AGREEMENT FOR AN INVESTMENT PARTNERSHIP IS NOT RESPECTED.**

A. In the *Holman* case, the Tax Court favored the IRS on discounts used in valuing a family investment partnership, relying on Section 2703(b) to disregard partnership restrictions and then speculating that family members would be involved in a potential transaction rather than hypothetical people. The Eighth Circuit affirmed but a strong dissent said this was a misapplication of the hypothetical willing buyer/willing seller standard (see Rev. Rul. 59-60 and the *Simplot* case). The dissent said this decision could result in a return to the days of family attribution prior to Rev. Rul. 93-12.

B. The reasoning under this case suggests that many intra family Buy Sell Agreements (if buy out price is anything less than pro rata fair market value) will not be respected.

1. Applied to buy sell agreements of a family investment partnership.

2. Applying "bona fide business arrangement requirement" to these agreements.

3. IRS has taken the position on audits that this principle should be applied to buy sell agreements for operating businesses with family members as owners.

IV. *JOHN W. FISHER ET UX. V. UNITED STATES*, NO. 1:08-CV-00908, UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF INDIANA; (SECTION 2703 -- VALUATION, DISREGARDED RIGHTS).

A. A U.S. district court, in a couple's gift tax refund suit, has held that transfer restrictions imposed on their gifts of interests in a limited liability company to their children should not be considered for gift tax valuation purposes under Section 2703, because the LLC wasn't a bona fide business.

B. The facts: over the course of a three year period, the Fishers transferred 4.762% membership interests in Good Harbor Partners, LLC ("Good Harbor"), to each of their seven children (the "Fisher Children") (the Fishers and the Fisher Children collectively, the "Members"). From the date of Good Harbor's formation through the last of the transfers at issue, Good Harbor's principal asset was a parcel of undeveloped land that borders Lake Michigan. The Fishers filed gift tax returns for each transfer and paid the amounts shown as due on those returns. As a result of an audit, the IRS assessed a deficiency of $625,986.00 in additional gift tax owed. The Fishers paid the deficiency and filed a claim for refund, alleging, in part, that the transfer restrictions imposed upon the membership interests that the Fishers gifted to the Fisher Children should be taken into account when determining the value of those gifts.

Good Harbor's operating agreement (the "Operating Agreement") provided that the Fishers formed Good Harbor primarily to engage in the business of investing in and holding for investment real property, and further states that the Fishers formed Good Harbor, in part, to select with whom they would be in "business" with and to keep Good Harbor's principal asset, the lakefront property, available for the Members' personal use. The Fishers' other stated objectives were to discourage business disputes among family members, prevent partition of the lakefront property, and protect the lakefront property from the Members' individual creditors.

The Operating Agreement contained restrictions on transfers of interests, including a "right of first refusal". The Fisher Children may disregard Good Harbor's right of first refusal only in the event of a transfer to the Fishers or their descendants by birth or adoption.

C. With regard to Section 2703(b)'s first requirement, the Fishers argued that the transfer restrictions and, specifically, the right of first refusal imposed upon the Fisher Children by the Operating Agreement renders Good Harbor a "bona fide business arrangement." 26 U.S.C. Section 2703(b)(1). In support, the Fishers asserted that holding real estate for investment or development is a bona fide business.

D. The Court: The court, in holding that Good Harbor was not a “bona fide business” within the meaning of Section 2703(b), followed the *Holman* case, finding no evidence that the Fishers had an investment strategy that was preserved by Good Harbor's formation, that the uncontradicted evidence demonstrated that neither the Fishers nor the Fisher Children made an ongoing investment in the lakefront property to increase its commercial value, and no

indication that the Fishers or the Fisher Children acquired or pursued the acquisition of additional real property as an investment for Good Harbor.

V. <u>ACTION ON DECISION 2010-002, 2010 IRB, 4/5/2010 LLC MEMBERS CAN BE MATERIAL PARTICIPANTS UNDER SECTION 469</u>.

The IRS acquiesced in result only in the Court of Federal Claims' holding in *Thompson, James R. v. U.S.* that a taxpayer's member interest in an LLC was not the equivalent of a limited partnership interest for purposes of Reg. Section 1.469-5T(e)(3) and Section 469(h)(2). Prior to this acquiescence, the IRS took the position in litigation that an LLC interest was the equivalent of a limited partnership interest to keep members of an LLC from satisfying the material participation rules of Section 469 (a taxpayer materially participates in an activity only if such taxpayer is involved in the activity's operations on a "regular, continuous, and substantial basis," met by satisfying one of the seven tests in Reg. Section 1.469-5T(a)).

In *Thompson*, the taxpayer directly owned 99% of an LLC that was an airplane charter business, and indirectly owned the remaining 1% interest through a wholly-owned S Corporation. The IRS disallowed losses that the taxpayer claimed on his return, stating that he failed to meet the material participation requirements that apply to limited partners under Reg. Section 1.469-5T(e)(3)(i). In the controversy, both parties stipulated that if the taxpayer's LLC interest was not characterized as a limited partnership interest under Section 469, then the taxpayer could establish his material participation using one of the seven tests under Reg. Section 1.469-5T(a).

The court held the taxpayer's interest was not a limited partnership interest for purposes of Section 469, and even if the interest was treated as an interest in a limited partnership, his interest would best be categorized as a general partnership interest under Reg. Section 1.469-5T(e)(3)(i). Therefore, the taxpayer could use one of the seven tests in Reg. Section 1.469-5T(a) to establish material participation. The IRS has acquiesced in result only to the decision in *Thompson*. This means that the IRS accepts the holding of the court and the IRS will follow such result in disposing of cases with the same controlling facts.

VI. <u>IRS ANNOUNCES REQUIREMENT TO DISCLOSE SECTION 469 GROUPINGS REV. PROC. 2010 13, 2010 4 IRB 329</u>.

This revenue procedure requires taxpayers to report to the Internal Revenue Service their groupings and re-groupings of activities and the addition of specific activities within their existing groupings of activities for purposes of Section 469 of the Code and Reg. Section 1.469-4.

Special rules apply for groupings by partnerships and S corporations and are described in Section 4.05 of this revenue procedure, which provides that partnerships and S corporations are not subject to the requirements of Sections 4.02, 4.03, and 4.04 of this revenue procedure. Instead, Partnerships and S corporations must group their activities as required under Reg.

Section 1.469 4(d)(5) and comply with the disclosure instructions for grouping activities provided on Form 1065, Return of Partnership Income, and Form 1120 S, S Corporation Income Tax Return, respectively. Generally, compliance with the applicable form requires disclosing the entity's groupings to the partner or shareholder by separately stating the amounts of income and loss for each grouping conducted by the entity on attachments to the entity's annual Schedule K-1. The partner or shareholder is not required to make a separate disclosure of the groupings disclosed by the entity unless the partner or shareholder:

A. groups together any of the activities that the entity does not group together,

B. groups the entity's activities with activities conducted directly by the partner or shareholder, or

C. groups the entity's activities with activities conducted through other Code Sec. 469 entities.

VII. REVENUE PROCEDURE 2009-41 -- ADMINISTRATIVE RELIEF FOR FAILURE TO MAKE TIMELY ENTITY CLASSIFICATION ELECTION.

If an eligible entity fails to elect its classification timely, Rev. Proc. 2009-41 provides new procedures for qualifying for administrative relief from the IRS service centers. If the entity qualifies for administrative relief, the Revenue Procedure provides the exclusive means to obtain late election relief. To qualify under Rev. Proc. 2009-41, the following requirements must be satisfied:

A. The eligible entity failed to obtain its requested classification as of the date of formation or on the entity's classification becoming relevant (within the meaning of Reg. 301.7701 3(d)) solely because the Form 8832, Entity Classification Election, was not timely filed under Reg. Section 301.7701 3(c)(1)(iii), or the entity failed to obtain its requested change in classification solely because Form 8832 was not filed timely under Reg. Section 301.7701 3(c)(1)(iii);

B. The eligible entity seeking an extension of time to make an election has not filed any tax or information return for the year in which the election is to be effective, because the due date of the applicable return has not passed, or the eligible entity timely filed all required federal tax and information returns consistent with its requested classification and no inconsistent tax or information returns have been filed by or with respect to the entity during any of the tax years for which the entity intended the requested election to be effective (Consistent Filing Requirement);

C. The eligible entity has reasonable cause for its failure to make the entity classification election in a timely manner;

D. Three years and seventy-five (75) days from the requested date of the classification election have not passed. For entities that are electing to change their classification,

the Consistent Filing Requirement includes filing returns consistent with the deemed treatment of elective changes under Reg. Section 301.7701 3(g). For example, if an entity classified as a partnership elects to be treated as a corporation, under Reg. Section 301.7701 3(g)(1) the partnership is treated as contributing all of its assets and liabilities to the corporation in exchange for stock and immediately distributing the stock in liquidation to its partners. The analysis of Situation 1 in Rev. Rul. 84-111, 1984 2 CB 88, describes the tax effects of these deemed transactions.

The Revenue Procedure provides that the procedural requirements for relief are that, within three years and seventy-five (75) days of the requested effective date, the eligible entity must file with the applicable IRS service center a completed Form 8832, signed as required by Reg. Section 301.7701 3(c)(2). The Form 8832 must include a statement at the top of the form that it is being filed in accordance with Rev. Proc. 2009-41, and it must also include a declaration that the elements required by the Revenue Procedure are satisfied and a statement explaining the reason for failure to file a timely entity classification election. The statement and declaration must be signed under penalty of perjury by an authorized representative of the eligible entity who has personal knowledge of the facts and circumstances related to the election and all affected persons.

VIII. ***DONALD W. WALLIS ET UX. V. COMMISSIONER*- T.C. MEMO, 2009-243 -- STRUCTURING PAYMENTS TO DEPARTING PARTNERS IN SERVICE PARTNERSHIPS.**

A. Payments At Issue.

1. Capital account - Wallis was paid the amount shown on the firm's record as his capital account balance on his departure.

2. Schedule C Units were -

a. An amount that was payable based on a predetermined formula;

b. The same for each "capital partner" regardless of the size of the partner's interest and without regard to the income of the firm;

c. Not based on any reserve or capital, just a promise to pay upon departure;

d. and the firm issued a Form 1099 MISC and reported these payments as non-employee compensation to Wallis, and deducted those on its return.

B. Departing Partner's Position.

1. Capital Account - There was no issue that this was a 736(b) payment. Wallis took the position that he had a basis equal to the capital account payment, and thus there

was no taxable income on this payment. The IRS argued his basis was close to zero by adding up his capital contribution and income allocated to him on the Form K-1s, and subtracting all distributions to him.

2. Schedule C Units Wallis said these were made in exchange for his interest in the firm i.e. Section 736(b) payments and thus should be taxed as long term capital gain. (Actually, Wallis failed to report these payments at all on his tax return, so this position appears to be more of an argument made in that context than one of real substance.)

C. Court's Finding.

1. Capital Account Court comments that the firm's records were inconsistent (what they showed as the final balance of the capital account, and the records the IRS used to calculate basis [it seems there must be an explanation for the discrepancy I'm sure the firm keeps good track of the capital account], but held the IRS hadn't met its burden to prove the firm's capital account amount wasn't correct.

2. Schedule C Units - Court found these were guaranteed payments, and thus all ordinary income to Wallis. This was based on their "character" as retirement payments and not determined with regard to the income of the partnership.

D. Lessons Learned.

1. Consider stating specifically in the partnership or operating agreement the character of the payment under Section 736, so everyone is clear.

See Exhibit “A” for more on structuring payments to departing partners in service partnerships.

IX. *GRACIA V. COMMISSIONER*, T.C. MEMO. 2004-147 APPLICATION OF SECTION 108(A)(1)(A) TO GUARANTOR PARTNERS WHERE PARTNERSHIP LEVEL INDEBTEDNESS IS DISCHARGED IN A TITLE 11 BANKRUPTCY CASE.

A. In *Gracia v. Comr.*, the Tax Court concluded that a solvent general partner of a partnership could exclude his allocable share of debt-discharge income under Section 108(a)(1)(A) based on the bankruptcy of the partnership, where the bankruptcy court had explicitly asserted jurisdiction over such solvent general partner individually for the specific purpose of discharging and releasing him from all liability relating to claims against partnership, his partner status and his guarantee agreement.

B. What happened: In *Gracia*, the taxpayer/general partner had personally guaranteed partnership debt. The partnership later declared bankruptcy, and the bankruptcy trustee negotiated a settlement with some of the general partners (including the taxpayer) under which, in exchange for paying a fixed amount to the partnership's bankruptcy estate, the

contributing partners would be discharged from all liability under the confirmed bankruptcy plan. The order of the bankruptcy court released the taxpayer from "the claims or potential claims of all creditors" of the partnership, and stated that the taxpayer "is subject to the jurisdiction of the Bankruptcy Court." The taxpayer excluded from gross income his allocable share of the resulting debt-discharge income under Section 108(a)(1)(A).

C. The Court: The Tax Court began its analysis by noting that, for purposes of §108, a "Title 11 case" is defined as "a case under Title 11 of the United States Code (relating to bankruptcy), <u>but only if</u> the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court." Because (a) the partnership's Chapter 11 bankruptcy was a case under Title 11 of the United States Code, (b) the bankruptcy court discharged the taxpayer from all liability, and (c) the bankruptcy court order "explicitly asserted its jurisdiction over petitioner for this purpose," the Tax Court concluded that the taxpayer's debts were discharged in a Title 11 case within the meaning of Section 108(d)(2). Under this literal reading of the statute, the court concluded that the taxpayer was entitled to exclude the debt-discharge income under Section 108(a)(1)(A).

X. <u>*MULTI-PAK CORP.* -- MULTI-FACTOR AND INDEPENDENT INVESTOR TESTS USED TO DETERMINE REASONABLE COMPENSATION</u>.

A. In *Multi-Pak Corp.*, TC Memo 2010-139 , RIA TC Memo ¶2010-139 , 99 CCH TCM 1567, the Tax Court recharacterized a portion of the compensation paid to the sole shareholder by his corporation in 2003 as a nondeductible dividend distribution, finding that the amount of compensation paid to the sole shareholder in 2003 was unreasonable.

B. The Facts: The sole shareholder performed all of Multi-Pak's managerial duties, made all personnel decisions, and was in charge of Multi-Pak's price negotiations, product design, machine design and functionality, and administration. In 2003, Multi-Pak paid a total compensation of $2,058,000 to the sole shareholder, consisting of a salary of $353,000 and a $1,705,000 bonus. The IRS determined in a Notice of Deficiency that Multi-Pak could deduct only $660,000 of officer compensation for 2003 as reasonable compensation for the sole shareholder's services during 2003.

C. The Law: Section 162(a)(1) allows a deduction for ordinary and necessary expenses paid or incurred during a tax year in carrying on a trade or business, including a "reasonable allowance" for salaries or other compensation for personal services actually rendered. Reg. Section 1.162-7(a) provides that the test of deductibility in the case of compensation payments is whether the payments are reasonable and are, in fact, payments purely for services. Although framed as a two-prong test, the inquiry under Section 162(a)(1) generally turns on whether the amounts of the purported compensation were reasonable.

D. The Multi-Factor Test: The Tax Court applied the following five factors in *Multi-Pak* in reaching its decision:

(1) The employee's role in the company, including the position held, hours worked and duties performed by the employee, and the general importance of the employee to the success of the company. In *Multi-Pak*, the Tax Court found that this factor favored the taxpayer based on the sole shareholder's importance to Multi-Pak.

(2) An external comparison of the employee's salary with those paid by similar companies for similar services. If a shareholder is performing the work of three employees, for example, the relevant comparison would be the combined salaries of those three employees in a similar corporation. After an extensive analysis of the expert testimony presented by the taxpayer and the IRS, the Tax Court in Multi-Pak found that the analysis performed and the opinions expressed by both parties' experts were not persuasive or reliable, and, therefore, found that the comparison to the compensation paid by unrelated firms was a neutral factor which did not favor either party.

(3) The character and condition of the company as indicated by its sales, net income, and capital value, together with the complexities of the business, as well as general economic conditions. The Tax Court found that although Multi-Pak's net income in 2003 was low when compared to revenues, other factors such as equity, revenue, and gross profit pointed towards a successful operation. Thus, the court determined that this factor favored the taxpayer.

(4) Whether some relationship exists between the corporation and its shareholder-employee that might permit the company to disguise nondeductible corporate distributions of income as salary expenditures deductible under Section 162(a)(1) . This category employs the <u>independent investor standard</u>, which provides that if a company's return on equity remains at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned off as disguised salary. As will be discussed in more detail below, the Tax Court found that this factor favored the IRS in 2003.

(5) A reasonable, long-standing, consistently applied compensation plan is evidence that the compensation paid for the years in question is reasonable. The Tax Court found that the taxpayer's payment of the sole shareholder's bonuses was made under a consistent business policy, and as such, this factor favored the taxpayer.

D. The Independent Investor Test: As The independent investor standard provides that if the corporation's return on equity remains at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company as disguised salary. This is referred to as the "independent investor test."

In determining the rate of return that would be received by the hypothetical independent investor, the Tax Court in Multi-Pak divided the taxpayer's net profit (after payment of compensation and a provision for income taxes) by the year-end shareholder's equity as reflected in its financial statements. This yielded a negative 15.8% return on equity for 2003. The court agreed with the IRS that a negative 15.8% return on equity in 2003 called into question the level of the sole shareholder's compensation for that year.

The court went on to state that when compensation results in a negative return on shareholder's equity, it cannot conclude, in the absence of a mitigating circumstance, that an independent investor would be pleased. Consequently, the court felt that if the sole shareholder's salary was reduced to $1,284,104 in 2003, which would result in a return on equity of 10% in 2003, that would be sufficient to satisfy an independent investor. The court, therefore, held that taxpayer was entitled to deduct $1,284,104 out of the original compensation of $2,058,000 paid to the sole shareholder in 2003.

XI. CONGRESS STILL CONSIDERING IMPOSITION OF SELF-EMPLOYMENT TAX ON CERTAIN S CORPORATION SHAREHOLDERS.

Although the American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213 (the "Act") failed to pass the Senate after passing the House, it included a provision that would have a significant impact on S corporations, and which may very well be raised in subsequent tax bills as a significant revenue raiser. Act Section 413 would have added new Section 1402(m) to subject certain S corporation shareholders to the self-employment tax imposed under Section 1402 on their distributive share of the income of an S corporation. Specifically, Section 1402(m)(1)(a) provided that in the case of any "disqualified S corporation," each shareholder of the disqualified S corporation who provides "substantial services" with respect to the "professional service business" referred to in Section 1402(m)(1)(C) must take into account such shareholder's pro rata share of all items of income or loss described in Section 1366 which are attributable to such business in determining the shareholder's net earnings from self-employment.

A disqualified S corporation is defined in Section 1402(m)(1)(C) as:

(1) Any S corporation that is a partner in a partnership that is engaged in a professional service business, if substantially all of the activities of the S corporation are performed in connection with the partnership.

(2) Any other S corporation that is engaged in a "professional service business," if the "principal asset" of the business is the "reputation and skill" of three or fewer employees.

Section 1402(m)(3) defines the term "professional service business" as being any trade or business if substantially all of the activities of the trade or business involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services.

Except as otherwise provided by the Secretary, a shareholder's pro rata share of items of the S corporation subject to the self-employment tax will be increased by the pro rata share of the items of each member of the shareholder's family (within the meaning of Section 318(a)(1)) who does not provide substantial services with respect to the professional service business.

Additionally, Section 1402(m)(2) provides that in the case of any partnership that is engaged in a professional service business, Section 1402(a)(13) —which generally exempts limited partners from the self-employment tax—will not apply to any partner who provides substantial services with respect to the professional service business.

XII. MEDICAL PRACTICE SOLUTIONS, LLC ET AL. V. COMMISSIONER- T.C. MEMO, 2010-98 B PERSONAL LIABILITY FOR EMPLOYMENT TAXES.

A. The Result. The Tax Court upheld IRS determinations sustaining the filing of a notice of federal tax lien and a levy action against the sole member of a limited liability company to collect the LLC's unpaid payroll taxes.

B. The Facts. Ms. Britton was the sole member of the LLC for the calendar quarters ending September 30, 2006, December 31, 2006, and June 30, 2007. Ms. Britton timely filed the LLC's Forms 941, Employer's Quarterly Federal Tax Return, for each of those quarters. Those returns named not Ms. Britton personally but "MEDICAL PRACTICE SOLUTIONS LLC" as the taxpayer. The returns gave the LLC's employer identification number (EIN) and its business address in Beverly, Massachusetts. Ms. Britton signed the first two of those returns, and Ms. Britton's husband Randy Britton signed the third as "Power of Attorney". The LLC left unpaid some of the tax liabilities reported on each of those returns. The IRS duly assessed the liabilities under the LLC's name and EIN. On various dates in 2007 the IRS gave Ms. Britton notice of the balances due for the three quarters.

C. Ms. Britton’s Argument. At a collection due process hearing, Ms. Britton argued that the collection action is against the wrong taxpayer and that the IRS check the box rules are invalid.

D. The IRS Argument. The lien had been properly filed against Ms. Britton, because the LLC is a disregarded entity.

E. The Holding. Ms. Britton's arguments -- about the liability of the LLC versus her own liability, or assessments being made against the LLC and not herself, or the use of the LLC's EIN rather than her Social Security number, or the presence of both her name and the LLC's name on the demand for payment and the Forms 4340, or notices of the lien and of the proposed levy being given to herself rather than to the LLC -- all of these arguments failed because Ms. Britton and the LLC are, as the court explicitly held, "a single taxpayer or person to whom notice is given." When the IRS thereafter issued notices of lien and proposed levy to Ms. Britton, it addressed the correct taxpayer. When the Office of Appeals sustained the lien and proposed levy in notices of determination issued to Ms. Britton as sole member of the LLC, it made no mistake.

XIII. IRS ISSUES PROPOSED REGULATIONS PROVIDING GUIDANCE ON SERIES LLCS AND CELL COMPANIES THAT CONDUCT INSURANCE BUSINESSES (26 CFR PART 301. [REG-119921-09]).

A. Under current law, there is little specific guidance regarding whether for Federal tax purposes a series (or cell) is treated as an entity separate from other series or the series LLC (or other cells or the cell company, as the case may be), or whether the company and all of its series (or cells) should be treated as a single entity. The proposed regulations provide guidance regarding the classification for Federal tax purposes of a series of a domestic series limited liability company (LLC), a cell of a domestic cell company, or a foreign series or cell that conducts an insurance business. The proposed regulations provide that, whether or not a series of a domestic series LLC, a cell of a domestic cell company, or a foreign series or cell that conducts an insurance business is a juridical person for local law purposes, for Federal tax purposes it is treated as an entity formed under local law. Classification of a series or cell that is treated as a separate entity for Federal tax purposes generally is determined under the same rules that govern the classification of other types of separate entities. The proposed regulations provide examples illustrating the application of the rule. The proposed regulations will affect domestic series LLCs; domestic cell companies; foreign series, or cells that conduct insurance businesses; and their owners.

B. A number of states have enacted statutes providing for the creation of entities that may establish series, including limited liability companies (series LLCs). In general, series LLC statutes provide that a limited liability company may establish separate series. Although series of a series LLC generally are not treated as separate entities for state law purposes and, thus, cannot have members, each series has “associated” with it specified members, assets, rights, obligations, and investment objectives or business purposes. Members’ association with one or more particular series is comparable to direct ownership by the members in such series, in that their rights, duties, and powers with respect to the series are direct and specifically identified. If the conditions enumerated in the relevant statute are satisfied, the debts, liabilities, and obligations of one series generally are enforceable only against the assets of that series and not against assets of other series or of the series LLC.

C. Certain jurisdictions have enacted statutes providing for entities similar to the series LLC. For example, certain statutes provide for the chartering of a legal entity (or the establishment of cells) under a structure commonly known as a protected cell company, segregated account company or segregated portfolio company (cell company). A cell company may establish multiple accounts, or cells, each of which has its own name and is identified with a specific participant, but generally is not treated under local law as a legal entity distinct from the cell company. The assets of each cell are statutorily protected from the creditors of any other cell and from the creditors of the cell company.

D. Curtis Wilson, IRS associate chief counsel (passthroughs and special industries), indicated on September 24 that the proposed regulations for series within LLCs could be interpreted to mean that series have joint and several liability for their federal tax obligations, despite state statutory language limiting debt liability among series.

The proposed regulations treat an individual series of a series LLC or an individual cell of a cell company as an entity under local law for testing its tax status. Series and cells are also likely to be separate taxable entities for federal tax purposes.

State statutes authorizing series LLCs typically specify that series do not share liabilities for their debts, but "the reg refers to the series statute, not the entirety of the state code," Wilson said, speaking at the Real Estate session of the American Bar Association Section of Taxation fall meeting in Toronto. "I think what we had in mind was the portion of [the state code] that authorizes the creation of the entity."

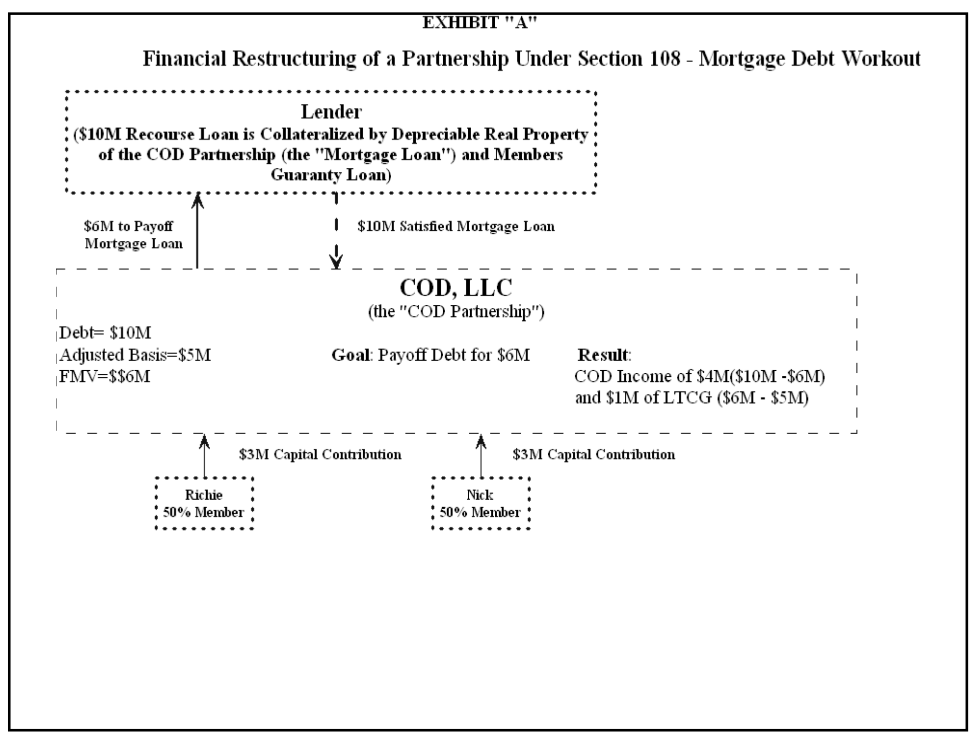


EXHIBIT "A"
Financial Restructuring of a Partnership Under Section 108 - Mortgage Debt Workout
Lender
($10M Recourse Loan is Collateralized by Depreciable Real Property of the COD Partnership (the "Mortgage Loan") and Members Guaranty Loan)
$6M to Payoff Mortgage Loan
$10M Satisfied Mortgage Loan
COD, LLC
(the "COD Partnership")
Debt= $10M
Adjusted Basis=$5M
FMV=$$6M
Goal: Payoff Debt for $6M
Result:
COD Income of $4M($10M -$6M)
and $1M of LTCG ($6M - $5M)
$3M Capital Contribution
$3M Capital Contribution
Richie
50% Member
Nick
50% Member

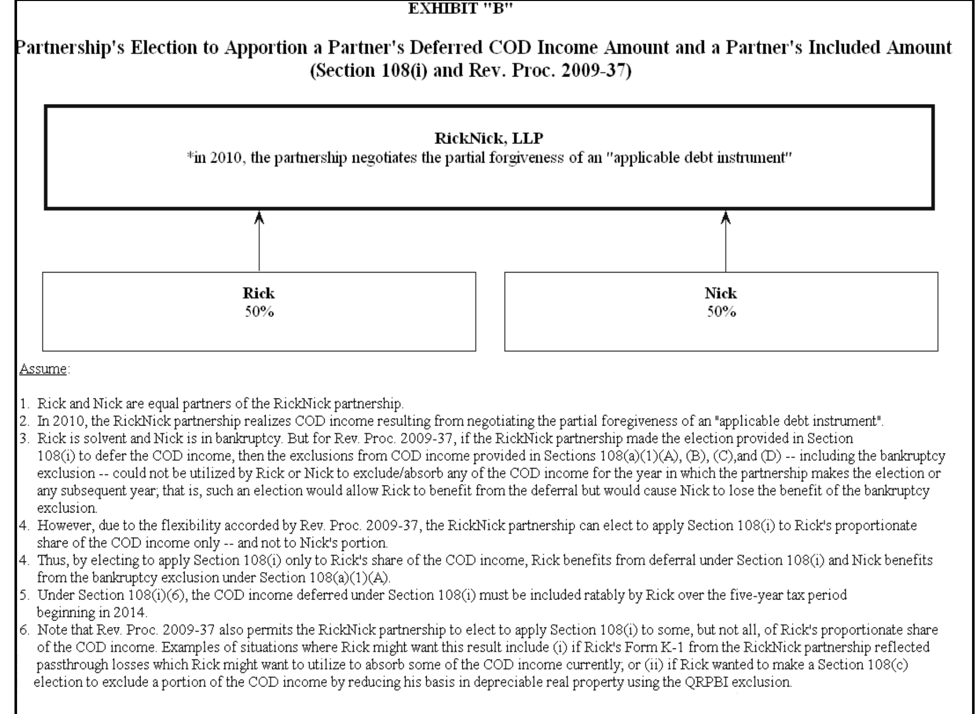
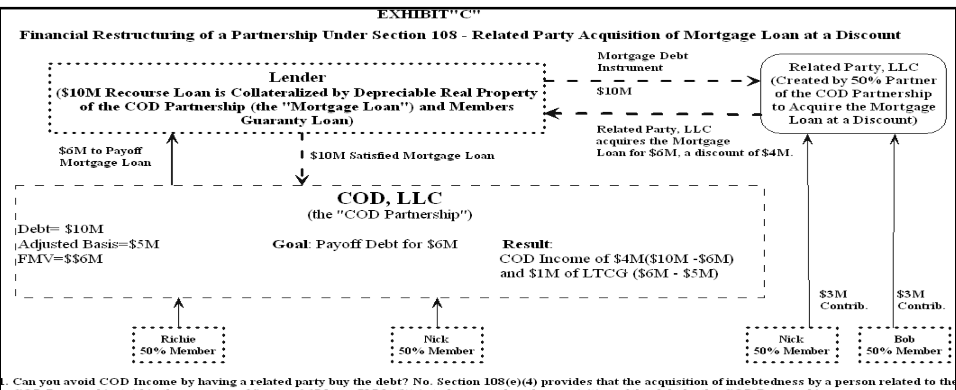


EXHIBIT "B"
Partnership's Election to Apportion a Partner's Deferred COD Income Amount and a Partner's Included Amount (Section 108(i) and Rev. Proc. 2009-37)
RickNick, LLP
*in 2010, the partnership negotiates the partial forgiveness of an "applicable debt instrument"
Rick
50%
Nick
50%
Assume:
1. Rick and Nick are equal partners of the RickNick partnership.
2. In 2010, the RickNick partnership realizes COD income resulting from negotiating the partial foregiveness of an "applicable debt instrument".
3. Rick is solvent and Nick is in bankruptcy. But for Rev. Proc. 2009-37, if the RickNick partnership made the election provided in Section 108(i) to defer the COD income, then the exclusions from COD income provided in Sections 108(a)(1)(A), (B), (C),and (D) -- including the bankruptcy exclusion -- could not be utilized by Rick or Nick to exclude/absorb any of the COD income for the year in which the partnership makes the election or any subsequent year; that is, such an election would allow Rick to benefit from the deferral but would cause Nick to lose the benefit of the bankruptcy exclusion.
4. However, due to the flexibility accorded by Rev. Proc. 2009-37, the RickNick partnership can elect to apply Section 108(i) to Rick's proportionate share of the COD income only -- and not to Nick's portion.
4. Thus, by electing to apply Section 108(i) only to Rick's share of the COD income, Rick benefits from deferral under Section 108(i) and Nick benefits from the bankruptcy exclusion under Section 108(a)(1)(A).
5. Under Section 108(i)(6), the COD income deferred under Section 108(i) must be included ratably by Rick over the five-year tax period beginning in 2014.
6. Note that Rev. Proc. 2009-37 also permits the RickNick partnership to elect to apply Section 108(i) to some, but not all, of Rick's proportionate share of the COD income. Examples of situations where Rick might want this result include (i) if Rick's Form K-1 from the RickNick partnership reflected passthrough losses which Rick might want to utilize to absorb some of the COD income currently; or (ii) if Rick wanted to make a Section 108(c) election to exclude a portion of the COD income by reducing his basis in depreciable real property using the QRPBI exclusion.

EXHIBIT"C"

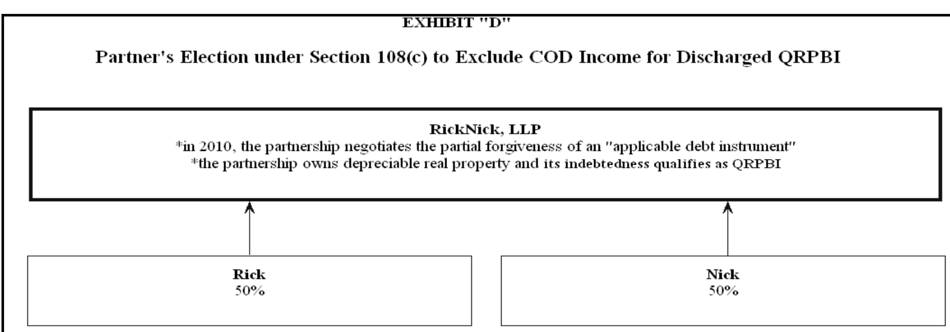
Financial Restructuring of a Partnership Under Section 108 - Related Party Acquisition of Mortgage Loan at a Discount



1. Can you avoid COD Income by having a related party buy the debt? No. Section 108(e)(4) provides that the acquisition of indebtedness by a person related to the COD Partnership (within the meaning of Section 267(b) or 707(b)(1)) is to be treated as the acquisition of the debt by the COD Partnership.
2. The COD income recognized by the COD Partnership depends on the cost of the Mortgage Loan at the time of its acquisition. The COD Partnership (debtor) is treated as having satisfied the old Mortgage Loan ($10M) with an amount equal to the issue price of the newly issued debt instrument ($6M). The COD Income is equal to the difference ($4M) between the issue price of the newly issued debt instrument ($6M) and the Mortgage Loan ($10M).
3. During the remaining life of the new Mortgage Loan, the Related Party, LLC that acquired the Mortgage Loan at a discount will be required to recognize OID income, and the COD Partnership will have OID deductions.
4. Under Section 108(i), the COD Partnership could elect to defer COD income arising from the reacquisition of the Mortgage Loan if such reacquisition occurs after 2008 and before 2011. The COD income deferred pursuant to Section 108(i) with respect to the "reacquisition" of the Mortgage Loan during 2009 and 2010 only is included ratably over the 5-tax-year period beginning: (i) for a reacquisition occurring in 2009, with the fifth tax year (2014) following the tax year in which the reacquisition occurs; or (ii) for a reacquisition occurring in 2010, with the fourth tax year following the tax year in which the reacquisition occurs.
5. Alternatively, under §108(a)(1)(D), there is an exclusion from gross income for discharged "qualified real property business indebtedness". Generally, the effect of the exclusion for discharged qualified real property business indebtedness is to provide the partners of the COD Partnership an election to reduce the basis of depreciable real property by the amount of discharged qualified real property business indebtedness ($4M), in lieu of recognizing the COD income. To qualify for this exclusion, the partners may not be in bankruptcy or insolvent. For this purpose, insolvency is determined at the partner level.
6. The price to pay for the "qualified real property business indebtedness" exclusion is a basis reduction on the first day of the next tax year, the basis reduction is accelerated if the depreciable property is sold by year end.
7. The additional price to pay for the "qualified real property business indebtedness" exclusion is the recapture of basis reductions applies to the subsequent sale of reduced basis property and the QRPBI basis reduction is deemed to be attributable to depreciation deductions. Thus, if the property is later sold at a gain the portion of the gain attributable to QRPBI basis reduction is taxable as ordinary recapture income, whereas all of the COD Income is taxed as ordinary income.
8. With respect to basis reduction in a partnership, an electing partner treats his partnership interest as depreciable property to the extent of such partner's share of such property. The partnership interest is depreciable property only if the partnership actually reduces inside adjusted basis of partnership property. See Section 1017.
9. The "qualified real property business indebtedness" exclusion amount cannot exceed the adjusted basis of depreciable real property held immediately before cancellation of indebtedness, and is limited to the excess of the outstanding debt minus the FMV of the property.

EXHIBIT "D"

Partner's Election under Section 108(c) to Exclude COD Income for Discharged QRPBI

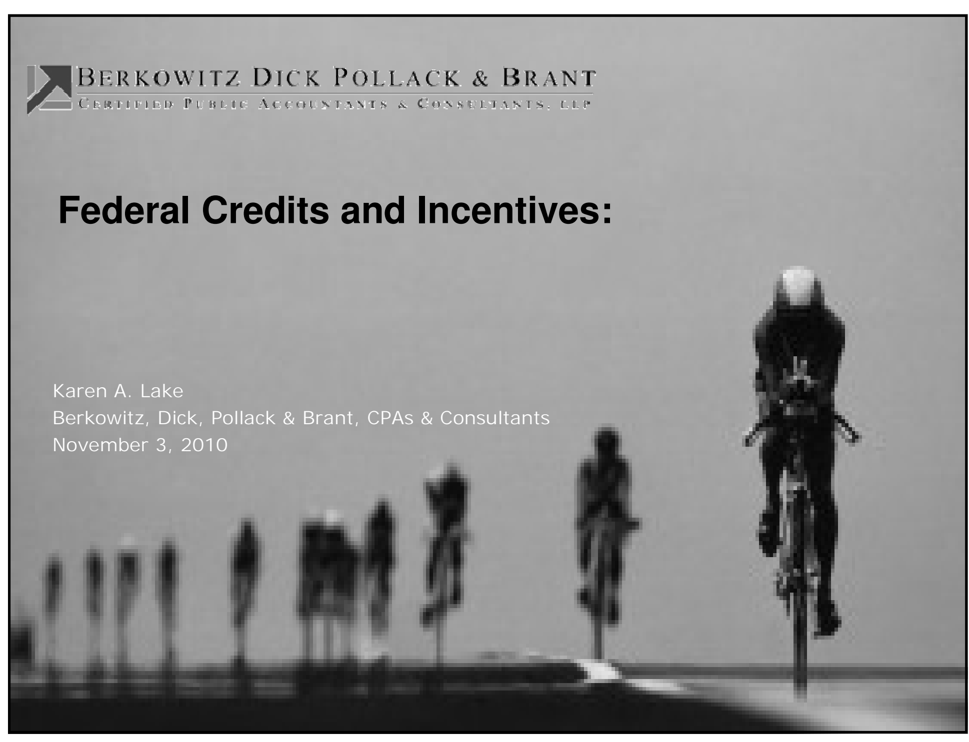


<u>Assume</u>:

1. Rick and Nick are equal partners of the RickNick partnership. The partnership owns depreciable real property and its indebtedness qualifies as QRPBI.
2. In 2010, the RickNick partnership realizes COD income resulting from negotiating the partial foregiveness of an "applicable debt instrument".
3. Rick is solvent and Nick is in bankruptcy. In addition to his interest in the RickNick partnership, Rick owns a partnership interest in the XYZ partnership that owns depreciable real property.
4. Because he is solvent, Rick can elect to avail himself of the QRPBI exclusion by filing Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness, by attaching the same to his Form 1040 for the taxable year 2010 (the taxable year of the discharge).
5. If Rick makes the QRBPI election under 108(c) to reduce the basis by the amount of excluded COD income, he must decrease his basis in his partnership interests in the RickNick partnership and/or the XYZ partnership (both of which interests are treated as depreciable real property to the extent of Rick's proportionate interest in the depreciable real property held by the partnerships). However, the recapture of basis reductions applies to the subsequent sale of reduced basis property and the QRPBI basis reduction is deemed to be attributable to depreciation deductions. Thus, if the property is later sold at a gain the portion of the gain attributable to QRPBI basis reduction is taxable as ordinary recapture income.
6. Note that a partner is generally required to obtain the consent of the partnership to make a corresponding reduction in the basis of depreciable partnership real property with respect to that partner. See Regs. Section 1.1017-1(g)(2). However, a partnership <u>must</u> consent to reduce its partners' shares of inside basis with respect to QRPBI if consent is requested with respect to that QRPBI by partners owning (directly or indirectly) an aggregate of more than 80 percent of the capital and profits interests of the partnership or five or fewer partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership. In this case, Rick would need the consent of the RickNick partnership.
7. For Nick, it is important to note that the QRPBI exclusion does not apply to a cancellation of debt in a Title 11 bankruptcy case. Since the QRPBI was canceled while Nick was in a Title 11 case, Nick must apply the bankruptcy exclusion rather than the exclusion for canceled QRPBI.
8. As a practical matter, electing a basis reduction with respect to QRPBI usually will be more advantageous than electing to defer COD income under Section 108(i). This is because the "cost" of excluding the COD income with respect to QRPBI will be spread over the remaining useful life of the real property; whereas, the deferral under Section 108(i) is only until 2014, with the COD income being recognized in the following five years. See "Recovery Act Allows Deferral of COD Income—To Elect or Not?", by Richard M. Lipton (Journal of Taxation, Volume 110, Number 05, May 2009).

Federal Credits and Incentives

Karen A. Lake, CPA



Agenda

- What are Federal tax credits and incentives?
- Why are not the tax credits and incentives being used today?
- How credits and incentives can help your business.
  - Hiring Incentives to Restore Employment Act (HIRE Act)
  - Small Business Jobs and Credit Act
    - Empowerment Zone Employment Credit (IRC §1396)
    - Investment Tax Credit (IRC §46)
    - Low Income Housing Credit (IRC §42a)
    - Research & Development Credit (IRC §41)
    - Work Opportunity Tax Credit (IRC §51)
  - Domestic Production Activities Deduction (IRC §199)
  - Healthcare Tax Credits
  - New Markets Tax Credit
  - Welfare to Work Credit
- Summary of benefits.

What Are Federal Tax Credit & Incentives?

Money in Your Pocket

Federal Tax Credits Can Result in A Dollar-For-Dollar Reduction In Your Company's Tax Liability!

Return on Investment Example

- Annual tax credits based on current New Hire trends
  - Approximately 25% of new hires qualify
- An estimated return to your company (For example, Work Opportunity Tax Credit - one type of hiring credit that all business qualify for):
  - It takes less than 2 minutes to prescreen each new hire.
  - Potential savings of approximately $20,000 per 100 new hires.
  - Human Resource Department gives a $15,000 return for 3.33 hours of work.
  - Where else does your company get a similar return-on-investment of time?

Why Are Not Companies Using These Credits Today?

- Credits and incentives are a narrow part of tax laws, the majority of businesses and a significant number of Certified Public Accountants are unaware of the Federal and state credits and incentives available.
- It is difficult to stay current with changes in tax law.

Hiring Incentives to Restore Employment Act (HIRE Act)
April 20, 2010

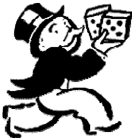
- Payroll Tax Forgiveness
- Business Retention Credit
- Expanded IRC §179; No Bonus Depreciations

Hiring Incentives to Restore Employment Act (HIRE Act)

The "Hire Now Tax Cut" combines payroll forgiveness
for Social Security taxes paid on qualified new hires, along with a tax credit for then keeping them on the payroll for at least 52 consecutive weeks.

Hiring Incentives to Restore Employment Act (HIRE Act)

PAYROLL TAX FORGIVENESS



Employers who hire unemployed workers this year (after Feb. 3, 2010 and Before Jan. 1, 2011) may qualify for a 6.2% payroll tax incentive, in effect exempting them from their share of Social Security taxes on wages paid to these workers after March 18, 2010. This reduced tax withholdings will have no effect on the employee's future Social Security benefits, and employers would still need to withhold the employee's 6.2% share of Social Security taxes, as well as income taxes. The employer and employee's share of Medicare taxes would also
still apply to these wages.

Hiring Incentives to Restore Employment Act (HIRE Act)

Example:

Park Place hires qualified employees, Adam Cannon, Joanie Top-Hat, Andreea Racecar and Patrick Iron who start working on June 1, 2010 and continue their employment through December 31, 2010 and beyond.

Their respective salaries are all above the Social Security wage cap of $106,800 for 2010. Park Place does not have to pay the 6.2% Social Security tax that otherwise must be paid for Adam, Joanie, Andreea and Patrick for the period they are employed by the company in 2010.

- Since payroll taxes are deductible as ordinary and necessary business expense, employers will have correspondingly smaller business expense to deduction on their 2010 tax returns.

Hiring Incentives to Restore Employment Act (HIRE Act)

Qualified Employers

- Businesses, agricultural employers, tax-exempt organizations, public colleges and universities all qualify to claim the payroll tax benefit for eligible newly-hired employees.
- Household employers cannot claim this new tax benefit.

Hiring Incentives to Restore Employment Act (HIRE Act)

Qualified Employees

A qualified individual must begin employment with the qualified employer after February 3, 2010 and before January 1, 2011. The individual must certify that he or she was not employed for more than 40 hours during the prior 60 day period ending on the date the individual begins employment. The IRS developed form W-11 for employees to make the required statement.

The qualified individual cannot displace a current employee unless that employee was separated from employment voluntarily or for fired for cause.

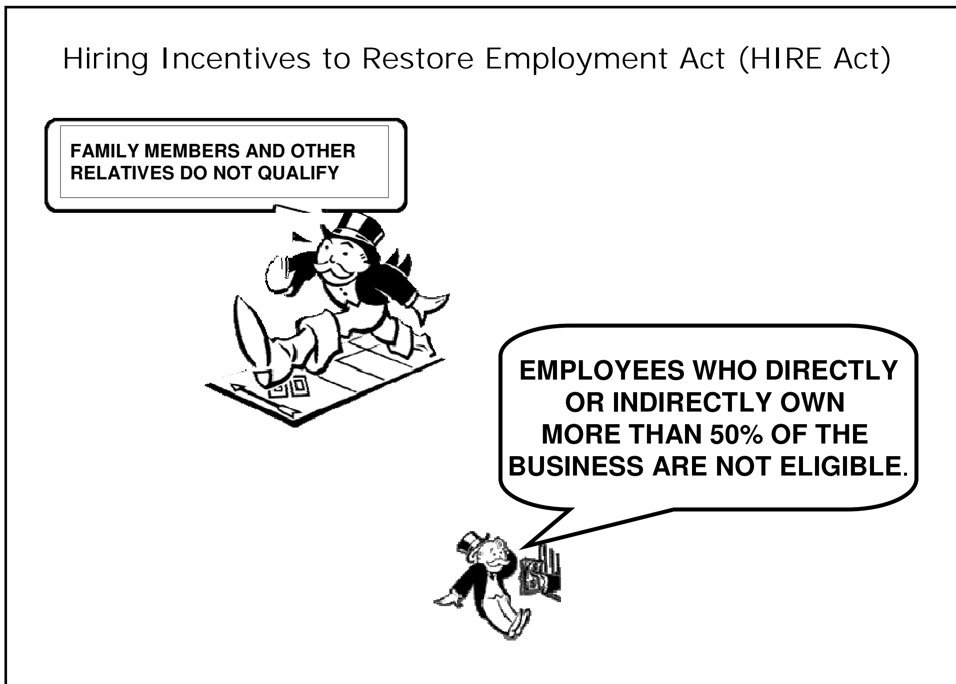
Hiring Incentives to Restore Employment Act (HIRE Act)

Work Opportunity Tax Credit (WOTC)

The provisions for payroll tax forgiveness is coordinated with WOTC. The term "wages" for purposes of the WOTC does not include any amount paid or incurred to a qualified individual during the one year period beginning on the individual's hiring date unless the qualifying employer makes an election NOT to have payroll tax forgiveness apply.

Additionally, do not confuse this either/or employer benefit (i.e. either Payroll Tax Forgiveness Credit or WOTC) with the Making Work Pay Credit for employees.

Hiring Incentives to Restore Employment Act (HIRE Act)



Hiring Incentives to Restore Employment Act (HIRE Act)

PAYOUT MECHANICS

Although the 6.2% Social Security's Old-Age, Survivors, and Disability Insurance (OASDI) tax forgiveness relates to salaries paid for work performed after March 18, 2010, an employer will not see cash savings on this forgiveness until the beginning of the second quarter payroll of 2010.

To allow payroll departments and the IRS a few weeks to get direct OASDI forgiveness up and running, Congress provided that the payroll tax holiday will not apply to wages paid during the first quarter of 2010. Instead, whatever tax holiday amount would have applied for the first quarter of 2010 will be credit against the employer's general OASDI liability for the second quarter of 2010.

Beginning for any new-hire wages paid on or after April 1, the employer takes direct OASDI forgiveness into account when depositing payroll taxes under the regular deposit rule applicable to that employer.

Hiring Incentives to Restore Employment Act (HIRE Act)

RETAINED WORKER BUSINESS CREDIT

Employers that hire new workers who qualify for "Payroll Tax Forgiveness" and keep them for at least 52 consecutive weeks may be eligible for a tax credit for each of those qualifying employees. This new retention incentive is provided by way of the current year's Code Sec. 38(b) business tax credit, which is increased, with respect to each qualified retained worker, by the lesser of:

- $1,000. or
- 6.2% of wages paid by the taxpayer to the qualified retained worker during a 52 consecutive week period.

Hiring Incentives to Restore Employment Act (HIRE Act)

RETAINED WORKER BUSINESS CREDIT

To prevent further manipulation of the credit, a "qualified retained worker" must be paid an amount equal to at least 80 percent of his first six months of wages during the last six months of the 52 consecutive week qualified period.

The law also excludes wages earned by a domestic worker or an individual eligible for the foreign earned income exclusion.

Hiring Incentives to Restore Employment Act (HIRE Act)

WHAT HAPPENS IF THE NEW HIRE STAYS ON THE JOB FOR AT LEAST 52 CONSECUTIVE-WEEK PERIOD?

WHAT HAPPENS IF THE NEW HIRE VOLUNTARILY LEAVES AFTER 50 CONSECUTIVE WEEKS FOR A BETTER JOB?

Hiring Incentives to Restore Employment Act (HIRE Act)

RETAINED WORKER BUSINESS CREDIT

The retained worker business credit generally would be taken on the employer's 2011 income tax return because of the 52 consecutive week prerequisite. To prevent any retroactive benefit the HIRE Act disallows carrying back any portion of the unused Code Sec 38 business credit attributable to the provisions for retained workers.

Hiring Incentives to Restore Employment Act (HIRE Act)

EXPANDED IRC §179; NO BONUS DEPRECIATION

The HIRE Act extends enhanced Code Sec. 179 expensing at the $250,000/$800,000 threshold levels, through December 31, 2010.

Small Business Jobs and Credit Act
September 27, 2010

RESTRICTIONS ON GENERAL BUSINESS CREDITS REMOVED.

With limited exceptions, general business credits can not be used to offset a taxpayer's alternative minimum tax ("AMT)" liability. The new law removes this restriction for "eligible small business". To qualify, average annual gross receipts of a non-public corporation, partnership or small proprietorship for the prior three years can not exceed $50 million. The provision is effective for credits determined in the taxpayer's first taxable year beginning after December 31, 2009. In addition, beginning in 2010, an eligible small business may carry back general business credits for five years instead of one year.

Small Business Jobs and Credit Act
September 27, 2010

WHAT ARE EXAMPLES OF GENERAL BUSINESS CREDITS?

Empowerment Zone Employment Credit (IRC §1396)
Investment Tax Credit (IRC §46)
Low Income Housing Credit (IRC §42a)
Research & Development Credit (IRC §41)
Work Opportunity Tax Credit (IRC §51)

Small Business Jobs and Credit Act
September 27, 2010

S CORPORATION DISPOSTION RULES EASED

After a C corporation converts to S corporation status, it may be liable for the "built-in gains" ("BIG") tax if it sells or otherwise disposes of appreciated property within in a specified time period.

The normal recognition period of ten years was shortened to seven years for dispositions in tax years beginning in 2009 and 2010. Small Business Jobs and Credit Act reduces this period to five years for dispositions in tax years beginning in 2011.

Small Business Jobs and Credit Act
September 27, 2010

SELF-EMPLOYED TAXPAYERS GET A BREAK ON HEALTH INSURANCE

A self-employed individual must pay self-employment tax comparable to the Social Security tax paid on employee wages. For 2010, eligible self employed individuals can deduct health insurance premiums form the self-employment income subject to employment tax. This tax break is limited one-year window of opportunity.

Small Business Jobs and Credit Act
September 27, 2010

TAX BREAKS FOR PURCHASES OF PERSONAL PROPERTY – SOME REAL PROPERTY AND LEASEHOLDS

Enhances IRC §179 Depreciation Deductions

Under IRC §179 , a business can currently deduct the cost of qualified property places in service during the year, within an annual limit. The new law increases the maximum deduction to $500,000 for 2010 and 2011 with a phase-out threshold of $2 million. Eligible assets include computers, office equipment, and furniture. Certain real estate improvement costs now qualify for IRC §179 deductions of up to $250,000.

Small Business Jobs and Credit Act
September 27, 2010

TAX BREAKS FOR PURCHASES OF PERSONAL PROPERTY – SOME REAL PROPERTY AND LEASEHOLDS

"Bonus Depreciation" is Back for 2010

Small Business Jobs and Credit Act also restores the bonus depreciation tax break, which expired after 2009. A business can claim a deduction equal to 50% of the cost of qualified assets, which includes vehicles. An additional year of bonus depreciation through 2011 is allowed for property with a cost recovery period of ten years or longer and certain transportation property. Qualifying new assets must be placed in service by December 31, 2010.

Small Business Jobs and Credit Act
September 27, 2010

ENCOURING INVESTMENTS AND START-UPS
SECTION 1202 STOCK – 100% CAPITAL GAINS EXCLUSION

Section 1202 stock is stock for an C Corporation whose gross assets do not exceed $50 million and is an active business ("Qualified Small Business Stock"). Assuming certain restrictions are meet, an investor in Qualified Small Business Stock may exclude part of gain from the sale of stock after a five-year holding period. Small Business Jobs and Credit Act allows a 100% exclusion. WARNING – this provision is only good for stock issued or an acquisition from the date of enactment through December 31, 2010 – a very small window.

Small Business Jobs and Credit Act
September 27, 2010

ENCOURING INVESTMENTS AND START-UPS
EXPENDITURE OF START UP COSTS

Prior to Small Business Jobs and Credit Act, taxpayer could elect to deduct up to $5,000. in start up costs under IRC §195. Small Business Jobs and Credit Act doubles the maximum deduction or 2010 to $10,000 with a $60,000 phase-out threshold. Effective for tax years beginning after December 31, 2009.

SUMMARY OF FEDERAL TAX CREDITS AND INCENTIVE BENEFITS

- Tax credits can result in a dollar-for-dollar reduction in your company's tax liability
- Increase cash flow to your business.
- Can result in high return on your investment of time.
- Tax credits and incentives enhance what you are already doing for your clients or your company.

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About Berkowitz Dick Pollack & Brant Certified Public Accountants & Consultants, LLP, was established in 1980 and has offices in Miami, Fort Lauderdale and Boca Raton. We are one of the largest public accounting firms in South Florida. We have been named by both *Accounting Today* and *INSIDE Public Accounting* as one of the top 100 firms in the U.S. We have also been named by *INSIDE Public Accounting* as one of the "Best of the Best" CPA firms in America 13 times. Our firm is widely recognized for integrity, knowledge, accuracy and resourcefulness in serving clients as trusted advisors. We believe our growth is an indicator of our clients' satisfaction.

Post Mortem Tax Planning

Mary Lee Moseley, JD, LL.M

Mary Lee Moseley, LL.M

Tax Director, Private Client Advisors
Deloitte Tax, LLP

As a Director in the Deloitte Tax PCA practice, Mary Lee utilizes her 23 years of professional experience designing and implementing wealth transfer strategies to minimize estate, gift, and generation-skipping transfer taxes. She leads the Northern Pacific region's Estate, Gift, Trust & Charitable Competency Group, and in such role meets regularly with the other regional leaders and Deloitte's Washington National Tax specialists to keep apprised of technical developments and share effective tax techniques.

Mary Lee has significant experience with postmortem administration of large, complex estates and trusts. Her goal is to make the administration of a complex estate as tax beneficial and as efficient as possible for the fiduciaries. She works with the fiduciaries and their advisors to identify planning opportunities, model complex tax outcomes, and handle the unique compliance matters raised in each fact pattern.

Mary Lee has spoken on various topics at internal Deloitte trainings and for external audiences, including generation-skipping transfer tax planning, gift tax return compliance, postmortem estate and trust administration, community property, and fiduciary tax planning. She has published articles in Estate Planning and Trusts and Estates, national technical journals.

Before joining Deloitte, Mary Lee was a director at the law firm Titchell, Maltzman, Mark and Ohleyer in San Francisco, focusing on estate planning and tax law.

Professional Affiliations
Member of Maine and California Bars

Education
JD, University of Washington
LL.M, Taxation, Boston University
MS, University of Massachusetts
BA, Bowdoin College

Deloitte.

Postmortem Tax Planning

What Accountants Can Bring to the Wake

Mary Lee Moseley, Director, Deloitte Tax, LLP

Florida Institute on Federal Taxation Conference

November 3, 2010

Circular 230 Disclosure

- Any tax advice included in this written communication was not intended or written to be used, and it cannot be used by the taxpayer, for the purpose of avoiding any penalties that may be imposed by any governmental taxing authority or agency.

Deloitte.

A few words about 2010

Disclaimer - Requirements

- IRC section 2518 governs
  - In writing
  - Without accepting the disclaimed interest or any of its benefits (IRA exception, Rev. Rul. 2005-36)
  - Within 9 months of DOD
- Typical Uses
  - Qualifying property for the marital deduction
  - Working around an under-funded bypass trust
  - Utilizing decedent's GST exemption or absence of GST tax in 2010
  - Avoiding State inheritance/transfer taxes

Disclaimer – Example pre-2010

- Decedent dies prior to 2010 owning wholly owned S corporation valued at $4M and $1.5M in cash passing to Child
- Decedent fails to use GST exemption in estate plan
- Will provides that assets passing to Child passes to Grandchild if Child is predeceased and are held in trust (with terms acceptable to disclaiming child)
- Child then disclaims an amount of assets equal to the available GST exemption which pass into trust for Grandchild
- GST exemption allocated to Grandchild's trust

Disclaimer – Example 2010

- Decedent dies in 2010 owning wholly owned S corporation valued at $4M and $1.5M in cash passing to Child
- Will provides that assets passing to Child pass to Grandchild if Child is predeceased
- Child then disclaims an amount of assets which pass to Grandchild
- 2010 concerns if assets pass to trust for Grandchild

The Graegin Case

- Section 20.2053-1(b)(3).
- Ascertainable with reasonable certainty
- Certain to be paid – fixed and determinable interest

Graegin: P's and Q's

- The terms of the loan must be determined based on cash flow planning – "liquidity event";
- If it is not a trade or business, the scrutiny is greater;
- A mechanism must be in place that makes payment of the note a certainty;
- Circular cash flow is, as it is in most situations, a troublesome issue – and it should be avoided, where possible;
- Be careful about any structure in which one is required to commit 90% of his or her net worth – it lacks common sense; and,
- The same persons playing multiple roles will always attract attention.

Graegin – Demum, veniunt porci

- Deloitte's Experience
  - The concept is still respected when the facts support it
  - Deloitte Results:
    - Active Business, 10 yr, $3.5M note @ 9.23% for $5.37M deduction
    - Publicly traded stock, thinly traded, 80% of estate, financed with two notes: 8.5 yr, 9.25% interest, and 3 year, 7.5% interest for total $3.5M deduction, settled at Appeals
    - Active business, $61M @ 8.411% for 11 yrs, for $85M deduction
    - Farming business, $12.2M @ 10% for 20 years, settled for 8.5% for 20 years at exam level for $53M deduction

Graegin: Miscellaneous Considerations

- We strongly encourage the estate to have a respected borrowing in place as soon as possible based on the particular facts.
- Care must be exercised in the presentation of the expense on the estate tax return.
- The lender should not be a beneficiary of the estate.

Graegin – Demum, veniunt porci

- Internal IRS training on topic
  - Examiners more skilled at spotting the issue
- Push back areas: Deloitte's audit approach
- The IRS and Graegin Audits

Post-Graegin Case Law

- Rupert, 358 F. Supp.2d 421 (PA 10/22/04)
- PLR 200449031 (12/3/04)
- Gilman TCM 2004-286 (12/28/04)
- TAM200513028 (4/1/05)
- LGM: In re Deductibility of Balloon Payments of Interest As an Administrative Expense (TL-65)

2010 Graegin Cases

- Stick v. Commissioner, T.C. Memo 2010-192
- Keller V. United States, No. 02-62 (Sept. 14, 2010)

Section 645 Election – Mechanics

- Qualifying Revocable Trust "QRT"
- Electing Trust
- Related Estate
- Filing Trust
- Filing Trustee

Section 645 Election – Benefits

- Tax Holiday: Ability to Elect Fiscal Year
- Offset Gains Upon Funding Pecuniary Bequests With Losses – Section 267
- Sec 1239 Capital Gain Treatment Allowed Upon Funding Pecuniary Bequests With Appreciated Assets
- Sec 642(c) Charitable Set Aside Allowed

Section 645 – Benefits

- Prolongs Eligible S Corporation Shareholder Status
- Sec 469(i) Passive Activity Loss Benefit
- Compliance Costs of One Return vs Two
- $600 Exemption!!

Section 645 Election – Detriments

- Lose Ability to Income Split
- Less Flexible Rules for Allocating Depreciation/Depletion
- Small Estates May Find Additional Complexity of Fiscal Year Does Not Outweigh Deferral

Section 645 Election – Termination

- Termination of Section 645 May Surprise You
- Applicable Date
  - Six months after determination of final liability
- Final Determination of Liability
  - Six months after issuance of closing letter

Fiscal Year Planning

- Illustration
  - Estate elects Fiscal Year End
  - DOD – May 7, 2010 (Fiscal year end April 30)
  - If living trust, 645 election is made
  - Planning:
    - Income alternatively distributed to individual or retained by the trust/estate
    - ES payments alternating between actual and safe harbor for both trust/estate and individual

Fiscal Year Planning

- Illustration
  - Year 1:
    - Trust distributes out all income
    - Individual makes safe ES payments
    - Estate (no need to make ES payments for first 2 years)
    - Payment of tax on income deferred until April of year 3
  - Year 2:
    - Trust retains all income
    - Individual makes safe ES Payments (no estate income to beneficiary's year 1 tax return)
    - Estate still no need to make ES payments

Fiscal Year Planning

- Illustration – Year 1

Fiscal Year Payment Type							2010 Final			
Calendar Year Payment Type					2010 Final					2011 Final
	DOD	2Q '10	3Q '10	4Q '10	1Q '11	2Q '11		3Q '11	4Q '11	1Q '12
Payment Date	5/7/10	6/15/10	9/15/10	1/15/11	4/15/11	6/15/11	8/15/11	9/15/11	1/15/12	4/15/12
Trust										
Estate/645										
Individual*										$8,000,000

Fiscal Year Planning

- Illustration – Year 2

Fiscal Year Payment Type	2010 Final					2011 Final	
						1Q '12	
Calendar Year Payment Type				2011 Final			
		3Q '11	4Q '11	1Q '12	2Q '12		3Q '12
Payment Date	8/15/11	9/15/11	1/15/12	4/15/12	6/1512	8/15/12	9/15/12
Trust							
Estate/645						$8,000,000	
Individual*				$8,000,000			

Fiscal Year Planning

- Illustration
  - Year 3:
    - April of year 3 – taxes paid by beneficiary on year 1 income
    - October of year 3 – taxes paid by estate on year 2 income
    - Estate distributes out all income (but not deemed received by beneficiary until year 4 due to fiscal year)
    - Individual makes safe ES payments
    - Estate makes ES based on actual income (nothing – all income is distributed)
  - Year 4:
    - Trust retains all income
    - Individual makes safe ES Payments (no estate income on beneficiary's year 3 tax return)
    - Estate still no need to make ES payments

Fiscal Year Planning

- Illustration

Fiscal Year Payment Type				4Q '12		2012 Final					4Q '13		2013 Final
	2Q '12	3Q '12				1Q '13		2Q '13	3Q '13				1Q '14
Calendar Year Payment Type			2012 Final							2013 Final			
		4Q '12	1Q '13		2Q '13		3Q '13		4Q '13	1Q '14		2Q '14	
Payment Date	10/15/12	1/15/13	4/15/13	5/15/13	6/16/13	8/15/13	9/15/13	10/15/13	1/15/14	4/15/14	5/15/14	6/15/14	8/15/14
Trust													
Estate/645													$8,000,000
Individual*										$8,000,000			

Fiscal Year Planning

- Illustration
  - Benefit:
    - Assuming $8M paid in taxes each year
    - Assuming a 4% ROR on cash
  - Savings of about $2M over the 4 year period
- Implementation
  - Need to be involved in planning for estate and beneficiary income taxes early in the process
  - Need for oversight on distributions and ES payments each year

Ten Postmortem Tips

- Alternate Valuation – ALWAYS run the numbers.
- PTP Credit – ALWAYS run the numbers.
- Perform due diligence on decedent's gift tax returns.
- 754 elections – ALWAYS consider the numbers.
- Post 2010 estates - start liquidity planning early.

Ten Postmortem Tips

- Analyze Tax Apportionment Clause.
- File in the Correct State(s).
- 2053 Regulations
- Be aware that your closing letter or settlement will start the clock running on the end of the 645 election.
- 2010 – take advantage of any special opportunities that this interesting year presents.

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Real Estate Hot Topics

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HOT TOPICS IN

REAL ESTATE TAXATION

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2010

HOT TOPICS IN

REAL ESTATE TAXATION

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HOT TOPICS IN

REAL ESTATE TAXATION

I. Section 469 - The "Real Estate Professional" Rules.

A. Passive Activity Losses. The passive activity loss rules of § 469 are in the Code to generally prevent high income individuals and certain other taxpayers from offsetting income earned from their primary trades or businesses with losses from passive investments. Section 469 imposes limitations on the use of losses and credits from "passive activities" to shelter income from other sources. Section 469 requires taxpayers to whom it applies to effectively divide all of their income, deductions and credits into two separate "baskets" as follows:

1. The first basket (the "passive basket") consists of items attributable both to trade or business activities in which the taxpayer does not "materially participate," and to certain rental activities.

2. All other income, deductions and credits are included in a second basket ("active basket"). Deductions generated by a passive basket activity may only be used to offset income from the passive basket until the taxpayer disposes of his entire interest in the passive activity.

B. Passive Activities. Passive activities include trade or business activities in which the taxpayer does not materially participate. § 469(c)(1); Treas. Reg. § 1.469-1T(e)(1)(i).

1. Section 469(h)(1) defines material participation (discussed in more depth at Paragraph I.D.2. below) as regular, continuous and substantial involvement in the operations of a particular activity. In determining whether a taxpayer materially participates, the participation of the taxpayer's spouse is taken into account. § 469(h)(5).

2. A "trade or business" includes any activity in connection with a trade or business or any activity with respect to which expenses are allowable as a deduction under § 212. § 469(c)(6). A rental activity meets this definition and, thus, is a trade or business. However, with the exception of activities of certain taxpayers who are regularly engaged in real estate trades or businesses as described in § 469(c)(7)(B) (*i.e.*, Real Estate Professionals, as discussed below), and with one other exception found in § 469(i) that is of limited use and will not be discussed in this outline, rental activities are automatically classified as passive activities regardless of a taxpayer's level of participation. *See* §§ 469(c)(2) and 469(c)(4); Treas. Reg. § 1.469-1T(e)(1)(ii).

C. Rental Activities. The Code defines a rental activity as "any activity where payments are principally for the use of tangible property." § 469(j)(8). Real

estate is tangible property. Treas. Reg. § 1.469-1T(e)(3)(viii)(Ex. 7). Rental activities involving real estate, therefore, are passive activities unless an exception applies.

D. Real Estate Professionals. Rental activities are per se passive activities unless the activities are conducted by taxpayers meeting the two requirements of § 469(c)(7)(B) to be a so-called "Real Estate Professional". A taxpayer is a Real Estate Professional for a taxable year if both of the following tests are met:

1. The "More Than Half" Test. The first test requires that more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates. The term "real property trade or business" is defined in § 469(c)(7)(C) as "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or other brokerage trade or business." It is clear from this definition that Congress intentionally employed a very broad term. Most significantly, for purposes of both the "more than half" test of § 469(c)(7)(B)(i) and the "more than 750 hours" test of § 469(c)(7)(B)(ii) discussed below, Congress did not confine the examination to "rental real estate activities," but opted instead to focus on the much broader "real property trades or businesses." This test requires a separate determination of each of the following:

a. First, each trade or business in which the taxpayer was involved and in which she rendered personal services during the taxable year must be identified. For this purpose, "trade or business" is specially defined by applying the definition of "trade or business activity" in Treas. Reg. § 1.469-4(b)(1), as modified for this purpose by Treas. Reg. § 1.469-9(b)(1) to treat rental real estate as a trade or business.

b. Second, the degree to which the taxpayer rendered personal services in each of such trades or businesses during the taxable year must be determined.

c. Third, of the trades or businesses identified under "First" above, it must be determined which of such trades or businesses constitute "real property trades or businesses" as defined in § 469(c)(7)(C) and Treas. Reg. §§ 1.469(9)(b)(1) and (2).

d. Fourth, for those trades or business which have been identified as "real property trades or businesses" under "Third" above, it must next be determined if the taxpayer materially participated in such real property trades or businesses during the taxable year.

e. Fifth, the degree to which the taxpayer rendered personal services in each real property trade or business in which the taxpayer materially participated during the taxable year must be determined.

f. Finally, it must be determined if the personal services rendered by the taxpayer in real property trades or businesses in which she materially participated (as identified under "Fifth") constitute more than half of the personal services rendered by the taxpayer in all trades or businesses during such taxable year (as identified under "Second" above).

2. The "750 Hour" Test. The second requirement is that the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. In order to be treated as materially participating in a trade or business activity, the taxpayer must be involved on a regular, continuous and substantial basis. § 469(h)(1). The Regulations provide that an individual will be treated as materially participating in an activity during any given tax year if such individual satisfies any one of the following seven tests [Treas. Reg. § 1.469-5T(a)]:

a. The individual participates in the activity for more than 500 hours during the tax year;

b. The individual's participation in the activity for the tax year constitutes substantially all of the participation in the activity of all participants for the year;

c. The individual participates in the activity for more than 100 hours and his participation is not less than the participation of any other individual for the year;

d. The activity is a "significant participation activity" (meaning that the individual participates for more than 100 hours during the year but does not meet the other tests for material participation described in (1) through (6) of this list), and the individual's aggregate participation for all his significant participation activities during the year exceeds 500 hours;

e. The individual materially participated in the activity for any five years during the ten-year period preceding the current year;

f. The activity is a personal service activity (within the meaning of the Regulations) and the individual materially participated in such activity for any three years preceding the current year; or

g. Based upon a facts-and-circumstances test, the individual participates in the activity on a regular, continuous and substantial basis during the tax year in question.

E. Substantiation. The Regulations provide that "[t]he extent of an individual's participation in an activity may be established by any reasonable means." Treas. Reg. § 1.469-5T(f)(4). The Regulations do not require taxpayers to keep "daily time reports, calendars, or other similar documents" to substantiate participation in an activity. In particular, the Regulations provide that:

> Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries. Treas. Reg. § 1.469-5T(f)(4).

Thus, the methods available for a taxpayer to prove his participation in an activity are "quite lenient" and generally may be established by "any reasonable means." *Lee v. Comm'r*, T.C. Memo. 2006-194. The courts consistently hold that a taxpayer's estimate of participation hours, without the maintenance of a contemporaneous daily time report, calendar or log, satisfies the reasonable means test of the Regulations, provided that the taxpayer provides other objective supporting evidence. *Assaf v. Comm'r*, T.C. Memo. 2005-15; *Pohoski v. Comm'r*, T.C. Memo. 1998-17; *Harrison v. Comm'r*, T.C. Memo. 1996-509. However, the Tax Court has warned that the Regulations also do not allow for a "post-event 'ballpark guesstimate'." *Assaf*, supra.

F. Consequences of Qualification to be Treated as a Real Estate Professional. If, after applying the dual tests set forth in § 469(c)(7)(B), a taxpayer is found to be a real estate professional for the taxable year, the consequences of such determination are set forth in § 469(c)(7)(A). The first and most important consequence is that the taxpayer's rental real estate activities will not be automatically classified as passive activities under §§ 469(c)(2) and 469(c)(4), but rather will be treated like any other trade or business activity under § 469(c)(1). Thus, if the taxpayer can demonstrate material participation in such rental real property trade or business during the taxable year, then income, losses and credits from such activity will not be treated as having been derived from a passive activity for such taxable year. In addition, § 469(c)(7)(A)(ii) sets forth a second consequence of having made a determination that the taxpayer is a real estate professional for such taxable year. In such case, § 469(c)(7)(A)(ii) provides that each interest of the taxpayer in rental real property will be treated as a separate activity unless the taxpayer files a timely election to treat all interests in rental real estate as one activity. This second consequence has proved to be a focal point in a number of cases involving the determination of whether or not a taxpayer qualifies as a real estate professional. If each rental real estate activity is to be treated as a separate activity for purposes of applying the dual tests under

§ 469(c)(7), it will be more difficult to establish that the taxpayer materially participated in each and every such activity. By contrast, when the election to aggregate rental real estate activities is made in accordance with § 469(c)(7)(A)(ii), it is much easier for the taxpayer to establish material participation in the aggregated "activity."

II. Workouts Revisited. In 2004, A and B, both of whom are natural persons, joined together to form X, a Florida limited liability company which is treated as a partnership for federal income tax purposes. A and B each contributed $50 to X in exchange for equal 50% membership interests.

Shortly after formation, X purchased a commercial office building ("Blackacre") for $500, using the $100 of cash contributed by A and B and an additional $400 borrowed from Bank pursuant to a Note which is secured by a Mortgage on Blackacre. A and B were each required to guarantee the Note and each was proportionately liable (i.e., each was responsible for 50% of the liabilities under the Note) under the guarantees.

Due to the impact of the Great Recession, Blackacre has dropped in value to $300, and A and B each have a negative capital account of ($100). The Note is due in full on December 31, 2010. X has been paying interest only on the Note and Mortgage since 2004, and the current outstanding principal balance remains at $400.

A. Scenario One: Modification of the Note. In Scenario One, assume X is able to negotiate with Bank to modify the Note. Bank agrees to reduce the principal balance on the Note to $300, and to revise the terms to provide for interest only payments at 6% per annum until 2015 when the entire principal balance will be due and payable.

1. Tax Consequences to X.

a. Cancellation of Debt Income. Generally, if a debtor issues (or is deemed to issue) a new debt instrument in satisfaction of a liability, the debtor will be treated as satisfying the old debt with money in an amount equal to the issue price of the new debt instrument. § 108(e)(10).

(1) A taxable exchange of debt instruments is deemed to occur under the Supreme Court's analysis in *Cottage Savings Association v. Comm'r*, 499 U.S. 554 (1991) under certain circumstances if old debt is exchanged for other debt or if old debt is significantly modified. This test will be met if the new and old debt instruments "embody legally distinct entitlements." Under this standard, even minor modifications can result in a deemed exchange of debt instruments. The Regulations under § 1001 reflect this hair trigger analysis and provide that if a debt instrument is "modified," and such modification is treated as "significant," there will

be a deemed exchange of the old debt instrument (before modification) for a new debt instrument (after modification) under § 1001. Treas. Reg. § 1.1001-3(c)(1)(i). Certain changes in yield, timing of payments, security and/or the nature of the debt (i.e., from recourse to non-recourse) are treated as significant modifications. Treas. Reg. § 1.1001-3(e). Because the principal, interest rates and timing of payments under the Note have changed under the facts described above, X will be deemed to have issued a new debt instrument (i.e., the Note, as modified) for the old debt instrument (i.e., the Note, before modification). Treas. Reg. § 1.1001-3(b). This deemed exchange of an old debt instrument for a new debt instrument can have a number of tax ramifications, including the following:

(A) It may result in recognition of cancellation of debt income ("COD income") by the borrower/taxpayer if the new debt has an issue price that is less than the adjusted issue price of the old debt.

(B) The holder of the debt may have to recognize gain which can occur if the holder has a basis in the old debt that is less than the face amount of the new debt as a result of prior partial bad debt write-offs or the acquisition of the debt from a prior holder at a market discount.

(C) It can also result in the creation of original issue discount ("OID") in the new debt instrument if the face amount of the new debt exceeds its deemed issue price.

(2) So long as the new debt instrument is respected as debt for federal income tax purposes, with adequate stated interest payable not less frequently than annually, and if the new debt is <u>not</u> publicly traded, then the issue price of the new debt will be the face amount of such debt. On our facts, therefore, the issue price of the new Note will be $300, and, as a result, X will have COD income in the amount of $100 (the difference between the principal amount of the original Note ($400) and the principal amount of the newly modified Note ($300)).

b. <u>Allocation of COD Income to A and B</u>. Any COD income recognized by X will be allocated among A and B in accordance with the terms of the partnership agreement so long as those

allocations have "substantial economic effect." § 704(b). Since A and B share equally in the profits and losses of X, each will be allocated $50 of COD income. This allocation of income will increase each partner's basis in his partnership interest by $50. § 705.

c. Potential Section 108 Exclusions. COD income may be excluded under § 108 if discharge occurs in a Title 11 case, when (but only to the extent that) the taxpayer is insolvent, or where the debt is "qualified" farm, real property business, principal residence, or applicable debt instrument in 2009/2010. The test of bankruptcy or insolvency is made at the partner level, not at the partnership level. Therefore, if either of A or B is insolvent, he may be eligible to exclude the COD income under the insolvency exception. The § 108(i) election (which will not otherwise be discussed in great detail in this outline) is also made at the partnership level.

d. Qualified Real Property Business Indebtedness ("QRPBI") Exclusion.

(1) A taxpayer (other than a C corporation) may exclude COD income if the debt was incurred or assumed in connection with real estate used in the taxpayer's trade or business, the debt is secured by that real estate, the debt is not qualified farm indebtedness, and, if the debt was acquired on or after 1/1/93, the debt is qualified acquisition debt (QAI) (debt incurred to acquire, construct, reconstruct, or substantially improve the real estate secured by the debt, including refinanced QAI to the extent the amount does not exceed original principal amount).

(2) The amount excluded as QRPBI cannot exceed the excess of (a) outstanding principal balance of subject debt (immediately before and after the discharge), over (b) the fair market value (determined immediately before discharge and without regard to § 7701(g)) of the subject real estate, reduced by the outstanding principal amount of any other QRPBI securing the property before and after the discharge. Treas. Reg. § 1.108-6.

(3) Amount excluded cannot exceed the aggregate adjusted bases of depreciable real estate (after reductions under § 108(b) and (g) for the same taxable year) on the first day of the next taxable year.

(4) In order to take advantage of this exclusion, the taxpayer

must reduce his basis in depreciable real property owned by him by an amount equal to the excluded COD income. For this purpose, the taxpayer may treat partnership interests in certain partnerships holding real property as depreciable real property interests. This election would result in both a reduction in the taxpayer's basis in his partnership interest and a reduction in his allocable basis in the underlying real property.

(5) Section 1017, which determines the effect of the basis reduction caused by an election to treat a partnership interest as depreciable real property, effectively creates a separate tax asset in the form of a basis reduction account. Essentially the amount of basis adjustment will be recaptured either as depreciation deductions are allocated to the electing partner or when the underlying real property is sold. The recapture of this basis adjustment account is ordinary income under § 1017(d). Thus, at some point in time the COD income that was initially excluded from income under the qualified real property business indebtedness exception of § 108(a)(1)(D) will be recaptured in the form of reductions in ordinary (depreciation) deductions that would otherwise be allocable and/or as additional ordinary income upon the ultimate sale of the real property.

e. Section 752 Allocations. In addition to the COD income arising from this transaction, A and B also may have tax consequences from the changes in allocation of partnership liabilities.

(1) Under § 752(b), a reduction in a partner's share of a partnership's liability is treated as a distribution of cash to the partner. Generally, a constructive distribution reduces the outside basis to the distributee partner. The partner will have gain to the extent that the deemed distribution exceeds the partner's basis, except to the extent that § 751(b) applies. § 731. Because Bank is reducing the liability by $100, each of A and B will have a deemed distribution under § 752(b) of $50.

(2) Initially, the partners had a basis of $250 each in their partnership interests ($50 cash contributed plus $200 for their proportionate allocation of the partnership debt.) § 722 A negative capital account of $100 indicates that the partners likely have each been allocated $150 in losses from the partnership, reducing their respective bases in their partnership interests to $100. The COD income allocated to the partners would have increased their bases

to $150. After the deemed distribution, A and B will each have a basis of $100 ($150 minus the $50 deemed distribution).

2. Tax Consequences to Bank. The Bank will be entitled to a loss in the amount of $100, likely an ordinary loss as the Bank is in the business of making loans. § 166.

B. Scenario Two: Deed in Lieu of Foreclosure. In Scenario Two, assume X transfers the real property to Bank in complete discharge of the debt.

1. Tax Consequences to Partnership X.

a. Important Threshold Issue: Recourse versus Non-Recourse Debt.

(1) The transfer of property in complete satisfaction of a non-recourse debt does not generate income from the cancellation of indebtedness (which might allow an exclusion or deferral under § 108, discussed above). Instead, the transaction is treated as a § 1001 disposition of property and the amount of the outstanding debt is treated as an "amount realized" by the taxpayer. *Commissioner v. Tufts*, 461 U.S. 300 (1983). If property is transferred in complete satisfaction of a recourse debt, only the fair market value of the property is treated as an "amount realized" and the excess debt, if it is forgiven, constitutes COD income. Therefore, the determination of whether the debt at issue is recourse or non-recourse is crucial for determining the tax consequences of both a deed in lieu of foreclosure and the loss of the property in a foreclosure sale.

(2) The terms "recourse" and "non-recourse" are defined in the regulations under § 752, essentially based upon the extent of the lender's rights against the partners without regard to the lender's rights against the debtor partnership. However, there is no strong authority for the application of these rules to § 1001 under circumstances in which property is transferred to the holder of mortgage debt which is secured by such property in full or partial satisfaction of such debt. In *Great Plains Gasification Assoc. v. Comm'r*, 59 T.C.M. 635 (1990), the lender foreclosed on property owned by a general partnership. Under the terms of the debt, the creditor could not reach the assets of any partner. The available collateral, however, did include "all real or personal property 'now owned or hereafter acquired by' the partnership." The court wrote that "[w]hether the partnership's debt was non-recourse is properly determined

at the partnership level" but the court also wrote, at footnote 34, that "the characterization of discharged debt as recourse or non-recourse may affect the character of any gain or loss on the transaction. In this proceeding, the parties have presented no issue as to the character of any gains realized by the partnership." The court ultimately concluded that "the partners should [not] be considered to have had any personal liability for the partnership's debt within the meaning of the then-applicable [section 752] regulations."

(3) In *Commissioner v. Tufts*, 335 U.S. 300, 304 (1983), the Supreme Court wrote:

> The only difference between [a non-recourse] mortgage and one on which the borrower is personally liable is that the mortgagee's remedy is limited to foreclosing on the securing property. This difference does not alter the nature of the obligation, its only effect is to shift from the borrower to the lender any potential loss caused by devaluation of the property. If the fair market value of the property falls below the amount of the outstanding obligation, the mortgagee's ability to protect its interests is impaired, for the mortgagor is free to abandon the property and be relieved of his obligation.

(4) Based upon the above-quoted language in *Tufts*, a loan should be treated as recourse only when the lender has recourse against some property (presumably, with more than a *de minimus* value) other than the security. If an LLC holds only one parcel of property and it is secured by a mortgage that is fully recourse against the LLC but not guaranteed by any member or other party, the lender's only effective recourse is against the property. This would seem to fall within the category of non-recourse debt.

(5) Alternatively, the recourse or non-recourse nature of a partnership's loan may be determined by looking at the lender's rights against the partnership exclusively, so that any personal liability of the partners would be irrelevant.

b. <u>Consequences of Deed in Lieu of Foreclosure</u>.

(1) As addressed above, if the debt to Bank is non-recourse debt, X will have gain or loss on the sale or exchange of the

property equal to the difference between the debt ($500) and X's tax basis in the real property, with the character of the gain or loss dependent on the purpose for which the real property was held. None of the exclusions discussed above in § 108 are available for gain from the sale of property.

(2) If the debt to Bank is recourse debt, X will have a bifurcated transaction. First, X will have gain or loss on the sale or exchange of the property where the amount realized is the fair market value of the real property, $300. X will also have COD equal to the excess of the debt over the fair market value of the property, or $100. If the real property is § 1231 property, then the loss from the sale/exchange may net out the COD income. If, however, X held Blackacre for purely investment purposes the loss would be capital in nature and could not be used to offset the COD income (which is ordinary income). In that case, the § 108 exclusions discussed above should be considered for the COD income.

(3) In addition, A and B will have § 752 consequences as discussed above.

2. Tax Consequences to the Bank. The Bank will have a worthless debt deduction equal to the excess of the Bank's adjusted basis in the debt over the fair market value of the real property. Note that if the creditor is also the original seller of the property (i.e. owner-financed sales of property), § 1038 provides that gain or loss will not be recognized as a result of the reacquisition of the property subject to the debt, except to the extent that principal payments previously received exceed the amount of gain reported.

C. Scenario Three: New Investors. In Scenario Three, assume that X negotiates with Vulture Fund, an unrelated third party, to have Vulture Fund invest $300 cash in X. Bank has agreed to accept the $300 in full satisfaction of the debt. In return for the cash contribution, Vulture Fund will receive certain preferred allocations ("waterfall allocations").

1. Tax Consequences to Partnership X and its Existing Partners.

a. Cancellation of Debt Income. X will realize $100 of COD income, the difference between the outstanding amount of the debt ($400) over the amount Bank has accepted in full satisfaction of the debt ($300). § 61(a)(12). To the extent applicable, § 108, as discussed above, may be available to exclude the income.

b. Allocation of COD Income to A and B. The $100 of COD income recognized by X must be allocated in equal portions to A and B, because they are the parties who will receive the economic benefit of the relief from the debt. § 704(b). Since A and B share equally in the profits and losses of X, each will be allocated $50 of COD income. This allocation will increase each partner's basis in his partnership interest by $50 to $150.

c. Section 752 Allocations. Because of the complete satisfaction of the outstanding debt, the debt will no longer be allocated for Section 752 purposes to A and B. Therefore, each of A and B will have a deemed distribution under Section 752 of $200 (the amount of debt which had previously been allocated to each of A and B). After the allocation of the COD income, each of A and B had a basis in his partnership interest of $150. Therefore, each of A and B will realize gain of $50 (the excess of the $200 deemed distribution over the $150 basis) and a remaining basis in their partnership interests of zero. The gain realized by A and B should be capital (because X does not have any § 751(b) assets).

2. Tax Consequences to the Bank. The Bank will be entitled to take a loss in the amount of $100, likely an ordinary loss as the Bank is in the business of making loans. § 166.

III. Carried Interests.

A. General Description. This proposed legislation, which would add a new § 710 to the Code, is ostensibly aimed at shutting down a tax loophole enjoyed by managing partners of private equity funds and hedge funds who receive an allocable share of profits, often taxed at long-term capital gains rates, as compensation for services rendered. As will be explained in more detail below, the scope of this potential new provision is much broader than advertised.

B. History of Proposed Legislation.

1. In 2007, Representative Sander Levin introduced a bill to address carried interests.

2. Later in 2007, House of Representatives passed the "Temporary Tax Relief Act of 2007," which included a provision on carried interests.

3. Similar provision passed House of Representatives in "Alternative Minimum Tax Relief Act of 2008."

4. On April 2, 2009, Representative Levin introduced bill revising technical aspects of House legislation.

5. On May 11, 2009, Administration budget included carried interests provision.

6. On December 9, 2009, House of Representatives passed "Tax Extenders Act of 2009," which included carried interests provision.

7. On February 1, 2010, Administration budget again included carried interests provision.

8. On May 28, 2010, House of Representatives passed the "American Jobs and Closing Tax Loopholes Act of 2010" (the "House Bill"), which included carried interests provision.

9. Senate Finance Chairman, Max Baucus, introduced amendments to House Bill in Senate on June 8, 2010; further amendments on June 16 and 23, 2010 (the "Senate Bill"); Senate Bill fails to garner sufficient votes in cloture motions.

C. <u>Proposed Carried Interest Legislation Does Much More Than Most People Think</u>.

1. The perception of most people is that new § 710 would convert the long-term capital gain into ordinary income and, in addition, impose employment taxes on such income. All of this is true, but it does much more.

2. The proposed legislation has a significant loss deferral aspect to it.

3. The proposed legislation will "turn off" most non-recognition provisions in the Code and will result in a current taxable transaction in the case of many transactions that previously had not been taxed.

4. It potentially affects a very broad class of partners.

5. It potentially applies to many transactions beyond income allocations in connection with the sale of portfolio investments.

6. There is no grandfathering of existing partnerships.

D. <u>What is an ISPI</u>?

1. Section 710, as contained in the House Bill, will apply to all holders of an "investment services partnership interest" (an "ISPI").

2. Under the House Bill, an ISPI is a partnership interest held (directly or indirectly) by a person if it was reasonably expected at the time such person acquired such interest that such person (or any person related to

such person) would provide (directly or indirectly) a substantial quantity of any of the following services with respect to assets held (directly or indirectly) by the partnership:

a. advising the partnership as to the advisability of investing in, purchasing, or selling a specified asset (i.e., securities, real estate held for rental or investment, partnership interests, commodities or options or derivative contracts with respect to any of the foregoing);

b. managing, acquiring or disposing of any such specified asset;

c. arranging financing with respect to acquiring any of such specified assets; or

d. any activity in support of any of the previously described activities.

3. The Senate Bill is the same except that it would apply to persons whose services rise to the requisite level due to services provided "indirectly" only to the extent provided in Regulations.

4. Caveat: Although the proposed legislation generally applies by reference to a person's anticipated services at the time the partnership interest is received, if a person who did not anticipate providing investment management services at the time the partnership interest is received subsequently begins to provide these services with respect to specified assets of the partnership, that person's partnership interest can become an ISPI as of the time of such change.

E. The Basics -- Character Conversion and Loss Deferral.

1. What is the potential impact of the House Bill for a party who holds an ISPI?

a. Net income and net loss with respect to an ISPI generally is treated as ordinary.

b. Net losses are allowed only to the extent that aggregate net income from prior years exceeds aggregate net losses for such prior years. Note: "Prior years" included only years with respect to which § 710 is in effect. To the extent not utilized, the losses carry over to the following year.

(1) The loss deferral differs from § 704(d) in that, for example, it gives no credit for debt basis or basis from capital other than "qualified capital."

(2) Basis in partnership interest is <u>not</u> adjusted downward where loss is not allowed for a given taxable year.

2. The House Bill contains a provision that would insure that *individual* partners will be subject to partial application of § 710. The general rule relating to classification as ordinary income applies only with respect to the "applicable percentage" of such income.

   a. For taxable years beginning <u>prior</u> <u>to</u> January 1, 2013, the "applicable percentage" is 50%.

   b. For subsequent taxable years, the "applicable percentage" is 75%.

   c. The rule relating to loss deferral applies only by reference to the "applicable percentage" of the net loss for the taxable year.

   d. The partial application rules apply only to *individuals*.

3. What is the potential impact under the Senate Bill for a party who holds an ISPI?

   a. The Senate Bill would alter the partial application in the House Bill.

   b. The "applicable percentage" generally would be 75% for all taxable years after the effective date.

   c. Under the Senate Bill, the "applicable percentage" would be 50% for net income or net loss properly allocable to gain or loss *from the disposition (or distribution) of property (other than an ISPI) held for at least 5 years*.

F. <u>What is the Potential Impact Under the House Bill for a Party Who Disposes of an ISPI</u>?

1. Gain from the disposition of an ISPI is treated as ordinary income (or blended ordinary/capital gain based upon applicable percentage for individuals). Loss from the disposition of such an interest is an ordinary loss (or blended) to the extent that prior post-enactment net income attributable to such interest exceeds prior net loss.

   a. Deferred losses do not reduce the basis of the partnership interest, so that deferred losses will, in effect, be recognized on the disposition of the interest. However, the losses would be capital rather than ordinary.

   b. An ISPI held by another partnership is treated as an inventory item for purposes of § 751, unless the interest being disposed of is an

interest in a publicly traded partnership that is not an ISPI in the transferor's hands.

2. Provision generally overrides non-recognition rules for gain transactions.

   a. Exception for contributions of an ISPI to another partnership where taxpayer elects to treat the partnership interest received as an ISPI and agrees to comply with applicable recording and recordkeeping requirements.

   b. For individuals, gain is recognized only to the extent that gain is treated as ordinary income by reference to applicable percentage.

G. What is the Potential Impact of Being Subject to the House Bill for a Party Who Receives a Distribution of Property With Respect to an ISPI?

1. If the partnership distributes property with respect to an ISPI:

   a. Gain will be triggered to the partnership as if it sold the property for its fair market value and that gain generally will be allocated to the distributee as ordinary income (or blended ordinary/capital based upon applicable percentage for individuals).

   b. The property is treated as cash with respect to the distributee partner, so that gain will be triggered to the extent that the value of the distributed property exceeds the partner's basis in the partnership interest (determined *after* adjustment for gain allocated).

   c. Distributee partner takes fair market basis in distributed property.

   d. Losses in distributed property are not recognized but basis will be stepped down to fair market value.

H. Sponsors Should Be Taxed on Capital Invested Just Like Any Other Capital Partner, Shouldn't They?

1. Although the entire partnership interest is treated as an ISPI, the legislation does make provision for "qualified capital interest." However, these rules are narrower than most people realize.

   a. Must focus on the source of the capital and where, in the structure, the capital is invested.

   b. Also necessary to consider allocations with respect to capital and how it compares to allocations to other partners.

2. What provision is made for service providers who also invest capital?

a. The House Bill essentially exempts from its coverage the portion of a service provider's partnership interest that is acquired for invested capital.

b. This requires that the partnership interest be acquired in exchange for invested capital and that allocations of a distributive share to the service provider satisfies certain requirements.

c. This exemption relates to ordinary income treatment, loss deferral and forced gain recognition.

3. A "qualified capital interest" means the portion of a partner's interest in the capital of the partnership that is attributable to:

   a. money or the fair market value of property contributed to the partnership (but not "deemed contributions" under § 752(a));

   b. amounts included under § 83 with respect to the transfer of an interest in the partnership; and

   c. the excess of items of income and gain taken into account under § 702 with respect to the partnership interest, over items of deduction or loss so taken into account, reduced by distributions to the partner and losses allocated in excess of income.

4. The "allocation rule" provides that allocations with respect to a "qualified capital interest" will not be subject to re-characterization and loss deferral if:

   a. allocations are made to the qualified capital interest in the same manner as such allocations are made to other qualified capital interests held by partners who do not provide investment management services to the partnership (and who are not related to the partner holding the qualified capital interest); and

   b. allocations made to the non-service partners are significant compared to the allocations made to the qualified capital interest of the service partners.

Foreign Trusts - Dancing Through the Minefield

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I. Foreign vs. Domestic Trust - Definition.

A. Relevancy.

1. Different tax and reporting rules apply, depending on whether a trust is foreign or domestic.

2. A conversion of a trust from domestic to foreign can trigger Code §684 gain recognition on appreciation.

B. Before 1996, test was a facts and circumstances test.

1. The old rules may still be relevant for determining taxation of pre-1997 accumulated income to a U.S. beneficiary.

2. Trusts that were domestic in 1996 could have elected to remain as domestic notwithstanding new rules.

C. All trusts are deemed to be FOREIGN unless both (a) a court in the U.S is able to exercise primary supervision over the trust administration (the "Court Test"), and (b) one or more U.S. persons have the authority to control all substantial decisions of the trust (the "Control Test"). Code §7701(a)(30)(E).

1. Court Test

a) "a court within the US is able to exercise primary supervision over the administration of the trust." Treas. Regs. §301.7701-7(a)(1)(I).

(1) If want a U.S. trust, need to watch state law jurisdictional requirements.

(a) In Florida, a trustee submits personally to the jurisdiction of Florida courts by accepting the trusteeship of a trust having its principal place of administration in Florida, or by moving the principal place of administration to Florida. Fla.Stats.§736.0202.

(b) In Florida, the beneficiaries of the trust having its principal place of administration in Florida are subject to the jurisdiction of Florida courts regarding any matter involving the trust.

(2) Courts within a territory or possession of the United States or within a foreign country are not U.S. courts. Treas. Regs. §301.7701-7(c)(3)(ii).

(3) "Able to exercise" means that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning administration of the trust. Treas. Regs. §301.7701-7(c)(3)(iii).

(4) "Primary supervision" means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust. A court may have primary supervision even though another court has jurisdiction over a trustee, a beneficiary, or trust property. Treas. Regs. §301.7701-7(c)(3)(iv).

(a) COMMENT: Thus, the circumstances of property, beneficiaries, or trust administration being located outside of the U.S. is not necessarily fatal. While these circumstances may give rise to local court jurisdiction, if primary supervision remains in the U.S., then U.S. trust status is not forfeited.

(5) COMMENT: It would appear that statutory or trust provisions that designate a particular State's law as the governing law of a trust is not determinative of whether a US court is able to exercise primary supervision over trust administration for these purposes.

(6) If both a U.S. and a foreign court are able to exercise primary supervision, the trust meets the Court Test. Treas. Regs. §301.7701-7(c)(d)(i)(D).

b) Regulatory Safe Harbor - Domestic Trust:

(1) Trust instrument does not direct administration outside the U.S.;xx

(2) Trust is in fact administered in the U.S.; and

(3) Trust is not subject to an automatic migration clause. Treas. Regs. §301.7701-7(c)(1).

(4) SUMMARY: Actual administration in the U.S., combined with the absence of certain trust provisions, will result in domestic status.xx

c) Effect of a Flee Clause.

(1) A trust does not meet the U.S. Court Test if the trust instrument contains a provision whereby the trust would be removed from the U.S. jurisdiction if a U.S. court attempted to assert jurisdiction or otherwise supervise the administration of the trust, directly or indirectly. Treas. Regs. §301.7701-7(c)(4)(ii).

(a) But a flee clause is permitted if activated only upon foreign invasion of the U.S. or widespread confiscation or nationalization of property within the U.S.

(2) DANGER: A domestic asset protection trust that provides for removal to outside of the U.S. in the event of creditor attack will be considered to be a foreign trust. Treas. Regs. §301.7701-7(c)(5), Ex. 2.

(a) Such clauses are often found in domestic creditor protection trusts so as to inhibit creditor attacks.

2. Control Test

a) "One or more US persons have the authority to control all substantial decisions of the trust." Treas. Regs. §301.7701-7(a)(1)(ii).

b) Uses the standard Code §7701(a)(30) definition of U.S. person.

c) EFFECT: If a foreign person has control over only one "substantial decision," foreign trust status results.

(1) Thus, have to watch for powers not just of trustees, but of protectors, beneficiaries, and other persons granted power or authority over the trust.

(2) Regulation examples allow for foreign person to serve, if can be "outvoted" by U.S. persons.

(a) Also, can give powers to foreign persons, so long as a U.S. fiduciary can veto it (and the U.S. fiduciaries are not foreclosed from making those decisions themselves - see Treas. Regs. §301.7701-7(d)(1)(iii) and (v) ex. 2, 3 and 4).

(i) "(iii) The term control means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions. To determine whether United States persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries."

(ii) Example 1 provides the foreign trustee(s) cannot have veto power, and there cannot be a requirement for unanimity if there is a foreign trustee.

(iii) Example 2 importantly blesses a straight majority vote, where one of 3 trustees is foreign.

d) "Substantial Decision":

(1) Defined as those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial. Treas. Regs. §301.7701-7(d)(1)(ii).

(a) "Ministerial decisions": bookkeeping, the collection of rents, and the execution of investment decisions (as compared to the actual making of investment decisions, which can be a substantial decision).

(2) Regulatory nonexclusive list of "substantial decisions" (Treas. Regs. §301.7701-7(d)(1)):

(a) Whether and when to distribute income or corpus;

(b) The amount of any distributions;

(c) The selection of a beneficiary;

(i) Thus, a special power of appointment is a problem.

(a) Note that a power of appointment, allowing appointment of a U.S. beneficiary, can also create a Code §679 issue.

(d) Whether a receipt is allocable to income or principal;

(e) Whether to terminate the trust;

(f) Whether to compromise, arbitrate, or abandon claims of the trust;

(g) Whether to sue on behalf of the trust or to defend suits against the trust;

(h) Whether to remove, add, or replace a trustee;

(i) COMMENT: There is no exception in the Regulations for a power that is limited to changes in trustees that do not change the tax residence of trust, so the prohibition on the exercise of this power by foreign persons must be absolute.

(i) Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa; and

(j) Investment decisions; however, if a U.S. person under Code §7701(a)(30) hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the United States person if the United States person can terminate the investment advisor's power to make investment decisions at will.

(k) A power to revoke the trust was held to vest substantial decision making power in the power holder in PLR 200243031.

e) 12 month safe harbor provided in the Regulations to replace any person who has authority to make a substantial decision if there is an inadvertent change in such persons. Treas. Regs. §301.7701-7(d)(2).

(1) An inadvertent change means the death, incapacity, resignation, change in residency, or other change that would change the residency of the trust but was not intended to do so.

(a) What other "changes" might come within this rule?

(i) Perhaps the removal of a trustee for malfeasance or nonfeasance, or the bankruptcy of a corporate fiduciary.

(2) Thus, for example, if a sole U.S. trustee dies and the trust designates a foreign person to serve as successor, if that foreign person is replaced with a U.S. person within 12 months, then the trust will not have been converted to a foreign trust.

(3) An extension of the 12 month period can be requested from the IRS.

3. Apply the applicable law and terms of the trust in evaluating these items. Treas. Regs. §301.7701-7(b).

D. Traps!

1. Florida trust, Florida assets, two trustees - one situated in Florida and one in Canada.

a) Inadvertent foreign trust for a CPA without knowledge of these rules would likely assume it is a Florida/domestic trust.

2. Same facts. CPA who knows the rules treats the trust as a foreign trust.

a) Unfortunately, CPA did not know that this was a pre-1996 trust which had elected to remain/be treated as a domestic trust.

3. Trust instrument says it is governed by Florida law. Trustee is a U.S. person who resides abroad. There are no Florida assets and the trustee spends no time in the U.S.

a) No adequate state ties to trigger Florida court jurisdiction - therefore, it is a foreign trust.

4. Client has a trust created with an eye towards asset/creditor protection. Smart lawyer includes a provision Creditor protection trust provisions direct that administration of the trust be moved offshore in the event of creditor attack.

a) Flee provision results in a foreign trust.

5. Trust with U.S. administrator, trustee, assets, and beneficiary. Non-U.S. protector has power to terminate a trust.

a) This is enough to establish non-U.S. control and thus a foreign trust.

6. Trust with U.S. administrator, trustee, assets, and beneficiary. Non-U.S. beneficiary has a power to appoint trust assets.

a) This is enough to establish non-U.S. control and thus a foreign trust.

7. Trust with U.S. administrator, trustee, assets, and beneficiary. Non-U.S. beneficiary has a power to remove a trustee, even though the trust says upon removal a U.S. successor must be appointed.

a) This is enough to establish non-U.S. control and thus a foreign trust.

8. Trust that is subject to U.S. court jurisdiction and with a U.S. trustee signs a one year contract with an investment advisor situated in the U.K., which advisor will be making the investment decisions for the trust.

a) This is enough to establish non-U.S. control and thus a foreign trust.

b) If contract was terminable at will, that would not be a problem.

II. Gain on Funding of Foreign Trust.

A. History.

1. In 1997 it replaced former Code §1491 excise tax.

2. New Code §684 applies to transfers after August 4, 1997.

B. Elements.

1. Transfer of property

a) Direct, indirect, or constructive transfer. Treas. Regs. §1.684-2(a).

(1) Example of "indirect:" transferring property first to an intermediary, and the intermediary makes the transfer to the trust. Treas. Regs. §1.684-2(b)(2), Ex. 1.

(2) Example of "constructive:" Termination of grantor trust status of a foreign trust when there was a U.S. grantor. Treas. Regs. §1.684-2(e)(2), Ex. 2.

2. By a U.S. person

a) Use regular Code §7701(a)(30) definition.

b) Includes Code §6013(g) election by NRA to be treated as a resident alien. Treas. Regs. §1.684-1(b)(1).

3. To a foreign estate or trust

4. Treated as a sale or exchange, and gain recognized.

C. Exceptions.

1. Transfer to a grantor trust to the extent a U.S. person is treated as the owner under Code §671.

2. Transfer to a foreign trust described in Code §501(c)(3). Treas. Regs. §1.684-3(b).

3. Transfers at death that result in a basis step-up under Code §1014(a). Treas. Regs. §1.684-3(c).

4. Transfers for fair market value to unrelated trusts. Treas. Regs. §1.684-3(d).

5. Code §1032 transfer by a domestic corporation to a foreign trust. Treas. Regs. §1.684-3(e).

6. Distributions to a trust by an entity other than a trust and certain other special forms of entities. Treas. Regs. §1.684-3(f).

D. Nonobvious Applications.

1. Transfer by a U.S. estate.

2. Conversion of a domestic trust to a foreign trust. Code §684(c); Treas. Regs. §1.684-4.

a) Deemed to occur on same day, but immediately before, conversion to a foreign trust. Treas. Regs. §1.684-4(b).

b) Exception for "inadvertent migrations." Treas. Regs. §1.684-4(c).

3. Foreign grantor trust with U.S. grantor ceases to be a grantor trust. Treas. Regs. §1.684-2(e)(1).

a) E.g.: Trust was a grantor trust by reason of having a U.S. grantor and a U.S. beneficiary. If trust loses grantor trust status by ceasing to have a U.S. beneficiary, Code §684 is triggered. Treas. Regs. §1.684-2(e)(2), Ex. 1(ii).

b) E.g.: U.S. grantor of foreign grantor trust dies. Treas. Regs. §1.684-2(e)(2), Ex. 2.

4. Transfers of property to entities owned by a foreign trust. Treas. Regs. §1.684-2(f).

E. Observations.

1. Loss is not recognized. Treas. Regs. §1.684-1(a)(2).

a) Gain recognized on an asset by asset basis - no offset for losses. Treas. Regs. §1.684-1(a)(2).

2. Irrelevant whether the foreign trust has U.S. beneficiaries. Treas. Regs. §1.684-1(d), Ex. 1.

a) Except to the extent that it may create a grantor trust under Code §679.

3. Receipt of partial consideration will not usually change the result, nor the amount of gain.

a) A transfers property that has a fair market value of 1000X to FT in exchange for 400X of cash. A's adjusted basis in the property is 200X. A recognizes gain at the time of the transfer equal to 800X. Treas. Regs. §1.684-1(d), Ex. 3.

4. Transfer in exchange for private annuity still results in full gain recognition even if deferral otherwise allowed under the Code. Treas. Regs. §1.684-1(d), Ex. 4.

5. Such deemed transfers are subject to reporting requirements under Code §6038.

F. Traps!

1. Joe, a U.S. person, sets up a revocable trust in Nevis for credit protection purposes. The trustee is a Nevis bank. Joe dies.

a) Gain triggered!

b) But subject to reduction for basis step-up at death.

2. U.S. domestic trust. U.S. trustee dies, and Uncle Jose, a resident of Panama, takes over as successor trustee.

a) Conversion of trust from a domestic trust to a foreign trust triggers gain recognition.

3. Foreign trust has a U.S. grantor and U.S. beneficiaries, and is thus treated as a grantor trust under Section 679. U.S. beneficiary dies, and Mexican daughter of beneficiary succeeds as a beneficiary.

a) Conversion out of grantor trust status triggers gain recognition.

4. U.S. grantor gifts a portfolio of securities with $1 million in accrued gains and $1 million in accrued losses to a nongrantor foreign trust.

a) No offset permitted - losses not recognized under Section 684.

5. U.S. person sells a Bahamas condominium to a foreign trust. The trust is worth $1 million, and the U.S. person has a $500,000 basis in it. The sales price is $900,000.

a) All $500,000 in gain is recognized.

III. Foreign Nongrantor Trust Issues

A. General U.S. Income Taxation.

1. Common Types of Income - Taxation of Trust.

a) Foreign Source Income.

(1) Similar to any non-U.S. person under the Code, the U.S. does not generally tax a foreign trust on its foreign source income.

(a) Although U.S. beneficiaries may be taxed on distributions.

(2) However, again similar to other non-U.S. persons, a foreign trust will be taxed on its income that is effectively connected with a U.S. trade or business. Code §§ 641(b) & 871(b).

(a) A U.S. payor of such income should withhold 30% unless the trust provides to the payor a Form W-8ECI with a taxpayer identification number.

(b) Subject to treaty variations.

b) U.S. Source Income.

(1) Capital gains taxed at U.S. capital gains rates, if it is effectively connected with a U.S. trade or business. Code §871(b); Treas. Regs. §§1.641(a)-2, 1.871-8(b)(2)(ii).

(2) Gain from dispositions of U.S. real property interests are taxable under FIRPTA. Code §897(a)(1).

(a) And such gains are subject to FIRPTA Code §1445 withholding rules.

(3) Other capital gains are not taxed by the U.S. Code §§871(a)(2) & 641(b).

(a) Under Code §641(b), a foreign trust is treated as a nonresident alien who "is not present in the United States at any time." Thus, the 183 days or more rule of Code §871(a)(2) which could tax capital gains is not applicable. See Code §641(b).

(4) Periodic fixed and determinable income (FDAPI) that is not effectively connected with a U.S. trade or business is subject to a 30% rate of tax (or lower treaty rate), and should be withheld by U.S. payors.

(a) Although a foreign trust can made a Code §871(d) election to treat passive income from U.S. real estate activities as effectively connected income.

(b) The payor is obligated to withhold even if all of the trust beneficiaries are U.S. persons. Treas. Regs. §§1.1441-1(c)(6)(ii)(D) & -5(e)(2).

(5) Foreign trusts are also subject to U.S. income taxes at graduated rates if they incur income that is effectively connected with a U.S. trade or business.

(a) The test of whether income of a foreign trust is effectively connected with a U.S. trade or business is generally applied at the trust level.

2. Taxation of U.S. Beneficiaries.

a) Generally apply normal Subchapter J rules.

b) DNI includes capital gains, unlike domestic trusts.

c) Special rules will create constructive distributions. Code § 643(i).

(1) Loans to beneficiaries, but see Notice 97-34 exception for "qualified obligations."

(2) Free use by beneficiaries of trust property.

(3) Amounts paid to a U.S. person indirectly from a foreign trust of which the payer is not the grantor is treated as paid directly by the foreign trust. Code §§643(h)/665(c).

d) U.S. beneficiaries receive a credit against their U.S. tax liability of the trust's U.S. taxes.

(1) If taxes were withheld by the payor to the trust, the U.S. beneficiary includes the withheld taxes in income as a "gross up". Treas. Regs. §§1.1441-3(f), 1.1462-1(b).

3. Taxation of Non-U.S. Beneficiaries.

a) No withholding is required as to foreign source income distributed to NRA beneficiary and the foreign beneficiary should not be subject to U.S. tax. However, effectively connected income will be taxed to the foreign beneficiary.

b) U.S. source effectively connected income is taxable to foreign beneficiaries.

c) U.S. source FDAPI.

(1) If the payor withheld on the FDAPI when paying it to the foreign trust, the foreign trust does not have to withhold on a distribution to a foreign beneficiary.

(2) If there was no such withholding, the foreign trust must withhold 30% (or lower treaty rate) on such distributions.

d) The character of trust income as effectively connected with a U.S. trade or business will carry out to the beneficiary. See Krause v. Comr., TC Memo 1974-291.

(1) Including gains from dispositions of real property under Code §897. See Treas. Regs. §1.89-1(e)(3) for allocation rules.

e) The trustee is obligated to withhold 10% of the value of the distribution of any U.S. real property interest to a foreign beneficiary. Code §1445(e)(4).

4. AMT

a) Applies to foreign trusts. Code §§55 & 59(c).

5. Foreign Tax Credits.

a) No explicit Code provision provides a credit for foreign income taxes incurred to a U.S. beneficiary receiving a CURRENT distribution from a foreign trust.

(1) Conduit principle of Code §652, which shifts the gross amount of the foreign income (unreduced by foreign taxes imposed on) arguably should treat the taxes as having been paid by the beneficiary.

(a) Such treatment is supported by Rev.Rul. 56-30, 1956-1 C.B. 646.

(b) Code §901(b)(5) indicates that a beneficiary may receive a credit (subject to Code §904 limitations) on his or her "proportionate share of the taxes" paid or accrued to a foreign country.

(c) See also GCM 36304 (1975) ("a United States beneficiary of a foreign trust could credit those foreign income taxes paid or accrued by the trust and attributable to certain foreign-source income of the trust that was included in the beneficiary's gross income under the predecessor of Code § 662(a)(2)").

(2) It is unclear whether all foreign taxes are creditable, or there is some reduction in the amount of the credit due to less dollars being available to distribute to the beneficiary due to the trust's payment of foreign tax.

(a) Based on analogous issues raised in American Chicle Co. v. U.S., 316 U.S. 450 (1942).

b) The Code does provide that a beneficiary who receives an ACCUMULATION distribution of foreign source income on which foreign income tax has been paid must "gross up" the distribution to include the taxes deemed distributed under Code §666(b). Code §667(a). The beneficiary can then claim a credit if the beneficiary elects the provisions of the foreign tax credit, or a deduction if no credit is claimed. Code §667(d).

(1) Because the credit does not arise under Code §901, the limitations thereunder should not apply.

c) Trusts are allowed the foreign tax credit for taxes not allocable to beneficiaries. Code §§901(m) & 642(a).

(1) Although foreign trusts will typically not be taxable directly by the U.S. on foreign source income.

6. Watch out:

a) Amounts paid to a U.S. person indirectly from a foreign trust of which the payor is not the grantor is treated as paid directly by the foreign trust. Code §§643(h)/665(c). This can trigger DNI distributions and throwback distributions.

(1) For example, a distribution to a foreign beneficiary, who then gifts the distribution to a U.S. person. Under Regulations, the recipient U.S. person need not even be a beneficiary.

(2) Interestingly, these rules do not apply to a distribution to the grantor, who then makes a gift to a U.S. person, although perhaps other tax principles can be applied to find a disguised distribution to a U.S. person in those circumstances.

b) Loans of cash or marketable securities to a U.S. person who is grantor or beneficiary is a distribution, as well as free use by beneficiaries of trust property. Code §643(i).

(1) But see Notice 97-34 exception for "qualified obligations."

c) Try to plan to get items that are nontaxable to nonresident alien beneficiaries to them and not to U.S. beneficiaries, if possible.

(1) For example, non-USRPI long-term capital gains could be distributed to NRA beneficiaries in one year, and then distributions of other types of income incurred in later years distributed to U.S. beneficiaries.

7. Traps!

a) Foreign nongrantor trust owns a Bahamas condominium with a value of $1 million and a basis of $500,000. The trust sells the condominium for $500,000. Since the gain is not U.S. source income nor effectively connected with a U.S. trade or business, no U.S. taxes are paid. The trust terminates in the same year and distributes the sales proceeds to its U.S. beneficiaries. The trust has no other income in that year.

(1) If this was a U.S. trust, there would be no DNI and thus the beneficiaries would not have any income tax. However, since foreign trusts include capital gains in DNI, the beneficiaries pick up the capital gain for U.S. income tax purposes.

b) Same facts, except the condominium is situated in the U.S.

(1) Foreign trust subject to FIRPTA tax and withholding per its disposition of a U.S. real property interest. Sections 897 and 1445.

c) Foreign trust leases out a U.S. condominium. The tenant correctly withholds 30% of the gross rent payments.

(1) Foreign trust should consider a Section 871(d) net election to be taxed on a net basis (thus allowing for deduction of depreciation, taxes, and other expenses).

d) Foreign trust allows one of its U.S. beneficiaries to occupy its Bermuda condominium on a rent-free basis.

(1) Oops! That's a taxable distribution to the U.S. beneficiary. Section 654(i).

e) Foreign trust lends its U.S. beneficiary $100,000.

(1) Oops! That's a taxable distribution to the U.S. beneficiary. Section 654(i).

f) Foreign trust distributes funds to nonresident alien son, which distributes involve non-U.S. source income. Son is not taxed since he is an NRA. Son makes a gift to sister of those proceeds - sister is a U.S. resident.

(1) Under Code §643(h), sister can be taxed as if she received a direct distribution from the trust, even if she is not a beneficiary of the trust.

B. Throwback Rules

1. Which trusts do the rules apply to?

a) The only trusts remaining subject to throwback are foreign trusts and domestic trusts that either (a) were at any time foreign trusts, or (b) were created before March 1, 1984, and would have been subject to the aggregation requirement of §643(f) if that provision had then applied.

b) Not applicable to grantor trusts.

2. What is happening here?

a) Undistributed DNI (reduced by applicable taxes) carries out in later years to beneficiaries.

3. Statutory Mechanics:

a) Calculate UNI (undistributed net income) for years after 1969 on a year by year basis.

(1) UNI = excess of DNI over (a) distributions to beneficiaries in that year under Code §661(a)(1) and (2), and (b) taxes imposed on trust allocable to the undistributed DNI. Code §665(a).

(a) Essentially, undistributed DNI, less taxes on that undistributed DNI.

(b) ALERT: Watch for unexpected sources of DNI (e.g., depreciation recapture, imputed income under Code §§ 482, 446, 551, 951, 7872).

(c) If no records are available, assume UNI arose in earliest taxable years of trust. Code §666(d).

(d) Foreign taxes can be included for this purpose. Code §665(d)(2).

(2) But credit against UNI accumulation distributions previously made for that year. Code §665(a)(1) and Code §666(a).

b) Calculate accumulation distribution for the current tax year. Code §666(a).

(1) This is essentially the excess of Code §661(a) distributions over DNI for the current tax year. Code §665(b).

c) Allocate the accumulation distribution amount to prior tax years with UNI. Code §666(a).

(1) Apply to oldest tax year with UNI first, and then second oldest, etc.

(2) Gross up the distribution amount for each such year with UNI by taxes previously imposed on the trust in that year. Code §666(b) & (c).

d) The accumulation distribution is deemed to occur in each prior year and is included in the income of the recipient beneficiary when paid, credited, or required to be distributed as if it was a current year Code §662(a)(2) distribution. Code §667(a).

(1) Thus, U.S. beneficiaries will include the distribution in income. Code §667(a)(2).

(2) However, the rate of tax is determined by averaging formula applied over the 5 years preceding the current tax year. Code §667(b).

(a) For the 5 preceding tax years, throw out the years with the highest and lowest taxable income amounts of the beneficiary.

(i) Augmented by accumulation distributions that increased prior years' taxable income.

(b) Then divide the accumulation distribution by the number of prior tax years to which the accumulation distribution is allocated.

(i) However, this number of prior tax years may be reduced for years with low amounts of UNI allocated to them. Code §667(b)(3). Amounts accumulated in that year are still part of the total accumulation distribution.

(c) Add that fractional amount of the total accumulation distribution to the taxable income of the remaining 3 preceding tax years and determine the resulting tax increases for those years, and then determine the average tax increase for those three years.

(d) Multiply the average tax increase by the number of prior tax years to which the accumulation distribution is allocated.

(e) Reduce that figure by the amount of taxes deemed distributed to the beneficiary under Code §§665(b) and (c).

(i) The beneficiary may not obtain a refund where the credit for taxes paid by the trust exceeds the partial tax obligation. Code §666(e).

(f) The remaining amount is the net tax imposed on the accumulation distribution.

(i) Subject to adjustment for estate and GST taxes attributable to the partial tax. Code §667(b)(6).

(a) For example, assume the trust sold property during the beneficiary's lifetime, but the beneficiary died before the gain was distributed so that the gain was included in the beneficiary's estate as income in respect of a decedent. The ultimate recipients of the gain would be able to reduce their tax on the distribution by a ratable portion of the estate or generation-skipping taxes paid on the UNI of the trust.

(3) Are special rules for multiple trusts and foreign taxes. Code §§667(c) & (d).

(4) U.S. beneficiaries will thus be taxed on the accumulation distribution at ordinary income rates, since there is no provision for the pass-through of character.

(a) Foreign beneficiaries will get the benefit of a character pass-through. Code §667(e).

(b) Implications:

(i) No preferential capital gains rates.

(ii) Distribution will lose any applicable foreign income character and thus may reduce otherwise available foreign tax credits.

(iii) Distribution will lose passive activity income character and thus may not allow for offset by passive losses.

(c) However, tax-exempt municipal bond interest should keep its tax-free character. Code §643(a)(5).

4. Observations.

a) Deemed Accumulation Distributions.

(1) See under Reporting below the filings that are needed by a beneficiary to properly report, or avoid, accumulation distributions.

b) There can be no accumulation distribution in any year in which total distributions do not exceed trust accounting income.

c) A "simple" trust (one operating under an instrument requiring the current distribution of all income and allocating no income to charity, and that in the particular taxable year made no distributions of principal) will almost never make an accumulation distribution.

d) Nonresident alien beneficiaries are subject to the throwback rules, but they are taxable only on items of income that are otherwise taxable to an NRA per Code §667(e) look-throughs as to character.

e) Tax cost of accumulation in a foreign trust for a u.s. beneficiary can be exorbitant.

(1) Conversion of capital gains to ordinary income.

(2) Loss of foreign tax credits that might have been available if amounts were distributed currently.

(3) Interest charge (discussed below).

(a) Although if growth can outperform interest charge, may still come out ahead.

5. Traps!

a) Beneficiary of foreign trust is a 5 year old U.S. person. The trustee accumulates the income of the trust until the beneficiary reaches age 18, and then distributes it.

(1) Throwback rules apply - there is no exception for accumulations while there is a minor beneficiary.

b) Foreign trust sells a condominium for a $500,000 gain on 11/1/2010. On 6/30/2011, it distributes the proceeds of the sale to a U.S. beneficiary.

(1) Capital gain goes into DNI. In 2010 this DNI was not distributed, so there was an accumulation. In 2011, there is an accumulation distribution. As an accumulation distribution, the accumulated capital gain loses its character and is taxed as ordinary income to the U.S. beneficiary.

6. Watch out:

a) Since foreign trusts include capital gains in DNI, undistributed capital gains are included in undstributed income.

b) If inadequate information is provided to IRS, under Code §6048(c)(2) the IRS can treat all distributions as accumulation distributions.

c) There is no minority exception for younger beneficiaries. Therefore, accumulation of income during minority is a problem.

7. Planning Considerations.

a) Domesticate trust?

(1) Still covered by throwback for years of accumulation as a foreign trust, but see separate discussion below as to avoiding interest charge.

(2) May still be a good idea to get capital gains rates, and also avoid interest on accumulation distributions of gains since unlikely to distribute them currently on a regular basis.

b) U.S. beneficiary expatriation.

(1) Perhaps can avoid throwback rules.

(a) But throwback may still enter into 30% withholding tax imposed.

(2) 30% withholding tax imposed under expatriation rules. Code §877A(f).

C. Interest Charge on Accumulation Distributions.

1. In addition to income from an accumulation distribution, an interest charge is imposed. Code §667(a)(3).

2. Rate of Interest.

a) Use rates and method of interest under Code §6621 applicable to underpayments of tax. Code §668(a)(1).

b) However, for portion of period which occurs before 1/1/96, use 6% (with no compounding). Code §668(a)(6).

3. Mechanics.

a) Identify the tax years that have undistributed net income.

(1) QUERY WHETHER 668*A(*5 HAS A DIFFERENT ALLOCATION FORMULA)

b) For each such year, multiply the UNI for that year by the number of years away that year is from the current year of distribution.

(1) But exclude years in which the beneficiary was a nonresident alien. Code §668(a)(4).

c) Add up all those products.

d) Divide that sum by the aggregate UNI of all years.

e) Multiply the result by the partial tax under Code §667(b) (after tax credits) and the applicable Code §6621 interest rate.

f) The result is the applicable interest charge.

g) Effect: Creates a weighted number of years for which interest should be charged, based on the years with UNI and the relative amounts of UNI in each years.

4. Misc.

a) The interest charge is not deductible. Code §668(c).

b) Maximum interest charge is limited so that it, when added to the Code §667(b) tax on the accumulation distribution, does not exceed 100% of the accumulation distribution. Code §668(b).

5. Traps!

a) Foreign trust accumulates foreign source for 15 years. It then distributes the income to a U.S. beneficiary.

(1) The interest charge is so high that between tax on the accumulation distribution and interest, almost all of the distribution is taxed away.

IV. Grantor Trusts

A. U.S. Grantors - When is There a Grantor Trust?

1. Apply usual grantor trust rules to determine if one exists. Code §§671-8.

2. Foreign trust funded by a U.S. person with a U.S. beneficiary. Code §679.

a) Thus, trust need not otherwise meet the traditional grantor trust rules of Subchapter J. Treas. Regs. §1.679-1(b). For example, a U.S. grantor that makes a completed gift to a foreign trust with U.S. beneficiaries and retains no continuing rights, powers, or interests in the trust, will be taxed under the grantor trust rules.xx

b) When will a trust be considered to have a U.S. beneficiary?

(1) The test is made annually. Treas. Regs. §1.679-2(a)(1).

(2) It is defined in the negative. A U.S. beneficiary will be deemed to exist unless:

(a) Under the trust terms, no part of income or corpus may be paid or accumulated to or for the benefit of a U.S. person, and

(i) Income will be treated as being accumulated for a U.S. person even if that person's interest is contingent on a future event. Code §679(c)(1).

(a) Thus, merely contingent U.S. person beneficiaries will be enough.

(ii) It does not matter if no income or corpus is actually distributed to a U.S. person. Treas. Regs. §1.679-2(a)(2)(i).

(iii) Exception for negligible interests.

(a) A person who is not named as a beneficiary and is not a member of a class of beneficiaries as defined under the trust instrument is not taken into consideration if the U.S. transferor demonstrates to the satisfaction of the Commissioner that the person's contingent interest in the trust is so remote as to be negligible. Treas. Regs. §1.679-2(a)(2)(ii).

(b) However, this exception is not applicable to such a person if they are also a discretionary beneficiary. Id.

(iv) The Regulations provide 13 examples of situations that provide guidance on when there is a potential beneficiary and the exception for negligible interests. Treas. Regs. §1.679-2(a)(2)(iii).

(b) If the trust were terminated at any time in the taxable year, no part of the income or corpus could be paid to or benefit a U.S. person. Code §679(c)(1); Treas. Regs. §1.679-2(a)(1).

(3) Attribution of ownership can occur through foreign corporations, foreign partnerships, foreign trusts, and foreign estates. Code §679(c)(2). A U.S. person beneficiary will be deemed to exist as to amounts paid to or accumulated for:

(a) A controlled foreign corporation,

(b) A foreign partnership with a U.S. person partner, or

(c) A foreign trust or foreign estate with a U.S. beneficiary.

(4) Where a trustee or other person has discretion to determine beneficiaries (e.g., under a power of appointment), a U.S. beneficiary will be deemed to exist, unless:

(a) The trust terms specifically identify the class of persons, and none of those persons are U.S. persons in the taxable year. Code §679(c)(4).

(b) Thus, powers of appointment are a danger.

(c) Powers to amend the foreign trust to benefit a U.S. person, either under the instrument or applicable local law, may also trigger the existence of a U.S. beneficiary. Treas. Regs. §1.679-2(a)(4)(ii).

(5) Oral or written agreements or understandings that effectively result in a U.S. person beneficiary will be treated as trust terms. Code §679(c)(5).

(a) Such as letters of wishes, or actual distributions that are made. Treas. Regs. §1.679-2(a)(4)(i).

(6) Loans of cash or property to U.S. persons will result in such person being treated as a U.S. beneficiary. Code §679(c)(6).

(a) Except for loans repaid at a market rate of interest within a reasonable period of time or fair market value rent being paid.

(7) If a U.S. person transfers property to a foreign trust, the IRS may presume there is a U.S. beneficiary absent the submission of satisfactory information or evidence to the contrary. Code §679(d).

(8) Can also extend to U.S. persons who are indirect beneficiaries via agent or nominee relationships. Treas. Regs. §679-2(b)(2).

c) Extended "transfers."

(1) "Transfers" include indirect transfers if there is a principal purpose of tax avoidance. Treas. Regs. §1.679-3(c).

(2) They will also include an assumption or satisfaction by a person of a foreign trust's obligation to a third party. Treas. Regs. §1.679-3(d)(1).xx

(3) Guarantees of trust obligations by a related U.S. person can constitute a transfer. Treas. Regs. §1.679-3(e)(1).

(4) Transfers by a related U.S. person to an entity owned by the foreign trust may constitute a transfer. Treas. Regs. §1.679-3(f).

d) Exceptions

(1) Excluding deferred compensation and charitable trusts. Code §§6048(a0)3)(B)(ii).

(2) Transfers by reason of death of transferor. Code §679(a)(2).

(3) Transfers by sale/exchange for fair market value. Code §679(a)(2)(B); Treas. Regs. §1.679-4(b).xx

(a) In testing consideration, obligations of, and obligations guaranteed by, the trust, any grantor, owner, or beneficiary, or certain related persons, will not be counted unless they are "qualified obligations." Code §679(a)(3); §1.679-4(c).

(4) Not applicable to any transfer of property by reason of a beneficiary becoming a U.S. person more than 5 years after the transfer. Code §679(c)(3); Treas. Regs. §1.679-2(a)(3)(i).

e) Late entries to grantor trust status.

(1) Foreign grantor later becomes a U.S. person.

(a) If residency starting date is within 5 years of the date the grantor transferred property to the trust, such transfer will be deemed to have occurred on the residency starting date (and thus may trigger grantor trust status). Code §679(a)(4); §1.679-5(a).

(b) Determine residency start date using Code §7701(b)(2)(A) rules. Code §679(a)(4)(C).

(c) Property deemed transferred includes undistributed income. §1.679-5(b)(2).

(2) U.S. trust becomes a foreign trust.

(a) If there is a U.S. grantor and a U.S. beneficiary, the grantor will be treated as having made the transfer as of the day the trust becomes foreign, thus triggering grantor trust status. Code §679(a)(5).

(i) Property transferred includes undistributed net income. §1.679-6(b).

(3) Foreign trust with U.S. grantor acquires a U.S. beneficiary.

(a) This will trigger the operation of the grantor trust rules in the year it acquires a U.S. beneficiary, including by reason of a beneficiary becoming a U.S. person. Code §679(a)(1); Treas. Regs. §1.679-2(a)(3).

(i) But note above exception as to transfers that occurred more than 5 years before a foreign person becomes a U.S. person.

(b) Interestingly, if there was no U.S. beneficiary in the prior year, any undistributed income at the end of the year will be income to the U.S. grantor in the next year when there is a U.S. beneficiary. Code §679(b); Treas. Regs. §1.679-2(c)(1).

(i) This will trigger an accumulation distribution interest charge on the undistributed net income. Treas. Regs. §1.679-2(c)(1).

f) Trusts ceasing to have a U.S. beneficiary.

(1) The U.S. transferor is treated as transferring a portion of the trust to the trust as of the first day of the first year that there no longer is a U.S. beneficiary. Treas. Regs. §1.679-2(c)(2).

(a) Such a deemed transfer is subject to Code §684 gain recognition provisions.

g) Misc.

(1) Applies only to the portion of the trust attributable to the property transferred within these rules. Treas. Regs. §1.679-1(a).

(2) Will override grantor trust status attributed to another owner under Code §678. Treas. Regs. § 1.679-1(b).; Treas. Regs. §1.679-1)(d), Ex. 1.

3. Traps!

a) U.S. grantor establishes an irrevocable foreign trust for his two grandchildren - one of whom is a U.S. citizen. The grantor retains no rights, powers, or interests over or in the trust.

(1) Grantor trust, even though it would not be if it was a domestic trust.

b) U.S. grantor establishes an irrevocable foreign trust for his two grandchildren - both of whom are foreign. The grantor retains no rights, powers, or interests over or in the trust. The grantor allows the grandchildren to use a trust condominium rent free - the parents of the grandchildren (who are U.S.) stay at the condominium with the grandchildren.

(1) Possible exposure to grantor trust treatment for rent-free use of trust property by a U.S. person.

c) Foreign trust established by foreign grandparent for his U.S. grandchildren. Trust borrows funds and U.S. child of grandparent guarantees repayment.xx

(1) Creates a U.S. "grantor" or transferor.

d) Foreign trust established by foreign grandparent for his U.S. grandchildren. Grandparent moves to the U.S. and becomes a U.S. resident alien by spending too many days in the U.S. under the substantial presence test.xx

(1) Grandparent now becomes a U.S. grantor if he moved to the U.S. within 5 years.xx

e) U.S. father establishes an irrevocable foreign trust for his child who has a green card. When the child reaches age 21, he gives up the green card and moves abroad.

(1) Trust was a grantor trust, but when child ceased to be a U.S. person, the grantor trust status ended. The father is treated at that time as having transferred all of the trust property to a foreign trust, thus subjecting himself to Section 684 gain on any appreciation.

B. Foreign Grantors

1. Code §672(f) imposes limits on when a foreign person can be treated as owner under the grantor trust rules. Thus, a trust may appear to be a grantor trust under other Subchapter J rules, but will not be treated as such unless it meets the requirements for grantor trust status that apply when the grantor is foreign.

a) The situations where grantor trust will be allowed to operate with a nonresident alien grantor are:

(1) Revocable trust, or

(a) Power to revest absolutely in grantor; and

(i) Power to revest must be held for at least 183 days. Treas. Regs. §1.672(f)-3(a)(2).

(b) Revocation power exercisable solely by grantor (or, in the event of the grantor's incapacity, by a guardian or other person who has unrestricted authority to exercise such power on the grantor's behalf) (a) without approval or consent of any person, or (b) with consent of related or subordinate party who is subservient to grantor. Treas. Regs. §1.672(f)-3(a)(1).

(i) "Related or subordinate party" is defined under Treas. Regs. §1.672(c)-1. Treas. Regs. §1.672(f)-3(a)(1).

(ii) A related or subordinate party is subservient to the grantor unless the presumption in the last sentence of §1.672(c)-1 is rebutted by a preponderance of the evidence. Treas. Regs. §1.672(f)-3(a)(1).

(iii) See Treas. Regs. §1.672(f)-3(a)(4) examples for IRS interpretations of these general rules.

(2) Benefit trust, or

(a) Distributions (income or corpus) during lifetime of grantor can only be made to grantor or the grantor's spouse.

(i) A distribution in satisfaction of a legal obligation of the grantor or the grantor's spouse is considered a distribution to the grantor/grantor's spouse, but subject to some restriction for related party obligations. Treas. Regs. §1.672(f)-3(b)(2).

(3) Compensatory trust.

(a) A trust whose distributions are taxable as compensation for services rendered. See Treas. Regs. §1.672(f)-3(c).

b) Trusts that are not treated as a grantor trust by reason of Code §672(f) are taxed as regular trusts, subject to accumulation distribution and interest charge rules for accumulation distributions to U.S. beneficiaries. Treas. Regs. §1.672(f)-1(a)(1).

c) Code §672(f) applies to trusts for which the grantor is not a U.S. citizen or resident or a domestic corporation.

d) Code §672(f) applies to both domestic and foreign trusts.

e) Special Rules:

(1) A CFC is treated as a domestic corporation for this purpose. Code §672(f)(3)(A).

(2) A PFIC is treated as a domestic corporation for this purpose. Treas. Regs. §1.672(f)-2(a).

(3) These rules do not apply for purposes of Code §1297 PFIC rules in determining whether a corporation is a PFIC. Code §672(f)(3)(B). Treas. Regs. §1.672(f)-2(c)(1).

(4) Once a trust fails to be treated as a grantor trust under these rules, later qualification under these rules will not then allow grantor trust status. Treas. Regs. §1.672(f)-3(a)(3).

f) Grandfathered trusts.

(1) These limits on grantor trust status do not apply to any portion of a trust that was treated as owned by the grantor under Code §§676 and 677 on September 19, 1995, as long as the trust would continue to be so treated thereafter. However, the preceding sentence does not apply to any portion of the trust attributable to gratuitous transfers to the trust after September 19, 1995. Treas. Regs. §§ 1.672(f)-3(a)(3) and -3(b)(3).

2. If foreign owner under grantor trust rules, and trust has a U.S. beneficiary, such beneficiary is treated as grantor to the extent such beneficiary has made gratuitous transfers of property to such foreign grantor. Code §672(f)(5).

a) A 1996 amendment to Code §901(b)(5) states that the Treasury will promulgate regulations that deem such U.S. beneficiaries to have paid, for foreign tax credit purposes, any foreign taxes paid by the grantor or the trust on the income that the U.S. beneficiaries are deemed to have received personally. Any resulting foreign tax credits would be subject to the appropriate limitations under Code §904(d). Regulations have not yet been promulgated.

3. Traps!

a) Foreign grandfather sets up a foreign trust for his family members, some of them are U.S. The trust invests in real estate in Panama. On the advice of counsel, grandfather retains the right to change the beneficiaries of the trust, so as to create a grantor trust and thus have himself treated as the owner of the trust for U.S. tax purposes. He does this so any gains on the investments will be taxable to him, and not the trust (or its U.S. beneficiaries).

(1) Since such grantor trust power is not one of the 3 required powers, the trust will not be a grantor trust for U.S. tax purposes. The U.S. beneficiaries will be subject to U.S. income tax on any distributions they receive of investment gains (either in the year of the gains or under the accumulation distribution rules).

C. Conversion from Grantor Trust to Nongrantor Trust with U.S. Beneficiaries at Death of Grantor.

1. Trust is subject to regular foreign trust taxation rules previously discussed, including throwback rules, interest charge on accumulation distributions, and special DNI rules.

a) Consideration should be given to domesticating the trust to avoid these rules.

2. Unlikely that the throwback rules will apply to accumulations that occurred during the grantor trust period.

a) Code §671 says that only the portion of trust not taxable to the grantor is subject to subparts A through D, which subparts include the throwback provisions, etc.

3. If grantor was U.S., and then the grantor dies, this can be a Code §684 deemed transfer to the foreign trust that triggers gain recognition.

a) Treas. Regs. §1.684-2(e)(2), Ex. 2.

(1) Treas. Regs. §1.684-3(c) indicates that a Code §1014 basis adjustment will be permitted to apply, even though the Regulations treat the conversion as occurring immediately before death.

b) Can this be avoided by having trust become a domestic trust at death of grantor?

(1) Treas. Regs. §1.684-2(e)(1) can be read that this won't work because the conversion is deemed to occur "immediately before" the death of the grantor. However, policy would dictate this should not be a trigger, the "immediately before" is not found in the statute or committee report, and an argument could be made that there is "foreign trust" at the time of the death of the grantor so the Regulation may not apply by its language.

4. Traps!

a) U.S. grantor establishes a foreign trust with himself and his U.S. family members as discretionary beneficiaries, in a typical creditor protection trust setup. Grantor dies.

(1) Section 684 gain occurs as trust is converted to a nongrantor trust, subject to Section1014 basis step-ups.

V. Foreign Corporations Owned by a Foreign Trust with U.S. Beneficiaries

A. Can create a controlled foreign corporation (CFC).

1. Code §958(a)(2) - stock owned through a foreign trust shall be considered as being owned proportionately by its beneficiaries. See also Treas. Regs. §1.958-1(b) & (c).

2. But query whether these rules are appropriate where discretionary beneficiaries have no voting rights. An argment can be made that it is okay to use Code §958(a) for purposes of testing for the "more than 50% in value by U.S. persons" test, but still otherwise have to find a 10% or more U.S. shareholder that has true voting control.

B. Can create a passive foreign investment company (PFIC).

1. Prop. Regs. §1.1291-1(b)(8)(iii)(C) attributes stock from from trusts to beneficiaries on a "proportional" basis.

VI. Major Reporting Requirements

A. Forms 3520.

1. Who must file Forms 3520?

a) U.S. beneficiaries (including grantor) who receive, directly or indirectly, any distribution from a foreign trust.

(1) A distribution is any gratuitous transfer of money or other property.

(a) It does not matter whether the trust is owned by another person under the grantor trust rules.

(b) It does not matter whether the recipient is a person designated as a beneficiary under the trust instrument.

(c) A distribution includes the receipt of a specific bequest under Code §663(a).

(2) Distributions include indirect and constructive transfers.

(a) Charges made on a credit card that are paid by foreign trust or guaranteed are secured by the assets of the foreign trust.xx

(b) Checks written by the US person on a foreign trust's bank account.

(c) Payments from a foreign trust in exchange for property or services in excess of the fair market value of the property or services.

(d) Loans from foreign trusts to a U.S. beneficiary, U.S. grantor, or any U.S. person related to the beneficiary or grantor, that are not qualified obligations. See Code §643(i); Notice 97-34.

(e) Use of trust property without fair market value consideration is considered a constructive distribution under the 2009 HIRE Act revisions. Code §643(i).

(f) Amounts paid to a U.S. person indirectly from a foreign trust of which the payer is not the grantor is treated as paid directly by the foreign trust. Code §§643(h)/665(c).

b) U.S. person creates a foreign trust or who directly or indirectly transfers money or other property during the tax year to a foreign trust.

(1) If a partnership or corporation makes a gratuitous transfer to a trust the partners or shareholders are generally treated as the grantors of the trusts unless the transfer is made for a business purpose. See instructions to Form 3520.

(2) If a trust makes a gratuitous transfer to another trust, the grantor of the transferor trust is treated as the grantor of the transferee trust except as to certain exercises of powers of appointment. See instructions to Form 3520.

c) U.S. owner of all or a portion of a foreign trust at any time during the tax year under the grantor trust rules.

d) Estate of a U.S. decedent if:

(1) decedent makes a transfer to a foreign trust by reason of death, or

(2) the decedent was treated as the owner of any portion of a foreign trust immediately prior to death, or

(3) the decedent's estate includes any portion of the assets of a foreign trust.xx

e) Foreign trust makes a loan of cash or marketable securities during the year to U.S. person who is a grantor or beneficiary of the trust that is reported as a "qualified obligation" - such U.S. person must file.

(1) See Treas. Regs. §1.679-4(d) and form instructions for definition of a qualified obligation.xx

f) U.S. owner of an outstanding obligation of a related foreign trust (or a person related to the trust) issued during the current tax year that was reported as a "qualified obligation."

(1) See Treas. Regs. §1.679-4(d) and form instructions for definition of a qualified obligation.xx

g) While not related to foreign trusts, U.S. persons who receive certain gifts or bequests from a foreign trust must also file.

2. Exceptions.

a) Transfers to foreign trusts described in Code §§402(b), 404(a)(4), or 404A.

b) Most fair market value transfers to a foreign trust.

(1) Unless transfers in exchange for obligations that are qualified obligations.

(2) Unless US transferor does not immediately recognize all of the gain on the property transferred.

(3) Unless it involves transfers with a US transferor that is related to the foreign trust.

(4) See Notice 97-34.

c) Transfers to foreign trusts that are recognized Code §501(c)(3) organizations.

d) Transfers to Canadian registered retirement savings plans or income funds under certain circumstances.

e) Distributions taxable as compensation for services rendered it reported as compensation income.

f) Transfers from foreign trusts to domestic trusts that are recognized Code §501(c)(3) organizations.

g) Domestic trusts that become foreign trusts to the extent the trust is treated as owned by one person after application of Code §672(f).

3. When?

a) On due date of income tax return (with extensions).

b) For US decedents, on due date of estate tax return (or the date such return would have been required if a return is not actually do).

4. Penalties?

a) Statute of limitations for assessment of any tax imposed with respect to any event or period to which the information required to be reported relates will not expire before the date that is three years after the date on which the required information is reported. Code §6501(c)(8).

b) For failure to report a transfer, penalty of 35% of the value of the property transferred.

c) For failure to report a distribution, penalty of 35% of the value of the distribution.

d) For failure of the US owner under the grantor trust rules to report trust activities and income, 5% of the value of the property deemed owned.

e) Additional penalties for continuing failures after IRS notice. See Code §6677.

f) However, no penalties will be imposed if the taxpayer can demonstrate reasonable cause and not willful neglect.

(1) The fact that a foreign country would impose penalties for disclosing the required information is not reasonable cause.

5. Misc.

a) A separate Form 3520 must be filed for transactions with EACH foreign trust.

b) Joint returns may be allowed if the filers file joint income tax returns.

c) The returns must be consistent with any Form 3520-A filed by the foreign trust unless the inconsistency is reported on a Form 8082.

6. Traps!

a) Foreign grandfather has a rrevocable grantor trust in the Bahamas. The trust makes a distribution to U.S. grandson.xx

(1) Reporting required - grantor trust status is irrelevant.

b) Foreign grandfather sets up a foreign trust for his grandchildren, some of whom are U.S. He gives credit cards to all the grandchildren, the bills of which are paid by the trust, even though they are not beneficiaries.xx

(1) Indirect/constructive transfer to U.S. person - reporting required.

c) Foreign grandfather sets up a foreign trust, which owns a house in Bermuda. The Bermuda house is used by the U.S. grandchildren on their college breaks. xx

(1) Rent-free use of trust property by a U.S. person triggers reporting.

d) U.S. grantor of a revocable foreign trust dies. The assets are included in his estate for estate tax purposes.

(1) Reporting required.

B. Forms 3520-A.

1. Annual return filed by a foreign trust with a U.S. owner under the grantor trust rules.

a) Each U.S. person that owns a part of the trust under the grantor trust rules is responsible for assuring compliance with filing requirements.

2. Purpose is to provide information to the U.S. owner so it can satisfy its annual reporting requirements.

3. Exception for Canadian registered retirement savings plans and Canadian registered retirement income funds.

4. Due by the 15th day of the third month after the end of the trust's tax year.

a) Unless an extension is granted. See Form 7004.

5. Penalties.

a) The US owner is subject to a penalty equal to 5% of the gross value of the portion of the trust's assets treated as owned by the US person. Code §6677(b).

b) Exception for reasonable cause and not willful neglect.

(1) The fact that a foreign country would impose penalties for disclosing the required information is not reasonable cause.

6. Allows for appointment of U.S. agent to respond to IRS requests to examine records or produce testimony or IRS summonses.

a) Alternatively, the trustee can attach all written and oral agreements and understandings relating to the trust, the trust instrument, and gives IRS right to determines how much of the trust assets must be taken into account by the U.S. owner.xx/xx?

7. Requires income statement and balance sheet along with statement providing income attributable to the U.S. owner.xx

8. Includes preparation and distribution of Foreign Grantor Trust Owner Statement, which is delivered to each U.S. person owner.

a) Deliver by the 15th day of the third month after the end of the trust's tax year.

9. Includes preparation and distribution of Foreign Grantor Trust Beneficiary Statement which is distributed to each U.S. beneficiary who receives a distribution from the foreign trust during the tax year.

a) But not for any portion of the trust for which that U.S. person is treated as the owner under the grantor trust rules.

b) Deliver by the 15th day of the third month after the end of the trust's tax year.

C. Beneficiary Reporting to Properly Report, or Avoid Accumulation Distributions - Foreign Grantor Trust Beneficiary Statements and Foreign Nongrantor Trust Beneficiary Statements and Form 4970.

1. Under Code §6048(c)(2), any distribution of income or principal from a foreign trust to a U.S. beneficiary is treated as an accumulation distribution includible in the gross income of the recipient unless adequate records are provided to determine the proper treatment of the distribution. Thus, absent a proper submission from a beneficiary, a distribution from a foreign trust will be taxable to the beneficiary under Code §§665–668, together with the interest charge under Code §668. See Notice 97-34.

2. A U.S. beneficiary who receives a complete Foreign Grantor Trust Beneficiary Statement with respect to a distribution should treat the distribution as a nontaxable gift from the owner of the trust. Such a Statement is prepared with the Form 3520-A.

3. A U.S. beneficiary who receives a complete Foreign Nongrantor Trust Beneficiary Statement that provides adequate information to determine the U.S. tax consequences of the distribution from the foreign trust may determine the tax consequences of the distribution on the basis of the actual status of the income as DNI or undistributed net income (UNI), without regard to the default rule. A U.S. beneficiary may not, however, rely on a beneficiary statement that he or she knows or has reason to know to be incorrect.

a) This Statement is not part of any return and must be prepared independently. It is attached to the beneficiary's Form 3520 filing. See the Line 30 instructions to Form 3520 for what must be contained in the Statement.

b) See Code §6048(c) and IRS Notice 97-34. The foreign trust is supposed to prepare this statement. No penalties are imposed on the foreign trust for failure to provide it, but the U.S. beneficiary may be subject to penalties if he or she does not obtain it.

c) The Statement will also assist U.S. beneficiaries in determining the amount of any available foreign tax credits.

4. A U.S. beneficiary who receives an accumulation distribution from a nongrantor foreign trust should file Form 4970, as an attachment to the Form 3520 to compute the tax and interest charge.

D. Form TD F 90-22.1

1. Filings relating to foreign trusts.

a) A U.S. beneficiary of a foreign trust with a a beneficial interest in more than 50% of the assets or income of a trust that owns foreign financial accounts must file an annual Form TD F 90-22.1 Report of Foreign Bank and Financial Accounts.

(1) Thus, the presence of multiple beneficiaries (2 or more) with equal interests presumably will avoid meeting the more than 50% threshold.

b) A U.S. grantor of a foreign trust with foreign accounts if there is a trust protector must also file.xx

c) Proposed 31 CFR §103.24(e)(2)(iii) would provide that a U.S. person who is the settlor of a trust and has an ownership interest in a trust account for U.S. income tax purposes under Code §§671 - 679 has a financial interest in the account for purposes of these rules.

2. A financial account includes any bank, securities, derivatives, mutual fund, or other financial instruments account.

3. The account must exceed $10,000.

4. Due by June 30 of the following year.

5. Watch for additional, similar filings under HIRE Act foreign reporting rules.

6. Watch for need to also report accounts held by any entities controlled by the foreign trust.

E. Form 56.

1. A trustee should notify the IRS of the commencement of a trusteeship by filing a Form 56. Code §6903.

2. There are no penalties for nonfiling. However, if not filed, the IRS will send correspondence to the last known address of the trust and the trustee may be bound by notices not actually received by it.

a) As a practical matter, these are not always filed.

F. Form 1040NR.

1. If a foreign trust has income taxable by the U.S. it is obligated to file the return.

2. Due by the 15th day of the fourth money after the end of the trust's taxable year, or the sixth month if the trust has no office in the U.S.

G. HIRE Act Disclosures.

1. The HIRE Act requires reporting of interests in foreign trusts and accounts, separate from and independent of the FBAR filing. At this time, no forms or guidance on such reporting have been issued. See Code §6038B.

a) Note that the HIRE Act provisions do not have the "more than 50%" in value threshold for filing, so foreign trust interests may be reportable here even if not reportable under the FBAR form.

2. The HIRE Act also authorizes the IRS to impose on the U.S. grantor of a grantor trust such information reporting as it may prescribe.

a) Prior to the HIRE Act, such a grantor was (and remains) responsible for the trust providing such information as the IRS prescribes. The new rule allows for additional reporting requirements to be directly imposed on the U.S. grantor.

H. CFC and PFIC Reporting, if applicable

Lunch Presentation: A Reader's Digest Version of the Patient Protection Act of 2010

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President

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A "READERS DIGEST" VERSION OF

THE PATIENT PROTECTION ACT OF 2010

PURPOSE:

TO DISCUSS THE MAJOR POINTS OF BOTH HEALTH AND TAX CHANGES FOUND IN A 974 PAGES OF LEGISLATION WITHIN ONE HOUR

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- A LONG GESTATION PERIOD WITH A VERY LONG HISTORY
- ITEMS IMPLEMENTED IN 2010

  -DEPENDENT COVERAGE

  -LIFETIME BENEFITS

  -OTHER MEIDCAL ITEMS

  -ADOPTION CREDIT
- ITEMS IMPLEMENTED IN 2011

  -EXCISE TAXES ON THE MEDICAL INDUSTRY

  -FORM W-2 CHANGES

  -CREDITS TO SMALL BUSINESSES

  -LONG TERM HEALTH CARE

  -HSA CHANGES
- ITEMS IMPLEMENTED IN 2012

  -FORM 1099 REPORTING
- LUCKY 2013

  -ITEMIZED MEDICAL EXPENSES

  -MEDICARE PAYROLL TAX

  -MEDICARE TAX ON NET INVESTMENT INCOME
- 2014-2020 IMPLENTATION ITEMS

  -STATE HEALTH INSURANCE EXCHANGES

  -EMPLOYER MANDATE

  -UNINSURED CITIZENS

  -UNINSURED BENEFIT COVERAGE

  -CADILLAC PLANS

Miscellaneous Employment Tax Issues

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John has more than 38 years experience in handling tax disputes ranging from criminal tax cases, criminal and Grand Jury investigations to litigation in Tax Court, administrative appeals in the IRS Appeals Division, audits, collection issues, offers in compromise, innocent spouse issues, proceedings against return preparers and other matters before the Internal Revenue Service. He has also represented taxpayers before the Department of Revenue and in State courts relating to sales tax audits and civil and criminal proceedings in the State courts relating to sales tax. He also has extensive experience in commercial and real estate litigation.

Employment Tax Issues

To alert the Practitioner to current issues in employment taxes and how to address them

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I. The Why? - Revenue

- 60% of all Federal revenue comes from employment taxes
- It is estimated that there is an $86 billion gap in the amount of employment taxes that should be collected.
- As a result, the IRS has a very strong interest in seeing to it that individuals are properly classified as employees.
- Further, under the new health care law, in order to make it successful, the government needs as many people to be employees as possible.

II. The When – The National Research Project

- The IRS has instituted a new National Research Program (NRP) focused on employment Tax Issues.
- The NRP is going to audit 6,000 taxpayers over 3 years. Among the 6,000 audited, 500 will be non-proift employers, 330 will be governmental entities, and 36 will be universities.
- IRS will be looking hard at worker classification. Even if §530 relief would be available upfront, they will continue worker classification in these NRP audits in order to determine the size of the problem.

II. The When – The National Research Project (cont.)

- Other issues that the NRP will be looking at are under reporting and late deposit trends.
- There are other implications from these audits;

a) Social Security and Medicare taxes,

b) Department of Labor and related State employment authorities.

c) Written policies for employee benefits, non-qualified deferred compensation, expense reimbursement policies, and procedures.

III. The How – Part One - Reclassification

- "Worker Classification is the bread and butter of employment tax enforcement", Jeannine Cook, Internal Revenue Service, Office of Chief Counsel.
- If a worker files a Form SS-8, the IRS will contact you and provide you a Form SS-8 along with a letter asking your client to answer a number of questions and to provide a number of documents:

1) Written agreements with the worker,

2) all 1099's filed for the worker, and

3) other written documents pertinent to the issue.

III. The How – Part One - Reclassification(cont.)

- Other consequences resulting from re-determination by the IRS include:
- a) Whether the individual or individuals involved were entitled to employee insurance coverage
- b)Whether or not the individuals involved were entitled to retirement benefits and , therefore, is your retirement plan in danger of being disqualified.
- c) Other more common employee benefits, such as vacation time and sick leave.

III. The How – Part One - Reclassification(cont.)

- The primary issue in determining whether a worker is an employee is whether the employer has the authority to control how the worker does their work.
- The IRS has historically used twenty questions to try to determine whether or not the worker was, in fact, an employee. Revenue Ruling 87-41, 1987-1 C.B.296
- More recently, the IRS has developed so called primary categories of evidence. These include:
- a) Behavioral control – Those facts which show whether there is a right to direct or control how the worker does the work
- b) Financial control – Those facts which demonstrate whether there is a right to direct or control the business aspect of work.
- c) Relationship of the Parties – Those facts that demonstrate how the business and the workers, themselves, perceive their relationship.

Section 530 Relief (A)

- Section 530 provides an employer with potential relief for its allegedly erroneous past treatment of workers.
- Requirements for §530 Relief:
- a)The taxpayer had a reasonable basis for not treating the individual as an employee.
- b) The taxpayer filed all Federal tax returns (such as 1099's) required with respect to that individual which reflect that the individual was treated as a non-employee.

Section 530 Relief (B)

- In determining reasonable basis for not treating the individual as an employee there are three safe harbor positions:
- a) Judicial precedent, published rulings, or technical advice.
- b) A past IRS audit did not question the employment tax treatment.
- c) Reliance on a long standing recognized practice of a significant segment of the industry.
- d) The taxpayer may also rely on the advice of an accountant or an attorney familiar with the facts of his business.

Section 530 Relief (C)

- How will this affect preparers going forward?
- 1) Be prepared to reflect legitimate differences between employees and independent contractors.
- 2) Encourage employers not to alienate the workers as they probably will be interviewed.
- 3) Gather and review those documents which the IRS agent will be examining to determine proper classification.

Section 530 Relief (C)(cont.)

- How will this affect preparers going forward?
- 4) Review workers payments. Pay attention to the frequencey of payments.
- 5) Review Forms 1099 to see if they were properly prepared and issued.
- 6) Consider the possibility of a voluntary disclosure.

III. The How – Part Two – Trust Fund Penalty § 6672

(A) The Rule

- 1) IRC §6672 provides that any person required to collect, truthfully account for, and pay over any employment taxes who willfully fails to collect or willfully attempts to evade or defeat any such tax, shall be liable for a penalty equal to the total amount of the tax evaded, or not collected.
- The employee receives credit for the withheld amounts and , therefore, the government may not receive payments unless it can collect under the provisions of the statute. Slodov v. United States, 436 U.S. 238, 243 (1978).
- It can also be applied where there was no withholding because of employer misclassification of workers as independent contractors. See In re: Smith, 99-1 USTC Para. 50,278, (Bank. D. Haw. 1999)

B. General Rules of Liability – Trust Fund Penalty (cont.)

- More than one person may be assessed the penalty. Turner v. United States, 423 F. 488 (9th Cir. 1970)
- All persons assessed the penalty are jointly and severally liable; that is , they are each liable for the full amount. Brown v. United States, 591 F. 2d 1136 (5th Cir. 1979)
- A right of contribution exists among those persons deemed liable for the penalty. IRC § 6672(d)
- A trust fund penalty assessment is not dischargeable in bankruptcy. 11 U.S.C. §507(a)(8)(C).

C. Responsible Person – Trust Fund Penalty

- Under §6672, there are two major issues:
  - A) Responsible Person, and
  - B) Willfulness
- A responsible person can be virtually anyone who controls the decisions making process as to which creditors are paid.
- Usually, the cases focus on the functional issue of whether the individual exercised control. However, sometimes the naked legal power to act is sufficient.

C. Responsible Person – Trust Fund Penalty (cont.)

- A frightening aspect is that an individual may be responsible if he merely had the authority to exercise control over financial affairs regardless of whether he, in fact, exercised that control. In re: Marino, 311 B.R. 111 (M.D. Florida 2004); Schlicht v. United States, No. CIV-05-1606 (D. Az. 2005); Hartman v. U.S., 532 F. 2d 1336 (8th Cir. 1976).
- Liability can not be escaped by showing that the collecting and paying of the taxes has been delegated. This is commonly referred to as the Nuremberg defense. See Roth v. United States, 779 F. 2d 1567(11th Cir. 1986); Howard v. United States, 711 F. 2d 729 734-735 (5th Cir. 1983)
- Factors that have been considered include: a) corporate by-laws setting forth duties of officers and directors, b) ownership interests in the business, c) status as an officer or director, d) signature authority over bank account, e) actual day to day management of a business, f) hiring and firing employees, g) authority to sign and file the payroll tax return, and h) unexercised authority.

D. Willfulness – Trust Fund Penalty (cont.)

- The best definition of willfulness is in United States v. Macagnone, 86 AFTR 2d Para. 5307 (M.D. Fla. 2000): willfulness means merely that the responsible person had knowledge of the tax delinquency and knowingly failed to rectify it when there were available funds to pay the government.
- This requires knowledge that the taxes are due and have not been paid. Thosteson v. United States, 304 F. 3d 1312 (11th Cir. 2002)
- One who acts with reckless disregard and has actual knowledge of previous delinquencies, so as to establish a known or obvious risk that the taxes are not currently being paid, can be deemed liable. Malloy v. United States, 17 F. 3d 329 (11th Cir. 1994); Rife v. United States, 809 F. 2d 425, 427 (7th Cir. 1987); In re: Frye, 91 B.R. 69, 70 (Bankr. E.D. Ms. 1988).

Potential Defenses as to Willfulness

- Establish that your actions were simply negligent and not knowing or intentional.
- Establish that there were no funds or no unencumbered funds available to pay the taxes
- Misclassification of workers – if you can establish that you honestly believed that they were properly classified, could establish a lack of willfulness.

Representing the Client

- The agent will try to interview the taxpayer in person. If at all possible, try to avoid being interviewed
- Form 4180, "Report of Interview with Individual Relative to Trust Fund Recovery Penalty" is the agent's weapon.
- It is critical that you obtain a copy of this form, review it in detail, and consult with a tax professional concerning your response.

Representing the Client (cont.)

- If payments are to be made by the business, try to designate them to be applied against the trust fund portion.
- Always protest the proposed assessment.
- Try to establish that someone else is the responsible person.
- Try to establish that you do not have the ability to pay tax. The IRS will not assert the penalty against an individual who has no ability to pay. Internal Revenue Manual 5.7.5.1.
- Remember that you have a right to contribution from the other responsible parties under §6672.

IV. The How – Part Three – Criminal Offenses Relating to Payroll Taxes

- Section 7202, Failure to account for and pay over the tax, consists of 4 elements:
- a) A duty to collect, account for, or pay over a tax.
- b) A failure to truthfully account for the tax.
- c) A failure to pay over the tax.
- d) Willfulness
- Section 7215 prohibits a violation of 7512(b)
- 7215 is a misdemeanor
- Willfulness is not an element of Section 7215. It is a strict liability issue.

IV. The How – Part Three – Criminal Offenses Relating to Payroll Taxes (cont.)

- Section 7204 prohibits furnishing a fraudulent statement or failing to furnish a withholding statement to an employee.
- The elements are:
- a) A legal duty under Section 6051 to furnish a statement
- b) Furnishing a false or fraudulent statement
- c) Willfulness

IV. The How – Part Three – Criminal Offenses Relating to Payroll Taxes (cont.)

- The elements under failing to furnish a statement are:
- a) Legal duty under Section 6051 or regulations thereunder to furnish a statement in a manner, at a certain time, and showing certain information.
- b) Failure to furnish such a statement, and
- c) Willfulness

- Other Potential Criminal Offenses, include Section 7207, providing a false document; Section 7212, corruptly interfering with the administration of the tax laws. Both are felonies.

State & Local Tax Issues

Mark R. Arrigo, CPA, MBA

Current Issues Affecting S Corporations, Partnerships and LLCs

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CURRENT ISSUES AFFECTING S CORPORATIONS, PARTNERSHIPS AND LLCs

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CURRENT ISSUES AFFECTING S CORPORATIONS, PARTNERSHIPS AND LLCs

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I. RECENT FEDERAL INCOME TAX DEVELOPMENTS APPLICABLE TO INDIVIDUALS AND ENTITIES

A. CURRENT TAX RATES FOR 2010 AND 2011

Set forth below are some tax rates (for corporations, individuals, capital gain and dividends) for 2010 and 2011 assuming no legislative changes are made.

1. Individual Income Tax Rates (2010)

Tax Bracket	Single	Married Filing Jointly
10% Bracket	$0 - $8,375	$0 - $16,750
15% Bracket	$8,375 - $34,000	$16,750 - $68,000
25% Bracket	$34,000 -$82,400	$68,000 -$137,300
28% Bracket	$82,400 - $171,850	$137,300 - $209,250
33% Bracket	$171,850 - $373,650	$209,250 - $373,650
35% Bracket	$373,650+	$373,650+

2. Estimated Individual Income Tax Rates - 2011

Tax Bracket	Single	Married Filing Jointly
15% Bracket	$0 - $34,850	$0 - $58,200
28% Bracket	$34,850 -$84,350	$58,200 -$140,600
31% Bracket	$84,350 - $176,000	$140,600 - $214,250
36% Bracket	$176,000 - $382,650	$214,250 - $382,650
39.6% Bracket	over $382,650	over $382,650

The rates in 1. and 2. above also apply to ordinary income that flows through an S corporation, LLC or partnership to its shareholders, members or partners.

3. **<u>Corporate Income Tax Rates (C Corporations - 2010 and 2011 (No Changes)</u>**

Tax Bracket	**Amounts**
15% Bracket	$0 - $50,000
25% Bracket	$50,000 - $75,000
34% Bracket	$75,000 -$100,000
39% Bracket*	$100,000 - $335,000
34% Bracket	$335,000 - $10,000,000
35% Bracket	$10,000,000 - $15,000,000
38% Bracket**	$15,000,000 - $18,333,333
35% Bracket	over $18,333,333

*The 39% tax bracket applies until the benefit of the 15% bracket and 25% bracket have been "given back" and the average rate is 34%.

**The 38% tax bracket applies until the benefit of the 34% tax bracket has been "given back" and the average tax rate is 35%.

4. **<u>Tax Rate on Long-Term Capital Gain (Non-Corporate Taxpayers)</u>**

2010	**2011**
15% maximum rate	20% maximum rate

These rates also apply to net long-term capital gain that flows through an S corporation, LLC or partnership to its shareholders, members or partners.

5. **<u>Tax Rate on Dividends (Non-Corporate Taxpayers)</u>**

2010	**2011**
15% maximum rate	39.6% maximum rate

6. **<u>Maximum Marginal Federal Tax Rate on a C Corporation's Income or Gain that is Distributed as a Dividend to the Shareholders as *Ordinary Income*</u>**

2010	**2011**
44.75%	60.74%

B. CODIFICATION OF ECONOMIC SUBSTANCE DOCTRINE

1. **Health Care and Education Reconciliation Act of 2010**. Section 7701(o) as added by the Health Care and Education Reconciliation Act of 2010 (the "Health Care Act"), codified the economic substance doctrine and imposed certain penalties in connection with the economic substance doctrine under Sections 6662, 6662A, 6664 and 6676. Section 7701(o) as added by the Health Care Act, provides that a transaction will be treated as having economic substance only if, under a two-prong ***conjunctive*** test, the transaction changes the taxpayer's economic position in a meaningful non-tax way ***and*** the taxpayer has a substantial non-tax purpose for entering into the transaction. The Health Care Act also added Section 6662(b)(6), which applies the accuracy-related penalty to underpayments resulting from the disallowance of a claimed tax benefit because a transaction lacked economic substance, and added Section 6662(i), which increases the accuracy-related penalty for some parts of the underpayment. The Health Care Act also amended Section 6664 on the reasonable cause exception for underpayments and Section 6676 on excessive amounts.

2. **Notice 2010-62**. On September 13, 2010, the IRS issued Notice 2010-62, 2010-40 IRB 1, which provides interim guidance on the codification of the economic substance doctrine and the related amendments made to the various penalty sections.

   a. Accordance to the guidance, the IRS will continue to rely on relevant case law under the common-law economic substance doctrine in applying the two-prong conjunctive test. The IRS will challenge taxpayers relying on prior case law under the common-law economic substance doctrine for the proposition that a transaction will be treated as having economic substance merely because it satisfies either prong under Section 7701(o)(1)(A) or (B) or the common-law corollary.

   b. The interim guidance provides that the IRS will continue to analyze when the economic substance doctrine will apply in the same fashion as it did prior to the enactment of Section 7701(o). If authorities prior to the enactment of Section 7701(o) provided that the economic substance doctrine was not relevant to whether certain tax benefits are allowable, the IRS will continue to take the position that the economic substance doctrine is not relevant to whether those tax benefits are allowable. Additionally, the IRS does not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.

   c. The interim guidance provides that in determining whether the two-prong conjunctive test is met, the IRS will take into account the taxpayer's profit motive only if the present value of the

reasonably expected pre-tax profit is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected for federal income tax purposes.

d. The interim guidance provides that unless the transaction is a reportable transaction, the adequate disclosure requirements of Section 6662(i) will be satisfied if the taxpayer adequately discloses on a timely filed original return (determined with regard to extensions) or a qualified amended return the relevant facts affecting the tax treatment of the transaction. The disclosure will be considered adequate only if it is made on a Form 8275 or 8275-R, or as otherwise prescribed in forms, publications or other guidance subsequently published by the IRS. Disclosures made consistent with the terms of Rev. Proc. 94-69 also will be taken into account for purposes of Section 6662(i). If a transaction lacking economic substance is a reportable transaction, the adequate disclosure requirement under Section 6662(i)(2) will be satisfied once the taxpayer meets the disclosure requirements discussed above ***and*** the disclosure requirements under the Section 6011 regulations.

C. RESCISSIONS

1. Rescission of Incorporation of Partnership. In Ltr. Rul. 200952036, the IRS held that the conversion of a state law limited partnership into a corporation could be rescinded as proposed by the taxpayer (Partnership), and that Partnership would be treated as a partnership for federal tax purposes for the entire tax year that includes the rescission. The ruling assumes that all relevant persons reported on a calendar tax year for federal income tax purposes and that all of the transactions occurred during a single calendar year.

Partnership engages in three lines of business and intended to raise new capital by converting to corporate status and offering shares to the public. On Date 1, a corporation was formed when the state-law limited partnership converted to a state law corporation under a Plan of Conversion pursuant to state law. In the Plan of Conversion, partners holding Class A partnership interests received Class A common stock and partners holding Class B partnership interests received Class B or Class C common stock. In the next month, the corporation made a distribution of partnership profits and a tax distribution with respect to the previous tax year. The corporation also granted three employees options to acquire nonvoting Class D common stock of the corporation. The options were unvested and were later canceled in anticipation of the proposed rescission of corporate status.

Because of an inability to raise capital, the following was proposed. The corporation would file a certificate of conversion with the state and convert to a limited liability company (LLC) under state law. All shareholders would receive LLC interests having rights, preferences, and restrictions that are substantially similar in all material respects to the corresponding interests in corporation and, prior to that, to the original corresponding interests in the state law limited partnership. The LLC would not make an election to be treated as a corporation for federal tax purposes, and the corporation would convert directly to an LLC because status as an LLC would provide certain nontax advantages over status as a state law partnership.

Partnership represented that since the time of the conversion to a corporation, no actions were taken that were inconsistent with actions that would have been taken had the entity remained a partnership for federal tax purposes, except that the corporation had not distributed each partner's share of allocated net income that would have been distributed by the partnership. In addition, Partnership represented that it would make retroactive distributions to its equity holders in accordance with an operating agreement that would be substantially similar in all material respects to that which governed the relations in the prior state-law limited partnership. Partnership also represented that the proposed rescission was intended to restore the legal and financial arrangements between the equity holders that would have existed had it not converted from a state-law limited partnership to a state-law corporation, and that there was no material difference in the ultimate economic outcome and tax consequences between a two-step conversion from a corporation to a limited partnership to an LLC and the one-step conversion from a partnership to an LLC.

The IRS concluded that the LLC would be treated as a partnership for federal income tax purposes for the entire tax year during which conversion/rescission occurred and that no liquidation of the corporation occurred for federal tax purposes.

2. **PLR Approves Rescission of Corporate Restructuring that had Unintended Tax Consequences**. In Ltr.Rul. 201008033, the IRS allowed a consolidated group of taxpayers to rescind a transaction that resulted in unintended tax consequences to the Group.

In Ltr. Rul. 201008033, P is a privately held domestic corporation that is the common parent of an affiliated group of corporations that files a Federal income tax return on a calendar-year basis.

P owns all of the stock of Acquiring, a domestic corporation, and Acquiring owns all of the stock of Sub, a Country X entity, required to be treated as a corporation under the "per se" corporate classification rules of

Reg. §301.7701-2(b)(8)(i). Sub is a controlled foreign corporation under Section 957(a).

Acquiring owned all of the stock of Target, a domestic corporation. Acquiring formed Target to hold an X% interest in Target Sub, a Country Y entity treated as a corporation for Federal income tax purposes. The remaining interest in Target Sub was owned by persons unrelated to Acquiring. Target had loaned funds to Target Sub, designated as the Year 1 Note, which funds were loaned to Target by Acquiring (the "Target Note"). In Year 2, Target made an additional loan to Target Sub (the "Year 2 Note"), which amount had in turn been loaned to Target by Acquiring. Other than its interest in Target Sub and the Target Sub Notes, Target had no material assets.

For valid business reasons, P caused the following transactions to occur during Year 2:

(1) On Date 1, Target and the unrelated owners of Target Sub contributed to Target Sub all of their Target Sub debt in exchange for Target Sub stock, except for the Year 2 Note which was retained by Target.

(2) On Date 2, Acquiring contributed the Target Notes to the capital of Target, in contemplation of a transfer of the Target Sub ownership to Sub.

(3) Pursuant to a share purchase agreement effective on Date 3, Acquiring sold all of the stock of Target to Sub for cash.

The sale was designated to provide Sub with benefits that would result from owning an interest in Target Sub. While originally the transaction was supposed to involve a sale by Target of the Target Sub stock directly to Sub, that plan had been discarded because of concerns that such a sale would violate P's third party debt covenants.

After the Acquiring sale to Sub was completed, P's tax advisors informed P that the sale would result in unintended adverse Federal tax consequences to the Group, namely, that the sale was a transaction to which Section 304(a)(1) would apply.

(1) To avoid the unintended tax consequences, on Date 4, Acquiring and Sub entered into a Rescission Agreement. Under this agreement, the parties agreed that the share purchase agreement was null and void from its inception and agreed to treat the rescission as a rescission of the share purchase agreement and not as an acquisition of Target stock by Sub followed by a re-acquisition of Target stock by Acquiring.

(2) On Date 5, the rescission was completed and Acquiring repaid the purchase cash to Sub.

(3) Following the rescission, additional steps were undertaken to provide the Sub with business benefits that the sale was designed to produce.

(4) On Date 6, Target converted under state law to a limited liability company.

(5) Pursuant to an agreement entered into on Date 7, Acquiring sold its interest in Target LLC (and thus its interest in the Target Sub and the Year 2 Note) to Sub for cash.

(6) The conversion of Target was intended to qualify as a reorganization under Section 368(a).

Ltr. Rul. 201008033 holds that the sale of Target to Sub will be disregarded, that the shares of Target stock held by Acquiring on Date 3 are treated as held by Acquiring through the period prior to the rescission, and that Target remained a wholly-owned subsidiary of Acquiring and a member of the Group at all times during Year 2 until consummation of the conversion on Date 7.

During the interim period, the sale had no legal or internal economic consequences to any of P, Acquiring, Sub or any other controlled entity.

The rescission placed P, Acquiring and Sub in the status quo ante immediately before the sale.

If the rescission is effective to disregard the sale, P and its subsidiaries will file their Federal income tax and information returns for Year 2 as if Acquiring had not sold the stock of Target to Sub.

Ltr. Rul. 201008033 thus continues a favorable trend recognizing rescission of transactions to avoid material unintended consequences of the transaction. See, e.g., Ltr. Ruls. 200923010 and 200911004.

3. **Observation**. Ltr. Rul. 200952036 and Ltr. Rul. 201008033 demonstrate the IRS's willingness to grant favorable rulings reversing transactions that resulted in unintended, undesirable tax consequences. The tax practitioner should be mindful of the rescission doctrine in dealing with a transaction that a taxpayer desires to unwind. At least one commentator thinks that the IRS has become too liberal in its IRS rescissions ruling practice. See Sheppard, "News Analysis: Oh, Never Mind, IRS Rescissions Ruling Practice," 128 Tax Notes 915 (August 30, 2010). For an excellent discussion of the rescission doctrine see the report of the New York State Bar Association Tax Section, 2010 TNT 156-10 (August 11, 2010).

D. CANCELLATION OF INDEBTEDNESS

1. **COD Deferral**. The American Recovery and Reinvestment Act of 2009 allows certain taxpayers that reacquire certain debt instruments in 2009 and 2010 to elect to include the resulting discharge of indebtedness (or cancellation of debt -- COD) income ratably over a five-tax year period that begins in 2014.

   For purposes of the rule, a debt instrument means a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness (within the meaning of Section 1275(a)(1)). An eligible debt instrument is one issued by (i) a C corporation, or (ii) any other person "in connection with the conduct of a trade or business by such person." An eligible reacquisition includes:

   (1) An acquisition of the debt instrument for cash.

   (2) The exchange of the debt instrument for another debt instrument (including an exchange resulting from a modification of the debt instrument).

   (3) The exchange of the debt instrument for corporate stock or a partnership interest.

   (4) The contribution of the debt instrument to capital.

   It also includes the complete forgiveness of the indebtedness by the holder of the debt instrument.

   An eligible debt instrument may be reacquired either by the debtor which issued (or is otherwise obligated under) the debt instrument or by a related party to such debtor. Related party status is determined in the same manner as under Section 108(e)(4).

   The election to defer COD income is made on the tax return for the tax year in which the COD event occurs. An S corporation makes the election at the entity level. An electing taxpayer is precluded from using otherwise available exclusions from COD income (such as those for bankrupt or insolvent taxpayers or, for taxpayers other than C corporations, with regard to qualified real property business indebtedness).

   If an entity that made the election were to liquidate, sell substantially all of its assets, or otherwise cease business, the COD income is recognized at that time. Similar acceleration would occur if an S corporation shareholder transferred an interest in an S corporation that had elected deferral.

2. **IRS Issues Favorable Guidance on COD Income Deferral Election**. The IRS recently issued Rev. Proc. 2009-37, 2009-36 IRB 309, which

provides guidance on the Section 108(i) election to defer the recognition of cancellation of debt (COD) income. Section 108(i) allows taxpayers to file an election to defer COD income realized in connection with certain reacquisitions of debt instruments. To be eligible for the election, the reacquisition must take place after 12/31/08 and before 1/1/11, and the debt instrument must be an applicable debt instrument. An applicable debt instrument is any debt instrument issued by a C corporation or any other person in connection with the conduct of that person's trade or business. Section 108(i)(5)(B)(iii) requires pass-through entities to make the election on the entity level.

Rev. Proc. 2009-37 makes the Section 108(i) election very flexible. Of particular importance to partnerships, it allows taxpayers to elect to defer "any portion" of COD income realized from the reacquisition of an applicable debt instrument. Taxpayers may even elect to defer a particular portion of the COD income realized from the reacquisition of one applicable debt instrument and elect to defer a different portion of the COD income realized from the reacquisition of another applicable debt instrument. Furthermore, if a partnership has elected to defer less than all of the COD income realized from a reacquisition, it may determine, in any manner, how much COD income each partner will defer or include in income. In effect, the partnership can tailor the Section 108(i) election to each partner. To the extent the COD income is included in a partner's gross income, the partner may use any applicable provisions under Section 108(a) to exclude the income.

If a taxpayer concludes that a particular transaction does not result in the realization of COD income, it may report the transaction on its tax return consistent with that conclusion but with a protective Section 108(i) election in the event that its conclusion is incorrect. If, however, the IRS subsequently determines that the transaction has resulted in COD income, the protective election automatically becomes a valid, irrevocable Section 108(i) election and the IRS may require the taxpayer to report deferred COD income in later years, even if the statute of limitations has expired for the year in which the COD income was realized.

The protective election is made in much the same way as the general, non-protective Section 108(i) election. Taxpayers may also make protective elections as to additional amounts of COD income in the event the IRS concludes that a reacquisition results in more COD income than reported by the taxpayer. Further, taxpayers may specify the extent to which they would like to defer additional amounts of COD income in their election statements.

Although Section 108(i) requires taxpayers to make the election with their timely filed (including extensions) federal income tax return for the tax year in which the reacquisition occurs, the IRS has granted an automatic

12-month extension. Thus, a taxpayer must make the Section 108(i) election within 12 months of timely filing its return.

Taxpayers make the Section 108(i) election by including a statement with their federal income tax return. The statement generally should include a description of the debt instruments and reacquisition transactions involved, the total COD income, and the COD income the taxpayer is electing to defer. Taxpayers who make the election must also attach an information statement to their tax return every year until they recognize all of the deferred COD income. The information statement will generally show what amounts are being included for the relevant year and what amounts continue to be deferred.

The Procedure contains special instructions for partnerships and S corporations. In both the election year and the subsequent years in which the entities must provide information statements, these pass-through entities are instructed to provide information about the Section 108(i) elections on an aggregate basis for each partner or shareholder on the Schedule K-1. They must also provide statements with the Schedules K-1 to each partner or shareholder with information about the partner or shareholder's share of various items affected by the Section 108(i) election. The partners or shareholders are to keep those statements for their records. The Procedure also contains special instructions for tiered pass-through entities and non-filing foreign partnerships.

Taxpayers who made the Section 108(i) election before 9/16/09 should make sure their elections comply with the requirements of the Procedure. If the elections do not comply, they will not be effective unless the taxpayer files an amended return on or before 11/16/2009 that does comply with the requirements. Taxpayers who make the Section 108(i) election before 9/16/2009 may also modify their election by filing an amended return on or before 11/16/2009. For example, a partnership that has already elected to defer all of its COD income may wish to modify its election to defer only a portion of its COD income.

3. **IRS Issues Temporary Regulations on Deferred Discharge of Indebtedness Income of Partnerships and S Corporations**. In TD 9498 (August 13, 2010), the IRS issued temporary regulations under Section 108(i), providing rules on the deferral of COD income and original issue discount deductions by a partnership or an S corporation for reacquisitions of applicable debt instruments in 2009 or 2010. The temporary regulations are effective 8/13/2010.

   a. Reg. §1.108(i)-2T(d)(1) provides five safe harbors under which a debt instrument issued by a partnership or an S corporation is deemed to be issued in connection with the partnership's or S corporation's trade or business for purposes of Section 108(i). While a debt instrument generally does not qualify as an applicable

debt instrument unless the issuing taxpayer conducts a trade or business, one of the safe harbors under Reg. §1.108(i)-2T(d)(1) provides that if an electing partnership or an electing S corporation can establish that at least 95% of the interest paid or accrued on a debt instrument issued by the partnership or S corporation was allocated to a trade or business expenditure under Reg. §1.163-8T for the taxable year of issuance, then the debt instrument qualifies as an applicable debt instrument for purposes of Section 108(i). The temporary regulations also provide that for purposes of determining whether a debt instrument qualifies as an applicable debt instrument under Section 108(i), a debt instrument issued by a disregarded entity is treated as a debt instrument issued by the person treated as owning the assets of the disregarded entity for federal income tax purposes.

b. As provided in Rev. Proc. 2009-37, the temporary regulations confirm that a partnership may determine the portion of each partner's allocable share of the COD income from the applicable debt instrument that is the deferred amount, and the portion that is the included amount and therefore included in the partner's distributive share of partnership income for the taxable year of the partnership in which the reacquisition occurs.

With respect to S corporations, Temp. Reg. §1.108(i)-2T(c)(1) requires that the deferred COD income of an electing S corporation be shared pro rata, on the basis of stock ownership, among those shareholders that hold stock in the electing S corporation immediately prior to the transaction giving rise to the COD income.

c. Under the temporary regulations, a partner's basis in the partnership and an S corporation shareholder's stock basis are ***not*** adjusted to account for their share of deferred items at the time of reacquisition but only when such deferred items are recognized. Specifically, Temp Reg. §1.108(i)-2T(b)(2) provides that a partner's basis in its partnership interest is not adjusted under Section 705(a) to account for the partner's share of the partnership's deferred items at the time of the reacquisition, but is adjusted when the deferred items are recognized, either during the recognition period or as a result of an acceleration event.

Like the basis adjustment rules for partners, an S corporation shareholder's stock basis is not adjusted under Section 1367 to account for the shareholder's share of the S corporation's deferred items at the time of reacquisition, but is adjusted when the deferred items are recognized. Additionally, an S corporation's accumulated adjustments account is not adjusted to account for the

deferred items at the time of the reacquisition, but is adjusted in the tax year in which the deferred items. are recognized.

d. Section 2.09 of Rev. Proc. 2009-37 provides general guidelines for a partnership to use in determining the partners' deferred Section 752 amount (i.e., a decrease in a partner's share of partnership liability under Section 752(b) resulting from the reacquisition of an applicable debt instrument that is not treated as a current distribution of money to the partner under Section 752 by reason of Section 108(i)(6)). The temporary regulations include the same general rules that are set forth in Rev. Proc. 2009-37 and provide additional computational rules for determining the partners' deferred Section 752 amount.

e. Temp. Reg. §1.108(i)-2T(b)(2)(ii) provides that a partner's capital account is adjusted under Reg. §1.704-1(b)(2)(iv) for the partner's share of the partnership's deferred items as if no election under Section 108(i) were made. This reflects the IRS's belief that for capital account maintenance purposes, a partnership should treat deferred items as if no election under Section 108(i) has been made.

f. Temp. Reg. §1.108(i)-2T(d)(3) provides that a decrease in a partner's or S corporation shareholder's amount at risk in an activity that results from a discharge of a debt for which a Section 108(i) election is made is ***not*** taken into account in determining a partner's or shareholder's amount at risk in that activity under Section 465 in the tax year of the reacquisition. Rather, the decrease is taken into account at the same time and to the same extent as the partner or shareholder recognizes the deferred COD income.

g. Under Section 108(i)(2), if a debt instrument is issued in a debt-for-debt exchange described in Section 108(i)(2)(A) or a deemed debt-for-debt exchange described in Temp. Reg. §1.108(i)-3T(a) and there is any OID on the debt instrument, the issuer of the new debt instrument must defer some or all of the deductions for such OID under Section 108(i). The temporary regulations provide that the aggregate amount of the deferred OID is allowable as a deduction to the issuer of the debt instrument ratably over the inclusion period, or earlier upon the occurrence of an acceleration event.

h. The temporary regulations provide that the deferred items allocated to the direct and indirect partners of the electing partnership, which includes a shareholder of an S corporation that is a direct/indirect partner of an electing partnership (S corporation partner), and to the shareholder of an electing S corporation are accelerated if the

electing partnership or the electing S corporation (i) liquidates, (ii) sells, exchanges, transfers (including contributions and distributions), or gifts substantially all of its assets, (iii) ceases doing business, or (iv) files a petition in a Title 11 or similar case. Additionally, the deferred items of the shareholders of an electing S corporation or an S corporation partner are accelerated in a tax year in which the S corporation's or S corporation partner's election under Section 1362(a) is terminated. The temporary regulations specify that substantially all of the partnership's or S corporation's assets means assets representing at least 90% of the fair market value of the partnership's or S corporation's net assets and at least 70% of the fair market value of the partnership's or S corporation's gross assets, as measured immediately prior to the sale, exchange, transfer or gift in question.

In addition to the electing partnership level or electing S corporation-level events that trigger acceleration under Section 108(i), certain events occurring at the partner or shareholder level also trigger acceleration of that partner's or shareholder's share of the electing partnership's or electing S corporation's deferred items. for example, the deferred items allocated to a direct or indirect partner of an electing partnership are accelerated if: (i) the partner dies or liquidates, (ii) the partner sells, exchanges (including redemptions treated as exchanges under Section 302), transfers (including contributions and distributions), or gifts (including transfers treated as gifts under Section 1041) all or a portion of the separate interest, (iii) the partner's separate interest is redeemed, or (iv) the partner abandons its separate interest. Likewise, a shareholder's share of an electing S corporation's deferred items is accelerated if the shareholder: (i) dies, (ii) sells, exchanges (including redemptions treated as exchanges under Section 302), transfers (including contributions and distributions), or gifts (including transfers treated as gifts under Section 1041) all or a portion of its interest in the electing S corporation, (iii) abandons its interest in the electing S corporation.

Transactions wholly governed by Section 721 in which a partner's or shareholder's share of the partnership's or S corporation's deferred items can continue to be allocated to that partner or shareholder are generally not acceleration events for purposes of Section 108(i). Such Section 721 non-acceleration events include contributions by an electing partnership or an electing S corporation, contributions of an entire separate interest by direct or indirect partners of an electing partnership, and Section 708(b)(2)(A) mergers or consolidations of an electing partnership or a partnership that is a direct or indirect partner of an electing partnership.

In addition to the Section 721 non-acceleration events, like-kind exchanges of property by an electing partnership or an electing S corporation pursuant to Section 1031(a) are generally not acceleration events.

Moreover, a technical termination of an electing partnership or a partnership that is a direct or indirect partner of an electing partnership under Section 708(b)(1)(B) is not an acceleration event for purposes of Section 108(i).

In addition to the Section 721, Section 1031 and Section 708(b)(1)(B) non-acceleration events, certain distributions of separate interests by a partnership (upper-tier partnership) that is a direct or indirect partner of an electing partnership are not acceleration events for purposes of Section 108(i).

E. PASSIVE ACTIVITY LOSS RULES

1. **IRS Announces Requirement to Disclose Section 469 Groupings**. Rev. Proc. 2010-13, 2010-4 IRB 329, effective for tax years beginning on or after 1/25/10, requires taxpayers to report their groupings and regroupings of activities and the addition of certain activities to existing groupings for purposes of the passive activity loss rules of Section 469. A passive activity is:

- trade or business activity in which the taxpayer does not materially participate.
- Any rental activity (unless the taxpayer is in a real property trade or business as defined in Section 469(c)(7)).

Section 469 provides that neither a passive activity loss nor a passive activity credit will be allowed to an individual, estate, trust, closely held C corporation, or personal service corporation (each a Covered Taxpayer). Under the rules of Section 469 generally, losses from a Section 469 activity directly offset income from the same activity in a tax year. If there is a net passive loss from the activity, it is aggregated with all net passive losses from all passive activities of the Covered Taxpayer and may be used to offset net passive income, if any, generated by other passive activities of the Covered Taxpayer in that year. Any remaining net passive loss must then be suspended and allocated among the Covered Taxpayer's passive activities for the tax year.

Under Section 469(b), the suspended losses are treated as incurred in the applicable activity in the next tax year. Section 469 suspended losses from an activity may be fully used when the Covered Taxpayer disposes of the entire activity to an unrelated person in a fully taxable transaction (a Section 469(g) Disposition). While Section 469 does not apply directly to

partnerships and S corporations, these entities are subject to certain grouping and reporting rules of Section 469 because they are often owned by Covered Taxpayers.

Reg. §1.469-4 provides that a Covered Taxpayer's trade or business activities may be grouped as a single Section 469 activity if the activities are an appropriate economic unit. Grouping is important for purposes of determining if a Covered Taxpayer materially participates in the activity (so that the activity is not passive), and for determining whether a Section 469(g) Disposition has occurred.

The IRS, in Notice 2008-64, 31 IRB 268, proposed a disclosure regime for taxpayer groupings under Section 469 and requested comments on the proposed regime. In light of the comments received, Rev. Proc. 2010-13 implements a disclosure regime that is somewhat different from that proposed in the Notice. For example, in contrast to the Notice proposals, the Procedure does not require Covered Taxpayers to make a disclosure each time there is a disposition of an activity within a grouping. Additionally, the Procedure contains a relief provision in the case of failure to make the required disclosures.

Rev. Proc. 2010-13 applies to all taxpayers to which the rules in Reg. §1.469-4 apply. As a result, it applies both to Covered Taxpayers and to partnerships and S corporations. It does not, however, apply to rental real estate activities in a year in which the taxpayer qualifies under Section 469(c)(7) (i.e., the taxpayer is in a real property trade or business). The Procedure requires written disclosure in an annual income tax return, including the name, addresses, and employer identification number (EIN) (Identifying Information), if applicable, for each activity as follows:

Covered Taxpayers must file a written statement with the original tax return for the first tax year in which two or more trade or business activities or rental activities are originally grouped as a single activity that includes the Identifying Information for each grouped activity. In addition, the statement must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of Section 469 (the Declaration).

If a Covered Taxpayer adds a new trade or business activity or a rental activity to an existing grouping for a tax year, the taxpayer must file a written statement for that tax year that includes Indentifying Information for the additional activity or activities, and for the existing grouping, and the Declaration.

If the Covered Taxpayer determines that the original grouping was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original grouping clearly inappropriate, the Covered Taxpayer must regroup the activities and file a written statement

with the original income tax return for the tax year in which the regrouping is made. The written statement must include the Indentifying Information for the activities that are regrouped, the Declaration, and an explanation of why the original grouping was determined to be clearly inappropriate or the nature of the material change in the facts and circumstances that makes the original grouping clearly inappropriate.

Partnerships and S corporations must group activities under the rules of Reg. §1.469-4 and must comply with the disclosure instructions provided on Form 1065, U.S. Return of Partnership Income, and Form 1120S, U.S. Income Tax Return for an S Corporation. As described in the Procedure, these forms generally require disclosing the entity's groupings to the partners or shareholders, as applicable, by separately stating the amounts of income and loss for each grouping conducted by the entity on attachments to the annual Schedules K-1. The partner or shareholder is not required to make a separate disclosure of the groupings disclosed by the entity unless the partner or shareholder:

(1) Groups together any of the activities that the entity does not group together.

(2) Groups the entity's activities with other activities of the partner or shareholder.

(3) Groups the entity's activities with activities conducted by other Section 469 entities (a C corporation that is subject to Section 469, a partnership, or an S corporation).

(4) Groupings that exist prior to the effective date of the revenue procedures need not be disclosed unless the taxpayer makes a change to the grouping as described in (2) or (3) above.

If the taxpayer fails to disclose a grouping that is required to be disclosed under the Procedure, then each trade or business activity will be treated as a separate activity for purposes of Section 469, unless the IRS regroups a taxpayer's activities to prevent tax avoidance under Reg. §1.469-4(f). If, however, a taxpayer has filed all affected income tax returns consistent with the claimed grouping of activities and makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered, the taxpayer will be considered to have made a timely disclosure of activity groupings under the Procedure. If the failure to disclose is first discovered by the IRS, however, the taxpayer must also have reasonable cause for not making the required disclosures. Finally, no relief is available for untimely disclosures under Reg. §301.9100 because the Procedure provides relief for untimely disclosures.

II. S CORPORATIONS

A. INTRODUCTION

1. Although LLCs have gained increasing popularity over the last decade, the number of entities taxed as S corporations still exceeds the number of entities taxed as partnerships for federal tax purposes, and it is projected to stay that way for the foreseeable future, as set forth in the table below published by the IRS (Document 6292, Office of Research, Analysis and Statistics, Fiscal Year Return Projections for the United States: 2010-2017, Rev. 6/2010):

Statistics Regarding Choice of Entity

	2009	**2010 (Projected)**	**2014 (Projected)**	**2017 (Projected)**
Form 1065	3,564,630	3,719,500	4,439,800	4,856,300
Form 1120S	4,495,685	4,472,200	5,068,200	5,553,800
Form 1120	2,148,339	2,042,100	1,968,300	1,941,100

2. Many professional and other personal service corporations have remained C corporations based on the assumption that they can successfully avoid the double tax on earnings to which C corporations are generally subject by utilizing the strategy of zeroing out their taxable income by payment of all or substantially all of their earnings as deductible compensation to their shareholder-employees. It has been widely accepted in the past by practitioners and taxpayers that the IRS cannot successfully assert unreasonable compensation arguments against a personal service corporation to recharacterize a portion of the compensation paid to its shareholder-employees as dividend distributions. However, in light of the Tax Court's decision in *Pediatric Surgical Associates, P.C. v. Commissioner*, TCM 2001-81, tax practitioners must recognize that the IRS can make a successful argument to recharacterize the wages paid to the shareholders-employees of a personal service corporation as dividends subject to double taxation.

3. Additionally, in order to avoid double taxation on the sale of a professional or other service corporation's assets to a third party, tax practitioners have often sought to avoid the double tax imposed upon C corporation's selling their assets by allocation of a large portion of the purchase price to the "personal goodwill" of the shareholders of the professional corporation. Although this strategy has worked under certain circumstances, very recent cases have suggested that the IRS can and will

recharacterize so-called personal goodwill as corporate goodwill subject to double taxation (or at the least to ordinary income tax rates rather than capital gain tax rates) on the sale of the assets of a professional corporation.

B. UNREASONABLE COMPENSATION

1. **Seventh Circuit Reverses Tax Court's Recharacterization of Unreasonable Compensation as Dividend**. In *Menard, Inc. v. Comm'r*, 560 F.3d 620 (7th Cir. 2009), the Seventh Circuit reversed the holding of the Tax Court and found that the compensation paid by a corporation to its chief executive officer constituted reasonable compensation rather than a non-deductible dividend distribution to him.

   Menard, Inc. is a Wisconsin firm that under the name "Menard's" sells hardware, building supplies and related products through retail stores scattered throughout the Midwest. In 1998, it was the third largest home improvement chain in the United States, with only Home Depot and Lowe's being larger. It was founded by John Menard in 1962, who through 1998 was the company's chief executive officer and uncontradicted evidence shows him as working 12 to 16 hours a day six or seven days a week and only taking seven days of vacation per year. Under his management, Menard's revenues grew from $788,000,000 in 1991 to $3,400,000,000 in 1998 and the company's taxable income grew from $59,000,000 to $315,000,000 during the same time period. The company's rate of return on shareholders' equity in 1998 was, according to the IRS's expert, 18.8%, which was higher than the rate of return on shareholders' equity for either Home Depot or Lowe's.

   Mr. Menard owned all of the voting shares in the company and 56% of the non-voting shares, with the rest of the shares being owned by members of his family. In 1998, his salary was $157,500, and he received a profit-sharing bonus of $3,017,100 as well as a "5% bonus" that resulted in Mr. Menard receiving an additional $17,467,800.

   The 5% bonus program (5% of the company's net income before income taxes) was adopted in 1973 by the company's Board of Directors at the suggestion of the company's accounting firm. There was no suggestion that any shareholder was disappointed that the company obtained a rate of return of only 18.8% or that the company's success in that year or any other year had been due to windfall factors. In addition to finding that Mr. Menard's compensation was excessive (primarily based on the compensation paid to the chief executive officers of Home Depot and Lowe's), the Tax Court found that such amounts were actually ***intended as a dividend***. The Tax Court reached this conclusion because Mr. Menard's entitlement to his 5% bonus was conditioned on his agreeing to reimburse the corporation if the deduction of the bonus from the corporation's taxable income was disallowed by the IRS and because 5% of the

corporate earnings year-in and year-out looked more like a dividend than a salary to the Tax Court. As will be discussed in more detail below, the Seventh Circuit found that the Tax Court's holding was based on "flimsy grounds."

The relevant authority in this area is Section 162(a)(1), which allows a deduction for ordinary and necessary expenses paid or incurred during a taxable year in carrying on a trade or business, including a "reasonable allowance" for salaries or other compensation for personal services actually rendered.

Reg. §1.162-7(a) provides that the test of deductibility in the case of compensation payments is whether such payments are reasonable ***and*** are, in fact, payments purely for services. Consequently, there is a two-prong test for the deductibility of compensation payments: (1) whether the amount of the payment is ***reasonable*** in relation to the services performed, and (2) whether the payment was, in fact, ***intended*** to be compensation for services rendered.

Reg. §1.162-7(b)(1) additionally provides that any amount paid in the form of compensation, but not in fact as the purchase price of services, will ***not*** be deductible. The regulation continues as follows: "An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock."

Reg. §1.162-7(b)(2) provides that the form or method of fixing compensation will not be decisive as to deductibility. The regulation continues that although any form of contingent compensation invites scrutiny as a possible distribution of earnings of the corporation, it does not necessarily follow that payments on a contingent basis will be treated fundamentally on any basis different than that applying to compensation at a flat rate.

Reg. §1.162-7(b)(3) provides that "the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."

Reg. §1.162-8 provides that in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to

stockholders, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend.

Reg. §1.162-9 provides that bonuses to employees will constitute allowable deductions from gross income if such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to salaries, do not exceed a reasonable compensation for the services rendered.

As discussed above, the regulations set forth a two-prong test for the deductibility of compensation payments: (1) whether the amount of payment is reasonable in relation to the services performed, and (2) whether the payment was, in fact, intended to be compensation for services rendered. Although a majority of the cases focus on the reasonableness of the compensation paid, and do not focus separately on the intent of the payment, several cases have discussed the intent requirement.

In determining whether the payment was intended to be compensation for services rendered, the courts have relied heavily on the initial characterization of the payment by the corporation and have focused on such objective criteria as whether the board of directors authorized the payment of the compensation in question, whether employment taxes were withheld from the payment, whether a Form W-2 was issued with regard to the payment in question, and whether the payment was deducted on the accounting records or tax records of the corporation as salary.

The leading case in this area is *Paula Construction Co. v. Comm'r*, 58 TC 1055 (1972), *aff'd per curiam*, 474 F.2d 1345, 73-1 USTC ¶9283 (5th Cir. 1973). In *Paula Construction*, the shareholder-employees believed that the corporation's Subchapter S status was in effect (it had been inadvertently and retroactively terminated for the years in issue), and as such, did not reflect the corporation's distributions as compensation in the corporate records or its tax returns as it believed such distributions would be nontaxable distributions from the S corporation to its shareholders. In holding that the corporation was not entitled to a compensation deduction for the amounts paid, the Tax Court stated that "it is now settled law that only if payment is made with the intent to compensate is it deductible as compensation. ... Whether such intent has been demonstrated as a factual question is to be decided on the basis of the particular facts and circumstances of the case." See also *Electric & Neon v. Comm'r*, 56 TC 1324 (1971), *aff'd per curiam*, 496 F.2d 876, 74-2 USTC ¶9542 (5th Cir. 1974), and *International Capital Holding Corp. v. Comm'r*, TCM 2002-109, in which the Tax Court found that payments made to a management company were intended to compensate the recipient for services rendered. Since the IRS conceded the reasonableness of the amount paid, the payments were found to be deductible. But see *Neonatology Associates*

P.A., et al. v. Comm'r, 2002 USTC ¶50,550 (3rd Cir. 2002), *aff'g* TCM 2001-270, where the Third Circuit affirmed the Tax Court in three cases on VEBA deductions by medical corporations, holding that the corporations could not deduct payments made to the VEBAs since the VEBAs were not designed to provide benefits to employees, but were instead intended to benefit the sponsoring owners of the VEBAs, and treating the payments as constructive dividends. These cases make it clear that it is absolutely necessary to properly document payments made by a corporation to its shareholder-employees as compensation (rather than as dividend distributions) in order for the payments to be deductible. *See also* IRS Field Service Advice, 1994 W.L. 1725566 (addressing compensatory intent in the context of a law firm); IRS Field Service Advice, 1995 W.L. 1918240; IRS Field Service Advice 200042001; GCM 36801 (1976); and *Nor-Cal Adjusters v. Comm'r,* 74-2 USTC ¶9701 (9th Cir. 1974).

Reasonableness of Compensation and the Multi-Factor Test. The leading case in the unreasonable compensation area is *Mayson Manufacturing Co. v. Comm'r*, 178 F.2d 115, 49-2 USTC ¶9467 (6th Cir. 1949), which sets forth nine factors to be used in evaluating the reasonableness of the amount of an employee's compensation. These factors have generally been used in one form or another in almost all subsequent cases analyzing the reasonableness of compensation.

The nine factors set forth in the *Mayson* case are as follows:

(1) the employee's qualifications,

(2) the nature, extent, and scope of the employee's work,

(3) the size and complexities of the business,

(4) a comparison of the salaries paid with the gross income and the net income of the business,

(5) the prevailing general economic conditions,

(6) a comparison of salaries with distributions to stockholders,

(7) the prevailing rates of compensation for comparable positions and comparable businesses,

(8) the salary policy of the taxpayer for all employees,

(9) the compensation paid to the particular employee in prior years where the business is a closely-held corporation.

Another significant case utilizing the multi-factor test is *Elliotts Inc. v. Comm'r*, 716 F.2d 1241, 83-2 USTC ¶9610 (9th Cir. 1983), *rev'g* TCM

1980-282. *Elliotts* involved a corporation that sold and serviced equipment manufactured by John Deere Company and other manufacturers. The taxpayer's sole shareholder, Edward G. Elliotts, was found to have total managerial responsibility for the taxpayer's business and was the ultimate decision and policy maker and, in addition, performed the functions usually delegated to sales and credit managers. He worked approximately 80 hours each week.

The taxpayer had compensated Elliotts by paying a base salary plus a year-end bonus, which, since incorporation, had been fixed at 50% of net profits (before deduction for taxes and management bonuses). On audit of the 1975 and 1976 tax years, the IRS determined that a portion of the compensation paid to Elliotts was unreasonable in amount.

After reviewing the testimony and statistical evidence presented by the parties, the Tax Court concluded that the payments to Elliotts, in addition to providing compensation for personal services, were intended in part to distribute profits and were, therefore, nondeductible dividends.

The taxpayer appealed the Tax Court's determination to the Court of Appeals for the Ninth Circuit. The Ninth Circuit's opinion is important for three main reasons. First, the Ninth Circuit recognized that in analyzing the two-prong test for deductibility under Section 162(a)(1), a taxpayer's proof that the amount paid is reasonable will often result in similar proof that the purpose for which the payments are made is compensatory.

The second reason *Elliotts* is important is that the court rejected any requirement that a profitable corporation should use part of its earnings to pay dividends. First, the court stated that no statute requires profitable corporations to pay dividends. Second, any such requirement is based on the faulty premise that shareholders of a profitable corporation will demand dividends. Third, it may well be in the best interest of the corporation to retain and invest its earnings.

Although the first two issues outlined above are important, *Elliotts* is probably more important for categorizing the nine *Mayson* factors discussed above into the following five categories:

(1) The employee's role in the company, including as relevant to such consideration the position held, hours worked and duties performed by the employee, in addition to the general importance of the employee to the success of the company.

(2) An external comparison of the employee's salary with those paid by similar companies for similar services. Thus, if a shareholder is performing the work of three employees,

for example, the relevant comparison would be the combined salaries of those three employees in a similar corporation.

(3) The character and condition of the company as indicated by its sales, net income, and capital value, together with the complexities of the business, as well as general economic conditions.

(4) Whether some relationship exists between the corporation and its shareholder-employee which might permit the company to disguise nondeductible corporate distributions of income as salary expenditures deductible under Section 162(a)(1). This category employs the independent investor standard, which provides that if the company's return on equity remains at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company as disguised salary.

(5) A reasonable, long-standing, consistently applied compensation plan is evidence that the compensation paid for the years in question is reasonable.

In addition to the factors established by the courts, the IRS has developed its own factors set forth in the Internal Revenue Manual, I.R.M. 4233, Part IV, Examination, at Section 4.3.1.5.2.5.2.2. *See also* Martin and Harris, "Unreasonable Compensation: *Pediatric Surgical* Poses a Major New Threat for PCs," 97 J. Tax'n 41 (July 2002). The favorable factors (indicative of a finding of reasonable compensation) listed in prior versions of the Internal Revenue Manual include the following:

(1) long hours,

(2) uniqueness of the employee's contribution,

(3) success in turning the company around,

(4) the company's above-average growth or profitability,

(5) experience level of the employee,

(6) high productivity and effectiveness of the employee,

(7) bonus arrangements entered into prior to becoming a stockholder,

(8) whether the employee was offered a higher salary by outsiders,

(9) inability of the employee to control compensation levels or dividends,

(10) salary compared favorably with that of employees of other companies,

(11) employee was undercompensated in previous years, and

(12) high return on equity.

Unfavorable factors (indicative of a finding of unreasonable compensation) listed in prior versions of the Internal Revenue Manual) include the following:

(1) compensation rate exceeded that of comparable companies,

(2) lack of dividend payments,

(3) inappropriate compensation formulas,

(4) lack of unique employee skills,

(5) employee spent little time on the job or worked less than in previous years,

(6) the board of directors was not independent,

(7) salary increased without increase in duties, and

(8) bonus formulas changed because of high profits.

Regs. §1.162-7(b)(1) and §1.162-8 provide that it is likely that a compensation payment is in fact a dividend distribution where excessive payments correspond or bear a close relationship to the recipient's stock holdings in the company. The "automatic dividend" rule set forth in *Charles McCandless Tile Service v. United States*, 422 F.2d 1336, 70-1 USTC ¶9284 (Ct. Cl. 1970), was rejected by the *Elliotts* case discussed above as well as by the IRS in Rev. Rul. 79-8. 1979-1 CB 92. Although there is no automatic dividend rule, the dividend history of the corporation and whether the compensation (bonuses) is paid in proportion to the stock ownership of the shareholder-employees are important factors in the multi-factor test. The fact that compensation payments are not made in proportion to the shareholder-employee's stock ownership does not, however, preclude a finding that the compensation payment actually constituted a dividend. *See Kennedy v. Comm'r*, 671 F.2d 167, 82-1 USTC ¶9186 (6th Cir. 1982), *rev'g and remanding*, 72 TC 793 (1979).

Reasonableness of Compensation: The Independent Investor Test. In the *Elliotts* case, the five factors used by the court in determining the

reasonableness of compensation paid by the corporation to its shareholder-employees employed an independent investor standard. That standard provides that if the corporation's return on equity remains at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company as disguised salary. This is referred to as the "independent investor test."

In *Dexsil Corp. v. Comm'r*, 147 F.3d 96, 98-1 USTC ¶50,471 (2nd Cir. 1998), the Second Circuit vacated and remanded a decision of the Tax Court finding unreasonable employee compensation in the context of a closely held corporation. In reaching its decision, the court quoted its opinion in *Rapco Inc. v. Comm'r*, 85 F.3d 950, 96-1 USTC ¶50,297 (2nd Cir. 1996), in stating that "in this circuit the independent investor test is not a separate autonomous factor; rather, it provides a lens through which the entire analysis should be viewed," 147 F.3d at 101. The court thus articulated the notion that the independent investor test is more than a mere factor in determining the reasonableness of compensation and provides the very basis for assessing reasonableness.

Other circuits have adopted the independent investor test as set forth by the Second Circuit in *Dexsil*. In *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 99-2 USTC ¶50,964 (7th Cir. 1999), the Seventh Circuit (the circuit deciding the *Menard* case) held that the salary paid to a shareholder-employee was reasonable based on the fact that an independent investor would achieve a high rate of return even with the shareholder's salary. In following the *Dexsil* court's reasoning, Chief Judge Posner stated that "[b]ecause judges tend to downplay the element of judicial creativity in adapting law to fresh insights and changed circumstances, the cases we have just cited [*Dexsil* and *Rapco*] prefer to say ... that the 'independent investor' test is the 'lens' through which they view the seven ... factors of the orthodox test. But that is a formality. *The new test dissolves the old and returns the inquiry to basics*."

In reviewing the Tax Court decision, the Seventh Circuit pointed out that a corporation is ***not*** required to pay dividends. The main focus of the Tax Court decision was whether Mr. Menard's compensation exceeded that of comparable CEOs in 1998. Specifically, the CEO of Home Depot was paid only $2,800,000 in 1998, and the CEO of Lowe's was paid a salary of $6,100,000 in 1998 (both of which were considerably less than the total compensation paid to Mr. Menard in 1998 of over $20,000,000).

The Seventh Circuit found that salary is just the beginning of a meaningful comparison, because it is only one element of a compensation package. Specifically, the Seventh Circuit pointed out that a risky compensation structure implies that the executive's salary is likely to vary substantially from year to year, and that Mr. Menard's compensation could have been considerably less than $20,000,000 if the corporation did not have a good

year, a possibility the Tax Court completely ignored. Additionally, the Seventh Circuit found that the Tax Court did not consider the severance packages, retirement plans or other perks of the CEOs when it compared Menard with the CEOs of Home Depot and Lowe's. The Seventh Circuit also found that the Tax Court's opinion strangely remarked that because Mr. Menard owned the company he had all the incentive he needed to work hard without the need for a generous salary. The Seventh Circuit pointed out that under the Tax Court's reasoning, reasonable compensation for Mr. Menard might have been zero. In short, the Seventh Circuit found that for compensation purposes, the shareholder-employee should be treated like all other employees and that if an incentive bonus is appropriate for a non-shareholder employee, there is no reason why a shareholder-employee should not be allowed to participate in the same manner. Based on these considerations and the fact that an independent investor would be satisfied with an 18.8% rate of return, the Seventh Circuit concluded that Mr. Menard's compensation was ***not*** excessive in 1998, and that the Tax Court committed clear error in finding that Mr. Menard's compensation was unreasonable.

2. **Tax Court Applies Independent Investor Test**. In *Multi-Pak Corp. v. Comm'r*, TCM 2010-139, the Tax Court held that the compensation paid by the taxpayer's wholly owned corporation for one of the years in issue (2002) was reasonable, but recharacterized a portion of the compensation paid to the taxpayer in the other year in issue (2003) as a non-deductible dividend distribution because the amount of compensation paid to the taxpayer in that year was unreasonable.

The taxpayer, Multi-Pak Corp., was a C corporation wholly owned by Randall Unthank, who was the president, CEO and COO for the years in issue. Mr. Unthank performed all of Multi-Pak's managerial duties and made all personnel decisions, and was in charge of Multi-Pak's price negotiations, product design, machine design and functionality, and administration. Mr. Unthank also personally oversaw the expansion of Multi-Pak's office and warehouse in order to accommodate Multi-Pak's growing operations.

In 2002, Multi-Pak paid total compensation of $2,020,000 to Mr. Unthank, consisting of a salary of $150,000 and a $1,870,000 bonus. In the other year at issue, 2003, Multi-Pak paid a total compensation of $2,058,000 to Mr. Unthank, consisting of a salary of $353,000 and a $1,705,000 bonus. The IRS determined in a Notice of Deficiency that Multi-Pak could deduct only $665,000 and $660,000 of officer compensation for 2002 and 2003, respectively, as reasonable compensation for Mr. Unthank's services during those years. Additionally, the IRS imposed Section 6662(a) accuracy-related penalties on Multi-Pak for the years in issue.

In reaching its decision, the court in *Multi-Pak* discussed and analyzed the five categories previously set forth in the *Elliotts* case:

a. ***The employee's role in the company, including as relevant to such consideration the position held, hours worked and duties performed by the employee, in addition to the general importance of the employee to the success of the company.*** In Multi-Pak, the Tax Court found that this factor favored the taxpayer based upon Mr. Unthank's importance to Multi-Pak.

b. ***An external comparison of the employee's salary with those paid by similar companies for similar services. Thus, if a shareholder is performing the work of three employees, for example, the relevant comparison would be the combined salaries of those three employees in a similar corporation***. After an extensive analysis of the expert testimony presented by the taxpayer and the IRS, the Tax Court in Multi-Pak found that the analysis performed and the opinions expressed by both parties' experts were not persuasive or reliable, and as such, found that the comparison to the compensation paid by unrelated firms was a neutral factor which did not favor either party.

c. ***The character and condition of the company as indicated by its sales, net income, and capital value, together with the complexities of the business, as well as general economic conditions***. The Tax Court found that although Multi-Pak's net income in 2002 and 2003 was low when compared to revenues, other factors such as equity, revenue, and gross profit pointed towards a successful operation, and as such, found that this factor favored the taxpayer.

d. ***Whether some relationship exists between the corporation and its shareholder-employee which might permit the company to disguise nondeductible corporate distributions of income as salary expenditures deductible under Section 162(a)(1)***. This category employs the independent investor standard, which provides that if the company's return on equity remains at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company as disguised salary. As will be discussed in more detail below, the Tax Court found that this factor favored the taxpayer in 2002 but favored the IRS in 2003.

e. ***A reasonable, long-standing, consistently applied compensation plan is evidence that the compensation paid for the years in question is reasonable***. The Tax Court found that in 2002 and 2003, Mr. Unthank paid himself a monthly bonus of $100,000 to $250,000 in 19 of the 24 months, in four other instances, Mr. Unthank paid himself a bonus of $50,000 or less, and in one other instance paid himself a bonus of $375,000. Additionally, Mr.

Unthank's sons each were paid monthly bonuses that ranged from -0- to $90,000. Based on all these facts, the Tax Court concluded that the taxpayer's payment of Mr. Unthank's bonuses was made under a consistent business policy, and as such, this factor favored the taxpayer.

f. In determining the rate of return which would be received by the hypothetical independent investor, the Tax Court in *Multi-Pak* divided the taxpayer's net profit (after payment of compensation and a provision for income taxes) by the year-end shareholder's equity as reflected in its financial statements. This yielded a return on equity of 2.9% for 2002 and negative 15.8% for 2003. The court concluded that although an independent investor may prefer to see a higher rate of return than the 2.9% in 2002, they believed that an independent investor would note that Mr. Unthank was the sole reason for the company's significant rise in sales in 2002 and would be satisfied with the 2.9% rate of return. However, the court agreed with the IRS that a negative 15.8% return on equity in 2003 called into question the level of Mr. Unthank's compensation for that year. The court went on to state that when compensation results in a negative return on shareholder's equity, it cannot conclude, in the absence of a mitigating circumstance, that an independent investor would be pleased. Consequently, the court felt that if Mr. Unthank's salary was reduced to $1,284,104 in 2003, which would result in a return on equity of 10% in 2003, that would be sufficient to satisfy an independent investor. The court therefore held that taxpayer was entitled to deduct the full $2,020,000 paid by it to Mr. Unthank in 2002 and was entitled to deduct $1,284,104 out of the original compensation of $2,058,000 paid to Mr. Unthank in 2003.

g. Although the Tax Court did evaluate each of the five factors set forth in the *Elliotts* case, it seemed to rely primarily on the independent investor test in reaching its conclusions as to the reasonableness of the compensation paid to Mr. Unthank in 2002 and 2003.

Additionally, the court found that the taxpayer reasonably relied upon professional advice so as to negate a Section 6662(a) accuracy-related penalty because it met each of the following tests:

(1) The advisor was a competent professional who had sufficient expertise to justify reliance;

(2) The taxpayer provided necessary and accurate information to the advisor; and

(3) The taxpayer actually relied in good faith on the advisor's judgment.

(4) Thus, the Tax Court declined to sustain the IRS's determination as to the accuracy-related penalty.

C. GOODWILL

1. **Court Recharacterizes Personal Goodwill as Corporate Goodwill in Sale of Dental Practice**. In Howard v. U.S., _____ F.Supp. 2010-2 USTC ¶50,542 (E.D. Wash. 2010), the court denied the taxpayer's motion for a summary judgment and granted the government's motion for summary judgment in finding that goodwill in connection with the sale of a dental practice was corporate goodwill rather than personal goodwill.

Under the facts of the case, the taxpayer incorporated his practice as the sole shareholder, officer and director in 1980, and also entered into an employment agreement and a covenant not to compete with the corporation. The covenant not to compete provided that for so long as the taxpayer held any stock and for a period of three years thereafter, he would not engage in any business which was competitive to that of the corporation within 50 miles of Spokane, Washington. In 2002, the taxpayer and his corporation sold the practice to another personal service corporation. In the Asset Purchase Agreement, the taxpayer was allocated $549,900 for his "personal goodwill" and $16,000 for consideration regarding a covenant not to compete with the acquiring personal service corporation. The selling corporation itself received $47,100 for its assets.

Following an audit by the IRS, the IRS recharacterized the sale of goodwill as a corporate asset and treated the amount received by the taxpayer from the sale to the acquiring personal service corporation as a dividend from the selling professional service corporation to the taxpayer. The government argued that the goodwill was corporate goodwill versus personal goodwill for three main reasons. First, the goodwill at issue was a corporate asset because the taxpayer was an employee with the corporation and had a covenant not to compete with the corporation. Second, the corporation earned the income and correspondingly earned the goodwill. Third, attributing the goodwill to the taxpayer would not comport with the economic reality of the taxpayer's relationship with his personal service corporation.

The government, citing *Furrer v. Comm'r*, 566 F.2d 1115 (9th Cir. 1977), *Martin Ice Cream v. Comm'r*, 110 TC 189 (1998), *Norwalk v. Comm'r*, TCM 1998-279, and *MacDonald v. Comm'r*, 3 TC 720 (1944), found that the goodwill was an asset of the corporation and not of the taxpayer personally because of the contractual obligation of the taxpayer under the Employment Agreement to continue to work for and not to compete against his corporation. In granting summary judgment in favor of the

government, the court found no merit in the taxpayer's argument that Washington state dissolution case law supported the proposition that professional goodwill is a community property right in dissolution cases, and as such, is of a personal nature.

2. **First Circuit Holds Taxpayer to Contractual Allocation**. In *Muskat v. Comm'r*, 103 AFTR2d 2009-666 (1st Cir. 2009), the First Circuit Court of Appeals rejected taxpayer's refund suit based on the taxpayer's claim that payments contractually delineated as payments for taxpayer's covenant not to compete and originally reported by the taxpayer as ordinary income, actually were payments for taxpayer's personal goodwill, taxable as capital gain.

Irwin Muskat (TP) was the CEO of JacPac Foods, Ltd., a family business. In 1993, an agreement was reached between JacPac and a subsidiary of Corporate Brand Foods America, Inc. (CBFA) for purchase of JacPac's assets for approximately $45,000,000 plus assumption of JacPac's liabilities. As part of the sale, TP entered into an employment agreement, a noncompetition agreement and a subscription agreement (under which he invested $2,000,000 in the purchaser). Under the noncompetition agreement, the purchaser agreed to pay TP $3,955,599 for a covenant not to compete over a 13 year period. The first installment of $1,000,000 was paid at closing with the remainder payable over the 13 years. These payments survived TP's death.

TP received the first installment in 1998 and reported the payment as ordinary income on his 1998 federal income tax return and paid self-employment taxes on the income. In 2002 however, TP filed an amended return for 1998 reclassifying the $1,000,000 payment as capital gain and seeking a refund of $203,434, which included $21,479 of self-employment tax. After the IRS denied TP's refund claim, he filed suit in the federal district court. The District Court denied TP's refund claim on the ground that he failed to present strong proof that the parties intended the payment to be a payment for TP's personal goodwill and denied TP's self-employment tax claim on the ground that it lacked jurisdiction over that claim because that claim was not part of TP's administrative refund claim.

Initially, the court reaffirmed the application of the "strong proof" rule in the First Circuit. Under this rule, when parties to a transaction have executed a written contract providing for allocation of sums to particular items and one party thereafter seeks to alter the written allocation, for tax purposes, the proponent must present "strong proof" that, at the time of execution of the contract, the contracting parties actually intended the payments to be compensation for something else.

The court found that TP did not produce strong proof that the contracting parties intended the challenged payment to be compensation for TP's personal goodwill. First, the court clarified that "strong proof" means that

a taxpayer's evidence must approach "clear and convincing" evidence required to reform a written contract on the ground of mutual mistake. The court found that the district court did not clearly err in holding that TP failed to adduce such strong proof. In this respect, the trial testimony revealed no discussion of TP's personal goodwill during the negotiations and none of the transaction documents, including early drafts of those documents, mentioned TP's personal goodwill. Further, the court found it significant that the noncompetition agreement referenced protection of JacPac's goodwill (purchased by purchaser for $16,000,000, which made it extremely unlikely that the contracting parties intended the payments under the noncompetition agreement to serve as de facto compensation for TP's personal goodwill.

The court rejected TP's argument that survivability of the noncompetition payments mandated a conclusion that the payments were for something other than refraining from competition. The court stated that other courts have classified agreements that contain survivability provisions as valid noncompetition agreements for tax purposes.

The court also rejected TP's argument that the terms of his employment and subscription agreement were so lucrative that they eliminated any realistic possibility that, at an advanced age, TP would compete with the purchaser. The court responded that proof that a written allocation does not have economic reality, does not in of itself, constitute strong proof that the parties intended some other allocation. Further, the court found that there was evidence that the noncompetition provisions were grounded in economic reality, including the fact that CBFA representatives testified that the noncompetition agreement was to prevent the possibility that TP would use his relationships with customers, suppliers and distributors to pursue competitive opportunities.

Finally, the court upheld the district court's rejection of TP's self-employment tax claim on the ground that it lacked subject matter jurisdiction over the claim. In this respect the court agreed that TP had substantially varied the legal theory and factual basis of his self-employment refund claim made to the IRS. TP's refund claim to the IRS was based on the argument that he had incorrectly characterized the claim as ordinary income and not capital gain. However, at trial, TP shifted gears and argued that sums paid in consideration of a covenant not to compete are not deemed to have been earned in the conduct of a trade or business and, thus, are not subject to self-employment tax. The court concurred with the district court that the taxpayer's refund claim filed with the IRS did not properly raise the revised self-employment tax claim and thus, was not within the subject matter jurisdiction of the court to address.

3. **Tax Court Recharacterizes Payments for Personal Goodwill as Ordinary Income**. In *Kennedy v. Comm'r*, TCM 2010-206, the Tax Court held that payments received by a shareholder of an employee

benefits consulting company which was a C corporation did not constitute payments for personal goodwill, and consequently, were taxable as ordinary income.

James Kennedy was the sole shareholder of an employee benefits consulting firm taxed as a C corporation for federal income tax purposes. Kennedy was approached by another company that proposed to acquire the assets of Mr. Kennedy's corporation. Early in the negotiations, the parties basically agreed that the purchase price should be 150% of the projected annual income to be generated from Mr. Kennedy's corporation with certain adjustments (approximately $660,000). Late in the negotiations, Mr. Kennedy's attorney consulted with a tax advisor who informed him that if the transaction was structured as an asset purchase, then the payment would be taxed twice, once at the corporate level and again at the shareholder level when distributed to Mr. Kennedy. On the other hand, if the transaction were instead structured as a purchase of the corporation's stock, there would be only one level of tax on which Mr. Kennedy would pay capital gain rates, but this would be disadvantageous to the purchaser because the purchaser would not be able to claim any deductions with respect to the purchase of the stock, and as such, would likely not agree to such an arrangement. The tax advisor alternatively suggested that Kennedy take the position that he owned the personal goodwill of the business, and that he enter into an Agreement for Assignment of Know-How and Goodwill, an Asset Purchase Agreement and a Consulting Services Agreement. Only $10,000 of the purchase price was allocated to the assets of the C corporation, with the remaining amounts being allocated 75% to the sale of Kennedy's personal goodwill and the remaining 25% being allocated to the Consulting Services Agreement.

The taxpayer argued that under *Martin Ice Cream Company v. Comm'r*, 110 TC 189 (1998), the court was compelled to conclude that Kennedy owned personal goodwill and that the payments he received from the purchaser were to purchase personal goodwill since Kennedy did not have a non-compete agreement with his corporation.

The Tax Court, despite the fact that Mr. Kennedy had no employment agreement or non-compete agreement with his corporation, held that the amounts paid were consideration for services rather than goodwill because there was no economic reality to the contractual allocation of payments to personal goodwill. Specifically, the court found that the allocation of 75% of the total consideration paid by the purchaser to personal goodwill was a "tax-motivated afterthought" that occurred late in the negotiations.

D. EMPLOYMENT TAX ISSUES

1. **The Self-Employment Tax**. The self-employment tax ("SE Tax") can be a significant burden on taxpayers as it is imposed on net earnings from

self-employment ("NESE") at the rate of 15.3% on the first $106,800 of such net earnings, and 2.9% on amounts in excess of $106,800. (Section 1402(a)). Excluded from the definition of NESE are certain capital gains, rental income, interest and dividends. Because individuals are entitled to an above the line deduction equal to one-half of the SE Tax paid under Section 164(f), the effective tax rate for the SE Tax is somewhat reduced. Among the factors to be considered in choosing the form of business entity that will be used to operate a closely-held business is the applicability of the SE tax on an owner's share of income from the business entity.

2. **<u>Health Care and Education Reconciliation Act of 2010</u>**. The recently enacted Health Care and Education Reconciliation Act of 2010, H.R. 4872, P.L. 111-152, imposes a new Medicare tax on unearned income on partners, members of LLCs taxed as partnerships and S corporation shareholders. Specifically, Section 1411(a)(1) imposes a 3.8% Medicare tax on the lesser of (a) "net investment income" or (b) the excess of modified adjusted gross income over $250,000 in the case of taxpayers filing a joint return and over $200,000 for other taxpayers. Under Section 1411(c)(A)(i), "net investment income" includes gross income from interest, dividends, annuities, royalties, and rents other than such income which is derived in the ordinary course of a trade or business. Consequently, items of interest, dividends, annuities, royalties, and rents which pass through a partnership, LLC or S corporation to its partners, members or shareholders, will retain their character as net investment income and will be subject to the new 3.8% Medicare tax.

Additionally, the term "net investment income" includes: (1) any other gross income derived from a trade or business if such trade or business is a passive activity within the meaning of Section 469, with respect to the taxpayer; and (2) any net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business that is not a passive activity under Section 469 with respect to the taxpayer.

Consequently, not only does the new health care reform legislation subject investment income, for the first time ever, to the Medicare tax (rather than imposing the Medicare tax only on income derived from labor consistent with the policies underlying the Social Security tax), now a partner, ***including a limited partner***, LLC member and an S corporation shareholder, will be subject to the new 3.8% Medicare tax on his or her distributive share of the operating income of the partnership, LLC or S corporation, as the case may be, if the activity generating such income is passive under Section 469 with respect to such partner, LLC member or S corporation shareholder. It is disturbing to see the Medicare tax extended to investment income in general, and in particular to the operating income

of S corporations, without a reasoned analysis of the effect that such a substantive change in the tax law will have on closely held businesses.

The Health Care and Education Reconciliation Act of 2010 also increased the Medicare portion of the self-employment tax by .9% (to 3.8%) on wages in excess of $250,000 in the case of taxpayers filing a joint return and more than $200,000 for other taxpayers.

The new Medicare tax provisions are effective for tax years beginning after 12/31/12.

3. **Sole Proprietorships**. Clearly, individuals earning income as sole proprietors (either as a sole proprietorship or a single member LLC which is treated as a disregarded entity under the Check-the-Box Regulations) from a trade or business are generally required to treat such ordinary income from that trade or business as NESE.

4. **Partnerships**. The SE Tax treatment of general partners is generally understood: each general partner must include as NESE his distributive share of ordinary income (other than the excluded interest, rent and dividends). Section 1402(a)(13) excludes from NESE a limited partner's distributive share of partnership income (other than distributions that are guaranteed payments or compensation for services to the extent that those payments are established to be in the nature of remuneration for those services to the partnership). Accordingly, a general partner's distributive share of income from the partnership normally ***will be*** treated as NESE, while a limited partner's distributive share of income from the partnership normally ***will not*** *be* treated as NESE. The legislative history of Section 1402 makes clear that this exception for limited partners was intended to prevent passive investors, who do not perform services, from obtaining social security coverage or coverage under qualified retirement plans. One troubling issue relates to the application of the SE Tax with respect to a limited partner who also serves as a general partner in a partnership. Section 1402's legislative history reflects an intent to apply these rules separately to limited partnership and general partnership interests, even if held by the same partner. The lack of legislative or regulatory clarity has caused the application of rules for limited partners to be difficult.

5. **LLCs Taxed as Partnerships**. While multi-member LLCs (which do not elect to be treated as associations taxable as corporations) are treated as partnerships for tax purposes under the Check-the-Box Regulations, the SE Tax issues relating to LLCs and their members are at best unclear. The question to be addressed is whether members of such LLCs (taxed as partnerships) would be treated as limited partners under Section 1402(a)(13), so that their distributive share of LLC income and loss relating to their LLC interest is exempt from SE Tax.

On its face, the language of Section 1402(a)(13) would only exclude from NESE the distributive share of income ***of a limited partner*** of a partnership. Under such a literal reading, the distributive share of income of any other type or class of partner in the partnership would be considered NESE. Rev. Rul. 58-166, 1958-1 C.B. 224, held that the taxpayer's earnings from a working interest in an oil lease was NESE despite the fact that he had limited involvement in the organization.

a. The 1994 Proposed Regulations. With the advent of LLC statutes in the early 1990's and thereafter, the IRS attempted to address the SE Tax issue with respect to members of LLCs through the promulgation of Prop. Reg. §1.1402(a)-18 (the "1994 Regulations"). Under the 1994 Regulations, a member of a member-managed LLC would have been treated as a limited partner for purposes of Section 1402(a)(13) if: (i) the member was not a manager of the LLC; (ii) the LLC could have been formed as a limited partnership (rather than as an LLC in the same jurisdiction); and (iii) the member could have qualified as a limited partner in that limited partnership under applicable law.

Accordingly, for manager-managed LLCs, whether a non-manager member's share of the LLC's income would be considered NESE turned on whether such member's interest could have been characterized as a limited partnership interest had the LLC been formed as a limited partnership. This factual determination often proved to be unworkable and depended on several factors, including the amount of the member's participation in the LLC's business operations and the provisions of the LLC Act and Limited Partnership Act of the applicable state.

b. The 1997 Proposed Regulations. The next attempt by the IRS to address the application of the SE Tax to members of an LLC were the 1997 proposed regulations. Prop. Reg. §1.1402-2(h) defines a "limited partner" for purposes of the SE Tax as an individual holding an interest in an entity classified as a federal tax partnership unless one of the following exceptions applies:

(1) The individual has personal liability for the debt of or claims against the partnership by reason of being a partner. For this purpose, an individual has personal liability if the creditor of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from such individual.

(2) The individual has authority under the law of the jurisdiction in which the partnership is formed to contract on behalf of the partnership.

(3) The individual participates in the partnership's trade or business for more than 500 hours during the partnership's tax year.

Additionally, there are three exceptions to the general rule set forth in Prop. Treas. Reg. §1.1402-2(h), as follows:

Under the first exception, an individual who holds more than one class of interest in a partnership and who is not a limited partner under the general definition, may still be treated as a limited partner with respect to a specific class of interest. This exception is satisfied if immediately after the individual acquires the class of interest: (1) persons who are limited partners under the general definition own a substantial continuing interest in the class of interest; and (2) the individual's rights and obligations with respect to that class of interest are identical to the rights and obligations of the specific class held by the partners of that class who satisfy the general definition of a limited partner. Whether the interests of the limited partners in the specific class under the general definition are substantial is determined based on all of the relevant facts and circumstances. There is a safe harbor under which 20% or greater ownership of the specific class is considered substantial. The proposed regulations define class of interest as an interest that grants the holder specific rights and obligations. A separate class exists if the holder's rights and obligations attributable to an interest are different from another holder's rights and obligations. The existence of a guaranteed payment to an individual for services rendered to the partnership is not a factor in determining the rights and obligations of a class of interest.

The second exception applies to an individual who holds only one class of interest. Under this exception, an individual who cannot meet the general definition of limited partner because he or she participates in the partnership's trade or business for more than 500 hours during the partnership's tax year is treated as a limited partner if: (1) persons who are limited partners under the general definition own a substantial continuing interest in the class of interest; and (2) an individual's rights and obligations with respect to that class of interest are identical to the rights and obligations of that specific class held by persons who satisfy the general definition of a limited partner.

The third exception applies to a service partner in a service partnership and provides that regardless of whether the individual can satisfy the general definition of a limited partner under one of the above-described exceptions, that individual may not be treated as a limited partner. A partnership is a service partnership if substantially all of its activities involve the performance of

services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting. A service partner is a partner who provides services to or on behalf of the service partnership's trade or business unless that individual's services are de minimis.

c. The Moratorium. Immediately following the issuance of the 1997 regulations, significant protests were made. As a result of this significant protest, Congress enacted Section 935 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, which prohibited the issuance or effectiveness of temporary or final regulations with respect to the definition of a limited partner under Section 1402(a)(13) prior to July 1998. Although the moratorium period has long since passed, no guidance on the definition of a limited partner for self-employment tax purposes under Section 1402(a)(13) has been issued to date

(1) Accordingly, as a result of the moratorium, there is a dearth of authority with respect to the SE Tax treatment of an LLC member's distributive share of an LLC's income. The only available guidance in existence are several private letter rulings that hold that a member is a partner and that a member's distributive share of partnership income is not excepted from NESE by Section 1402(a)(l3).[1]

(2) While the Congress and the Treasury seem to have reached a deadlock on the self-employment tax issue involving partnerships, the American Bar Association Taxation Section and the AICPA Tax Division developed a legislative proposal to treat members of LLCs that are taxed as partnerships in the same manner as partners of partnerships generally. Simply put, under this proposal, income attributable to capital would be excluded from NESE and income attributable to services would be included. The effect of the proposal is to adopt two safe harbors for determining income attributable to capital, one on an interest-base return of capital, the other on an exclusion for amounts in excess of reasonable compensation for services rendered. This legislative proposal was submitted to Congressman Bill Archer by Paul Sachs on 7/6/1999.[2]

(3) Interestingly, on 6/10/2003, Lucy Clark, a national tax issue specialist in the IRS's examination specialization program, stated that taxpayers may rely on the 1997 regulations. Specifically, she said that "if the taxpayer

[1] See Ltr. Ruls. 9432018, 9452024 and 9525058.
[2] See Tax Notes, July 19, 1999, at 469.

conforms to the latest set of proposed rules, we generally will not challenge what they do or don't do with regard to self-employment taxes."[3]

d. The *Thompson* Case. In *Thompson v. U.S.*, 87 F. Cl. 728 (2009), the United States Court of Federal Claims held that ***an LLC member could not be treated the same as a limited partner*** for purposes of meeting the material participation rules under the passive activity loss limitation rules of Section 469.

(1) The taxpayer-member formed Mountain Air Charter, LLC ("Mountain Air") under the laws of the state of Texas. The taxpayer directly owned a 99% membership interest in Mountain Air and indirectly held the remaining 1% through an S corporation. Mountain Air's Articles of Organization designate the taxpayer-member as its only manager. Because Mountain Air did not elect to be treated as a corporation for federal income tax purposes, by default it was taxed as a partnership.[4] On his 2002 and 2003 individual income tax returns, the taxpayer-member claimed Mountain Air's losses of $1,225,869 and $939,870, respectively. The IRS disallowed the losses because it believed that the taxpayer did not materially participate in the business operations of Mountain Air.

(2) Specifically, the IRS rested its conclusion on Reg. §1.469-5T, which sets forth the tests for what constitutes taxpayer material participation for purposes of applying the passive activity loss limitation rules of Section 469. The IRS found that Reg. §1.469-5T "explicitly treats interests in any entity which limits liability as limited partnership interests." Because the taxpayer enjoyed limited liability as a member of his limited liability company (Mountain Air), the IRS concluded that the taxpayer's interest was identical to a limited partnership interest. The taxpayer, on the other hand, argued that his membership interest should not be treated as a limited partnership interest for purposes of the passive activity loss limitation rules. The classification of a membership interest in an LLC as a "limited partnership interest" is important because a limited partner has fewer means by which he can demonstrate his material participation in the business. The parties specifically stipulated that if the taxpayer's membership interest is a limited partnership interest, then the taxpayer cannot demonstrate his material participation in the LLC and

[3] BNA's Daily Tax Report (Friday June 13, 2003), G-3.
[4] Reg. §301.7701-3(b)(1)(i).

Section 469 will limit his losses. Likewise, the parties also stipulated that if the taxpayer's membership interest is ***not*** a limited partnership interest, then the taxpayer can demonstrate his material participation in the LLC and Section 469 does ***not*** limit his losses.

(3) The taxpayer simply argued that his interest should not be treated as a limited partnership interest because Mountain Air was ***not*** a limited partnership. The IRS, on the other hand, argued that it was proper to treat the taxpayer's interest in Mountain Air as a limited partnership interest because the taxpayer elected to have Mountain Air taxed as a partnership for federal income tax purposes and the taxpayer's liability was limited under the laws of the state in which it was organized (Texas).

(4) Based on the plain language of both the statute and the regulations, the court concluded that in order for an interest to be classified as a limited partnership interest the ownership interest must be in an entity that is, in fact, a partnership under state law and not merely taxed as such under the Code. Specifically, the court stated that once Reg. §1.469-5T(e)(3) is read in context and with due regard to its text, structure, and purpose, it becomes abundantly clear that it is simply inapplicable to a membership interest in an LLC.

(5) Furthermore, the court found that even if Reg. §1.469-5T(e)(3) could apply to the taxpayer and the court had to categorize his membership interest as either a limited or general partnership interest, it would best be categorized as a general partner's interest under Reg. §1.469-5T(e)(3)(ii) since a member in an LLC can actively participate in the management of the LLC (unlike limited partners of a limited partnership).

e. IRS Action on Decision. In Action on Decision 2010-14, IRB 515 (April 5, 2010), the IRS announced its acquiescence in result only in *Thompson*. In addition to *Thompson*, *Garnett v. Comm'r,* 132 TC 19 (2009), *Gregg v. U.S.*, 186 F.Supp.2d 1123 (D. Or. 2000), and *Newell v. Comm'r*, TCM 2010-23, have all ruled against the IRS's position that an interest in an LLC is a limited partnership interest under Reg. §1.469-5T(e)(3)(i).

According to Diana Miosi, special counsel in the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), the AOD was issued "to get the word out that we're not going to be litigating these cases anymore." Ms. Miosi's remarks were made

on March 10, 2010 at a BNA Tax Management luncheon. Additionally, Miosi stated that the string of litigation losses has "gotten our attention," and that "it is important to try to get some guidance out in this area." Finally, Miosi noted that the government has struggled with the issue, not only with respect to Section 469, but also in other areas of the Code as well, such as Sections 464 and 736, and the self-employment tax area.

The distinction between membership interests in limited liability companies and limited partnership interests in limited partnerships will be of even greater significance because the new Medicare tax imposed on a partner's distributive share of the operating income of a partnership if the activity of the partnership producing the income is passive with respect to the partner under the passive activity loss limitation rules of IRC Section 469.

f. Implication of *Thompson* Case on Self-Employment Tax to LLC Members. The issue of whether the members of a multi-member LLC which is taxed as a partnership for federal income tax purposes are treated as general partners or limited partners for purposes of the self-employment tax is unclear at best. Obviously, the IRS could use the same reasoning used against the IRS in the *Thompson, Garnett, Newell* and *Gregg* cases to reach the conclusion that a member's interest in the LLC is *not* equivalent to a limited partner's interest in a limited partnership for purposes of self-employment tax. This would result in members of an LLC being subject to the self-employment tax on their distributive share of the income of an LLC (with certain exceptions for interest, dividends, rent and capital gain). However, on January 14, 2010, Diana Miosi reassured practitioners that they may rely on the proposed 1997 regulations in dealing with the application of the self-employment tax to limited liability companies. See *Tax Notes Today*, Jan. 15, 2010.

6. **S Corporations**. Because the Federal Insurance Contributions Act ("FICA") and Federal Unemployment Tax Act ("FUTA") taxes may be substantial, many shareholder-employees of S corporations have employed a strategy of decreasing the amount of wages that they receive from the S corporation and correspondingly increasing the amount of S corporation distributions made to them.

a. Limitation of Social Security Taxes. As part of FICA, a tax is imposed on employees and employers up to a prescribed maximum amount of employee wages. This tax is comprised of two parts, the Old-Age, Survivor, and Disability Insurance (OASDI) portion and the Medicare Hospital Insurance (HI) portion. The HI tax rate is 1.45% on both the employer and the employee, and the OASDI tax rate is 6.2% on both the employer and the employee. The

maximum wages subject to the OASDI tax rate for 2010 is $106,800.

RRA '93 repealed the dollar limit on wages and self-employment income subject to the HI portion of the FICA tax as well as the self-employment tax. Thus, employers and employees will equally be subject to the 1.45% HI tax on ***all*** wages, and self-employed individuals will be subject to the 2.9% HI tax on ***all*** self-employment income.

As discussed above, beginning in 2013, the HI portion of the Social Security tax will be increased from 2.9% (combined employer and employee) to 3.8% (combined employer and employee) for wages in excess of $250,000 for married individuals filing jointly and in excess of $200,000 for other taxpayers. Additionally, as discussed above, beginning in 2013, a taxpayer having modified adjusted gross income in excess of $250,000 in the case of married individuals filing jointly and $200,000 for other taxpayers will be subject to the 3.8% Medicare tax on their net investment income.

In order for shareholder-employees of S corporations to realize employment tax savings by withdrawing funds in the form of distributions rather than compensation, such distributions must not be recharacterized as "wages" for FICA purposes or as NESE for purposes of the SE Tax. For FICA and FUTA purposes, Sections 3121(a) and 3306(b), respectively, define the term "wages" to mean all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions.

Although it might appear at first glance that a shareholder's distributive share of income from an S corporation constitutes NESE since a general partner's distributive share of the income of any trade or business carried on by a partnership of which he is a member generally constitutes NESE subject to the SE Tax, in Rev. Rul. 59-221, 1959-1 C.B. 225, the IRS found that an S corporation's income does not constitute NESE for purposes of the SE Tax. Additionally, Section 1402(a)(2) specifically excludes from the definition of NESE dividends on shares of stock issued by a corporation.

Consequently, neither a shareholder's distributive share of income passed through from the S corporation under Section 1366 nor any S corporation distributions actually received by the shareholder from the S corporation constitute NESE subject to the SE Tax. In Rev. Rul. 66-327, 1966-2 C.B. 357, the IRS found that the taxable income of an S corporation included in its shareholders' gross

income is not income derived from a trade or business for purposes of computing the shareholders' net operating losses under Section 172(c). Similarly in Ltr. Rul. 8716060, the IRS concluded that the income derived by a shareholder-employee from an S corporation did not constitute net earnings from self-employment for self-employment tax purposes and that such taxpayer was not eligible to adopt a qualified pension plan based on the income derived from his S corporation since such income did not constitute earned income.

Because wages paid to shareholder-employees of S corporations are subject to Social Security taxes while S corporation distributions are not, shareholder-employees have an opportunity for significant tax savings by withdrawing funds from the S corporation in the form of distributions rather than wages. Prior to advising an S corporation with shareholder-employees to undertake such a tax planning strategy, however, the tax practitioner should analyze the economic and tax consequences that such a strategy will have on the S corporation and its shareholders. [5]

Although the amount of funds available for distribution to an S corporation's shareholder-employees will increase as the wages paid to them decrease, all distributions made by the S corporation to its shareholders must be made in proportion to the number of shares held by such shareholders under Section 1361(b)(1)(D). Thus, if an S corporation which has both shareholders who are employees and shareholders who are not employees adopts a tax strategy to reduce Social Security taxes by minimizing wages and maximizing distributions, the increase in the amount of distributions received by the shareholders who are employees will be less than the amount by which their wages were reduced (since distributions must also be made to the shareholders who are not employees). Additionally, a program that minimizes the amount of wages paid to shareholder-employees will increase: (1) purchase price formulas based on earnings; and (2) bonus formulas based on earnings. Decreasing the amount of wages paid to shareholder-employees of S corporations also will reduce the contribution base for contributions to the corporation's qualified plans.

[5] See generally, Looney & Levitt, Reasonable Compensation Issues for Closely-held and Service Companies," 61st N.Y.U. Ann. Inst. Fed. Tax'n 16 (2003); Looney & Comiter, "Reasonable Compensation: Dividends vs. Wages - A Reverse in Positions," 7 J. Partnership Tax'n 364 (Winter 1991); Clements & Streer, "How Low Can Owner-Employee Compensation be Set to Save on Employment Taxes?" 2 J. S. Corp. Tax'n 37 (1990); Andrews, "Current Non-Stock Executive Compensation and Fringe Benefit Issues," 1 S Corp.: J. Tax, Leg. & Bus. Strategies 3 (1989); and Spradling, "Are S Corp. Distributions Wages Subject to Withholding?" 71 J. Tax'n 104 (1989).

In addition to these economic considerations, the tax practitioner should also analyze the tax consequences of making distributions to the corporation's shareholders. In Rev. Rul. 74-44, 1974-1 C.B. 287, two shareholders of an S corporation withdrew ***no salary*** from the corporation and arranged for the corporation to pay them dividends equal to the amount that they would have otherwise received as reasonable compensation for services performed. This arrangement was made for the express purpose of avoiding payment of federal employment taxes. Based on the expansive definition of wages for FICA and Federal Unemployment Tax Act ("FUTA") purposes (which includes all remuneration for employment), the IRS found that the dividends paid to the shareholders constituted wages for FICA and FUTA purposes. Rev. Rul. 74-44 did not, however, address the issue of what constitutes reasonable compensation in the S corporation context since the ruling expressly stated that the dividends were received by the shareholder-employees in lieu of the reasonable compensation that would have otherwise been paid to them. Despite this shortcoming, Rev. Rul. 74-44 clearly indicates that the payment of ***no*** compensation will be unreasonable where shareholder-employees provide substantial services to the corporation.[6]

In *Radtke V. United States,* 895 F.2d 1196 (CA-7, 1990), the court recharacterized distributions made to the sole shareholder (an attorney) of an S corporation (a law firm) as wages subject to FICA and FUTA taxes, where the shareholder made all of his withdrawals from the S corporation in the form of S corporation distributions and received ***no salary*** from the S corporation during the tax year. The court relied on a broad definition of wages for FICA and FUTA purposes as all remuneration for employment, and concluded that the dividend payments were remuneration for services performed by the shareholder for the S corporation. Likewise, in *Spicer Accounting, Incorporated v. United States,* 918 F.2d 80 (CA-9, 1990), the court recharacterized dividend distributions made to a shareholder (an accountant) of an S corporation (an accounting firm) as wages subject to FICA and FUTA taxes where the shareholder received ***no salary*** during the tax year.

[6] See also Rev. Rul. 71-86, 1971-1 C.B. 285 (president and sole shareholder of closely-held corporation found to be an "employee" of the corporation for employment tax purposes); Rev. Rul. 73-361, 1973-2 C.B. 331 (officer-shareholder of an S corporation who performed substantial services as an officer of the S corporation is an "employee" of the corporation for purposes of FICA, FUTA and income tax withholding); and Ltr. Rul. 7949022 (shareholder-employees of S corporation who perform substantial services for S corporation treated as "employees" for employment tax purposes).

Additionally, in *Fred R. Esser, P.C. v. United States,* 750 F. Supp. 421 (D. Ariz. 1990), the court recharacterized amounts received by the sole shareholder, officer and director of a legal services S corporation, as wages subject to FICA and FUTA taxes, rather than as distributions. As in the *Radtke* and *Spicer Accounting* cases, the shareholder received ***no salary*** from the S corporation during the tax year.

The *Radtke, Spicer Accounting* and *Esser* cases indicate that in abusive situations, such as where the shareholders of an S corporation make all withdrawals from the S corporation in the form of S corporation distributions and ***receive no salary from the S*** corporation ***during the*** **tax year*,*** ***the courts*** will recharacterize such distributions as wages subject to Social Security taxes. These earlier cases have been followed in more recent cases. See *Veterinary Surgical Consultants, P.C. v. Comm'r*, 117 TC 14 (2001), *Van Camp and Brennion v. U.S.*, 251 F.3d 862 (CA-9, 2001), *Old Raleigh Realty Corp. v. Comm'r.*, TC Summ. Op. 2002-61, and *David E. Watson PC v. U.S.*, _____ F.Supp. ______, 2010-1 USTC ¶50,444 (S.D. Iowa 2010).

In non-abusive situations, however, the IRS may have difficulty in successfully asserting that distributions made by S corporations to shareholder-employees should be recharacterized as wages subject to Social Security taxes. In order for the IRS to recharacterize S corporation distributions as wages subject to Social Security taxes in non-abusive situations, the IRS would have to overcome: (i) the lack of express authority for its position (unlike the express authority granted to the IRS under Section 1366(e) to recharacterize dividend distributions as wages in the family context); (ii) the reluctance of the courts to recharacterize distributions as wages; and (iii) the uncertainty surrounding the utilization of Section 162(a)(1) by the IRS in the employment context to bring salaries ***up*** to a reasonable level.

Consequently, in such situations, a tax strategy of decreasing wages and correspondingly increasing distributions to shareholder-employees could result in substantial employment tax savings**.** As a result of this tax planning technique, the IRS, the Joint Committee on Taxation and the Department of Treasury have issued reports and notices addressing the use of S corporations as a means of avoiding the SE Tax.

7. **Recent Attempts to Subject S Corporations to the Self-Employment Tax**. There have been numerous attempts in recent years to subject S corporation earnings to the self-employment tax.

a. In 2002, the Treasury Inspector General for Tax Administration issued a report entitled "The Internal Revenue Service Does Not Always Address Subchapter S Corporation Officer Compensation During Examinations," (Reference No. 2002-30-125 (July 5, 2002)), where it was found that IRS examiners failed to address officer compensation issues in 13 out of 58 cases reviewed, and it was recommended that additional technical guidance be given to field personnel in determining reasonable officer compensation.

b. On April 5, 2004, the IRS issued a news release, I.R. 2004-47, identifying several types of "schemes" to avoid the payment of employment taxes that have resulted in adverse court rulings or convictions of taxpayers. Among the schemes listed is "S corporation officers' compensation treated as corporate distributions", which it describes as follows: "In an effort to avoid employment taxes, some corporations are improperly treating officer compensation as a corporate distribution instead of wages or salary. By law, officers are employees of the corporation for employment tax purposes and compensation they have received for their services is subject to employment taxes."

c. In January, 2005, the staff of the Joint Committee on Taxation ("JCT") released a report titled "Options to Improve Tax Compliance and Reform Tax Expenditures." This report proposed that S corporations be treated as partnerships and any shareholders of S corporations be treated as general partners. As a result, the shareholders of the S corporation would be subject to SE Tax on their shares of S corporation net income (whether or not distributed) in the same manner as partners. Under the JCT's proposal, with respect to service businesses, all shareholders' net income from the S corporation would be treated as NESE.

d. On May 25, 2005, J. Russell George, the Inspector General, Treasury, Inspector General, for Tax Administration testified before the Senate Finance Committee, complaining about the employment tax inequities that exist between sole-proprietorships and single-shareholder S corporations. Mr. George noted that the amount of potential employment tax collection lost in 2000 was 5.7 billion dollars based on a comparison of the profits of single-shareholder S corporations and the amounts shown by the single shareholder as compensation subject to employment tax. In connection with that testimony, Pamela Gardiner, Deputy Inspector General for Audit of the Inspector General for Tax Administration issued a final audit report entitled "Actions are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole-Proprietorships and Single-Shareholder S Corporations."

e. In July, 2005, the IRS announced its plan to conduct an intensive study of 5,000 randomly selected S corporations. The IRS reports that the study will be used to more accurately gauge the extent to which the income, deductions and credits from S corporations are properly reported on returns and will assist the IRS in selecting and auditing S corporation returns with greater compliance risks. While the notice did not specify that compliance with the SE Tax rules is a focus of the study, it is not difficult to imagine that the SE Tax was one of the issues that will be closely watched.

f. In conjunction with its 2005 report, the Senate Finance Committee released a report on October 19, 2006 entitled "Additional Options to Improve Tax Compliance" that was prepared by the members of the JCT. The report addressed, among other things, a proposal that would generally treat service partnerships, LLCs and S corporations the same for SE Tax purposes, so that a partner's, member's or shareholder's distributive share of income from a service entity would be subject to the SE Tax. The proposal sought to eliminate the "choice of business form" decision that results in substantially different tax liability for otherwise similar forms of business.

g. In reaction to this "controversial and politically charged" report, the Partnerships and LLCs Committee and the S Corporations Committee of the American Bar Association published their comments. These comments suggested, among other things, that the rules currently in effect for S corporations were correct and should ***not*** be changed.

h. Senator Rangel introduced a Bill in 2007 that would essentially subject all income from a service entity, whether a partnership, LLC or S corporation, to the SE Tax.

i. The Joint Committee on Taxation again addressed the SE Tax issue in JCT Report (JCX-48-08) on Selected Federal Tax Reform Issues Relating to Small Business, Choice of Entity for a June 5, 2008, Senate Finance Committee Hearing.

j. In IRS Fact Sheet FS-2008-25, the IRS clarified information that small business taxpayers should understand regarding the tax law for corporate officers who perform services for S corporations. In the Fact Sheet, the IRS points out that just because an officer is also a shareholder of the S corporation, it does not change the requirement that payments to the corporate officer must be treated as wages, and that courts have consistently held that S corporation officer-shareholders who provide more than minor services to the corporation and who receive or are entitled to receive payments are

employees whose compensation is subject to federal employment taxes.

k. The Fact Sheet goes on to discuss that although there are no "bright line" tests for determining what constitutes "reasonable compensation" to S corporation officer-shareholders, the following factors have been considered by the courts in determining reasonable compensation:

(1) Training and experience.

(2) Duties and responsibilities.

(3) Time and effort devoted to the business.

(4) Dividend history.

(5) Payments to non-shareholder employees.

(6) Timing and manner of paying bonuses to key people.

(7) What comparable business pay for similar services.

(8) Compensation agreements.

(9) The use of a formula to determine compensation.

l. Faris Fink, Commissioner of the Small Business and Self-Employed Division of the IRS, stated on October 29, 2008 that over the next 12 months the Small Business and Self-Employed Division of the IRS will focus on taxpayer services and increased enforcement, and that S corporations "will be a significant compliance challenge going forward," noting that the Small Business and Self-Employed Division must carry out a better examination of S corporations and how they are used.

m. On January 15, 2010, the United States Government Accountability Office ("GAO") released a report entitled "Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules" (the "Report") (December 15, 2009, GAO-10-195). The author participated in the GAO study as part of a group of individuals who are members of the S Corporations Committee of the American Bar Association ("ABA") Tax Section. This group of individuals also included the immediate past Chair of the S Corporations Committee, Tom Nichols. The participation of such persons in the study was ***solely as individuals*** and not as representatives of the S Corporations Committee or the ABA Tax Section.

The involvement of this group included participating in a preliminary telephone call with GAO representatives, the review of a list of "S corporation Interview Topics" prepared by the GAO, and a lengthy follow-up telephone conference with GAO representatives.

The purported purpose of the GAO study was to look at "compliance challenges" for S corporations and their shareholders. The genesis of the GAO study seems to be the report released on October 19, 2006 entitled "Additional Options to Improve Tax Compliance" that was prepared by members of the Joint Committee on Taxation. The purpose of this report was to find ways to close the "tax gap." Simply defined, the "tax gap" is the difference between the federal income tax that taxpayers should be paying if they fully complied with the federal tax laws ***currently in effect***, and the actual amount of federal income taxes being paid by taxpayers. The report addressed, among other things, a proposal that would generally treat service partnerships, LLCs and S corporations the same for self-employment tax purposes, so that a partner's, member's or shareholder's distributive share of income from a service entity would be subject to the self-employment tax. The proposal sought to eliminate the "choice of business form" decision that results in substantially different tax liability for otherwise similar forms of business.

In reaction to this controversial and politically charged report, the American Bar Association Tax Section issued comments which provided, among other things, that the rules currently in effect for S corporations were correct and should not be changed. Specifically, the report provided that the self-employment tax, as well as FICA and FUTA taxes, were meant to be imposed on income from labor and that the IRS has all the necessary "tools" in place to combat abusive situations where S corporations are not paying their shareholder-employees reasonable compensation. *See*, e.g., Rev. Rul. 74-44, 1974-1 C.B. 287, *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990), and *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 80 (9th Cir. 1990). Specifically, the ABA Tax Section stated the following:

> Such a wholesale expansion of the base would not simply close the "tax gap"; instead it would represent a significant change in law for numerous closely-held businesses that are complying currently with the law. (ABA Section of Taxation Comments on Additional Options to Improve Tax Compliance Proposed by the Staff of J. Comm. on Tax'n at 44 (August 3, 2006)).

As stated above, although the purpose of the new GAO study was purportedly to look at compliance challenges for S corporations and their shareholders, based on the questions that were asked by the GAO as well as the comments of GAO members, this study appears, at least in part, to take the position that the self-employment tax should be imposed on some or all of the income of S corporations (and in particular, S corporations that are service corporations).

Because of the comments made by some of the GAO representatives as well as what the group perceived as an implied bias to assume and confirm noncompliance by S corporations, especially in connection with the payment of social security taxes, the group requested that the GAO let them review the Report before it was finalized. However, the Report was issued without the group having an opportunity to review it, and as the group feared, the Report contains several statements that are highly controversial and appear to be quite misleading, including statements that there have been "long-standing problems with S corporation compliance" and that there was misreporting on 68% of S corporation income tax returns. Although not expressly stated, the clear implication of the Report is that S corporations are somehow aberrantly noncompliant and abusive. As will be explained in more detail below, the statements made by the GAO seem unwarranted, based upon the Report itself as well as other publicly available information. Consequently, Tom Nichols submitted a Records Request to the GAO to find out what, if any, evidence had been gathered by the GAO to support these and other controversial conclusions contained in the Report.

To the surprise of the group, the GAO notified Mr. Nichols that the Senate Finance Committee, as the Requester of the Report, ***refused*** to authorize the release of any information relating to the Report. To put it simply, the members of the group were shocked at the response of the GAO and Senate Finance Committee, especially at a time when the President and the Commissioner of the Internal Revenue Service are demanding "transparency" from taxpayers and are stating publicly that the government will also be transparent in its actions. The problem is compounded by the fact that it has now been reported that certain ***closed door negotiations*** relating to the pending health care bills have included discussions of the possibility of imposing the self-employment tax on some or all of the net income of S corporations as a way to raise revenue for these proposals. Since these proposals are being discussed in ***private***, there is not any information available as to what and why such proposals are being made.

Based on the group's analysis of the GAO Report, there are at least several respects in which the noncompliance conclusions set forth in the Report are misleading. First, as stated above, the clear implication of the 68% misreporting rate highlighted in the Report is that S corporations are aberrantly noncompliant with the Tax Code. However, a careful review of page 10 of the Report suggests otherwise. Although it states that "an estimated 68% of the S corporation returns filed for tax years 2003 and 2004 misreported at least 1 item affecting net income," Footnote 22 to the Report indicates that this 68% estimate "includes misclassification adjustments where a taxpayer reports the correct amount but on the wrong line as well as the adjustments where the examiner zeroed out the entire return." Consequently, it appears that simply reporting a deduction amount on the wrong line would constitute "misreporting" for purposes of the 68% noncompliance rate, ***even though it had no impact on the S corporation's taxable income or the overall tax liability of the S corporation's shareholders***. This raises a serious question as to what portion of the 68% "misreporting" percentage genuinely constitutes noncompliance having an actual impact on income tax revenue. Additionally, in the Preliminary Results of the 2003/2004 National Research Program published at the IRS 2009 Research Conference held on July 8, 2009, the indicated net misreporting percentages for S corporations during tax years 2003 and 2004 were 12% and 16%, respectively. This compares favorably with the overall compliance rate for all taxpayers reported in the IRS Strategic Plan 2009-2013. In that Plan, the Voluntary Compliance Rate for tax years 1985, 1992, 1998 and 2001 were reported at between 83.6% to 84.6%. This implies a net misreporting percentage of 15.4% to 16.4%, i.e., somewhat worse than the S corporation noncompliance rate.

The second problem with the 68% "misreporting" percentage appears to be one of scale. In a follow-up telephone conference with Thomas D. Short of the GAO on January 21, 2010, Mr. Short indicated to Mr. Nichols that he thought there was some form of "de minimis" exception, such as $100, for which an item would not be treated as "misreported." Mr. Nichols specifically asked Mr. Short whether this meant if an S corporation reporting $10,000,000 of gross income incorrectly deducted $101 of expense, its return would be included within the "misreporting" category, and Mr. Short said he thought it would be. This obviously raises serious questions regarding the validity of the 68% misreporting percentage, and essentially would result in such statistic being of little value. (If a misclassification constitutes "noncompliance" and there is not a meaningful de minimis exception, it would not be surprising to find a noncompliance rate of 100% on any type of income tax return.)

Finally, it is important to note that the Report cites deduction of ineligible expenses as the most common error. Most certainly, this is not a problem unique to S corporations, but is a problem which is just as prevalent, if not more prevalent, in sole proprietorships, partnerships (including LLCs taxed as partnerships), and C corporations.

It is important to recognize that S corporation status is one of the most popular vehicles for closely-held businesses, and as such, raising taxes on such entities should never be considered lightly, and certainly not on the basis of statistics of questionable validity. Many of these same points were made in a follow-up letter Mr. Nichols sent to the GAO dated January 12, 2010, shortly prior to issuance of the Report. In this regard, the group believes that it is important for there to be at least one structure whereby closely-held businesses can earn entrepreneurial profits and be subject to only one level of tax without the imposition of social security taxes (where such entrepreneurial profits are not attributable to labor). Additionally, increasing marginal rates on such profits at this point in the economic cycle is likely to be counterproductive, and even more so based upon misleading statistics with respect to such entrepreneurs' tax compliance. The critique of the GAO Report discussed above was set forth in a letter dated February 9, 2010, from Stephen R. Looney and Ronald A. Levitt to the Editor of Tax Notes which appeared in the February 22, 2010 issue of Tax Notes Today.

In a letter dated February 22, 2010 published in Tax Notes Today (Tax Notes Today, March 8, 2010), Timothy P. Boling, Chief Quality Officer of the GAO, responded to the criticism set forth above contending that the GAO Report was "objective and fact based." Specifically, the letter stated that the GAO did not seek to "change the substantive law relating to the application of the self-employment tax to S corporations," properly analyzed the IRS's National Research Program Study of S Corporation Compliance in determining the misreporting percentage for S corporations and dismissed the argument that the lack of a meaningful de minimis exception raised serious questions regarding the validity of the 68% misreporting percentage.

Interestingly, the letter additionally states that GAO did not say "S corporations were aberrantly noncompliant" but instead provided the best data available on compliance from the IRS and put it in context. In this regard, the letter states that the noncompliance rate for sole proprietors in 2001 was 70%, which actually exceeded the 68% noncompliance rate for S corporations. One would expect a similar noncompliance rate for partnerships and LLCs.

While the author appreciates the statements made in Mr. Boling's letter, and certainly acknowledges that the GAO Report did not ***expressly*** state that "S corporations were aberrantly noncompliant," the author believes that the GAO Report has been misinterpreted (as the group suspected it would be) to "vilify" S corporations. The author hopes that based upon the group's comments as well as Mr. Boling's response on behalf of the GAO, the Report will be considered in proper context such that it is clear that S corporations are no more noncompliant with the tax law than sole proprietorships, partnerships, LLCs or any other form of business entity.

However, the GAO Report may very well have been a significant factor in the new Medicare tax imposed on certain shareholders' distributive share of an S corporation's operating income under the recently passed health insurance reform legislation, as well as the proposal to impose the self-employment tax on certain S corporations contained in The American Jobs and Closing Tax Loopholes Act discussed immediately below.

n. Section 413 of the American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213 (the "Act"), adds new Section 1402(m) to subject certain S corporation shareholders to the self-employment tax imposed under Section 1402 on their distributive share of the income of an S corporation. Specifically, Section 1402(m)(1)(a) provides that in the case of any "disqualified S corporation," each shareholder of such disqualified S corporation who provides "substantial services" with respect to the "professional service business" referred to in Section 1402(m)(1)(C) must take into account such shareholder's pro rata share of all items of income or loss described in Section 1366 which are attributable to such business in determining the shareholder's net earnings from self-employment.

A disqualified S corporation is defined in Section 1402(m)(1)(C) as:

- any S corporation which is a partner in a partnership which is engaged in a professional service business if substantially all of the activities of such S corporation are performed in connection with such partnership; and

- any other S corporation which is engaged in a "professional service business" if the "principal asset" of such business is the "reputation and skill" of three or fewer employees.

Senator Baucus, on June 16, 2010, introduced a new substitute to the House-passed bill which amends the S corporation provision.

Unfortunately, the proposed change is minor and will not alter the harmful impact of this provision. Specifically, the proposal as amended by Senator Baucus would change the definition of a "disqualified S corporation" to mean any other S corporation which is engaged in a professional service business ***if "80% or more of the gross income of such business is attributable to the service of three or fewer shareholders of such corporation***."

Section 1402(m)(3) defines the term "professional service business" as being any trade or business if substantially all of the activities of such trade or business involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services.

Except as otherwise provided by the Secretary, a shareholder's pro rata share of items of the S corporation subject to the self-employment tax will be increased by the pro rata share of such items of each member of such shareholder's family (within the meaning of Section 318(a)(1)) who does not provide substantial services with respect to such professional service business.

Additionally, Section 1402(m)(2) provides that in the case of any partnership which is engaged in a professional service business, Section 1402(a)(13) -- which generally exempts limited partners from the self-employment tax -- shall not apply to any partner who provides substantial services with respect to such professional service business.

(1) Proposal is Too Broad and Unfairly Taxes Small Businesses Complying with Law. Although the SBCA is certainly in agreement with the Committee's desire to prevent taxpayers from abusing the S corporation structure to avoid payroll taxes (by means of paying unreasonably low compensation to shareholder-employees), this provision will clearly increase taxes on small business owners who are fully complying with the law. This provision does not narrowly close tax loopholes for taxpayers abusing the system, but rather is a multi-billion dollar tax increase on tax-compliant small businesses in the middle of the most difficult economy the United States has faced since the Great Depression.

(2) Proposal is Inconsistent with Long-Standing Policy. Historically, employment taxes, were intended to be imposed on income derived from labor. The amendments made to Section 1402 by the Act will, however, would apply not only to income derived from ***services*** performed

by shareholder-employees of S corporations subject to the Act, but will also apply to income derived from ***capital*** by businesses engaged in service businesses. For example, a medical practice may have made significant investments in MRI machines, X-Ray equipment, CT scanners and related equipment, all of which reflect capital investments by the owners that will generate profits not derived by personal services performed by the shareholder-employees. Additionally, the proposal will subject an S corporation's investment in "human capital" to payroll taxes. For example, an S corporation conducting a medical practice may invest substantial sums in the hiring and training of para-professional employees, such as nurse practitioners and physician assistants, who will generate profits for the S corporation not attributable to personal services performed by the shareholder-employees. Existing case law clearly establishes the fact that service businesses (regardless of the number of shareholders of such business) may generate income from sources other than the personal services of the shareholder-employees. See, e.g., *Richlands Medical Association v. Comm'r*, TCM 1990-66, *aff'd without published opinion*, 953 F.2d 639 (4th Cir. 1992), and *Pediatric Surgical Associates, P.C. v. Comm'r*, TCM 2001-81. By blurring the line between income from labor and income from capital, this provision will set the stage for future increases in employment taxes on both service and non-service businesses and income.

(3) Provision Contrary to Recently Enacted Health Reform Bill. The new provision would also contradict and reverse the recent decision made by Congress in the new health care reform law. The Health Care and Reconciliation Act of 2010, H.R. 4872, PL 111-152, imposes a 3.8% Medicare tax on the "net investment income" of individual taxpayers having adjusted gross income of more than $250,000 in the case of taxpayers filing a joint return and more than $200,000 for all other taxpayers. The term "net investment income" is defined to include any gross income derived from a trade or business if such trade or business is a passive activity within the meaning of Section 469 with respect to the taxpayer. Consequently, when Congress adopted the new 3.8% Medicare tax on most forms of investment income, ***it specifically exempted active S corporation shareholders and active limited partners***. This provision would effectively reverse that exclusion, subjecting some active shareholders and active limited partners to the 2.9% Medicare tax, and, if their income

exceeds the $200,000/$250,000 thresholds, to the additional .9% Medicare tax under the Health Care Bill. In other words, this provision would be a double tax increase on a broad class of small businesses.

(4) IRS Already has Tools Necessary to Combat Abusive Situations. The IRS already has all the necessary "tools" in place to combat abusive situations where S corporations are paying their shareholder-employees unreasonably low compensation. The IRS has been very successful in recharacterizing S corporation distributions as wages subject to payroll taxes where taxpayers have taken compensation that was less than reasonable. See, e.g., Rev. Rul. 74-44, 1974-1 C.B. 287; *Radtke v. United States*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. United States*, 918 F.2d 80 (9th Cir. 1990); *Dunn & Clark, P.A. v. United States*, 853 F.Supp. 365 (D. Idaho 1994); and *David E. Watson PC v. U.S.*, _____ F.Supp. _____, 2010-1 USTC ¶50,444 (S.D. Iowa 2010). The answer to stopping this abuse is for the IRS to do a better job enforcing existing law, rather than for Congress to raise taxes on numerous S corporations and shareholders, the large majority of whom who are fully complying with the law. Additionally, the SBCA is not aware of payroll tax abuses (actual or perceived) involving limited partners of limited partnerships, so the inclusion of limited partnerships in the provision is puzzling and appears misdirected.

(5) Provision Unfairly Discriminates Against Small Business. The new provision arbitrarily discriminates against small businesses by taxing S corporations with three or fewer key employees at higher tax rates than S corporations that have four or more key employees. There appears to be no good reason to put smaller businesses at a competitive disadvantage vis-à-vis larger businesses; they already lack economies of scale, and provisions like this make it harder for them to compete and survive.

(6) Provision Inappropriately Taxes S Corporation Shareholders on Other Family Members' Distributive Share of Income. The provision will not only subject a shareholder who provides "substantial services" to the S corporation to self-employment tax on such shareholder's distributive share of the S corporation's income, but also on the distributive share of the S corporation's income attributable to any other family member who is also a

shareholder and who does not provide "substantial services". Consequently, this provision will result in a shareholder being subject to tax on income of other shareholders -- income to which the shareholder being taxed is ***not*** entitled and does not receive (i.e., "phantom income"). For example, assume that a medical practice has as its shareholders a father who has conducted the practice for many years and is now semi-retired. The father owns 99% of the stock of the S corporation, and his son, who does provide substantial services, owns the remaining 1% of the stock of the S corporation. In this situation, this new provision will require the son to pay payroll taxes on 100% of the corporation's income even though the son only owns 1% of the stock of the S corporation and is only entitled to 1% of the funds distributed by the corporation to its shareholders. Such a result seems to unfairly discriminate against family businesses.

(7) Provision Would Add Complexity to Tax Law. The new provision would introduce a host of compliance issues, and would add significant complexity and uncertainty for S corporations (and limited partnerships) engaged in professional service businesses. Key examples include:

(a) The definition of the term "professional service business" in the provision has, contrary to decades of prior statutory tax law, been expanded to include lobbying, athletics, investment advice or management, and brokerage services. This arbitrarily exposes numerous closely-held businesses to the self-employment tax without any prior notice. For example, a two-person investment advisory firm or real estate or insurance brokerage firm, will now be subject to a more onerous tax scheme. This will certainly come as a surprise to these small businesses. This certainly cannot be justified on the basis of closing tax loopholes.

(b) The provision uses the undefined term "substantial services" numerous times. How do taxpayers determine what substantial means? How will their advisors be able to advise them on that point? Many taxpayers won't know whether they owe the tax -- that type of uncertainty undermines our tax system, which is premised on voluntary reporting and compliance.

(c) The new provision would require S corporations engaged in a professional service business to determine whether its principal asset is the "reputation and skill" (again, undefined) of three or fewer employees.

S corporations engaged in a professional service business would be required to get valuations of each of their assets in order to determine their principal assets -- such a valuation would be extremely difficult and expensive to obtain, as assets such as reputation and skill are not easily valued.

All of these questions will invite litigation, and are contrary to the long-stated Congressional goal of tax simplification.

In addition to the complexity and uncertainty relating to the new provision itself, the overall effect of the new provision may well be to force small businesses into the much more complex world of partnership taxation, which will not only be burdensome on these small businesses, but which also presents numerous tax pitfalls for uninformed small businesses and, frankly, much greater potential for manipulation by sophisticated taxpayers.

(8) Concern Over Lack of Transparency; No Open and Informed Debate. Such substantial changes to well-established tax law and policy should only take place in a fully transparent process, rather than being conducted behind closed doors without an open and informed debate and analysis of the issues. Specifically, this new provision was never reviewed in committee, was not subject to debate on the House or Senate floors and is only later going to be attached to a major bill that has already cleared both Houses.

(9) Need for S Corporations for America's Small and Family-Owned Businesses. Finally, it is important to recognize that S corporations are one of the most popular vehicles for small and family-owned businesses, and as such, raising taxes on such entities should never be considered lightly, and certainly not without open and informed debate and analysis of the effects of such taxes. There should be at least one structure whereby small and family-owned businesses can earn entrepreneurial profits subject to only

one level of tax and not be subject to unlimited payroll taxes.

(10) Outcome of Provision. In response to a waive of criticism, Senators Snowe and Enzi introduced an amendment to delete the new provision imposing self-employment tax on certain S corporations. After several unsuccessful attempts at passage of the American Jobs and Closing Tax Loopholes Act of 2010, the extenders bill with the controversial S corporation offset was defeated.

o. On September 16, 2010, Senator Baucus introduced the Job Creation and Tax Cuts Act of 2010, which departs from its immediate predecessor, the American Jobs and Closing Tax Loopholes Act of 2010, most notably in that it would ***not*** impose self-employment payroll taxes on the pass-through income of S corporation shareholders.

8. **Social Security Taxes on S Corporations Operated Through Limited Liability Companies**. In those situations in which S corporations are the choice of entity for federal tax purposes, it still may be preferable for a number of non-tax reasons to operate for state law purposes as an LLC. One important issue is whether an LLC which has elected to be taxed as an S corporation for federal ***income*** tax purposes will also be taxed as an S corporation for ***Social Security tax*** purposes rather than as a partnership.

An LLC which has elected to be taxed as an S corporation should be subject to the same Social Security tax rules to which S corporations are subject rather than to the self-employment tax rules to which partnerships are subject.

Some practitioners have cited Reg. §1.1402(a)-2(f) as requiring an entity which elects not to be treated as a partnership for federal ***income tax*** purposes to nevertheless be treated as a partnership for ***self-employment tax purposes***. Specifically, Reg. §1.1402(a)-2(f) states that "an organization described in the preceding sentence [defining a "partnership"] shall be treated as a partnership for the purposes of the tax on self-employment income even though such organization has elected, pursuant to Section 1361 and the regulations thereunder, to be taxed as a domestic corporation."[7]

However, it should be noted that the reference in Reg. §1.1402(a)-2(f) to Section 1361 is actually a reference to Section 1361 as in effect ***prior to its repeal in 1966*** by Pub. L. No. 89-389, Section 4(b)(1), April 14, 1966, 80

[7] See also, McKee, Nelson and Whitmire, Federal Taxation of Partnerships and Partners (4th Ed. 2007), ¶9.02[5](b), which states that "a partnership that elects not to be treated as a partnership under Subchapter K apparently is nevertheless treated as a partnership for purposes of Section 1402."

Stat. 116, which formerly permitted some unincorporated entities to elect to be taxed as domestic corporations. Following the repeal of this former Section 1361, Congress did not "retire" this section number, but many years later (in 1982) used it again for Subchapter S corporations. Consequently, the author does not believe that this regulation in any manner would cause an LLC which has elected to be taxed as an S corporation to be subject to the self-employment tax as if it were a partnership.

E. BACK TO BACK LOANS AND S CORPORATION BASIS

1. **Introduction**. For a number of years, the IRS and the courts have taken a particularly harsh position with respect to loan restructurings between related entities where the purpose of the loan restructuring was to obtain an increase in the taxpayer's basis in an S corporation, and in turn, enable the taxpayer to deduct losses incurred by the S corporation during the tax year. In essence, the IRS and the courts have refused to allow a shareholder to increase his basis in an S corporation (at least in the restructuring context), where the shareholder obtains funds from a related entity (as opposed to an unrelated third-party lender) which are then loaned or contributed by the shareholder to the S corporation.

   More recent developments suggest that the IRS may take the position, in certain circumstances, that a basis increase is inappropriate even where the loan restructuring involves an unrelated third party lender, and that in certain circumstances, the IRS believes that no basis increase should be granted even if the loan was ***originally structured*** (as opposed to restructured) as a back-to-back loan if the shareholder obtains the funds from a related entity.

2. **Basis Limitation on Pass Through of Losses and Deductions**.

   a. General Rules. Under Section 1363(a), an S corporation is generally treated as a pass-through entity and not as a taxable entity for federal income tax purposes, and, as such, its shareholders are generally subject to only one level of tax on its earnings. Section 1366(a)(1) generally provides that all items of income, loss, deduction and credit of an S corporation pass through the corporation and are taxed directly to its shareholders in proportion to their ownership interest in the corporation.

      In order for an S corporation shareholder to deduct his pro rata share of the S corporation's losses under Section 1366(a), the shareholder must have sufficient basis in S corporation stock or debt under the basis limitation rules of Section 1366(d).[8] Section

[8] In addition to the basis limitation rules of §1366(d), S corporation shareholders seeking to deduct their pro rata share of an S corporation's losses are faced with two other loss limitation rules. First, the S corporation shareholder

1366(d)(1) provides that the total amount of losses and deductions taken into account by an S corporation shareholder for any tax year cannot exceed the sum of:

(1) The adjusted basis of the shareholder's stock in the S corporation (Section 1366(d)(1)(A)); and

(2) The shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder. Section 1366(d)(1)(B).

To the extent that any losses or deductions passing through to the S corporation's shareholder are disallowed because of the basis limitation rules prescribed under Section 1366(d)(1), Section 1366(d)(2) provides for a carryover of such disallowed losses and deductions.[9]

b. Qualified Indebtedness. Although Section 1366(d)(1)(B) provides that a shareholder is entitled to deduct his proportionate share of the S corporation's losses and deductions to the extent of such shareholder's adjusted basis in debt of the S corporation to him, it does not specifically define what constitutes "indebtedness of the S corporation to the shareholder." The Senate Finance Committee Report accompanying Section 1374(c)(2), the predecessor to Section 1366(d), indicates that the purpose of the section is to limit the amount of an S corporation's loss that may be deducted by a shareholder to the "adjusted basis of the shareholder's investment in the corporation."[10] Seizing upon this language (correctly or incorrectly), the cases and rulings interpreting Section 1366(d)(1)(B) have established two requirements that generally must be met in order for a loan to constitute "indebtedness of the S corporation to the shareholder" within the meaning of Section 1366(d)(1)(B):

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must have a sufficient amount "at risk" to deduct a pro rata share of the corporation's losses under the at-risk limitation rules of §465. See generally August & Looney, "S Shareholders Must Still Be Wary Of At-Risk Rules: Part II," 3 J. S Corp. Tax'n 179 (1992); August & Looney, "S Shareholders Must Still Be Wary Of At-Risk Rules: Part I," 3 J. S Corp. Tax'n 99 (1991); August, "Basis Traps Under Subchapter S: Competing In The Basis Triathlon," 48 N.Y.U. Inst. on Tax'n ch. 7 (1990); Wiesner, "S Corporation Basis, At-Risk And Passive Loss Limitations After Tax Reform," 46 N.Y.U. Inst. on Tax'n ch. 12 (1988); Bravenec, "S Corporations and Shareholders Under the At-Risk Rules of §465 - Revisited," 36 Tax Law. 765 (1983); Bravenec, "Subchapter S Corporations and Shareholders Under the At-Risk Rules of §465," 36 Tax Law. 93 (1982). Additionally, the shareholder's pro rata share of an S corporation's losses will be subject to the passive activity loss limitation rules of §469.

[9] The carryforward of losses suspended under §1366(d)(2) is *not* indefinite. The carryforward will generally cease when the shareholder terminates his interest in the S corporation, dies or the corporation ceases to be an S corporation.

[10] S. Rep. No. 1983, 85th Cong., 2d Sess. 220 (1958).

(1) The indebtedness must run directly from the S corporation to the shareholder; and

(2) The shareholder must have made an "actual economic outlay."

(3) While the IRS and the courts generally have been consistent in their application of the requirement that the loan run directly from the S corporation to the shareholder, they have been inconsistent in their application of the requirement that the S corporation shareholder make an actual economic outlay.

c. Loan Must Run Directly from the S Corporation to the Shareholder. The IRS and the courts have generally held that the indebtedness of the S corporation must run directly to the shareholder himself, and not to a related entity, in order for the shareholder to increase his basis in the S corporation.[11] Thus, shareholders have been denied an increase in their S corporation basis with respect to loans made to S corporations by other corporations,[12] partnerships,[13] trusts,[14] and estates[15] in which the shareholders held an interest. In fact, in *Bader v. Comm'r*, TCM 1987-30, the IRS denied an S corporation shareholder a basis increase even though the loan had originally been made by a third-party bank to the shareholder, who in turn had loaned such funds to the S corporation, since the loan had been restructured so that it ran directly from the bank to the S corporation (rather than to the shareholder).

d. Incorporated Pocketbook Theory. Although the courts and the IRS have historically required that the indebtedness of the S corporation run directly from the S corporation to the shareholder and not to another entity in which the shareholder owns an interest in order for a shareholder to increase his basis under Section

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[11] But see *Miles Prod. Co. v. Comm'r*, TCM 1969-274, *aff'd on other issues*, 457 F.2d 1150 (5th Cir. 1972), where a shareholder was allowed to increase his basis in an S corporation with respect to a loan made to the S corporation from a related corporation, since the loan was treated as a constructive dividend to the shareholder followed by a capital contribution of the amount received as a dividend to his S corporation.

[12] *Burnstein v. Comm'r*, TCM 1984-74 (shareholders not allowed to increase basis where their S corporation borrowed money from another S corporation in which the shareholders also owned an interest).

[13] *Frankel v. Comm'r*, 61 TC 343 (1973), *aff'd without published opinion*, 506 F.2d 1051 (3rd Cir. 1974); and Rev. Rul. 69-125, 1969-1 C.B. 207. (shareholders not allowed to increase basis where their S corporation borrowed money from a partnership in which the shareholders were partners).

[14] *Robertson v. United States*, 73-2 USTC (CCH) ¶ 9645 (D. Nev. 1973) (shareholders not allowed to increase basis where their S corporation borrowed money from a trust in which the shareholders were beneficiaries).

[15] *Prashker v. Comm'r*, 59 TC 172 (1972) (shareholder not allowed to increase basis where S corporation borrowed money from an estate in which the shareholder was the sole beneficiary).

1366(d)(1)(B), several recent cases have used the so-called "incorporated pocketbook" theory to find that indirect loans did result in basis increases.

(1) <u>*Culnen v Comm'r*</u>. In *Culnen v. Comm'r*, TCM 2000-139, the Tax Court held that amounts transferred by the taxpayer-shareholder's wholly-owned C corporation (Culnen & Hamilton) to an S corporation (Wedgewood) in which the taxpayer-shareholder held varying interests during the years in issue, and payments made by Culnen & Hamilton in payment of expenses of Wedgewood, constituted "indebtedness of the S corporation to the shareholder" within the meaning of Section 1366(d)(1)(B). As such, the taxpayer-shareholder was entitled to increase his basis in Wedgewood by such amounts and therefore able to deduct the losses incurred by Wedgewood during the tax years in issue.

The Tax Court first found that the direct payments by Culnen & Hamilton to Wedgewood did ***not*** preclude such amounts from being treated as loaned by Culnen & Hamilton to the taxpayer-shareholder, and then loaned from the taxpayer-shareholder to Wedgewood. The Tax Court stated that the statutory requirement under Section 1366(d)(1)(B) that the indebtedness of the S corporation run ***directly*** to the shareholder is not satisfied where the indebtedness of the S corporation is to an entity with pass-through characteristics that has advanced such funds to the S corporation and is closely related to the taxpayer. However, the Tax Court stated that the fact that the borrowed funds originate with a closely held entity does ***not*** necessarily preclude the indebtedness of the S corporation from running directly to the shareholder. The Tax Court continued that where there is a close relationship among the S corporation, the taxpayer, and the related entity, it will scrutinize relationships established with respect to the transfer of funds to ensure that those relationships comport with the statutory requirement prescribed under Section 1366(d)(1)(B). The Tax Court also distinguished *Underwood v. Comm'r*,[16] stating that it stood for the proposition that a shareholder who merely guarantees an S corporation indebtedness cannot increase his basis by such amount under Section 1366(d)(1)(B), and that was simply not the situation presented in *Culnen*.

[16] 63 TC 468 (1975), *aff'd*, 535 F.2d 309 (5th Cir. 1976).

The taxpayer called four witnesses, including himself, all of whom consistently testified that for many years (including the years in issue), the taxpayer-shareholder had used Culnen & Hamilton as an "incorporated pocketbook," having the corporation make payments on his behalf, which payments were posted to Culnen & Hamilton's books as loans to the taxpayer. The Tax Court found this evidence persuasive, and found the IRS's claim that the witness's testimony should be disregarded because it was "unsupported" as unpersuasive. In fact, the Tax Court stated that the IRS's only evidence was its unsupported attacks on the taxpayer-shareholder's witnesses, and that its resort to "name-calling" was not an acceptable fallback position and stated that it expressly disapproved of such tactics.

(2) *Yates v. Comm'r*. In *Yates v. Comm'r*, TCM 2001-280, the Tax Court held that various transfers made by a married couple from their mining company (Adena), an S corporation, to their farming operation (FoxTrot), an S corporation, increased their basis in FoxTrot. Additionally, the Tax Court held that transfers in the form of capital contributions from Adena to FoxTrot before the husband gave all of his shares of FoxTrot to his wife, constituted transfers from the husband to FoxTrot, which increased his basis in FoxTrot. The Tax Court also found that FoxTrot incurred indebtedness to the husband, which increased his basis in FoxTrot.

The Tax Court, contrary to its position in a number of prior cases, held that the husband could increase his basis in FoxTrot as a result of the funds transferred from Adena to FoxTrot while he was the sole shareholder of FoxTrot. Additionally, the Tax Court concluded that the "uncontradicted and credible testimony" of Mr. Yates established that Mr. Yates made gifts to Mrs. Yates of the subsequent transfers from Adena, followed by her contribution or loan of such amounts to FoxTrot, which increased her basis in FoxTrot. The court noted that Mr. Yates simply skipped the steps of having Adena transfer such funds to him, depositing the funds in Mr. and Mrs. Yates' joint account, and then having Mrs. Yates write a check to FoxTrot. In support of its decision, the Tax Court cited its prior decision in *Culnen*, where the court allowed an S corporation shareholder to increase his basis under similar circumstances.

e. Shareholder Must Make an Actual Economic Outlay. The requirement that an S corporation shareholder make an actual economic outlay in order to receive a basis increase for indebtedness of the S corporation to the shareholder is based upon the language of the Senate Finance Committee Report accompanying the predecessor to Section 1366(d) which provides that a shareholder's proportionate share of the S corporation's losses be limited to the adjusted basis of the shareholder's "investment" in the S corporation. The courts construing this requirement have held that in order for indebtedness of an S corporation to its shareholder to be comparable to an actual capital investment by the shareholder, an actual economic outlay must be made by the shareholder such that the shareholder is poorer in a material sense after the transaction than he was before the transaction began.[17]

In addition to there being questionable authority for the application of the actual economic outlay theory to the loan structuring and restructuring area, the IRS and the courts have not clearly defined what constitutes an actual economic outlay in the loan restructuring area.

f. Loan Restructurings Resulting in Basis Increase. The one constant in every situation where a shareholder has been permitted to increase his basis in an S corporation in connection with a loan restructuring is that the transaction originally involved a loan from an ***unrelated third-party lender***.

(1) In Rev. Rul. 75-144, a loan was made by a third-party bank directly to an S corporation, and was personally guaranteed by the sole shareholder of the S corporation. The shareholder subsequently substituted his own promissory note for the corporation's promissory note to the third-party bank, which then released the S corporation from liability. The IRS concluded that the substitution of the shareholder's promissory note, together with the acceptance of the shareholder's promissory note by the bank and the bank's release of the S corporation, caused the indebtedness of the S corporation to accrue to the shareholder. Consequently, the shareholder was permitted to increase his basis in the S corporation by the amount of such indebtedness.

(2) Similarly, in *Gilday*, the Tax Court held that shareholders

[17] See generally *Perry v. Comm'r*, 54 TC 1293 (1970), *aff'd*, 71-2 USTC (CCH) ¶ 9502 (8th Cir. 1971); *Wheat v. United States*, 353 F. Supp. 720 (S.D. Tex. 1973); and Rev. Rul. 81-187, 1981-2 C.B. 167.

acquired basis in their S corporation when they substituted their personal promissory notes for the S corporation's promissory note to a third-party bank. Again, the third-party bank released the corporation and the corporation then issued a promissory note to its shareholders.

(3) In Ltr. Rul. 8747013, the IRS once again granted a basis increase to shareholders in connection with the restructuring of a loan to their S corporation. Unlike Rev. Rul. 75-144 and *Gilday*, however, the shareholders did not "substitute" their own personal promissory notes for the S corporation's promissory note to the third-party bank. Rather, the loan was restructured by having the shareholders personally borrow the funds directly from the bank, who then loaned such funds to the S corporation, which then used the funds to satisfy its indebtedness to the third-party bank.

The results reached in Rev. Rul. 75-144 and *Gilday* are difficult to reconcile with the actual economic outlay requirement as developed by the IRS and the courts. Where a shareholder merely substitutes his own personal promissory note for the S corporation's promissory note which the shareholder had personally guaranteed, ***there are no actual funds flowing from the shareholder to the S corporation***. In this situation, shareholders are being allowed to increase their basis in the S corporation even though they have made no ***current*** economic outlay.[18]

Rev. Rul. 75-144 and *Gilday* can only be reconciled with the actual economic outlay requirement by assuming that the IRS and the courts are applying a legal fiction that results in the shareholder making an actual economic outlay. For example, where a shareholder substitutes his own promissory note for the S corporation's promissory note to a third-party lender, the shareholder could be viewed as borrowing the cash from the third-party lender in exchange for his personal promissory note, transferring such funds to the corporation as either a loan or a contribution, with the corporation then using such funds to satisfy its promissory note to the lender. This is precisely

[18] This is similar to the situation where a taxpayer purchases stock from an existing shareholder of an S corporation in exchange for the taxpayer's promissory note. Although the taxpayer makes no *current* economic outlay, he is permitted to increase his basis in the S corporation. In these situations, an immediate basis increase is given to the shareholder, possibly because the law is presuming that an independent creditor will require the taxpayer to make an economic outlay in the future. See J. Eustice & J. Kuntz, Federal Income Taxation of S Corporations at ¶ 9.05[2][i] n. 350 (Warren Gorham & Lamont, 4th ed. 2001).

the manner in which the loan was actually restructured in Ltr. Rul. 8747013. Alternatively, the shareholder could be viewed as purchasing the corporation's promissory note from the third-party lender in exchange for the shareholder's own promissory note, which would result in the shareholder receiving a cost basis in the S corporation's promissory note under Section 1012. In any event, if the actual economic outlay requirement is met at all in situations such as those presented in Rev. Rul. 75-144 and *Gilday*, it is being satisfied without an actual transfer of funds by the shareholder to the S corporation, and without the shareholder actually having a cost basis in the indebtedness of the S corporation.

(4) Ltr. Ruls. 9811016, 9811017, 9811018, and 9811019. In these related rulings, the IRS ruled that a restructured loan from the shareholders of an S corporation to the S corporation constituted "indebtedness of the S corporation to the shareholders" within the meaning of Section 1366(d)(1)(B), even though the loan was originally made by a third-party bank directly to the S corporation rather than to the shareholders.

Under the facts of the rulings, an S corporation had an outstanding liability evidenced by a note issued by the corporation to an unrelated third-party bank. The shareholders also had signed as co-makers on the bank note. Pursuant to a proposed loan restructuring, the shareholders will give the bank their personal notes and the bank will then cancel the S corporation's note to the bank. In exchange for relief of its indebtedness to the bank, the S corporation will then issue promissory notes directly to its shareholders.

The IRS, citing *Gilday* and Rev. Rul. 75-144, concluded that the shareholders of the S corporation would be permitted to increase their basis in the S corporation by the amount of the restructured indebtedness pursuant to Section 1366(d)(1)(B).

Ltr. Ruls. 9811016-9811019 are consistent with the IRS's prior position in the loan restructuring area. As discussed above, although the IRS has generally not permitted shareholders to increase their basis in an S corporation in connection with loan restructurings originally involving a loan from an entity controlled by the shareholder, the IRS has consistently allowed shareholders to increase their basis in an S corporation in connection with loan restructurings

originally involving a loan from an unrelated third-party lender, such as the loans involved in Ltr. Ruls. 9811016-9811019.

(5) In *Miller v. Comm'r*, TCM 2006-125, the IRS once again has demonstrated its dislike for loans between taxpayers and their related entities in the S corporation context, and has sought to further expand the universe of loans not qualifying for basis increases under Section 1366(d)(1)(B). The Tax Court held that the shareholder of an S corporation was entitled to increase his basis in the indebtedness of the S corporation under Section 1366(d)(1)(B) in connection with a loan restructuring pursuant to which the original loan made by a third-party lender (Huntington National Bank) to the S corporation was restructured as a loan from the bank to the shareholder, and then as a loan from the shareholder to his S corporation. Additionally, the Tax Court held that the shareholder was "at risk" within the meaning of Section 465 with respect to the indebtedness of the S corporation to him, and as such, was entitled to deduct the losses of the S corporation passing through to him under Section 1366 for the years in issue.

The S corporation was incorporated in 1988 and was engaged in the business of manufacturing mobile and modular medical diagnostic facilities. The taxpayer was the sole shareholder of the S corporation. The S corporation arranged with the bank to obtain financing for the business and loans were initially made directly by the bank to the S corporation. Subsequently, because of financial difficulties, the taxpayer obtained four outside investors in the S corporation (the "Rapp Group"), which made capital contributions to the S corporation in exchange for a certain percentage of the S corporation's stock. In connection with the Rapp Group's investment in the S corporation, the S corporation obtained a line of credit from the bank. The taxpayer executed an unlimited guarantee for the S corporation's indebtedness to the bank, secured by a second mortgage on his personal residence, and each member of the Rapp Group executed limited guarantees with respect to the S corporation's indebtedness to the bank.

Subsequently, based on advice from the shareholder's tax advisor at Ernst & Young, a decision was made to restructure the loan arrangement so that the shareholder would be able to increase his basis in the S corporation to

take advantage of the losses incurred by the S corporation during the years in issue. Specifically, the bank reissued the line of credit to the shareholder personally, who in turn loaned the funds to the S corporation which used those funds to satisfy the original letter of credit to the bank, which was canceled. The S corporation executed a promissory note and a security agreement (pledging its assets as security for the loan) in favor of the shareholder, which the shareholder in turn collaterally assigned to the bank as security for the loan made by the bank to the shareholder.

Several years later, the S corporation became insolvent and the Rapp Group, as guarantors, paid $900,000 to the bank in partial satisfaction of the loan. The Rapp Group then satisfied the remaining $475,000 on the loan by taking out personal loans from the bank and using the proceeds to purchase the bank's note to the shareholder. Concurrently, the shareholder and the Rapp Group formed a new entity which purchased the remaining assets of the S corporation and completed the S corporation's outstanding contracts. Upon completion of those contracts, the proceeds were paid to the Rapp Group, which in turn used those proceeds to repay their personal loans to the bank (the $475,000). The shareholder has not made any payments to the Rapp Group to reimburse them for payments to satisfy the loan pursuant to their guarantees, nor has the Rapp Group sought reimbursement from the shareholder.

The shareholder increased his basis in the S corporation as a result of the loan restructuring, and consequently deducted substantial losses incurred by the S corporation during the years in issue. The IRS argued that the shareholder was not entitled to any basis increase as a result of the loan restructuring because the S corporation remained the "true borrower" on the bank loan, and therefore disallowed the losses claimed by the shareholder. Additionally, the IRS argued that the shareholder was not "at risk" for the amounts borrowed from the bank and then loaned to the S corporation, and as such, did not increase his basis in the S corporation. Finally, the IRS argued in the alternative that if the shareholder was entitled to a basis increase as a result of the loans so that the deductions were allowable, then the payment to the bank by the Rapp Group under its guarantee constituted taxable forgiveness of debt income to the shareholder under Section 108.

Although the Tax Court allowed the shareholder to increase his basis as the result of the loan restructurings, it unfortunately reiterated its past reasoning that in order for a shareholder to be entitled to a basis increase, the shareholder must have made an "actual economic outlay" that leaves the taxpayer "poorer in a material sense" than he was before the transaction. Additionally, the court stated that where the source of funding for a back-to-back loan is a related party rather than an independent third-party lender, there may not be an economic outlay sufficient to create basis since the shareholder's repayment of the funds is uncertain (because the repayment is to a related party). Furthermore, the court stated that the presence of a third-party lender as the source of the funds lent by the shareholder to his S corporation is an important factor in determining whether the shareholder has made an actual economic outlay.

The court also went on to find that the taxpayer was sufficiently "at risk" within the meaning of Section 465 with respect to the loan to the bank, rejecting the IRS's argument that certain guarantee waivers executed by the Rapp Group in favor of the shareholder resulted in the shareholder being "protected against loss" within the meaning of Section 465(b)(4).

Finally, the court concluded that although the shareholder did realize discharge of indebtedness income as a result of the Rapp Group's payment under its guarantee of $900,000 to the bank, such amounts were excludable from the shareholder's gross income under Section 108(a)(1)(B) since the shareholder was insolvent at the time of the discharge.

Although the IRS and the courts have generally been unwilling to grant basis increases in connection with loan restructurings where the loan was originally structured as a loan from a related entity to the taxpayer's S corporation, the IRS and the courts have generally been willing to grant taxpayers a basis increase in connection with loan restructurings where the original loan came from an unrelated third-party lender. Consequently, the *Miller* case represents an unwarranted expansion of the IRS's position in this area, since the IRS was seeking to deny a basis increase in connection with a loan restructuring which originally involved a loan from an unrelated third-party lender. This is directly contrary to a number of cases and

rulings in the area. In fact, in Ltr. Rul. 8747013, the IRS ruled that shareholders would be permitted to increase their basis in an S corporation where the shareholders borrowed funds from a third-party bank, loaned such funds to the S corporation, and the S corporation then used the loaned funds to satisfy the original indebtedness to the third-party bank. This is the exact situation presented in the *Miller* case. The IRS's and courts' position denying basis increases in connection with loan restructurings between related parties is highly questionable, and for the IRS to attempt to expand this position to loan restructurings involving an unrelated third-party lender is very disturbing.

(6) In *Rose v. Comm'r*, 101 AFTR 2d 2008-1888, 2008-1 USTC ¶50,318 (CA-11, 2008), an unpublished decision, the Eleventh Circuit affirmed in part, and reversed in part, the Tax Court's earlier decision in *PK Ventures, Inc. v. Comm'r*, TCM 2006-36. In *Rose*, certain corporations underwent a reorganization at the beginning of 1994. Following the reorganization, Rose, an individual, owned all of stock of one corporation (Troubled) and some of the stock of another corporation (Profitable). Both Troubled and Profitable were S corporations. Troubled incurred losses before and after the reorganization, whereas Profitable was profitable.

Prior to the reorganization, Rose had transferred cash to a predecessor of Profitable; these "cash transfers" had been treated as loans. Following the reorganization, Troubled owed money to Profitable. During 1994 and 1995, Rose "paid" $1,150,000 of Troubled's debt to Profitable by reducing the amount that Profitable owed Rose (as a result of the previous cash transfers). Troubled, in turn, reported "loans from shareholder" in corresponding amounts. Rose claimed losses from Troubled on his 1994 and 1995 tax returns, taking the position that the transactions described above increased his basis in Troubled.

The Tax Court had found that Rose could not increase his basis in Troubled as a result of the transactions, reasoning that the transactions were merely bookkeeping entries that did not leave Rose "poorer in a material sense when fully consummated," and, therefore, that Rose had not made an "economic outlay" by engaging in them. The Eleventh Circuit, however, reversed and remanded, directing the Tax Court to reconsider the effect of Rose's "cash transfers" to the predecessor of Profitable prior to the reorganization.

The Eleventh Circuit indicated these cash transfers made Rose "poorer in a material sense" and constituted actual debt owed to Rose. Citing *Selfe v United States*, 778 F.2d, 769 (CA-11, 1985), an earlier Eleventh Circuit decision, the court suggested that these obligations were "properly shiftable" between Profitable and Troubled to increase Rose's basis in Profitable. The Eleventh Circuit also noted that the Tax Court had suggested that the cash transfers may have been capital contributions rather than loans; in this regard, the Eleventh Circuit indicated that Rose would have been entitled to increase his basis in Profitable regardless of whether the cash transfers constituted loans or capital contributions.

The Eleventh Circuit's analysis is somewhat cryptic. Although it is not completely clear, the court appears to be indicating that so long as A had basis in Profitable as a result of the cash transfers, A could shift that basis to Troubled by treating Troubled as having reduced its obligation to Profitable, Profitable as having reduced its obligation to A, and A as having loaned funds to Troubled. The court further seems to be suggesting that A might be considered to have made an "economic outlay" merely by virtue of having loaned or contributed money to Profitable in the first instance.

g. Loan Restructurings Not Resulting in Basis Increase. The one constant in every situation where a shareholder has not been allowed to increase his basis in an S corporation in connection with a loan restructuring is that the transaction originally involved a loan from an entity controlled by the shareholder.

(1) In TAM 9403003 and *Bergman v. United States*, 74 F.3d 928 (CA-8, 1999), the IRS ruled that amounts loaned by a shareholder to his wholly-owned S corporation did not constitute indebtedness of the S corporation to the shareholder within the meaning of Section 1366(d)(1)(B) where the loan originally had been structured as a loan from another S corporation controlled by the shareholder to the shareholder's wholly-owned S corporation.[19]

(2) In *Underwood v. Comm'r*, 63 TC 468 (1975), *aff'd*, 535

[19] It would be interesting to know whether the IRS would have taken the same position had the transaction *originally* been structured (rather than restructured) such that the S corporation shareholder borrowed funds from one controlled S corporation and then re-loaned those same amounts to another controlled S corporation. Under the reasoning used by the IRS to reach its conclusions in TAM 9403003, it would appear that the taxpayer would *not* be entitled to increase his basis in the S corporation even if the transaction originally had been structured in this manner. Perhaps this question has now been answered in TAM 200619021.

F.2d 309 (CA-5, 1976), the court held that the shareholders of an S corporation would not be entitled to increase their basis where they substituted their own personal promissory notes for the promissory notes that their S corporation had previously executed in favor of another corporation that was wholly-owned by the same shareholders.

(3) In *Shebester v. Comm'r*, TCM 1987-246, the Tax Court held that a shareholder's assumption of a promissory note payable by one controlled S corporation to another controlled S corporation would not result in the creation of indebtedness of the S corporation to the shareholder so as to permit the shareholder to increase his basis in the S corporation.

(4) In *Griffith v. Comm'r*, TCM 1988-445, the Tax Court held that an S corporation shareholder was not entitled to a basis increase where journal entries reflected the assumption of a loan between related S corporations by the shareholder.

(5) In a variation on a common loan restructuring theme, the Tax Court in *Wilson v. Comm'r*, TCM 1991-544, held that the shareholders of two S corporations could not increase their respective bases in the S corporations by the amount of loans distributed to the shareholders from a third S corporation controlled by them which had previously made the loans to the two S corporations. The court concluded that the distributed loans did not represent indebtedness for purposes of determining the shareholders' bases in the stock and indebtedness of the two S corporations since the shareholders made no actual economic outlay with respect to such loans. Specifically, the court found that even though the shareholders had reported the receipt of the loans on their individual federal income tax returns, the distribution of the loans to them by their controlled S corporation did not constitute an actual economic outlay sufficient to create indebtedness of the S corporation to the shareholders within the meaning of Section 1366(d)(1)(B).

(6) In *Hitchins v. Comm'r*, 103 TC 711 (1994), the Tax Court, in a case of first impression, held that a loan originally made by a shareholder to his controlled C corporation that was assumed by an S corporation in which the shareholder and his wife were 50% shareholders, did not constitute "indebtedness of the S corporation to the shareholder" within the meaning of Section 1366(d)(1)(B). Consequently, the shareholder was not permitted to increase his basis in the S corporation and was therefore

unable to deduct losses incurred by the S corporation during the taxable year.

Although the Tax Court found that shareholder had made an economic outlay, and that by virtue of the assumption, S became obligated to pay the $34,000 to shareholder, it concluded that since there was no ***direct obligation*** from S to shareholder, shareholder was simply a creditor-beneficiary of S whose rights against S were derivative through C, and as such, the loan did not constitute indebtedness of the S corporation to shareholder within the meaning of Section 1366(d)(1)(B). The court found it significant that as between C and S, C remained liable as a surety of the obligation of S to shareholder. Consequently, the court concluded that there was no investment by shareholder in S as contemplated under Section 1366(d)(1)(B). The court distinguished *Gilday* and Rev. Rul. 75-144 (in which shareholders were granted an increase in basis where they substituted their personal notes for the S corporation's note to a third-party bank), since C remained liable on the note to shareholder whereas the S corporations in *Gilday* and Rev. Rul. 75-144 were released of liability on their notes to the third-party banks.

The most interesting aspect of *Hitchins* is that the court went on to state that if C had been released from liability by a novation and a replacement note had been issued by S to shareholder, or alternatively, if shareholder loaned $34,000 to S, followed by S's payment of its debt to C, and C's repayment of the loan to S (a circular flow of funds), shareholder may well have been able to increase his basis in S under Section 1366(d)(1)(B). In effect, the court suggested that if the taxpayer had taken the steps taken by the taxpayer in TAM 9403003, the taxpayer could have increased his basis in the S corporation (contrary to the result reached by the IRS in TAM 9403003).

(7) In *Bhatia v. Comm'r*, TCM 1996-429, the Tax Court held that the sole shareholder of an S corporation was ***not*** entitled to increase his basis in the S corporation by reason of his assumption of the S corporation's indebtedness to another corporation which was also wholly owned by the shareholder. Consequently, the shareholder was unable to deduct the losses incurred by the S corporation during the taxable year.

Although the Tax Court rejected the taxpayer's argument, the court recognized that the decided cases did place a

heavy burden on shareholders who seek to rearrange the indebtedness of related closely held S corporations. The court additionally provided that the existence of such a relationship is ***not*** necessarily fatal if other elements are present which clearly establish the bona fides of the transaction and their economic impact, and specifically cited: (1) *Hitchins* (in which the Tax Court set forth alternative methods by which the shareholder in that case could have obtained a basis increase), and (2) Looney, "TAM 9403003: The Service's Not-So-Kind-And-Gentle Approach to Loan Restructurings Between Related Entities," 6 J. S Corp. Tax'n 297 (Spring 1995), as support for the position that loan restructurings between related entities, if properly structured and documented, should result in a basis increase for the S corporation shareholder.

(8) In *Thomas v. Comm'r*, TCM 2002-108, the Tax Court held that the taxpayer's basis in each of two S corporations (RAM and Intrusion) was not increased as a result of loans made by various other entities controlled by the taxpayer to the two S corporations.

(9) In *Oren v. Comm'r*, 357 F.3d 854 (8th Cir. 2004), the Eighth Circuit Court of Appeals held that amounts loaned to two S corporations by their sole shareholder did not create "indebtedness of the S corporation to the shareholder" within the meaning of Section 1366(d)(1)(B) so as to permit the shareholder to increase his basis in the S corporations, where the source of the loaned funds was another S corporation controlled by the shareholder.

(10) In *Kaplan v. Comm'r*, TCM 2005-217, the Tax Court held that in a case involving a circular flow of funds, the amounts loaned by a shareholder to his wholly owned S corporation did not constitute" indebtedness of the S corporation to the shareholder" within the meaning of Section 1366(d)(1)(B), and as such, did not increase his basis in the S corporation by the amount of such indebtedness.

(11) In *Ruckriegel v. Comm'r*, TCM 2006-78, the Tax Court held that loans made to an S corporation from a related partnership, which the taxpayers argued were subsequently restructured as loans from the partnership to the shareholders and then from the shareholders to the S corporation, did not increase the shareholders' basis in the S corporation under Section 1366(d)(1)(B).

The case involved two brothers who owned both an S corporation and a partnership. During the years at issue, the partnership operated at a profit while the S corporation operated at a loss. Each of the brothers' basis in his S corporation stock was zero. For the years at issue, the brothers claimed that they had basis in the S corporation as a result of two kinds of advances. The first were wire transfers that initially had been made by the partnership directly to the S corporation; however, at some point during the three-year period after the advances had been made, backdated notes were executed between the partnership and the brothers and between the brothers and the S corporation. The second kind of advance involved wire transfers from the partnership to the brothers followed by wire transfers from the brothers to the S corporation. The brothers claimed that all the advances were, in substance, direct loans from them to the S corporation, such that their basis in the S corporation should be increased. The IRS disagreed, contending that all of the advances were "inherently" loans from the partnership to the S corporation because the brothers had not made an "actual economic outlay" of their own funds.

Before analyzing the particular facts, the Tax Court made some general observations regarding the law. Importantly, the court rejected the IRS argument that the "economic outlay" requirement is met only if a taxpayer invests in or lends to the S corporation either his own funds or funds that are borrowed from an unrelated party to whom he is personally liable. Instead, citing *Yates*, the court stated that "the fact that funds lent to an S corporation originate with another entity owned or controlled by the shareholder of the S corporation does not preclude a finding that the loan to the S corporation constitutes an 'actual economic outlay' by the shareholder." The court in *Ruckriegel* further stated: " . . . we find no categorical rule, under Section 1366(d)(1)(B), the regulations thereunder, see Reg. §1.1366-2(a), Income Tax Regs., the applicable case law, or indeed, as a matter of plain common sense, requiring a common shareholder to fund the S corporation's losses with funds from his mattress or with funds borrowed by him from a bank or other unrelated party, rather than with funds obtained from another controlled entity, in order to obtain a basis in the unprofitable S corporation to the extent of the funding."

With respect to the advances that were made by the partnership to the S corporation, the Tax Court was willing to entertain the brothers' argument that, in substance, the brothers had loaned money to the S corporation. In this regard, the court indicated that the brothers' position, in effect, was premised on two grounds: (1) that the brothers used the partnership as an "incorporated pocketbook" to discharge their personal obligations, and (2) that the advances were intended to constitute bona fide back-to-back loans that would give rise to basis. The court, however, noted that where there are transactions between related parties, the taxpayer bears a heavy burden of demonstrating that the substance of a transaction is different than its form.

With respect to the "incorporated pocketbook" argument, the court explained that the term "incorporated pocketbook" describes a taxpayer's "habitual practice of having his wholly owned corporation pay money to third parties on his behalf." In this regard, the court noted that whether such a practice is "habitual" and whether such a practice proves that "any ambiguous payment is being made by the corporation on behalf of its owner (as opposed to on its own behalf)" are questions of fact. Based on the facts of the particular case (including the number of checks the partnership wrote to the brothers as partnership distributions), the court found that the brothers did not use the partnership for personal purposes to an extent that would justify treating the partnership's advances to the S corporation as advances on behalf of the brothers.

With respect to whether the advances from the partnership to the S corporation were intended by the parties to constitute loans from the brothers directly to the S corporation, the court found that the form of the transaction as a loan from the partnership to the S corporation was not necessarily fatal. The court also found that, unlike other cases in which there had been a "brief, circular flow of funds beginning and ending with the original lender," the loans to the S corporation in the instant situation had a valid business purpose of providing working capital for the operation and expansion of the S corporation's business. Nonetheless, the court indicated that the brothers' intent to establish a back-to-back loan structure in connection with the direct payments by the partnership would have to be "clearly manifested by the actions of the parties to those transactions." Based on the facts of the case, the court

found that the brothers had failed to meet this burden. Among other things, the court found that various backdated documents were not sufficient to establish that the parties had, at the time the funds were advanced, intended for the brothers to be lending funds to the S corporation and for the S corporation to be obligated directly to the brothers.

By contrast, the court found that the advances that were actually made from the partnership to the brothers and from the brothers to the S corporation did result in a basis increase. The court reasoned that "it is the form of the wire transfer payments and the manner in which they were consistently recorded on both [the partnership's and the S corporation's] books that furnish the evidentiary support" for the brothers' position that the loans gave them basis in the S corporation. The court further remarked that, "although we would normally be inclined to view petitioners' participation in the transactions, if they were essentially conduits for transfers of funds from [the partnership to the S corporation,] as without legal significance, in this instance petitioners' involvement, at some personal inconvenience, represented a concrete manifestation of an intent to create debt" from the S corporation to the brothers and from the brothers to the partnership.

(12) In *Kerzner v. Comm'r*, TCM 2009-78, the Tax Court held that the amounts loaned by a shareholder to his wholly-owned S corporation did not constitute "indebtedness of the S corporation to the shareholder" within the meaning of Section 1366(d)(1)(B), and as such, did not increase the taxpayer's basis in the S corporation by the amount of such indebtedness. Consequently, the taxpayer was unable to deduct substantial suspended losses of the S corporation.

The parties stipulated that TAM 200619021 related to the *Kerzner* case and that the statement of facts in the TAM was incorporated by reference into the Tax Court's decision. Under the facts of *Kerzner* (and TAM 200619021), the taxpayers, husband and wife, were 50% partners in a partnership ("Partnership") and 50% shareholders in an S corporation ("S Corp"). For years 1986 through 2001, the Partnership loaned money to taxpayers, the taxpayers in turn loaned money to S Corp, and the S Corp would then pay rent (presumably based on fair rental value) to the Partnership for property leased by the Partnership to the S Corp. The loans between the

Partnership and the taxpayers and between the taxpayers and S Corp were documented by duly executed promissory notes providing for principal payments at the end of the following year and stated interest. Except for one partial repayment of principal by S Corp to taxpayers, however, no repayments of either principal or interest were ever made with respect to any of the promissory notes.

The Partnership borrowed money on a non-recourse basis from a third-party lender to acquire and construct real property (the "HUD Loan"). Under the borrowing arrangement with the lender, no portion of the loan proceeds could be or were used in the loan arrangements between the taxpayers , the Partnership and the S Corp, and loans from the Partnership to the taxpayers were only permitted if the third-party lender approved of the loan, ***the proceeds were made from the net profits of the Partnership*** (after debt service payments to the third-party lender), and the proceeds were used to fund the activity of the Partnership.

The taxpayers increased their basis in S Corp under Section 1366(d)(1)(B) by the amount of the loans made by the Partnership to them, and then from them to S Corp, and deducted losses of S Corp based on the increased basis. The IRS's position was that the taxpayers were ***not*** entitled to a basis increase under Section 1366(d)(1)(B) for the loans made to S Corp attributable to the funds borrowed by taxpayers from the Partnership.

In reaching its decision, the Tax Court cited *Oren v. Comm'r*, TCM 2002-172 *aff'd* 357 F.3d 854 (8th Cir. 2004), for the proposition that transactions involving a brief, circular flow of funds (beginning and ending with the original lender) designed solely to generate basis in an S corporation have no economic substance and therefore do not evidence the required economic outlay. Specifically, the Tax Court held that each year, the partnership lent money to the taxpayers, the taxpayers then lent the proceeds to the S corporation and the S corporation then paid rent back to the partnership. From the Tax Court's point of view, the transaction lacked economic sense or substance since the money wound up right where it started.

Additionally, in reaching its decision, the Tax Court specifically distinguished *Ruckriegel v. Comm'r*, TCM 2006-78, *Yates v. Comm'r*, TCM 2001-280, and *Culnen v. Comm'r*, TCM 2000-139, *rev'd and remanded on another*

issue, 28 Federal Appx. 116 (3rd Cir. 2002). The Tax Court found in those cases that the transfers were made for valid business purposes, and that there was no circular flow of funds.

The Tax Court also distinguished *Gilday v. Comm'r*, TCM 1982-242, even though it too involved a circular flow of funds. The sole distinction in that case was that the original lender was an unrelated third party bank, and the court found that "when funds come from an unrelated third party, the arm's-length transaction tends to insure that repayment will be enforced." Thus, the Tax Court found that since the loan in the *Kerzner* case was from a related party, there was no economic outlay on the yearly loans and therefore the taxpayers did not acquire basis in indebtedness with respect to such amounts.

(13) In *Russell v. Comm'r*, TCM 2008-246, *aff'd* _____ F.3d _____ 106 AFTR2d 2010-6056 (8th Cir. 2010), the Tax Court held that certain instruments designated as "notes," "ledger debt," and "short-term debt," did ***not*** constitute indebtedness of the S corporation to the shareholders for purposes of Section 1366(d)(1)(B), and as such, the shareholders could not increase their basis by the amount of such indebtedness and in turn deduct the losses incurred by the S corporation.

h. Summary of Recent Cases and Rulings. While several Tax Court decisions, *Hitchens*, *Bhatia*, *Culnen*, *Yates, Ruckriegel* and *Rose*, seemed to indicate that the Tax Court and the 11th Circuit in particular had undergone a change of attitude with respect to granting basis increases in connection with the structuring or restructuring of loans between related entities, *Oren*, *Thomas*, *Kaplan, Miller* (even though decided in favor of the taxpayer), TAM 200619021 and *Kerzner* represent setbacks for taxpayers. In TAM 200619021 and *Kerzner*, the IRS and the Tax Court now appear to be taking the position that basis increases should be denied where the source of the funds for a loan to an S corporation is from a related entity and there is a circular flow of funds, ***even if the loan is initially structured in such a manner***. Additionally, in *Miller*, the IRS seems to be taking the position that ***even if a loan restructuring originally involved a third-party lender***, the taxpayer may not be entitled to a basis increase if it involves a circular flow of funds.

i. IRS Announces It Will Issue Guidance Under Section 1367 on S Corporations and Back-to-Back Loans. At an American Institute of Certified Public Accountants National Tax Conference in

Washington, DC on 10/30/2008, Curt Wilson, the newly appointed Associate Chief Counsel for Pass-Throughs and Special Industries, stated that in response to *Miller v. Comm'r*, TCM 2006-125, guidance under Section 1367 regarding S corporations and back-to-back loans should be issued before the end of 2008 (no regulations on back-to-back loans have had been issued as of mid-September 2010).

3. **<u>ABA Tax Section Submits Comments on Qualification of Debt as "Indebtedness of an S Corporation to a Shareholder" under Section 1366(d)(1)(B) in Connection with Back-to-Back Loans</u>**. The following comments (the "Comments") were prepared by members of the Committee on S Corporations of the Section of Taxation (the "Committee"). Principal responsibility was exercised by Stephen R. Looney. Substantive contributions were made by Ronald A. Levitt and Thomas J. Nichols. The Comments were approved and submitted on behalf of the American Bar Association Section of Taxation to the Treasury Department and the IRS on July 26, 2010.

a. <u>Back-to-Back Loans are Not Inherently Abusive Transactions Regardless of Whether Funds are Provided by Unrelated Third Party or a Related Party</u>. This can be demonstrated by a simple example. Suppose an individual, A, owns 90% of the stock of two S corporations, X and Y. Suppose further that corporation Y needs $1,000,000 of additional cash to buy a machine and A loans corporation Y the money from A's own personal funds to do so. It appears that nobody would challenge A's entitlement to losses based on the resulting $1,000,000 of indebtedness. Technically, A is not "poorer" in any sense. A has $1 million less in the bank, but also owns a $1,000,000 note payable by corporation Y.

Suppose, however, that instead of loaning funds from A's personal account, A instead causes corporation X to loan the $1,000,000 to corporation Y. Although, as noted above, some of the cases have held otherwise, in general, the $1,000,000 loan would not be available as additional basis to absorb losses passed through to A from corporation Y, simply because of the mechanical way in which the S corporation tax statutes operate. Significantly, as explained above, almost the exact opposite results would be obtained if X and Y were limited liability companies treated as partnerships under the Code. The additional outside loan would create additional basis at the partner level, which, in turn, would be fully available to absorb losses under Section 704(d), subject, of course, to the at-risk and passive activity rules, which are applicable to both partners and S corporation shareholders. None of the shareholders or the partners in any of these scenarios is "poorer." One of their entities has $1,000,000 less cash, but also

has a $1,000,000 note receivable. The other entity received cash, but owes it back to the first entity along with interest.

Finally, suppose that A, recognizing the above incongruity in the tax law, decides to have corporation X loan A the $1,000,000, which A promptly re-loans to corporation Y. Once again, neither A, nor for that matter either of the corporations, is "poorer." They have just reconfigured their assets and liabilities. However, independent of the tax consequences, interposing A between corporation X and corporation Y, as a borrower from corporation X and a lender to Corporation Y, has substantially changed A's financial and legal rights. A now owes corporation X $1,000,000, regardless of whether corporation Y ever pays A under its note to A. We do not believe A's borrowing from corporation X and loaning to corporation Y should be treated any differently from A's lending $1,000,000 of personal funds to corporation Y.

Moreover, economic uncertainty must also always be considered. Regardless of how favorable things may look now, both corporation X and corporation Y may ultimately go bankrupt. In that setting, interposing A between the two corporations has had a huge impact. A must now pay $1,000,000 of A's own personal funds, plus interest, to corporation X's creditors, and probably receive little or nothing on A's note from corporation Y. In fact, there is a good chance that A's claim as a shareholder creditor will be subordinated in corporation Y's bankruptcy. *See* 11 U.S.C. §510(c); *Pepper v. Litton,* 308 U.S. 295 (1939); *In re Lemco Gypsum, Inc.*, 911 F.2d 1553 (CA-11 1990). Moreover, even if A had managed to get corporation Y to pay off its note to A prior to bankruptcy, A would most likely be considered an "insider," which means that A would have to return any such payments received by A within the one-year period preceding bankruptcy. *See* 11 U.S.C. §§547(b)(4)(B) and 101(3).

Quite simply, provided there is a bona fide indebtedness between a shareholder and an entity controlled by such shareholder, the shareholder should be permitted to treat funds obtained in this manner and then loaned to another S corporation as indebtedness of the S corporation to such shareholder within the meaning of Section 1366(d)(1)(B). The S Corporations Committee acknowledges and generally concurs with the comments on back-to-back loans submitted by the American Institute of Certified Public Accountants (AICPA) to Treasury and the IRS on 5/29/2009. In particular, we believe that the items which must be met to fall within the AICPA's safe harbor are certainly relevant factors in determining whether a bona fide indebtedness exists. We believe, however, that a safe harbor is unnecessary, as the

statute is unambiguous and the regulations should clearly provide that a basis increase will occur in back-to-back loans so long as the indebtedness is bona fide and not a sham.

b. No Statutory Basis for Denying Basis Increases for Back-to-Back Loans. Notwithstanding the above, the IRS and some courts appear to take the position that back-to-back loans are somehow abusive -- especially if the principal source of the funds is the shareholder's related entity. In actuality, there is nothing inherently abusive about an S corporation shareholder borrowing funds from a third party, whether related or unrelated, and then loaning such funds to the S corporation in order to obtain a basis increase in such S corporation. The IRS and the courts have certainly allowed basis increases in connection with back-to-back loans, even with respect to loan restructurings, where an unrelated third party lender made the original loan to the S corporation. *See* Rev. Rul. 75-144, 1975-1 C.B. 277; Ltr. Rul. 8747013 (Aug. 20, 1987), Ltr. Rul. 9811016 (Dec. 3, 1997); *Gilday v. Comm'r*, 43 TCM (CCH) 1295, 1982 TCM (RIA) ¶ 38994; *Gurda v. Comm'r*, 54 TCM (CCH) 104, 1987 TCM (RIA) ¶ 44107; *Miller v. Comm'r*, 91 TCM (CCH) 1267, 2006 TCM (RIA) 2006-125, *rev'd on another issue*, 540 F.2d 184 (CA-3 1976). Additionally, in *Millar v. Comm'r*, 34 TCM (CCH) 554, 1975 TCM (RIA) ¶ 33,158, and *Rose v. Comm'r*, 2008-1 USTC ¶50,318, 311 Fed. Appx. 196 (CA-11 2008), the courts were willing to grant basis increases where the funds for the back-to-back loans *were provided by a related party*.

Perhaps, the Tax Court, in *Ruckriegel v. Comm'r*, 91 TCM (CCH) 1035, 2006 TCM (RIA) ¶ 2006-78, stated it most succinctly as follows:

> . . . we find no categorical rule, under Section 1366(d)(1)(B), the regulations thereunder, see Reg. §1.1366-2(a), Income Tax Regs., the applicable case law, *or indeed, as a matter of plain common sense*, requiring a common shareholder to fund the S corporation's losses with funds from his mattress or with funds borrowed by him from a bank or other unrelated party, rather than with funds obtained from another controlled entity, in order to obtain a basis in the unprofitable S corporation to the extent of the funding (emphasis added).

Consequently, the court rejected the IRS's argument that the "economic outlay" requirement is met only if a taxpayer invests in or lends to the S corporation either personal funds or funds that are borrowed from an unrelated party to whom the shareholder is personally liable. Instead, citing *Yates*, the court stated that "the

fact that funds lent to an S corporation originate with another entity owned or controlled by the shareholder of the S corporation does not preclude a finding that the loan to the S corporation constitutes an 'actual economic outlay' by the shareholder." *See also Hitchins v. Comm'r*, 103 TC 711 (1994), where the court stated that if a related C corporation had released the S corporation from liability by a novation and a replacement note had been issued by an S corporation to its shareholder which assumed the S corporation's indebtedness to the related C corporation, or alternatively, if the shareholder had loaned $34,000 to his S corporation, followed by the S corporation's payment of its debt to the related C corporation, and the related C corporation's repayment of the loan to the S corporation (***a circular flow of funds***), the shareholder should have been entitled to increase his basis in the S corporation under Section 1366(d)(1)(B), and *Bhatia v. Comm'r*, 72 TCM (CCH) 696, 1996 TCM (RIA) ¶ 51565, where the Tax Court specifically stated that a loan from a related corporation in a back-to-back loan restructuring is *not* necessarily fatal if other elements are present which clearly establish the bona fides of the transaction and their economic impact, and specifically cited: (1) *Hitchins* (discussed above), and (2) Looney, *TAM 9403003: The Service's Not-So-Kind-And-Gentle Approach to Loan Restructurings Between Related Entities*, 6 J. S Corp. Tax'n 297 (Spring 1995), as support for the proposition that loan restructurings between related entities, if properly structured and documented, should result in a basis increase for the S corporation shareholder.

The fact that the funds used by the shareholder originated from a related entity (rather than from an unrelated third party lender or from the shareholder's personal bank account) does not in any way make such funds any less of an "investment in the corporation" than funds obtained by the shareholder from any other source.

The application of the economic outlay rule requiring the shareholder to be poorer in a material sense after the transaction than before the transaction began, as well as any application of a "source of funds" rule, in order to determine whether the taxpayer is entitled to increase his, her or its basis in the S corporation is without any express statutory (or regulatory) basis. In effect, the S corporation shareholders are being punished for having access to cash from a source other than an unrelated third-party lender. The shareholder is being penalized solely because the source of funds is a related corporation rather than an unrelated third-party lender or from funds "from his mattress." *See Ruckriegel*, 91 TCM (CCH) 1035, 2006 TCM (RIA) ¶ 2006-78. In effect, an attribution rule is being applied in the context of Section 1366(d)(1)(B), so that funds which are obtained by a shareholder from a related corporation or

other entity and then loaned to an S corporation controlled by that same shareholder will not be treated as indebtedness of the S corporation to the shareholder under Section 1366(d)(1)(B). Because there is no such attribution rule that is applicable with respect to Section 1366(d), there is simply no authority to apply such a rule. In *Prashker v. Comm'r*, 59 TC 172 (1972), the IRS argued, and the Tax Court found, that the taxpayer-shareholder could *not* apply the attribution rules of Section 267 to treat a loan to his S corporation from an estate in which the shareholder was the sole beneficiary as a loan from the shareholder, and as such, the loan between the estate and the S corporation did not constitute indebtedness of the S corporation to the shareholder within the meaning of Section 1366(d)(1)(B). While denying taxpayers the use of an attribution rule in their favor, the IRS and some courts are implicitly applying an attribution rule to their detriment, by treating funds that are obtained by a shareholder from a related entity as not qualifying to increase the shareholder's basis in an S corporation when such funds are loaned (or contributed) by the shareholder to the S corporation. This is not only inequitable, but also unauthorized by the Code. Additionally, there are cases that hold that amounts loaned to shareholders by persons related to them, and then contributed by the shareholders to their S corporation, entitle the shareholders to increase their basis in the S corporation for loss purposes. *See, e.g. Millar v. Comm'r*, 34 TCM (CCH) 554, 1975 TCM (RIA) ¶ 33,158, and *Rose v. Comm'r*, 2008-1 USTC ¶50,318, 311 Fed. Appx. 196 (CA-11 2008).

One could conclude, as some of these cases suggest, that related party transactions always lead to abuse and therefore all loan restructurings involving related parties are "abusive." A more reasoned conclusion is that, since a number of the cases have involved poorly documented (or undocumented) loans, backdating of documents, and after-the-fact journal entries to support back-to-back loans, these factors should be considered in whether or not a bona fide indebtedness exists, and if no bona fide indebtedness exists, we would agree with the courts and the IRS that in those situations, no basis increase is warranted.

c. No Economic Basis for Denying Basis Increases for Back-to-Back Loans. In addition to the lack of statutory authority, there is no economic foundation for requiring an S corporation shareholder to have made an actual economic outlay such that the shareholder is poorer in a material sense after the transaction than before the transaction began in order to obtain a basis increase under Section 1361(b)(1)(D). As alluded to above, in an economic sense, a shareholder is *never* poorer after the shareholder makes a loan to his, her or its S corporation than before the loan was made

(regardless of how the shareholder obtained the funds that were loaned to the S corporation). Rather, the shareholder has merely shifted his current assets from cash to notes receivable while his, her or its net worth has remained the same. Clearly, a current economic outlay leaving the taxpayer poorer in a material sense was ***not*** required in either Rev. Rul. 75-144 or *Gilday* (where the original loan was made by an unrelated third party lender), and there is certainly no justification for requiring a current economic outlay simply because the original loan was made by a related corporation rather than by an unrelated third-party lender.

The IRS is simply assuming that if the loan is between related parties it will never be repaid and, therefore, that no real indebtedness exists. If the IRS and the courts assume that a related entity will never make a demand for payment, no loans made between related corporations or between shareholders and their controlled corporations would ever be treated as indebtedness for purposes of the Code. Such a position not only ignores the form of such transactions, but also the economic substance of such transactions and numerous cases. Regardless of whether a loan is between related parties or unrelated parties, the loan should constitute indebtedness for all purposes of the Code so long as it represents bona fide indebtedness and is not a sham. The IRS's concern that funds borrowed by a shareholder from a controlled or wholly-owned corporation will not be repaid is misplaced. In the case of a loan to a shareholder by a corporation controlled (but not wholly-owned) by such shareholder, the minority shareholders would have the right to bring an action to compel payment of the loan on behalf of the corporation in the event the shareholder does not repay the loan to the S corporation. In the context of a wholly-owned corporation, third-party creditors would likewise have a cause of action to compel payment of the loan by the shareholder to the corporation. Additionally, as discussed above, because of economic uncertainty, the shifting of the loans between the parties has economic significance and creates genuine liability exposure, especially in the event of the bankruptcy of one or more of the corporations.

Finally, from an economic standpoint, in situations where the funds are obtained by the S corporation shareholder from a related corporation, such funds will in all likelihood have already been subjected to taxation (either at the entity level in the case of a C corporation or at the shareholder or partner level in the case of an S corporation or partnership). In these situations, clearly the S corporation shareholder has a tax cost basis in such funds, and there is simply no economic basis to support a denial of a basis

increase where such funds are then loaned by the shareholder to the S corporation.

d. Recommendation. The S Corporations Committee recommends that the Treasury and the IRS adopt regulations that provide for basis increases under Section 1366(d)(1)(B), regardless of the source of the funds used by the S corporation shareholder to make the loan (whether unrelated third party lender, related party or shareholder's own personal funds), provided that there is a bona fide indebtedness between the shareholder and the lender of the funds. The regulations should focus on those factors that would be critical in the legal enforcement of the loans against the shareholder and the S corporation, respectively. Such factors include contemporaneous written documentation, interest at or above the AFR, clear payment terms, disclosure in financial statements, etc. If the creditors of both parties would be able to enforce such loans, there is no statutory or policy reason for such loans not to be respected for tax purposes under Section 1366(d)(1)(B).

4. **AICPA Proposes Safe Harbor for Back-to-Back Loans**. On 5/29/09, the American Institute of Certified Public Accountants (AICPA) proposed a safe harbor on when back-to-back loans should give rise to basis for purposes of Section 1366(d)(1)(B). In formulating the safe harbor, the AICPA essentially rejected the tests which have been applied by the IRS and the courts in the past on back-to-back loans, explaining that the reasoning used by the IRS and the courts was misplaced for a number of reasons.

a. AICPA Analysis. The AICPA's comments provide that "indebtedness of the S corporation to the shareholder" as used in Section 1366(d)(1)(B), is unambiguous and that the clear and common use of this term is at odds with court decisions in this area, which inject a vague and subjective level of analysis not required or warranted given that the statute is unambiguous.

Specifically, the AICPA comments point out that without any statutory basis for doing so, numerous court decisions consider the ***source of the funds*** used by the shareholder to make a loan to the S corporation as determinative of whether the shareholder loan is included in basis under Section 1366(d)(1)(B). The AICPA goes on to point out that the courts have, with one exception, adopted the economic outlay test and that many of these court decisions discuss the fact that the economic outlay theory is based on the concept that the shareholder is ***"poorer in a material sense."*** The AICPA points out that the irony of the economic outlay doctrine, as can be demonstrated by simple balance sheet analysis, is that when a loan is made to the S corporation entity, the shareholder is

not "poorer" since the cash previously held is replaced with a note receivable, and the net worth of the shareholder is unchanged immediately after the exchange. Consequently, the AICPA believes the economic outlay doctrine as defined as a shareholder who is poorer in a material sense is ***not*** the appropriate test for establishing bona fide indebtedness between a shareholder and an S corporation. Rather, the AICPA points out that bona fide indebtedness (and thus basis) should be created if the terms of the arrangement between the S corporation and its shareholders arise to "debt" status for federal income tax purposes.

Citing *Ruckriegel v. Comm'r*, TCM 2006-78, the AICPA points out that there is nothing inherently wrong or abusive about a related party lending money. Thus, it follows that as long as the terms of the related party indebtedness are reasonably equivalent to a commercial loan and the transactions have legal significance, the IRS should agree that related party transactions be included in the safe harbor test. The safe harbor test also includes transactions whereby cash movement is circular as occurred in *Oren v. Comm'r*, 357 F.3d 854 (CA-8 2004), *Bergman v. United States*, 74 F.3d 928 (CA-8 1999) and *Kaplan v. Comm'r*, TCM 2005-217. Finally, the AICPA points out that the at-risk rules of Section 465 and the passive activity loss rules of Section 469 still represent significant barriers to the deductibility of losses for S corporation shareholders.

b. AICPA Safe Harbor. The AICPA's safe harbor provides that a shareholder note will be treated as debt qualified to permit the S corporation's shareholder to increase his basis in indebtedness from the corporation and, assuming the at-risk and passive activity loss limitations are met, to deduct losses under Section 1366(d), if the following seven points are met:

(1) The note is a written unconditional promise by the corporation to pay the shareholder, on demand or on a specified date, a sum certain in money.

(2) The interest rate specified in the instrument meets, at the minimum, the published applicable federal rate for the type of loan and for the time the loan is made.

(3) Interest payment dates are specified in the instrument.

(4) The instrument is legally enforceable under state law. That is, a transferee, under a voluntary or involuntary transfer, receiving the note would have the right to proceed against the corporation to enforce the terms of the note.

(5) The S corporation is not an obligor or co-obligor on the note issued by the shareholder to the primary lender in a back-to-back situation. However, a guarantee or pledge of corporate assets is ***not*** to be considered as making the company an obligor (or co-obligor) with respect to the shareholder's loan from the primary lender.

(6) Interest and principal payments are made pursuant to the Agreement, i.e., the company pays the shareholder and the shareholder pays the primary lender (if mistakes are made and direct payment is made, the books and records are adjusted and appropriate information reporting forms are filed). ***A doctrine of substantial compliance as opposed to strict compliance would apply***. However, routine use of offsetting accounting entries without actual payment would ***not*** be considered as within the safe harbor.

(7) Loans are reported appropriately on tax returns and year-end financial statements, if any, of the company and shareholder.

The AICPA's comments also include three examples addressing back-to-back loans involving unrelated third party lenders, three examples on back-to-back loans involving related parties, and two examples that cover substitution of subrogated debt.

5. Ways to Restructure Loans Consistent with Courts' and IRS's Position. A shareholder who desires to restructure a non-qualifying loan, but who does not want to challenge the IRS's position on loan restructurings, has several options in restructuring the loan depending upon whether the original loan was made by an unrelated third-party lender or by a related corporation.

a. Original Loan Made by Unrelated Third-Party Lender. If the original loan was made by an unrelated third-party lender to the S corporation, the shareholder could rely on Rev. Rul. 75-144 and *Gilday*, and merely substitute his personal promissory note for the corporation's promissory note which would be canceled by the third-party lender, with the S corporation issuing a new note payable to the shareholder.

A more prudent course of action would be to follow the approach set forth in Ltr. Rul. 8747013. Under this approach, the shareholder would first borrow the funds from the unrelated third-party lender, loan such funds to the S corporation, which would in turn use the funds to satisfy its original indebtedness to the third-party lender. In this manner, the shareholder would clearly meet the actual economic outlay requirement since the shareholder

would be ***transferring actual funds*** to the S corporation, and, as such, would be entitled to increase his basis in the S corporation by the amount of funds he transferred to the S corporation.

b. Loan originally Made by Related Corporation. If the loan was originally made by a corporation controlled by the shareholder to the S corporation, however, a more difficult problem is encountered by the shareholder. An alternative that should produce a basis increase would be for the shareholder to borrow funds from an unrelated third-party lender (which could be guaranteed by the controlled corporation originally making the loan), have the shareholder lend such funds to the S corporation, which would in turn repay the original indebtedness to the shareholder's other controlled corporation. Under these circumstances, the shareholder should be treated as making an actual economic outlay sufficient to justify a basis increase, even in the IRS's overly restrictive view. Absent the interjection of an unrelated third-party lender, however, it does not appear that a shareholder can, in the IRS's view, successfully restructure a loan originally made by a related corporation in a manner that will permit the shareholder to increase his basis in the S corporation.

6. **Conclusion**. The current position of the IRS and the courts still appears to be that amounts loaned by a shareholder to his wholly-owned S corporation will ***not*** constitute indebtedness of the S corporation to the shareholder within the meaning of Section 1366(d)(1)(B), where the loan was originally structured as a loan from another corporation controlled by the shareholder to the S corporation. The position taken by the IRS and the courts is not justified by the Code or economic reality, and is even more egregious in situations where the original loan is distributed as a dividend by the controlled corporation to the shareholder, or where the shareholder transfers actual funds to the S corporation in connection with loan restructuring. Although several cases have provided taxpayers with some hope that the courts were changing their position, other cases as well as rulings have indicated that the IRS and the courts are not changing their positions, and may in fact be taking an even more aggressive position with respect to back-to-back loans. Hopefully, the IRS will give serious consideration to the comments of the ABA Tax Section and the AICPA when it issues much needed guidance on back-to-back loans.

F. BUILT-IN GAIN TAX DEVELOPMENTS

1. **Introduction**. Section 1374 imposes a corporate-level tax on the built-in gains of S corporations that were previously C corporations. Section 1374 as originally enacted applies to built-in gains recognized by a corporation during the 10-year period following such corporation's conversion to S status. Section 1374(d)(7). Reg. §1.1374-1(d) provides that the recognition period is the ten-calendar year period, and not the ten-tax year

period, beginning on the first day the corporation is an S corporation or the day an S corporation acquires assets under Section 1374(d)(8) in a carryover basis transaction. The tax rate is presently 35% (the highest rate of tax imposed under Section 11(b)) of the S corporation's "net recognized built-in gain." Section 1374(b)(1).

2. **Small Business Jobs Act of 2010**. On September 27, 2010, President Obama signed into law the Small Business Jobs Act of 2010, H.R. 5297. Section 2014 of the Act amends Section 1374 to provide for the reduction of the recognition period during which corporations that converted from C corporation status to S corporation status are subject to the built-in gain tax from 10 years to 5 years for taxable years beginning in 2011. Specifically, the text of the amendment is very similar to the temporary reduction from 10 years to 7 years made by the American Recovery and Reinvestment Act of 2009 discussed below. The text of the amendment reads as follows:

a. Text of Amendment.

> (b) Special Rules for 2009, 2010 and 2011. - No tax shall be imposed on the net recognized built-in gain of an S corporation - (i) in the case of any taxable year beginning in 2009 or 2010, if the 7th taxable year in the recognition period preceded such taxable year, or (ii) in the case of any taxable year beginning in 2011, if the 5th year in the recognition period preceded such taxable year.

b. Effective Date. The amendment is applicable to taxable years beginning after December 31, 2010, and generally raises the same questions as were raised in connection with the reduction from 10 years to 7 years for taxable years beginning in 2009 and 2010 discussed immediately below. However, it is interesting to note that the proposed amendment specifically uses the term "taxable year" in connection with the recognition period for taxable years beginning in 2009 and 2010, but only uses the term "5th year" (not taxable year) in connection with the recognition period for a taxable year beginning in 2011. The importance of this distinction will be discussed below.

3. **American Recovery and Reinvestment Tax Act of 2009**. The American Recovery and Reinvestment Tax Act of 2009 (the "2009 Act"), Pub. L. No. 111-5, 123 Stat. 115 (2/17/2009), was signed into law by President Obama on 2/17/2009. Section 1261 of the 2009 Act amends Section 1374, to provide for reduction of the recognition period during which corporations that converted from C corporation status to S corporation status are subject to the so-called built in gain tax from 10 years to 7 years under certain circumstances.

a. Text of Amendment. Specifically, Section 1374(d)(7)(B), as amended by the 2009 Act, reads as follows:

> (B) SPECIAL RULE FOR 2009 AND 2010. - In the case of any taxable year beginning in 2009 or 2010, no tax shall be imposed on the net unrecognized built-in gain of an S corporation if the 7th taxable year in the recognition period preceded such taxable year. The preceding sentence shall be applied separately with respect to any asset to which paragraph (8) applies."

While the statutory language itself is short, it raises a number of questions that will need to be clarified regarding its scope and application.

b. Dispositions of Assets in 2009 and 2010 by Converted C Corporations. Clearly, for dispositions made by converted C corporations in 2009 or 2010, no built-in gain tax will apply to such S corporation if the ***7th taxable year*** in the recognition period preceded the year of disposition (2009 or 2010). The 2009 Act's language which specifically refers to "***taxable years***" in the context of a converted C corporation's recognition period should be contrasted with the measurement of the recognition period for the built-in gain tax set forth under the current rules. Specifically, Section 1374(d)(7) and Reg. §1.1374-1(b) provide that the recognition period is the ***10-calendar year period, and not the 10-tax year period***, beginning on the first day the corporation is an S corporation (or the day an S corporation acquires assets under Section 1374(d)(8) in a carryover basis transaction). Consequently, in determining whether a converted C corporation is entitled to relief under the 2009 Act for the reduced recognition period, it would appear that taxable years rather than calendar years should be utilized, and as such, short taxable years should be counted as taxable years for purposes of the 7-taxable year standard in accordance with the express language of the statute. If, however, subsequent amendments are made to the 2009 Act that make it consistent with the prior application of calendar years rather than taxable years in measuring the duration of a converted corporation's recognition period, the focus would be on corporations whose conversions occurred at least seven complete years (84 months) before taxable years beginning in 2009 or 2010. The question is whether Congress really intended to apply a taxable year standard to Section 1374 since the standard has always been calendar years since the enactment of the built-in gain tax in 1986.

c. Dispositions of Assets After 2009 or 2010. Another question which remains open to interpretation is whether only dispositions occurring in 2009 and 2010 will qualify for relief from the built-in

gain tax provided that the 7th taxable year in the recognition period preceded either 2009 or 2010, or whether the built-in gain tax is forever suspended if the 7th taxable year in the recognition period occurred before 2009 or 2010. The express statutory language could certainly be interpreted as providing relief ***only*** when the built-in gain tax liabilities arise from dispositions occurring in 2009 and 2010, so that if the disposition occurs in 2011 or later the corporation would again be subject to the built-in gain tax so long as such year is still within the original 10-year recognition period. Yet another question that needs clarification is if the disposition occurred in 2009 or 2010, could such disposition still be subject to the built-in gain tax in 2011 or later years if sales proceeds are received in such years (which are within the original 10-year recognition period) and the corporation is reporting its gain on the installment method under Section 453. The Senate report (which was adopted by the Conference Committee) strongly suggests that if the corporation qualifies for relief from the built-in gain tax in 2009 or 2010 because more than seven taxable years have elapsed prior to 2009 or 2010, the corporation will ***not*** thereafter be subject to the built-in gain tax in any later years either. Specifically, the Conference Committee Report states: "Thus with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax will be imposed under Section 1374 ***after*** the seventh taxable year that the S corporation election is in effect."

Yet another question which arises is whether a disposition which occurred during the recognition period (but ***prior*** to 2009 or 2010) is subject to the built-in gain tax under new Section 1374(d)(7)(B) if gain is recognized under the installment method in 2009 or 2010 (and the 7-taxable year test is met for such years). Although arguments exist on both sides of this issue, the author believes that most likely if the disposition occurred ***before*** 2009 or 2010, but gain is recognized attributable to such disposition under the installment method in 2009 or 2010, ***the built-in gain tax would apply to such disposition***.

d. Application to Assets Acquired in Carryover Basis Transactions. New Section 1374(d)(7)(B) may apply differently (based on calendar years rather than taxable years) to assets acquired in a carryover basis transaction under Section 1374(d)(8). Section 1374(d)(8) and Reg. §1.1374-8(a) provide that if an S corporation acquires any asset in a transaction in which the S corporation's basis in the acquired asset is determined in whole or in part by reference to a C corporation's basis in such asset, Section 1374 applies to the net recognized built-in gain attributable to the asset so acquired.

Reg. §1.1374-8(b) provides that for purposes of applying the built-in gain tax under Section 1374(d)(8), a separate determination of tax is made with respect to the assets the S corporation acquires in one Section 1374(d)(8) transaction from the assets the S corporation acquires in another Section 1374(d)(8) transaction and from the assets the corporation held when it became an S corporation. Thus, an S corporation's Section 1374 attributes when it became an S corporation may only be used to reduce the built-in gain tax imposed on dispositions of assets the S corporation held at that time. Likewise, an S corporation's Section 1374 attributes acquired in a Section 1374(d)(8) transaction may only be used to reduce the built-in gain tax imposed on dispositions of assets the S corporation acquired in such transaction.

Reg. §1.1374-8(c) provides that an S corporation's taxable income limitation for any tax year is allocated between or among each of the S corporation's separate determinations of net recognized built-in gain for that year (determined without regard to the taxable income limitation) based on the ratio of each such net recognized built-in gain amount to the sum of all of the S corporation's net recognized built-in gain amounts.

Consequently, every asset acquisition from a C corporation (or from an S corporation subject to the built-in gain tax) will be subject to a separate determination as to the amount of net unrealized built-in gain and net recognized built-in gain, as well as to a separate recognition period beginning with the date the S corporation acquires such assets from the C corporation (or from the S corporation subject to the built-in gain tax). This rule applies to all S corporation, regardless of when their S elections were made or whether such corporations have always been S corporations.

Although the statutory language would appear to support the application of the seven taxable year period to assets acquired in a carryover basis transaction subject to Section 1374(d)(8) in the same manner as it applies to the assets of a converted C corporation, the legislative history indicates that commencing in taxable years beginning in 2009 and 2010, an S corporation will have no built-in gain tax liability with respect to assets acquired from a C corporation in a carryover basis transaction under Section 1374(d)(8) if at least ***seven complete years have elapsed from the date of the asset acquisition***. The Conference Committee Report specifically provides the following: "In the case of built-in gain attributable to an asset received by an S corporation from a C corporation in a carryover basis transaction, ***no tax will be imposed under Section 1374*** if such gain is recognized after the date that is

seven years following the date on which such asset was acquired." Consequently, the legislative history indicates that a ***taxable year standard*** is used with respect to the assets of C corporations that have converted to S corporation status, but that a ***calendar or complete year standard*** is used for assets acquired by an S corporation from a C corporation in a carryover basis transaction under Section 1374(d)(8), which is consistent with the standard used prior to the 2009 Act.

Additionally, just as in the case of converted S corporations, the legislative history (in contrast to the express language of the statute) would appear to provide that if the disposition takes place in 2009, 2010 or thereafter, so long as seven complete years have elapsed since the date of the asset acquisition, the built-in gain tax would ***not*** be applicable.

e. Observation. Although the amendment to Section 1374(d)(7)(B) is certainly beneficial to taxpayers, and was enacted for the purpose of encouraging the early disposition of assets which could not otherwise be disposed of without being subject to the built-in gain tax if the full 10-year recognition period remained applicable, this provision certainly needs substantial clarification with respect to the issues raised above.

4. **Tax Technical Corrections Act of 2009**. Section 2(h) of the Tax Technical Corrections Act of 2009, H.R. 4169, 111th Cong., 1st Sess., introduced on 12/2/09, would strike the phrase "7th taxable year" and insert "7th year" in Section 1374(d)(7)(B) retroactively for tax years beginning after 2008. This proposed technical correction to ARRA appears to effect a substantive change to the statute. "Taxable year" is defined by statute in Section 7701(a)(23) as either a calendar year, a fiscal year, or, in the case of a return made for a fractional part of a 12-month year, the part of the year for which that return is made. As a result, "seven taxable years" do not necessarily amount to the same period as "seven years." The AICPA has submitted a letter to members of Congress requesting that any change in the statutory language be prospective only.

5. **<u>IRS Confirms that Payment of Compensation to Shareholder-Employees within First Two and One-Half Months of Conversion to S Corporation Status Constitutes Built-In Deduction Item for Purposes of Built-In Gain Tax</u>**. In Ltr. Rul. 200925005, the IRS ruled that the payment of certain salary expenses and other outstanding costs relating to the production of the outstanding accounts receivable of the corporation at the time of its conversion to S status would constitute built-in deduction items, specifically including the payment of compensation to shareholder-employees of the corporation within the first two and one-half months following the corporation's conversion to S corporation status.

Under the facts of the ruling, the taxpayer is a cash basis C corporation with a calendar tax year. The corporation is a personal service corporation which is wholly-owned by a number of professionals. The corporation bills its clients for the services performed by the professionals and when invoices are paid, the corporation pays salaries and wages to the professionals. Additionally, the corporation has other employees, such as non-shareholder clerical staff and non-shareholder professionals to which it pays wages.

The taxpayer will elect to be an S corporation and will have built-in gain from its outstanding accounts receivable. The taxpayer requested the letter ruling to determine whether certain salary expenses and other outstanding costs relating to the production of the outstanding accounts receivable as of the date of the corporation's conversion to S status will qualify as built-in losses under Section 1374, and specifically, whether the amounts paid to its shareholder-employees within the first two and one-half months of the recognition period under Section 1374 of salary and wage expenses that are related to the production of accounts receivable that are outstanding as of the effective date of the S election will constitute built-in deduction items under Section 1374(d)(5)(B).

Built-*In Gain Tax*. Section 1374 imposes a corporate-level tax on the built-in gain of S corporations that were previously C corporations. The tax rate is presently 35% (the highest rate of tax imposed under Section 11(b) on corporations) of the S corporation's "net recognized built-in gain."

"Recognized built-in gain" means any gain recognized during the 10-year recognition period, beginning on the effective date of the corporation's S election, from the disposition of any asset except to the extent that: (1) the S corporation can establish that the asset disposed of was not held by it as of the effective date of its S election; or (2) such asset's built-in gain (the excess of the fair market value of the asset over the corporation's adjusted tax basis in the asset) as of the effective date of the S election was less than the gain recognized by the corporation on the disposition.

In addition to gain recognized on the sale or disposition of an appreciated asset held by a corporation as of the date of its conversion to S corporation status during the 10-year period following its conversion to S corporation status, any other item of income that is properly taken into account during the recognition period but which is attributable to periods prior to the date of the corporation's conversion to S status is treated as a recognized built-in gain for the tax year in which it is properly taken into account. ***This specifically includes the collection (after the conversion to S corporation status) of pre-conversion accounts receivable by a cash-basis taxpayer*** (i.e., the accounts receivable of a cash-basis taxpayer constitutes a built-in gain item for purposes of the built-in gain tax imposed under Section 1374 on corporations converting from C corporation status to S corporation status).

"Recognized built-in loss" means any loss recognized during the 10-year recognition period on the disposition of any asset to the extent that the S corporation can show that (1) such asset was held by it as of the effective date of its conversion to S status and (2) the loss recognized does not exceed the amount of such asset's built-in loss (the excess of the corporation's adjusted tax basis in the asset over the asset's fair market value) as of the effective date of the corporation's S election. Sections 1374(d)(3) and 1374(d)(4).

In addition to loss recognized on the disposition of a depreciated asset held by a corporation as of the date of its conversion to S status during the 10-year period following its conversion to S corporation status, Section 1374(d)(5)(B) provides that any amount which is allowable as a deduction during the recognition period but which is "attributable" to a period prior to the date of the corporation's conversion to S status will be treated as a recognized built-in loss for the tax year for which it is allowable. An example is the payment, after the conversion to S status, of an expense item that accrued prior to the date of conversion. ***This type of item is generally referred to as a "built-in deduction item***."

In determining whether an item constitutes a built-in income or built-in deduction item under Sections 1374(d)(5)(A) and 1374(d)(5)(B), the focus is therefore on whether such item is "attributable" to a period prior to the date of the corporation's conversion to S status. The IRS adopted an "accrual method rule" in determining whether an income item or a deduction item is attributable to a period prior to the date of the corporation's conversion to S status. Specifically, Reg. §1.1374-4(b)(1) provides that any item of income properly taken into account during the 10-year post-conversion recognition period is recognized built-in gain if the item would have been included in gross income before the date of conversion to S status by a taxpayer using the accrual method of accounting. Likewise, Reg. §1.1374-4(b)(2) provides that any item of deduction properly taken into account during the 10-year post-conversion

recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the date of conversion to S status by a taxpayer using the accrual method of accounting. Consequently, the benchmark for whether an item constitutes a built-in income or built-in deduction item under Section 1374(d)(5), is whether such item would have been includable in income, or allowed as a deduction, prior to the corporation's conversion to S status if the corporation had been an accrual basis taxpayer.

In determining whether an item would have been includable in income, or allowed as a deduction, prior to the corporation's conversion to S status if the corporation had been an accrual basis taxpayer, the regulations generally provide that ***all*** rules applicable to an accrual basis taxpayer apply, ***specifically including Section 267(a)(2) (relating to the timing of deductions by an accrual basis payor with respect to a cash basis payee that is a related party), and Section 404(a)(5) (relating to the timing of deductions for deferred compensation)***.

Section 267(a)(2) generally prohibits an accrual basis taxpayer from deducting an item payable to a cash basis payee until the amount is includable in the cash basis payee's income if the payor and payee are related within the meaning of Section 267(b). Similarly, Section 404(a)(5) generally prohibits a corporation from taking a deduction for any amounts deferred under a non-qualified deferred compensation plan, until such amounts are includable in the employee's gross income. Many commentators objected to the IRS's application of Section 267(a)(2) and Section 404(a)(5) to preclude treatment of an item as a built-in deduction under Section 1374(d)(5)(B). The commentators based their objections on H. R. Rep. No. 100-795, 100th Cong., 2d Sess. 63-64, which accompanied TAMRA, which provides the following:

> "As an example of these built-in gain and loss provisions, in the case of a cash basis personal service corporation that converts to S status and that has receivables at the time of the conversion, the receivables, when received, are built-in gain items. At the same time, built-in losses would include otherwise deductible compensation paid after the conversion to the persons who performed the services that produced the receivables, to the extent such compensation is attributable to such pre-conversion services. To the extent such built-in loss items offset the built-in gains from the receivables, there would be no amount subject to the built-in gains tax."

In determining whether an item would be deductible by an accrual basis taxpayer for purposes of the built-in gains tax, however, the ***regulations modify the rules generally applicable to accrual basis taxpayers*** in several respects. First, Reg. §1.1374-4(c)(1) provides that any amounts properly deducted in the recognition period under Section 267(a)(2), relating to payments to related parties, will be treated as recognized built-in loss to the extent that the following requirements are met:

- All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the date of conversion to S status; and

- ***The amount is paid in the first two and one-half months of the recognition period*** or is paid to a related party owning (under the attribution rules of Section 267) less than 5% (by voting power and value) of the corporation's stock, both as of the date of conversion to S status and when the amount is paid.

Additionally, Reg. §1.1374-4(c)(2) provides that any amount properly deducted in the recognition period under Section 404(a)(5), relating to payments for deferred compensation, will be treated as recognized built-in loss to the extent that the following requirements are met:

- All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the date of conversion to S status; and

- The ***amount*** is not paid to a related party to which Section 267(a)(2) applies.

An item that is classified as a built-in income item will be treated as a recognized built-in gain when taken into account by the S corporation during the 10-year recognition period, and thus, potentially be subject to the built-in gain tax imposed under Section 1374. Section 1374(d)(5)(A). Under Section 1374(d)(5)(C), a built-in income item also has the effect of increasing the corporation's "net unrealized built-in gain" or "NUBIG." NUBIG is important because it is an overall cap on the amount which may be subject to the built-in gain tax during the 10-year recognition period. Likewise, an item that is classified as a built-in deduction item will be treated as a recognized built-in loss when allowed as a deduction to the S corporation during the recognition period, and thus, will be available to offset any built-in gains recognized by the S corporation during such tax year. Section 1374(d)(5)(B). A built-in deduction item also has the effect of decreasing the corporation's NUBIG under Section 1374(d)(5)(C).

Even if an item does ***not*** constitute a built-in loss item within the meaning of Section 1374(d)(5)(B), it still may potentially affect a corporation's NUBIG. For example, an accrued bonus payable to a C corporation's sole shareholder-employee that is not paid by the corporation within the first two and one-half months following the date of its conversion to S status would ***not*** constitute a built-in deduction item under Section 1374(d)(5)(B) since, under both Sections 267(a)(2) and 404(a)(5), such amount would ***not*** have been deductible by the corporation prior to the date of its conversion if it were an accrual basis taxpayer. The accrued bonus would, however, still serve to reduce the corporation's NUBIG limitation since Reg. §1.1374-3(a)(2) provides that NUBIG is decreased by the amount of ***any*** liability of the corporation to the extent the corporation would be allowed a deduction on payment of such liability. In other words, the accrual method rule does ***not*** apply in determining whether a liability decreases a corporation's NUBIG.

Accrual and Payment of Bonus Within First Two and One-Half Months After Conversion to S Status. The post-conversion collection of accounts receivable of a cash-basis corporation, particularly the cash-basis service corporation, is potentially subject to a substantial tax liability for the built-in gain tax imposed under Section 1374. Due to the pass-through nature of an S corporation, the collection of accounts receivable by a cash-basis corporation that has converted from C corporation status to S corporation status, absent proper planning, will result in a forced double taxation on such receivables of approximately 57.75%. Assuming $100 of accounts receivable, the built-in gain tax would be $35 ($100 x 35%), and the shareholder-level tax (assuming the maximum marginal individual tax rate of 35%) would be $22.75 ($65 x 35%). Thus, total taxes on the $100 of accounts receivable would be $57.75 ($35 + $22.75), resulting in an effective federal tax rate of 57.75%. In addition, state corporate income taxes may be imposed on the corporate level gain. Consequently, it is imperative that the cash-basis service corporation converting from C corporation status to S corporation status consider all available planning opportunities to minimize the impact of the built-in gain tax with respect to its accounts receivable. For an in depth discussion on a number of planning opportunities available to minimize the impact of the built-in gain tax with respect to accounts receivable of cash basis corporations converting from "C" to "S" status, see Looney and Levitt, "Reasonable Compensation Issues for Closely-Held and Service Companies," 61 NYU Fed. Tax. Inst., ¶16.09 (2003).

Since built-in deduction items (such as accounts payable of cash-basis corporations) are taken into account in determining NUBIG of an S corporation under Section 1374(d)(5)(C), and the payment of such amounts is treated as a recognized built-in loss that may be matched against built-in income items (such as a cash-basis corporation's accounts receivable), a common method that has been employed by practitioners to

avoid the built-in gain tax imposed on the accounts receivable of a cash basis service corporation is to accrue bonuses (in an amount equal to its collectible receivables) to its shareholder-employees in its last tax year as a C corporation and pay such bonuses to its shareholder-employees in its first tax year as an S corporation. Even though such accrued bonuses may or may not be characterized as built-in deduction items (depending on whether they are paid in the first two and one-half months following conversion), the effect of accruing such bonuses nevertheless may be either to eliminate the potential application of the built-in gain tax altogether by reducing the corporation's NUBIG to zero, or alternatively, if the corporation has goodwill or other appreciated assets, to at least minimize recognition of any built-in gains by reducing the corporation's NUBIG by the amount of such accrued bonuses. There are a number of open issues regarding the mechanics of accruing such bonuses. These open issues include:

- whether such bonuses should be paid within the first two and one-half months so as to constitute built-in deduction items that offset the built-in income items (receivables), or whether such bonuses may be paid at any time during the corporation's first taxable year as an S corporation based on the position that the accrued bonuses reduce the corporation's NUBIG to zero;

- whether such bonuses could be paid by simply having the corporation distribute the accounts receivable attributable to the accrued bonuses within the first two and one-half months following conversion to S corporation status (as opposed to paying such bonuses out in cash);

- if the corporation intends to pay such bonuses within the first two and one-half months and funds must be borrowed to pay such bonuses, whether the corporation or the shareholder-employees should borrow such funds;

- whether the regular salaries of the shareholder-employees should be "suspended" in order to enable the corporation to pay such bonuses;

- assessment of the effect of such bonuses on any buy-out provision in the event a shareholder-employee's employment is terminated after receipt of the bonus but prior to any loans funding such bonus being repaid;

- whether the employment agreements of the shareholder-employees should be amended to provide compensation for

nonbillable services to support compensation paid in "C" years as well as accrual of the bonus;

- documentation of such accrued bonuses in the minutes of the board of directors as compensation for past services; and

- whether the corporation should continue zeroing out its taxable income for some period of time in order to support compensation amounts paid in prior "C" years as well as to provide a "back-up" for the bonus accrual strategy.

Although Ltr. Rul. 200925005 certainly does not answer all of these open questions, it certainly makes it clear that the built-in gain tax on accounts receivable can be avoided by the converted corporation paying out compensation related to such accounts receivable to its shareholder-employees within the first two and one-half months of the corporation's first tax year as an S corporation, which is the method that has been most commonly employed by practitioners in order to avoid imposition of the built-in gain tax on the accounts receivable of a cash basis service corporation.

The IRS expressly concludes in the ruling that the taxpayer's payments to its shareholder-employee of salary and wages relating to the production of accounts receivable on the effective date of the S election, ***if paid in the first two and one-half months of the recognition period***, qualify as built-in loss items under Section 1374(d)(5)(B). Additionally, the IRS found that the taxpayer's payments to its non-shareholder employees of salary and wages related to the production of outstanding accounts receivable on the effective date of the S election, ***if paid at any time during the recognition period***, will qualify as built-in loss items under Section 1374(d)(5)(B). Finally, the IRS concluded that the taxpayer's payments of other unpaid payable expenses and accounts payable related to the production of the accounts receivable outstanding on the effective date of the S election, ***if paid at any time during the recognition period***, would qualify as built-in loss items under Section 1374(d)(5)(B). It is interesting to note that Ltr. Rul. 200925005 did not specifically state that any type of special bonus had to be accrued prior to the last day of the corporation's last tax year as a C corporation or require any written evidence of such accrual in the corporate minutes or other documentation. Rather, the IRS simply concluded that the payment of salary and wages to the shareholder-employees of the corporation which related to the production of the accounts receivable on the effective date of the S election would qualify as built-in loss items if paid in the first two and one-half months of the recognition period. To be certain, the author would recommend that such bonus be accrued prior to the last tax year as a C corporation and evidenced at least in the Board of Director minutes of the corporation.

6. **S Corporation Allowed to Identify Publicly Traded Partnership Units to Avoid Built-In Gain Tax**. Ltr. Rul. 200909001 addresses the application of Section 1374 to a sale of units in a publicly traded partnership taxed as a partnership where the S corporation or its subsidiaries own some units with a holding period less than the 10-year recognition period and other units with a holding period greater than the 10-year recognition period.

TP is a corporation that elected to be taxed as an S corporation on Date 1, which is more than 10 years ago. TP is engaged in Business 1 ("B1"). TP owns all the stock of General Partner ("GP"), which has been a QSub since Date 1 and owns all the stock of Sub1, which has been a QSub since Date 2 (Ltr. Rul. 200909001 redacts the actual Date 2 date and does not otherwise state whether Date 2 is more than 10 years ago.) GP owns all of the outstanding interests in LLC1, a single member LLC treated as a disregarded entity. LLC1 owns all of the stock of Sub2, a corporation which has been a QSub since Date 1. Prior to Date 1, TP and all of its corporate subsidiaries were taxed as C corporations.

GP owns all of the outstanding general partnership units of PS1, a state law limited partnership. PS1 is classified as a publicly traded partnership under Section 7704(b). While the ruling does not address the status of PS1, based on our discussion, with TP's counsel, PS1 meets the qualifying income exception under Section 7704(c) and therefore PS1 is not treated as a corporation under Section 7704(a). GP also owns all of the general partner units of PS2, a state law limited partnership that operates B1. PS1 owns all of the common units of PS2. The common units of PS1 are publicly traded, however the general partner units of PS1 and PS2 are not publicly traded.

TP directly owns common units of PS1 and indirectly owns PS1 common units through Sub1 and Sub2. As of Date 1, TP, either directly or through GP, held a redacted number of PS1 common units. Since Date 1, TP acquired additional PS1 common units for cash. Additionally, after Date 1, TP made several acquisitions of unrelated target C corporations and liquidated each corporation pursuant to Section 332. As a result, pursuant to Section 1374(d)(8), the assets acquired by TP pursuant to these Section 332 liquidations become subject to their own 10-year recognition period. After acquiring these assets, TP contributed the assets to PS1 for additional PS1 common units and PS1 general partner units and to PS2 for additional PS2 general partner units. The ruling states that under Section 1374(d)(6) the PS1 common units, PS1 general partner units and PS2 general partner units acquired pursuant to these contributions possess the same 10-year recognition period taint as the contributed assets did under Section 1374(d)(8).

Finally, TP represents that it has identified in its books and records the specific assets acquired in each of the C corporation acquisitions and

identified the PS1 and PS2 units received in exchange for the contribution of those assets to PS1 and PS2, respectively. Further, TP represents that it has not sold or disposed of any identified PS1 or PS2 units.

Ltr. Rul. 200909001 holds that TP's sale of separately identified PS1 common units, after the units have been held for more than the 10-year recognition period under Section 1374(d)(7), will not subject TP to built-in gains tax under Section 1374(a), citing Cf Reg. §1.1223-3(c)(2); however, the ruling does not express an opinion on the sale of any PS1 or PS2 general partner units.

Reg. §1.1223-3 addresses the holding period of a partnership interest. Generally, the holding period of a partnership interest is divided if the partner acquires portions of an interest at different times. The holding period of a portion of a partnership interest generally must be divided in the same ratio as the holding periods of the partner's entire partnership interest. Reg. §1.1223-3(c)(2)(ii). However, a special rule can apply to sale of a portion of an interest in a publicly traded partnership. Under Reg. §1.1223-3(c)(2)(i), a partner in a publicly traded partnership may use the actual holding period of a portion of a partnership interest transferred if (i) the ownership interest is divided in identifiable units with ascertainable holding periods, (ii) the selling partner can identify the portion of the partnership interest transferred, and (iii) the selling partner elects to use the identification method for all sales or exchanges of interests in the partnership after 9/21/2000. Thus, Ltr. Rul. 200909001 approves the use of Reg. §1.1223-3(c)(2)(i) to avoid the imposition of built-in gains tax in this unique factual situation.

Observation: Ltr. Rul. 200909001 cites Reg. §1.1223-3(c)(2) as analogous authority for its holding because it limited that provision to its literal terms, that is, determination of the holding period of a partnership interest for purposes of identifying the portion subject to long term capital gain or loss (the portion held for more than one year) and the portion subject to short term capital gain or loss (the portion held for one year or less). Nevertheless, the crux of the exception contained in Reg. §1.1223-3(c)(2)(i) really turns on whether a partnership interest may be segregated into distinct parts for purposes of certain determinations under the Code. Thus, if units of a PTP can be segregated for purposes of determining their long term versus short term holding period, there would seem to be no cogent reason why PTP units should not be similarly segregated for purposes of determinations under Section 1374, provided that the units can be adequately traced to account for events material to Section 1374 determinations. In this respect, the Regulations under Section 1374 require identification of (1) a partnership interest owned at the beginning of the recognition period (Reg. §1.1374-4(i)(1)) and (2) disposition of the partnership interest (Reg. §1.1374-4(i)(3)) and also compute the S corporation's RBIG limitation by reference to the amount that would be

the amount realized if, at the beginning of first day of the recognition period, the corporation had remained a C corporation and had sold its partnership interest (and any assets the corporation contributed to the partnership during the recognition period) at fair market value to an unrelated party, ***over*** the corporation's adjusted basis in the partnership interest (and any assets the corporation contributed to the partnership during the recognition period) at the time of the hypothetical sale (Reg. §1.1374-4(i)(4)(i)). Therefore, although a partnership interest generally has been treated on a unitary basis, the segregated PTP unit concept contained in Reg. §1.1223-3(c)(2) seems as applicable to the above-listed Section 1374 applications as it does to the long-term versus short holding period determination under Section 1223. *See e.g.*, Reg. §1.704-1(b)(2)(iv)(b). "(f)or purposes of this paragraph, a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (e.g., general or limited) and regardless of the time or manner which such interests were acquired…."; Rev. Rul. 84-53, 1984-1 CB 159 (a partner has a single basis in a partnership interest, even if such partner is both a general partner and a limited partner in the same partnership).

7. **Gain on Disposition of Coal Property Not Subject to Built-In Gain Tax**. In Ltr. Rul. 201006004, the IRS ruled that transfers of interests in coal estates constituting "dispositions of coal with a retained economic interest under Section 631(c)" would not be subject to the built-in gain tax imposed under Section 1374. Additionally, the IRS ruled that gain recognized on the taxpayer's sale of certain property (which the taxpayer leased back from the purchaser) would not be subject to the built-in gain tax under Section 1374 pursuant to Section 1374(d)(7)(B), as amended by the American Recovery and Reinvestment Act of 2009, provided that such disposition occurred either in 2009 or 2010.

Under the facts of the ruling, an S corporation owned certain real properties, that included surface estates, service improvements, and subsurface, primarily coal, estates. The S corporation's seventh year electing to be an S corporation ended on date 2, a date prior to January 1, 2009. The S corporation is on a calendar tax year.

With respect to certain of the properties, the taxpayer sold interests in the coal estates and retained a royalty, which the court concluded constituted a disposition of coal with a retained economic interest under Section 631(c). Section 631(c) provides that, in the case of the disposal of coal mined in the United States, held for more than one year before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in the coal, the difference between the amount realized from the disposal of the coal and the adjusted depletion basis, plus the deductions disallowed under Section 272, will be considered as though it were gain or loss on the sale of the coal.

Section 1374 imposes a corporate-level tax on an S corporation's net recognized built-in gain during the 10-year recognition period following a C corporation's conversion to S corporation status. Situation four of Rev. Rul. 2001-50, 2001-2 CB 343, provides that notwithstanding the treatment accorded income under Section 631, the income received from the sale of produced coal involves the receipt of normal operating business income in the nature of rent or royalties and is not subject to the built-in gain tax imposed under Section 1374. Accordingly, the IRS concluded that the S corporation's gain recognized pursuant to Section 631(c) during the recognition period did not constitute recognized built-in gain within the meaning of Section 1374(d)(3).

Additionally, with respect to the S corporation's outright sale of certain other real property, the IRS determined that the gain recognized in such sale would not be subject to the built-in gain tax imposed under Section 1374(d)(7)(B), as amended by the American Recovery and Reinvestment Act of 2009, which provides that in the case of any tax year beginning in 2009 or 2010, no tax will be imposed on the net recognized built-in gain of an S corporation if the seventh tax year in the recognition period preceded such tax year. The IRS concluded that any gain recognized by the S corporation upon the disposition of such property would not be subject to the built-in gain tax under Section 1374, provided such disposition occurred in the 2009 or 2010 tax years.

Finally, the IRS found that pursuant to Reg. §1.1362-2(c)(5)(ii)(A)(3), the amounts received by the S corporation qualifying for Section 631(c) treatment would not be treated as passive investment income under Section 1362(d)(3)(C).

8. **IRS Addresses Treatment of Excess Depreciation Deductions with Respect to Built-In Gain Tax**. In ECC 201003018, the IRS, in an Email Chief Counsel Advice, found that a taxpayer could not reduce its recognized built-in gain under Section 1374 by depreciation attributable to the amount of built-in loss on assets at the time of its conversion to S corporation status.

Citing Notice 2003-65, 2003-40, IRB 747, the IRS concluded that the tax accrual rule and the regulations under Section 1374 do not allow for the reduction of the built-in gain tax with depreciation with respect to built-in loss assets, in contrast to Section 382(h)(2)(B), which expressly provides that except to the extent the loss corporation establishes that the amount is not attributable to the excess of an asset's adjusted basis over its fair market value on the change date, such amounts are treated as recognized built-in loss, regardless of whether they are accrued for tax purposes before the change date. Thus, the IRS concluded that the taxpayer's attempt to use a definition for recognized built-in gain that applies for Section 382(h) purposes, is not appropriate for Section 1374 purposes.

9. Tax Court Determines Value of Partnership Interests for Built-In Gain Tax. In *Ringgold Telephone Co. v. Comm'r*, TCM 2010-103, the Tax Court determined the fair market value of a partnership interest owned by an S corporation for purposes of determining the built-in gain tax imposed under Section 1374.

The taxpayer was a C corporation which elected to be taxed as an S corporation effective 1/1/2000, and was engaged in providing telecommunication services to customers in Georgia and Tennessee. The taxpayer owned a 25% partnership interest in Cellular Radio of Chattanooga ("CRC"). The remaining interests of CRC were owned 25% by BellSouth Mobility, Inc. ("BellSouth"), Trenton Telephone Co. and Bledsoe Telephone Co. The primary asset of CRC was a 29.54% limited partnership interest in Chattanooga MSA Limited Partnership ("CHAT"), which provided wireless telecommunication service in Chattanooga, Tennessee. The General Partner of CHAT was wholly owned by BellSouth.

On 11/27/2000, BellSouth acquired the taxpayer's 25% interest in CRC for $5,220,423. The taxpayer reported the recognized built-in gain attributable to the sale of its interest in CRC using a fair market value as of 1/1/2000 of $2,600,000. The IRS, on the other hand, asserted a deficiency based on a fair market value equal to the $5,220,423 sales price of the CRC interest.

The court went through an exhaustive analysis of: the evidence presented by the taxpayer's expert; the evidence presented by the IRS's expert; the probative value of the sale to BellSouth; the effect of the right of first refusal contained in the Partnership Agreement; and the unique circumstances surrounding BellSouth's purchase of the partnership interest. The court found that the taxpayer's expert was the more persuasive of the two expert witnesses, and in particular, that the taxpayer's expert was familiar with the telecommunications industry and considered the distribution history of CHAT (a factor likely to be an important consideration for a purchaser of a minority interest). However, the court noted that the taxpayer's expert failed to adequately consider the sale to BellSouth in his analysis, and the court determined that the sale to BellSouth must be taken into consideration in determining the fair market value of the interest. After considering all of the evidence in the records, the court concluded that the values yielded by the business enterprise analysis ($2,718,000), the distribution yield analysis ($3,243,000) and the BellSouth sales price ($5,220,423) should be weighted equally in arriving at the fair market value of the CRC interest, resulting in a fair market value of $3,727,141.

Finally, the court concluded that the taxpayer would not be subject to an accuracy related penalty under Section 6662 because the court concluded that the taxpayer acted with reasonable cause and in good faith.

10. Application of Built-In-Gains Tax To Section 481 Adjustments. In *MMC Corp. v. Comm'r*, 551 F.3d 1218 (CA-10, 2009), the Tenth Circuit affirmed a decision of the Tax Court that Section 481(a) adjustments that relate to an item of income or deduction that would have been included in an accrual-method taxpayer's income during the period before the taxpayer elected S status are subject to Section 1374.

The taxpayer, MMC Corp. (MMC), was incorporated as a C corporation under the law of the state of Kansas. MMC has always been an accrual-method taxpayer. Until 1997, MMC used an accounting method that valued its customer accounts receivable according to face value. In 1997, MMC adopted mark-to-market accounting, under which its assets were valued as though they were sold for their fair market value on the last day of the tax year. As a result of this change in method of accounting, MMC was able to deduct $5,300,000 on its accounts receivable and reduce its taxable income by that amount.

In 1998, Congress amended the Code to prohibit mark-to-market valuation of customer accounts. (See Section 475(c)(4).) As a result, MMC was required to return to face-value accounting for its accounts receivable. To avoid duplication or omission of gross income or deductions, Section 481(a) required MMC to make an adjustment in its taxable income during the tax year of the accounting method change. The court noted that Congress provided that the net amount of any Section 481 adjustment required by the new amendments in 1998 should be taken into account ratably over a four-year period, presumably to ease the burden of requiring a single large positive adjustment.[20]

In 1998 and 1999, MMC included in its income a portion of the Section 481 adjustment that related to the change to face-value accounting. Effective 1/1/2000, MMC elected to be an S corporation and, although it included the last two portions of its Section 481 adjustment in its taxable income for the next two years, it did not pay any additional tax that would have been imposed by Section 1374 on that income.

In general, a subchapter S corporation is not subject to an entity-level tax on its income, gain, losses, and deductions. Under Section 1374, however, the S corporation is subject to an entity-level tax on "recognized built-in gain." "Built-in gain" is gain that is attributable to appreciation or income that accrued in a year before the corporation elected S status. Thus, Section 1374 is intended to prevent the avoidance of the corporate-level tax by conversion to S status, at least for a 10-year recognition period after the S election is effective.

[20] See Internal Revenue Service Restructuring and Reform Act of 1998 (RRA), Pub. L. No. 105-206, §7003(c)(2) (1998).

MMC argued that its Section 481 adjustments were items of income that, in accordance with section 7003 of the RRA, MMC was required to include in its income over four years and that the last two portions of the Section 481 adjustment could not properly have been included in its income before the conversion to S status. Thus, the taxpayer concluded that the amounts of the Section 481 adjustments attributable to the first two years after it elected S status were not subject to the Section 1374 built-in gains tax.

The court, citing Reg. §1.1374-4(d)(1) and Reg. §1.1374-4(b)(1),[21] concluded that MMC's Section 481 adjustments related to the $5,300,000 in income that MMC deducted in 1997. The next question was whether that item of income was attributable to the period before MMC elected S corporation status. The court concluded that the answer was clearly yes, as MMC was an accrual-method taxpayer in 1997 and included the sum in income before using mark-to-market accounting to deduct it. Consequently, the Section 481 adjustment was subject to the built-in gain tax imposed under Section 1374.

11. **Tax Court Adopts Estate's 17.4% Discount for Built-In Gains Tax**. In *Estate of Litchfield*, TCM 2009-21, involving the valuation of a trust's minority interest in a family S corporation and C corporation, the Tax Court adopted the estate claimed 17.4% discount for potential built-in gains taxes of the S corporation, rejecting the IRS's 2% discount.

The decedent, Marjorie Litchfield, died on 4/17/2001. At the date of her death, she was the income beneficiary of a QTIP trust (the "Trust") established under the will of her late husband who died in 1984. On the date of his death, Mr. Litchfield owned minority stock interests in two closely-held family corporations, Litchfield Realty Co. ("LRC") and Litchfield Securities Co. ("LSC"). At the date of Mrs. Litchfield's death, the Trust held a 43.1% interest in LRC and a 22.96% interest in LSC. Under Section 2032(a)(2), the estate elected the 10/17/2001 alternate valuation date.

As of the valuation date, LRC had 18 shareholders, which consisted of the Trust and other Litchfield family members. LRC was established in 1921 to manage farmland and other assets of the Litchfield family in Iowa. As of the valuation date, LRC's assets, with an agreed net value of

[21] Reg. §1.1374-4(d)(1) provides: "Any section 481(a) adjustment taken into account in the recognition period is recognized built-in gain or loss to the extent the adjustment relates to items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section. The principles for determining recognized built-in gain or loss in this section include, for example, the accrual method rule under paragraph (b) of this section."

The accrual-method rule of Reg. §1.1374-4(b)(1) provides: "Income items. Except as otherwise provided in this section, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer. . . ."

$33,174,196, consisted largely of farmland and related equipment and supplies valued at $23,422,349 and marketable securities valued at $9,751,757.

LRC's farmland historically was leased to local farmers under crop-share leases, under which LRC paid a share of the crop's planting cost and received a share of the proceeds when the crops were sold. As of the valuation date, the farmland for many years had yielded below average income returns, amounting to less than 1% of the farmland's net asset value. On 1/1/2000, LRC had elected S status, based on the belief of its managers that pass-through taxation would result in increased profitability and a better return for the LRC shareholders. As of the date of its S election, the built-in gains of LRC amounted to $28,762,306 (86.7% of its net asset value). While LRC's management determined that cash leases with local farmers would provide a better return than crop-share leases, it did not use cash leases because of the potential Section 1375 passive investment income tax/termination issues after it converted to S status. Since 1921, LRC occasionally sold portions of its farmland to raise cash.

LSC was incorporated in 1924 when Litchfield family members contributed marketable securities they owned to LSC. At the valuation date, LSC had approximately 50 shareholders consisting of the Trust and other Litchfield family members. As of the valuation date, LSC's assets included "blue-chip" marketable securities (e.g., AT&T, Dupont and IBM) as well as partnership and other equity investments and LSC's agreed net asset value was $52,824,413, which included built-in gains of $38,984,799. LSC's investment strategy focused on maximizing cash dividends to shareholders.

No shares of either LRC or LSC had ever been sold on the open market and the stock transfer policies of each corporation discouraged stock redemptions and sales to outsiders.

Michael deMilt was an officer and director of LRC and LSC, a trustee of the Trust, and was also associated with an investment management company which advised the corporations. In the late 1990's, he became concerned that the Trust consisted of illiquid LRC and LSC shares and that decedent and other elderly shareholders did not have adequate cash for payment of estate taxes and other obligations upon their deaths. Mr. deMilt and other corporate officers contemplated sales of LRC and LSC corporate assets to finance stock redemptions from the Trust and these elderly shareholders and as a consequence, requested studies of the feasibility of selling parcels of LRC farmland to outsiders. Additionally, by 2000, a number of mergers of public companies, whose stock was held by LRC and LSC, anticipated mergers, and corporate reorganizations were anticipated to result in the disposition of significant appreciated securities held by the corporations.

The Tax Court stated that with respect to stock in closely held real estate holding companies and investment companies such as LRC and LSC, the net asset valuation method is often accepted as the preferred method and analyzed the three discounts applied by the estate's expert witness and the IRS's expert witness to the agreed net asset value of each corporation, which were as follows:

	Estate Expert	IRS Expert
LRC:		
NAV	$33.174 M	$33.174 M
NAV of estate's interest (43.1%)	14.298 M	14.298 M
Less Discounts: BIG	17.4%	2.0%
Lack of Control	14.8%	10.0%
Lack of Marketability	36.0%	18.0%
LSC:		
NAV	$52.845 M	$52.845 M
NAV of estate's interest (22.96%)	$12.133 M	$12.133 M
Less Discounts: BIG	23.6%	8.0%
Lack of Control	11.9%	5.0%
Lack of Marketability	29.7%	10.0%

In determining a 17.4% BIG discount for LRC and a 23.6% BIG discount for LSC, the estate's expert reviewed board minutes for each corporation, the history of their asset sales and talked with each company's officers and directors about plans for sale of each respective company's assets. He also projected holding periods and sales dates for each company's appreciated assets and estimated appreciation of the assets during the holding periods until the projected sales. For LRC, the estate's expert determined a projected average asset holding period of 5 years and based on a capital gains tax rate of 38.8% and discounting to present value determined a BIG tax of $5,616,085 (17.4% of LRC's NAV). For LSC, he determined a 12.5% annual turnover rate based on an 8-year holding period and estimated capital gains of $32,995,000. Using a capital gains tax rate of 35.32%, the present value of the BIG taxes due on LSC's assets was $12,455,000 (23.6% of LSC's NAV).

In contrast, the IRS's expert used a turnover rate based solely on historical sales and did not talk to LRC's or LSC's management. For LRC, he used a 1.86% asset turnover rate which resulted in a projected asset holding period of 53.76 years. Because LRC would avoid Section 1374 tax after 12/31/2009, the end of its 10-year recognition period, he did not include

any capital gains taxes that he projected to be incurred thereafter. He then multiplied a 38.8% capital gains tax rate by $8,961,922 capital gains that, as of the valuation date, would be realized on an immediate sale of LRC's assets to yield a capital gains tax of $3,477,266. He then determined a present value of LRC capital gains taxes by discounting a ratable portion of the $3,477,000 capital gains taxes per year for 9 years [$3,477,000 ÷ 53.76 [100 ÷ 1.86] = $64,681/year] or $383,116 [2% of LRC's NAV].

For LSC, the IRS's expert's 3.45% turnover rate resulted in a projected holding period of 29 years. Utilizing a 35.32% capital gains tax rate, he determined a $13,769,450 capital gains tax on an immediate sale of LSC's assets [$38,984,000 x .3532]. Spreading the $13,769,000 over 29 years produced an annual tax of $474,809 each year of the holding period to yield a present value of the tax payments of $4,107,147 (8% of LSC's NAV).

Regarding application of a BIG discount, the Tax Court first determined that a willing buyer/willing seller would negotiate and agree to significant discounts to NAV to account for estimated corporate level taxes that would be due on a sale of LRC's and LSC's nonoperating assets. Although the court noted the recent opinion of *Estate of Jelke*, 507 F.3d 1317 (CA-11, 2007) and the opinion of *Estate of Dunn*, 301 F.3d 339 (CA-5, 2002), where the courts determined that an assumption, as a matter of law, was appropriate that all corporate investment nonoperating assets would be liquidated on the valuation date, it declined to determine whether that approach was applicable to LRC and LSC, because the estate's expert did not utilize that approach. However, the court found that the estate's assumptions relating to asset turnover was based on more accurate data. It also faulted the IRS's expert for failing to take into account appreciation likely to occur during the holding period -- which one valuation expert has described as the tax-inefficient entity drag.[22] Accordingly, the Tax Court accepted the estate expert's estimate of BIG discounts for both LRC and LSC. The court noted, however, that its acceptance of a turnover rate for LRC that resulted in LRC's assets being deemed to be sold during the 10-year recognition period was based on the unique facts of the case, and that not all S corporations will be allowed a BIG tax discount. See, *Dallas*, TCM 2006-212.

G. F REORGANIZATIONS AND QSUBS

1. IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations

IRS Clarifies Treatment of S Elections and Employer Identification Numbers in F Reorganizations. In Rev. Rul. 2008-18, the IRS ruled that in the two situations presented in the rulings, which both qualified as F reorganizations within the meaning of Section 368(a)(1)(F), the S election of the existing corporations did not terminate (and were carried over to the

[22] Citing, Johnson, Barber, Tax-Inefficient Entity Discount, 6 Valuation Strategies 20, 46 (Mar./Apr. 2003).

newly formed corporations), but that the newly formed corporations would be required to obtain new employer identification numbers.

In situation 1 of the ruling, B, an individual, owned all of the stock of Y, an S corporation. In year 1, B forms Newco and contributes all of the Y stock to Newco, which meets the requirements for qualification as a small business corporation. Newco timely elects to treat Y as a qualified subchapter S subsidiary (QSub) effective immediately following the transaction. The ruling states that the transaction meets the requirements of an F reorganization under Section 368(a)(1)(F). In year 2, Newco sells 1% of the stock of Y to D, an unrelated party.

In situation 2, C, an individual, owns all of the stock of Z, an S corporation. In year 1, Z forms Newco, which in turn forms Mergeco. Pursuant to a plan of reorganization, Mergeco merges with and into Z, with Z surviving and C receiving solely Newco stock in exchange for his stock of Z. Consequently, C owns 100% of Newco, which in turn owns 100% of Z. Newco meets the requirements for qualification as a small business corporation and timely elects to treat Z as a QSub effective immediately following the transaction. Again, the ruling expressly states that the transaction meets the requirements of an F reorganization.

The ruling first cites Rev. Rul. 64-250, 1964-2 C.B. 333, which provided that when an S corporation merges into a newly formed corporation in a transaction qualifying as a reorganization under Section 368(a)(1)(F) and the newly formed surviving corporation also meets the requirements of an S corporation, the reorganization does ***not*** terminate the S election, and as such, the S election remains in effect for the new corporation (without the new corporation being required to file a new S election). The ruling then cites Rev. Rul. 73-526, 1973-2 C.B. 404, in which the IRS concluded that where an S corporation merged into another corporation in a transaction qualifying as an F reorganization, the acquiring (surviving) corporation should use the employer identification number of the transferor corporation.

Rev. Rul. 2008-18 provides, however, that since the publication of Rev. Rul. 73-526, the Code has been amended to provide the classification of certain wholly-owned subsidiaries of S corporations as QSubs and the regulations under Section 6109 have been amended to address the effect of QSub elections under Section 1361. Specifically, Reg. §301.6109-1(i)(1) provides that any entity that has a federal employer identification number will retain that employer identification number if a QSub election is made for the entity under Reg. §1.1361-3 or if a QSub election that was in effect for the entity terminates under Reg. §1.1361-5. Additionally, Reg. §301.6109-1(i)(2) provides that, except as otherwise provided in regulations or other published guidance, a QSub must use the parent S corporation's employer identification number.

Additionally, for tax years beginning after 12/31/2004, Section 1361(b)(3)(E) was amended to provide that except to the extent provided by the IRS, QSubs are not disregarded for purposes of information returns. Further, QSubs are not disregarded for certain other purposes as provided in the regulations. For example, Reg. §1.1361-4(a)(7) provides that a QSub is treated as a separate corporation for purposes of employment tax and related employment requirements effective for wages paid on or after 1/1/2009. Because a QSub is treated as a separate corporation for certain federal tax purposes, the QSub must retain and use its employer identification number when it is treated as a separate corporation for federal tax purposes.

Because of these recent changes, the IRS concluded that it would not be appropriate for the acquiring corporation in a reorganization under Section 368(a)(1)(F) to use the employer identification number of the transferor corporation that becomes a QSub. Thus, in situation 1, although Y's original S election will not terminate but will continue for Newco, Newco will be required to obtain a new employer identification number and Y will retain its employer identification number even though a QSub election is made for it and will be required to use its original employer identification number anytime Y is otherwise treated as a separate entity for federal tax purposes. Additionally, in year 2, when Newco sells 1% of the stock of Y to D, Y's QSub election will terminate under Section 1361(b)(3)(C) and Y will be required to use its original employer identification number following the termination of its QSub election.

Likewise, in situation 2, Z's original S election will not terminate as a result of the F reorganization but will continue for Newco, and as such, Newco will not be required to file a new S election. Again, however, Newco will be required to obtain a new employer identification number and Z must retain its employer identification number even though a QSub election is made for Z and must use its original employer identification number any time it is otherwise treated as a separate entity for federal tax purposes or if its QSub election terminates.

Rev. Rul. 2008-18 applies to F reorganizations occurring on or after 1/1/2009. For F reorganizations occurring on or after 3/7/2008 and before the effective date of the ruling, taxpayers may rely on Rev. Rul. 2008-18. The ruling acknowledges that the IRS is aware that prior to the effective date of the ruling, S corporations have undergone F reorganizations in a manner similar to those described in situations 1 and 2 in which the acquiring corporation continued to use the transferor corporation's employer identification number consistent with Rev. Rul. 73-526. In those cases, the IRS provides that the acquiring corporation should continue to follow Rev. Rul. 73-526 and use the transferor corporation's employer identification number and that after the F reorganization, the transferor QSub should use the parent's employer identification number

until such time as the QSub is otherwise treated as a separate corporation for federal tax purposes or until such time as the QSub terminates. At such time, the QSub must obtain a new employer identification number. The IRS also states in the ruling that for an F reorganization occurring prior to 1/1/2009, it may be prudent for the acquiring corporation to make a protective S election.

Rev. Rul. 2008-18 is consistent with a number of prior rulings issued by the IRS to the extent that the newly formed corporation making a QSub election for the existing (transferor) corporation is not required to make a new S election. On the other hand, Rev. Rul. 2008-18 reverses the holdings in a number of prior rulings which provided that the newly formed corporation should use the employer identification number of the existing corporation (which becomes a QSub).[23] The ruling does state, however, that in situations not involving a QSub, such as the specific situation set forth in Rev. Rul. 73-526 involving the merger of one S corporation with and into another corporation that constitutes an F reorganization, the surviving corporation in those circumstances would use the employer identification of the transferor corporation.

2. **IRS Applies Rev. Rul. 2008-18 to F Reorganization Involving Qualified Subchapter S Subsidiary**. In EEC 200941019 (10/9/2009), the IRS issued email guidance to a taxpayer providing that the taxpayer could rely on Rev. Rul. 2008-18, 2008-13, IRB 674.

In the email advice, C owns all of the stock of Z, an S corporation with an existing employer identification number. In year 1, Z forms NewCo, which in turn forms MergeCo. Pursuant to a plan of reorganization, MergeCo merged with and into Z with Z surviving and C receiving solely NewCo stock in exchange for Z stock. NewCo meets the requirements for qualification as a small business corporation and timely elects to treat Z as a QSub effective immediately following the transaction.

The email advice provides that the taxpayer may rely on the principles set forth in Rev. Rul. 2008-18, and consequently, Z's original S election will *not* terminate but will continue for NewCo, but NewCo will be required to obtain a new employer identification number and Z will retain its existing employer identification number even though a QSub election is made for it. Additionally, the IRS provided in the email advice that Z would *not* file a final Form 1120S, but rather that NewCo would report all of Z's and NewCo's income on its Form 1120S.

3. **Merger of Parent S Corporation into QSub Constitutes an F Reorganization**. In Ltr. Rul. 201007043, the IRS ruled that an S corporation's merger into its wholly owned qualified subchapter S

[23] See, e.g., Ltr. Ruls. 200701017 and 200725012.

subsidiary (QSub) constituted a tax-free reorganization under Section 368(a)(1)(F) without adversely affecting S corporation status.

In the ruling, the S corporation and one of its two wholly owned QSubs desired to combine their assets and operations into a single corporation in order to take advantage of planned efficiencies and to reduce expenses and redundancies. Because certain legal agreements of the QSub prohibited the QSub from merging upstream into the S corporation, it was decided that the S corporation should merge downstream into the QSub.

Citing Rev. Rul. 64-250, 1964-2 CB 333, the IRS concluded that pursuant to the F reorganization, the S corporation election would continue in effect with respect to the surviving QSub following the merger. Additionally, citing Rev. Rul. 2004-85, 2004-2 CB 189, the IRS found that the status of the S corporation's other QSub would not terminate as a result of the F reorganization.

Interestingly, the ruling does not address whether the surviving entity should continue to use the federal identification number previously used by the S corporation or the federal identification number of the QSub into which it was merged. In Rev. Rul. 73-526, 1973-2 CB 404, the IRS ruled that where an S corporation merges into another corporation in a transaction qualifying as an F reorganization, the acquiring (surviving) corporation should use the employer identification number of the transferor corporation. However, more recently in Rev. Rul. 2008-18, 2008-1 CB 674, the IRS ruled that in the two situations presented in the ruling, which both qualified as F reorganizations within the meaning of Section 368(a)(1)(F), the newly formed corporations would be required to obtain new employer identification numbers and that the existing corporation which became a QSub would retain its same employer identification number.

H. MISCELLANEOUS S CORPORATION DEVELOPMENTS

1. Final Regulations on Reduction of Tax Attributes for S Corporations. On 10/30/2009, the IRS published final regulations under Section 108 on the reduction of tax attributes for S corporations. The proposed regulations address situations in which S corporation losses and deductions that are treated as net operating losses (NOLs) for purposes of Section 108 exceed the S corporation's excluded COD income.

In TD 9469 (10/30/2009), the IRS published final regulations providing guidance on the manner in which an S corporation reduces its tax attributes under Section 108(b) for tax years in which the S corporation has discharge of indebtedness income that is excluded from gross income under Section 108(a). Specifically, the regulations address situations in which the aggregate amount of the shareholders disallowed Section 1366(d) losses and deductions that are treated as a net operating loss tax

attribute of the S corporation exceeds the amount of the S corporation's excluded discharge of indebtedness income. The regulations make several modifications to the proposed regulations.

a. <u>Proposed Regulations</u>. On 8/6/2008, the IRS published proposed regulations under Section 108 on the reduction of tax attributes for S corporations (REG-102822-08). The proposed regulations address situations in which S corporation losses and deductions that are treated as net operating losses (NOLs) for purposes of Section 108 exceed the S corporation's excluded COD income.

Under Section 108(d)(7)(A), the determination of insolvency is made at the corporate (and not the shareholder) level. As a result, attribute reduction under Section 108(b)(1) also occurs at the corporate level. Section 108(d)(7)(B) provides that any loss or deduction disallowed under Section 1366(d)(1) is treated as an NOL of the S corporation (Deemed NOL). The regulations explain how entity-level attribute reduction is coordinated with shareholder- level suspended losses.

The proposed regulations provide that the Deemed NOL is reduced under Section 108(b). If the S corporation's Deemed NOL exceeds the S corporation's COD income that is excluded under Section 108 (Excess Deemed NOL), the Excess Deemed NOL must be allocated back to the shareholders. To allocate the Excess Deemed NOL, each shareholder's total disallowed losses and deductions is reduced by the shareholder's share of excluded COD income to determine the shareholder's Excess Amount. The proposed regulations provide that the Excess Deemed NOL is allocated among the shareholders in accordance with the following formula: the Excess Deemed NOL of the S corporation is multiplied by a fraction, the numerator of which is the shareholder's Excess Amount and the denominator of which is the sum of all shareholders' Excess Amounts.

The effect of the proposed regulations is that generally shareholders with suspended losses suffer from the attribute reduction provided for in Section 108(b) while those who have sufficient basis in stock and debt to avoid suspending losses suffer no detriment. In addition, the proposed regulations required information sharing among the shareholders and the S corporation that may be difficult to implement.

The proposed regulations were also criticized on the grounds that the attribute reduction is not shared in proportion to the shareholders' respective ownership interests in the S corporation (unlike the proportionate sharing of the income, losses, deductions and credits of an S corporation by its shareholders).

b. Changes Made by the Final Regulations. The final regulations generally retain the provisions of the proposed regulations, with several modifications. First, because the impact of a terminating election under Section 1377(a)(2) may result in a different allocation of the S corporation's Excess Deemed NOL among the shareholders, the final regulations add an example to clarify how the allocation rules apply when a terminating election under Section 1377(a)(2) is made. Section 1377(a)(2) provides that if a shareholder's entire interest in an S corporation is terminated during the S corporation's tax year and all "affected shareholders" consent, the S corporation may make a "terminating election" to treat its tax year as if it consisted of two tax years with respect to the affected shareholders, the first of which ends as of the close of the day on which the shareholder's entire interest in the S corporation is terminated.

Although several commentators recommended that net operating losses of an S corporation carried forward from one or more C corporation tax years (C Year NOLs) should be considered S corporation tax attributes for purposes of Section 108(b)(2), the IRS found that Section 1371(b)(1) prohibits an S corporation from using a C Year NOL as an S corporation tax attribute for purposes of Section 108(b)(2). Additionally, the IRS found that the same analysis applies to capital losses and business credits that arose in a C corporation tax year and therefore, the final regulations do ***not*** adopt the commentators' recommendation on this issue.

A number of commentators also asked whether a Deemed NOL described in Section 108(d)(7)(B) includes any losses that are suspended under Section 465 (relating to the at-risk rules) or Section 469 (relating to the passive activity loss limitation rules). Section 108(d)(7)(B) provides that a Deemed NOL is any loss or deduction disallowed for the tax year of the discharge under Section 1366(d)(1) (which provides for the disallowance of losses due only to lack of basis). Consequently, the IRS concluded that a Deemed NOL does ***not*** include losses suspended under either Section 465 or Section 469.

Additionally, a commentator requested that the final regulations clarify whether disallowed losses and deductions under Section 1366(d)(1) of a shareholder that is an employee stock ownership plan (ESOP) are included in the S corporation's Deemed NOL. The IRS concluded that Section 108(d)(7)(B) applies to any shareholder, including an ESOP shareholder, that has disallowed losses and deductions for the tax year of the discharge under Section 1366(d)(1).

Another commentator asked whether nondeductible, noncapital

expenses that reduce basis under Section 1367(a)(2)(D) are treated as disallowed losses and deductions under Section 1366(d)(1) for purposes of Section 108(d)(7)(B). In response to this question, the IRS specifically stated that such expenses, including any that are carried over as a result of the elective ordering rule in Reg. §1.1367-1(g), are ***not*** losses and deductions that can be taken into account by a shareholder under Section 1366(a), and as such, are ***not*** included as disallowed losses and deductions under Section 1366(d)(1) for purposes of Section 108(d)(7)(B).

Another commentator asked for clarifications in situations where an S corporation shareholder has a different tax year than the S corporation. The IRS stated that because basis adjustments under Section 1367 are determined as of the close of the S corporation's tax year, a shareholder's disallowed losses and deductions under Section 1366(d)(1) are determined for purposes of Section 108(d)(7) as of the close of the S corporation's tax year.

The major criticism of the proposed regulations was that the attribute reduction was not shared in proportion to the shareholders' respective ownership interests in the S corporation but borne by those shareholders having suspended losses. The IRS was not sympathetic to this argument and the final regulations did not make any changes in this regard. Rather, the IRS simply provided that an S corporation may eliminate or mitigate inequitable results caused by this rule by making an election under Section 108(b)(5) to reduce the basis of its depreciable property before reducing its net operating loss. This assumes, of course, that the S corporation has depreciable property with sufficient basis to absorb the NOL ***and*** that the shareholders could come to a mutual agreement on this issue.

The final regulations also change the rule of the proposed regulations that ordinary losses are reduced before capital losses, by providing that the S corporation's Excess Deemed NOL that is allocated to a shareholder consists of a proportionate amount of each item of the shareholder's loss or deduction that is disallowed for the tax year of the discharge under Section 1366(d)(1).

The proposed regulations required a shareholder of an S corporation that excludes COD income from its gross income in a tax year to report to the S corporation the amount of the shareholder's losses and deductions that are disallowed for the tax year of the discharge under Section 1366(d)(1) (the shareholder-information reporting requirement). A number of commentators recommended changes to the shareholder-information reporting requirement to minimize dependence on information furnished by shareholders who provide (intentionally or unintentionally)

incorrect information or shareholders who fail to furnish this information. The final regulations modify the shareholder-information reporting requirements to alleviate dependence on shareholders who fail to furnish information or who provide incorrect information. The final regulations provide that in certain situations, the S corporation may rely on its own books and records as well as other information available to the S corporation to determine a shareholder's disallowed losses or deductions under Section 1366(d)(1), provided that the S corporation knows that the amount reported by the shareholder is inaccurate, or the information, as provided, appears to be incomplete or incorrect.

The final regulations apply to discharges of indebtedness occurring on or after 10/30/2009.

2. **IRS Recharacterizes Dividends to Sole Shareholder of S Corporation as Wages**. In *David E. Watson PC v. United States*, _____ F.Supp. _____, 2010-1 USTC ¶50,444 (S.D. Iowa 2010), the Tax Court denied the taxpayer's Motion for Summary Judgment in connection with its claim for refund of employment taxes paid where the IRS recharacterized dividends paid by the S corporation to its sole shareholder as wages subject to employment taxes.

During the years in issue, 2002 and 2003, David E. Watson, CPA ("Watson"), provided accounting services to a partnership ("LWBJ") and its clients as an employee of David E. Watson PC, an S corporation (the "S Corporation"). The S Corporation was a 25% partner in LWBJ. The IRS made assessments against Watson after it determined that portions of the dividend distributions from the S Corporation to Watson should be recharacterized as wages subject to employment taxes. Specifically, the IRS contended that $130,730.05 out of a total of $203,651 of dividend payments to Watson for 2002 should be recharacterized as wages subject to employment taxes, and that $175,470 out of a total of $203,651 of dividend payments to Watson for 2003 should be recharacterized as wages subject to employment taxes. In both years, Watson received a salary of $24,000 in addition to the dividend distributions.

In his Motion for Summary Judgment, Watson argued that the intent of the S Corporation was controlling in determining the characterization of the payments from the S Corporation to Watson. Because the S Corporation clearly intended to pay Watson compensation of only $24,000 per year, Watson contended that any amounts distributed in excess of the $24,000 were properly classified as dividends. In support of his position, Watson cited *Electric & Neon, Inc. v. Comm'r*, 56 TC 1324 (1971); *Paula Construction Co. v. Comm'r*, 58 TC 1055 (1972), *Pediatric Surgical Associates, P.C. v. Comm'r,* TCM 2001-81.

Citing Rev. Rul. 74-44, 1974-1 CB 287, *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990), *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 80 (9th Cir. 1990) and *Veterinary Surgical Consultants v. Comm'r*, 117 TC 141 (2001), the court found that the intent of the S Corporation was ***not*** controlling in determining the character of the payments, but rather that the analysis turns on whether the payments at issue were made as remuneration for services performed. Consequently, the court denied Watson's Motion for Summary Judgment because it found that there was a genuine issue of material fact as to whether the dividends paid to Watson by the S Corporation were remuneration for services performed subject to employment taxes.

3. **Contributions to Capital of S Corporation Do Not Increase Shareholder's Basis in Debt**. In *Nathel v. Comm'r*, 131 TC No. 17 (2008 *aff'd* _____ F.3d _____, 2010-1 USTC ¶50,443 (2nd Cir. 2010), the Tax Court examined the stock and debt basis rules of subchapter S and determined a shareholder's additional capital investment in an S corporation did *not* shield the shareholder from recognizing income on a repayment of debt which had a basis less than its face value.

Nathel involved two brothers, Ira and Sheldon Nathel (the taxpayers), who organized three S corporations (G&D, W&N, and W&N Cal) with a third person, Gary Wishnatzki (Gary). Each of the taxpayers contributed capital in exchange for 25% of each of the S corporations. Gary owned the other 50% of each of the S corporations. In addition, the taxpayers each made loans on open account to G&D and W&N Cal (open-account debt) and were employed by W&N. In 1999, G&D borrowed approximately $2.5 million from two banks (bank loans) and the three shareholders each personally guaranteed the bank loans. Because of losses realized by G&D and W&N Cal, as of 1/1/2001, the taxpayers had zero basis in their shares of G&D and W&N Cal and reduced basis in their open-account debt under Section 1366(a)(2) and (b)(2), which provide for a reduction in the basis of stock and debt when losses pass through to the shareholders of an S corporation.

The shareholders had disagreements and determined to reorganize the S corporations and the bank loans. Following the reorganization, Gary owned 100% of G&D, the taxpayers owned 100% of W&N, and W&N Cal was liquidated.

In 2001, the following transactions occurred:

With respect to G&D--

In February of 2001, G&D paid each of the taxpayers $649,775 on the open account debt.

In spring and summer of 2001, each of the taxpayers made additional capital contributions to G&D of $537,228.

The taxpayers were released from their guarantees of the bank loans.

Gary assumed the guarantees of the bank loans.

All of the taxpayers' stock in G&D was redeemed by G&D in exchange for no payment.

With respect to W&N Cal-

The taxpayers contributed $181,396 to capital.

Gary contributed $362,794 to capital.

W&N Cal paid outstanding third-party loans of $725,586.

W&N Cal paid $161,250 to each of the taxpayers to satisfy the open account debt obligation.

W&N Cal liquidated and the taxpayers received nothing in exchange for their stock.

With respect to W&N, Gary was fully redeemed in exchange for no payment on his stock.

Under Rev. Rul. 64-162, 1964-1 CB 304, and Rev. Rul. 68-537, 1968-2 CB 372, each repayment of reduced-basis debt is treated as in part a return of basis and in part ordinary income (in the case of open account debt that is not a capital asset) or capital gain. In calculating their ordinary income on receipt of payment of the open-account debt by G&D and W&N Cal, the taxpayers treated the amount of capital they contributed to each of those S corporations as income of the S corporation (albeit excludable under Section 118) that provided the shareholders' with a "net increase" in the basis of their open-account debt. The taxpayers argued that the income qualified as "tax-exempt income" for this purpose. Reg. §1.1366-1(a)(2)(viii) defines "tax-exempt income" for purposes of Section 1366(a)(1) as income that is permanently excluded from gross income.

On audit, the IRS determined that the capital contributions increased the shareholders' basis in their stock ***but did not restore or increase the*** shareholders' ***basis in the debt owed to them by the S corporations***. The IRS also concluded that, as a result of their increased basis, the taxpayers recognized a capital loss on redemption and liquidation of their stock in G&D and W&N Cal.

The rules relating to the restoration of debt basis provide that basis is restored only if there is a "net increase" for an S corporation's tax year. A "net increase" is defined in Section 1367(b)(2)(B) and Reg. §1.1367-2(c) as the amount by which the shareholder's share of items described in Section 1367(a)(1) (relating to income items and excess deduction for depletion) exceed items described in Section 1367(a)(2) (relating to losses, deductions, noncapital, nondeductible expenses, certain oil and gas depletion deductions, and certain distributions) for the tax year. See Reg. §1.1367-2(e), Examples 4 and 5. If there is a "net increase," debt basis is restored by the amount of the "net increase," but in no event may the shareholder's basis of indebtedness be restored above the adjusted basis of the indebtedness under Section 1016(a), excluding any adjustments under Section 1016(a)(17) for prior tax years. If there is no "net increase" for the S corporation's tax year, debt basis is not restored under Section 1367.

If the taxpayers had prevailed on the issue of the characterization of a capital contribution as tax-exempt income of the partnership, the "net increase" would have restored basis to the open account debt and reduced their income recognition on repayment of that debt. In addition, the taxpayers would not have recognized a capital loss on the liquidation of their interests in G&D and W&N Cal.

The court noted that upholding the taxpayers' position would undermine three cardinal and longstanding principles of the tax law:

a. That a shareholder's contributions to the capital of a corporation increase the basis of the shareholder's ***stock*** in the corporation.

b. That ***equity and debt are distinguishable*** and are treated differently by both the Code and the courts.

c. That contributions to the capital of a corporation do ***not*** constitute income to the corporation.

The court distinguished the holding in *Gitlitz*, 531 U.S. 206, 87 AFTR 2d 2001-417 (2001), saying that, unlike income from discharge of debt, contributions to the capital of a corporation are not listed in Section 61 as an item of gross income. In addition, Section 118 and the regulations under Section 118 (Reg. §1.118-1) specifically provide that capital contributions do ***not*** constitute income to a corporation.

In the alternative, the taxpayers argued that their $1,074,456 capital contributions to G&D were made exclusively to obtain a release of their personal guaranties on the G&D bank loans and that the payment should be deductible as an ordinary loss under Section 165(c)(1) or (2). Given the facts of the case, the court concluded that the capital contributions were not incurred in a trade or business under Section 165(c)(1) and were

not incurred in a transaction entered into for profit under Section 165(c)(2) and denied ordinary loss treatment.

4. **LIFO Recapture Tax Does Not Apply to Incorporation of Sole Proprietorship**. In Ltr. Rul. 201010026, the IRS ruled that the Section 1363(d) LIFO recapture tax does not apply when a sole proprietorship using the LIFO inventory method transfers its assets to a newly formed corporation in a Section 351 transaction and the new corporation elects to be an S corporation and use the LIFO method for the first year of its existence.

Under the facts of the ruling, a sole proprietorship was engaged in the business of manufacturing certain products. The sole proprietorship used the accrual method for inventory-production costs and the cash method for all other activities of the business. Additionally, the sole proprietorship used the LIFO inventory method and complied with the uniform capitalization rules of Section 263A.

Section 1363(d) generally provides that if an S corporation was a C corporation for the last tax year before the first tax year for which an election to be taxed as an S corporation was effective, and the corporation inventoried goods under the LIFO method for such last tax year, the LIFO recapture amount will be included in the gross income of the corporation for its last tax year as a C corporation. The "LIFO recapture amount" is the amount by which the corporation's ending inventory under the FIFO method exceeds the corporation's ending inventory valued under the LIFO method.

The IRS found that based on the express language of Section 1363(d), the LIFO recapture tax does not apply to the incorporation of a sole proprietorship which elects S corporation status from its inception. Additionally, the IRS concluded that not applying Section 1363(d) to the incorporation of a sole proprietorship where S status is elected effective as of the date of incorporation would not thwart the congressional intent of Section 1363(d). The IRS explained that because of the mechanics of the LIFO inventory method, the built-in gain from LIFO inventories would not be fully recognized until the taxpayer experiences a decrement in every inventory layer that existed on the date the C corporation elected to be an S corporation. Consequently, it is possible that an S corporation will not experience a decrement in any of these inventory layers during the 10-year recognition period and, thus, will escape taxation under Section 1374 altogether. This result gives an S corporation using the LIFO inventory method a tax-based competitive advantage over an S corporation using the FIFO inventory method. To counter this result, Congress enacted Section 1363(d), which prevents an S corporation from avoiding the taxation of any built-in gain attributable to LIFO inventories owned when it was a C corporation.

Because there is no avoidance of the built-in gain rules of Section 1374 in connection with the incorporation of a sole proprietorship which elects S status effective upon its incorporation, the IRS concluded that Section 1363(d) had no application to such transaction.

5. **Refund Denied Because No S Election Made**. In *Ward v. U.S.*, _____ F.Supp. _____, 2010-1 USTC ¶50,351 (S.D. Texas 2010), the United States District Court for the Southern District of Texas granted the United States' Motion for Summary Judgment denying the taxpayers' deduction of net operating losses from a corporation which they claimed was an S corporation. In 2001, the taxpayer operated a Christian bookstore that was formed on October 13, 2000. The taxpayer claimed $125,109 in losses from the S corporation, on Schedule E of his 2001 tax return. The IRS, however, had no record of the corporation ever filing a Form 2553, a Form 1120S, or a Schedule K-1. Consequently, the United States argued that the taxpayer could not elect to pass through the corporation's profits and losses directly onto his individual income tax return. Additionally, the government argued that even if the corporation were an S corporation, the taxpayer could not claim the $125,109 in losses because he failed to substantiate the losses. In reviewing the evidence, the court found that it was clear that the taxpayer wholly failed to demonstrate a genuine issue of material fact and granted summary judgment for the government.

6. **Tax Court has Jurisdiction in Case Involving Inconsistent Reporting of S Corporation Income**. In *Winter v. Comm'r*, 135 TC No. 12 (2010), the Tax Court held that it had jurisdiction in a deficiency case in which a subchapter S bank employee-shareholder reported his income differently from what was reported by the bank on the Schedule K-1 it filed with the IRS. In 2002, the employee-shareholder was hired by a subchapter S bank and received a bonus that was repayable when he quit or was fired. In 2003, the shareholder-employee was fired and litigation ensued regarding repayment of his bonus. On his 2002 income tax return, the shareholder-employee reported his income from the S corporation bank in a manner that was inconsistent with how it had been reported by the bank on his Schedule K-1 that had been filed with the IRS, but which the shareholder-employee claimed he did not receive. The IRS issued a notice of deficiency to him for the adjustments resulting from the Schedule K-1 and certain other items.

The Tax Court found that the first issue at hand was the jurisdictional issue presented by the case. The jurisdiction issue arose because of the shareholder-employee's failure to comply with Section 6037(c) by reporting consistently with the Schedule K-1 or notifying the IRS about the potential inconsistency. Specifically, the question was whether the failure to report the inconsistency resulted in treatment of the adjustments as a simple math error for which a summary-assessment was issued rather than a notice of deficiency that would result in lack of Tax Court

jurisdiction. The Tax Court looked to Section 6211 which defines a deficiency as "the amount by which the correct tax imposed by the Code exceeds the amount of tax shown on the return plus the amount of tax previously assessed less any rebates," and determined that a notice of deficiency had indeed been issued. Consequently, the court concluded that it had jurisdiction and once it has jurisdiction, it generally covers all items necessary to determine the correct tax. The court found that the Schedule K-1 adjustment by the IRS also could be addressed as part of the shareholder-employee's overpayment claim because the court has authority to consider all issues necessary to determine the correct amount of tax.

In a strongly worded dissent, Judge Holmes argued that the court lacked jurisdiction based on Section 6037(c). According to the dissent, that provision states that the IRS shall make adjustments to make an individual's return consistent with that of an S corporation and to assess tax under Section 6213(b)(1), which precludes the filing of a Tax Court Petition. The dissent also argued that Section 6037(c)(3) requires the taxpayer to notify the IRS of inconsistencies or face a summary assessment. The dissent found that the majority ignored the language of Section 6037 and that the court lacked jurisdiction to determine the shareholder-employee's pass-through income from the S corporation because the IRS did not have the authority to issue the notice of deficiency on that issue (but only a summary assessment).

7. **Seventh Circuit Reverses Tax Court, Holds Interest Incurred by QSub Bank Not Subject to Section 291(a)(3) Cutback**. In, *Vainisi v. Comm'r*, 599 F.3d 567 (7th Cir., 2010), *rev'g,* 132 TC No. 1 (2009), the Seventh Circuit held that the Vainisis, owners of an S corporation holding company ("Holdco") that owned all of the stock of First Forest Park National Bank (FFP), a QSub national bank, were not subject to the 20% interest expense limitation of Section 291(a)(3), for tax years following the third tax year after Holdco converted from C to S status.

Prior to 1997, both Holdco and FFP were C corporations. After enactment of the Small Business Jobs Protection Act of 1996 (SBJPA), however, which permitted banks and other financial institutions that do not use bad debt reserves to be S corporations and also permitted their wholly owned domestic corporation subsidiaries to be treated as disregarded entities (QSubs), Holdco elected S corporation status effective 1/1/97 and elected QSub status for FFP effective the same date.

The issue faced by the Seventh Circuit concerned whether the provisions of Section 291(a)(3) apply to a QSub bank more than three tax years after its parent's conversion from C corporation status to S corporation status. Section 265(b) applies generally to financial institutions and provides that no deduction is allowed for that portion of a financial institution's interest expense which is allocable to tax-exempt interest from tax-exempt

obligations acquired by the taxpayer after 8/7/86. There is an exception, however, for "qualified tax-exempt obligations" acquired after 8/7/86. Under Section 265(b)(3), these obligations are treated for purposes of Sections 265(b) and 291(e)(1)(B) as if acquired on 8/7/86. The net effect is to make qualified tax-exempt obligations 'free from the full cutback under Section 265(b), but subject the financial institution's interest expense to partial cutback under Section 291(a)(3). This occurs because interest on debt to carry tax-exempt obligations acquired after 12/31/82 and before 8/8/86 is a financial institution preference item under Section 291(e)(1)(B) and is reduced by 20% under Section 291(a)(3).

With respect to S corporation banks or QSub banks, a complication arises because Section 291(a), by its terms, applies only in the case of a corporation and Section 1363(b) provides that the taxable income of an S corporation is computed in the same manner as for an individual, except that Section 291 shall apply if the S corporation (or any predecessor) was a C corporation for any of the three immediately preceding taxable years.

Each of the above provisions was in place prior to the enactment of the SBJPA provisions allowing banks to be S corporations or QSub banks. Further, the provision establishing QSubs (SBJPA, section 1308(b)) originally provided that the QSub would not be treated as a separate corporation and all the assets, liabilities, and items of income, deduction, and credit of a QSub would be treated as assets, liabilities, and the items of the S corporation. (Section 1361(3)(A)) Regarding this latter provision, the Treasury and IRS generally were concerned that the QSub provision as enacted, along with the provision permitting S corporation and QSub banks, could produce unintended and inappropriate results for banks that were affiliated with nonbank entities. Therefore, in Notice 97-5, 1997-1 CB 352, the IRS announced that the Code's special provisions that apply to banks should apply to only the specific state law entity that qualifies as a bank and should not apply to nonbanks, even if the nonbank is affiliated with a bank and the parent elects QSub status for the affiliate.

Congress reacted by adding to Section 1361(b)(3)(A), "[e]xcept as provided in regulations prescribed by the Secretary," thus providing specific authority for Treasury to promulgate regulations recognizing the separate status of a QSub in circumstances the Treasury deemed appropriate. Taxpayer Relief Act of 1997, section 1601(c)(3).

Treasury used this authority to enact final QSub regulations in 2000. Reg. §1.1361-4(a)(3)(i) provides, in part, that if an S corporation is a bank, or if an S corporation makes a valid QSub election for a subsidiary that is a bank, any special rules applicable to banks under the Internal Revenue Code continue to apply separately to the bank parent or bank subsidiary as if the deemed liquidation of any QSub had not occurred (except as other published guidance may apply section 265(b) and section 291(a)(3) and

(e)(1)(B) not only to the bank parent or bank subsidiary but also to any QSub deemed to have liquidated).

Applying these various provisions, the IRS made the argument adopted by the Tax Court in *Vainisi,* namely, that Section 1363(b)(4), by its terms, did not apply to FFP because it was a QSub, not an S corporation, and Section 1363(b)(4) applies only to an S corporation. The Seventh Circuit disposed of this argument by stating that if Section 291 does not apply of its own force to S corporations and QSubs, the IRS's interpretation would exempt from the 20% cutback of Section 291(a)(3) all QSubs, even those owned by S corporations that converted from C corporation status in the three years before the tax year in issue.

The Seventh Circuit held that the clear language of Section 1363(b)(4) provides that Section 291, including the 20% cutback, applies to an S corporation only if it had been a C corporation within the three years before the tax year in issue (the "recency exception"). Because Holdco had not been a C corporation within three years of the tax year at issue, Section 291 did not apply. Further, the court stated that it did not agree that the "except as provided in regulations" amendment to Section 1361(b)(3)(A) indicated that Congress never intended Section 1363(b)(4) to prevent the application of Section 291 to banks. Rather, the court said that Section 1361(b)(3)(A) does not state or even hint at that.

The court similarly found that Reg. §1.1361-4(a)(3) did not address the issue in the case, since the regulation simply requires that the special banking rules be applied at the corporate level to banks that are S corporations or QSubs so that a bank's S corporation or QSub status will not emasculate the rules. In sum, the court found nothing in the statutes or regulations that would deprive certain S corporations, such as the Vainisis' bank, of the privileges that Congress provided to S corporations that do not fall within the three-year recency exception.

Finally, the court also referred to Prop. Reg. §1.1363-1(b), which would subject all S corporation banks or QSub banks to the Section 291(a)(3) cutback without regard to their prior C status or how long they had enjoyed that status. The court simply noted that "[u]nless and until such a regulation is adopted (assuming that it would be a valid interpretation of Section 1363(b)(4)) or the statute amended, the distinction stands, and excepts the Vainisis from Section 291."

8. **<u>Custodial Roth IRA Not Eligible S Corporation Shareholder</u>**. In *Taproot Administrative Services, Inc. v. Comm'r*, 133 TC No. 9 (2009), the Tax Court held that a corporation was taxable as a C corporation because its sole shareholder was a custodial Roth IRA.

During 2003, the year in issue, Taproot's sole shareholder was a custodial Roth IRA account for the benefit of Paul DiMundo.

Taproot made two arguments. First, it argued that since its stock was held under a custodial Roth IRA arrangement, under Reg. §1.1361-1(e)(1), Mr. DiMundo should be considered the owner of its stock. In this respect, Reg. §1.1361-1(e)(1) provides that "[t]he person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation for purposes of paragraph (e) [number of shareholders] and paragraphs (f) [shareholder must be an individual or an estate] and (g) [nonresident alien shareholder] of this section." Second, Taproot argued that an IRA is a grantor trust that qualifies as an S corporation shareholder under Section 1362(c)(2)(A)(i).

In granting summary judgment for the IRS, the majority acknowledged that a statute or regulation in effect in 2003 explicitly prohibited a traditional IRA or a Roth IRA from owning S corporation stock. According to the majority, the only legal authority specifically addressing the issue was Rev. Rul. 92-73, 1992-2 CB 224, which concludes that a trust that qualifies as an IRA is not a permitted shareholder of an S corporation.

The Tax Court acknowledged that although it is not bound by revenue rulings, the weight of revenue rulings and the deference accorded them depends on their persuasiveness and the consistency of the Commissioner's position over time. The court found the rationale of Rev. Rul. 92-73 persuasive. In this respect, the ruling holds that traditional IRAs are not eligible S corporation shareholders because the beneficiary of a traditional IRA is not taxed currently on the IRA's share of the S corporation's income whereas the beneficiaries of the permissible S corporation shareholder trusts listed in Section 1361(c)(2)(A) are taxed currently on the trust's share of such income. Thus, the court found the rationale of Rev. Rul. 92-73 sensibly distinguishes IRAs from grantor trusts governed by Sections 671-679. Unlike a person who is treated as an owner of a grantor trust and taxed currently, earnings accrue tax free in both traditional and Roth IRAs. Thus, the court found that the tax relationship between an individual beneficiary and a traditional or Roth IRA is not governed by the grantor trust provisions of Sections 671-679.

The court also found that there was no evidence that Congress ever intended to allow IRAs to own S corporation stock. In particular, in 2004, Congress added Section 1361(c)(2)(A)(vi) to create a narrow exception for IRA ownership of S corporation stock (The American Jobs Creation Act of 2004, Pub. C. 108-357, Sec. 233(a)). Under this provision, in the case of a bank or a depository institution holding company, a trust which constitutes an IRA, including a trust designated as a Roth IRA, may hold stock in an S corporation, but only to the extent of the stock held by such trust in the bank or bank holding company as of 10/22/2004. The court stated that the legislative history related to the amendment reflects that Congress acted to amend the law because it believed IRAs were ineligible

S corporation shareholders. Citing H. Rep. 108-548 (Part 1) at 129 (2004).

9. **IRS Rules that Disproportionate Distributions Did Not Terminate S Corporation Election**. In Ltr. Rul. 201006026, the IRS ruled that disproportionate distributions made by an S corporation to its two shareholders did not cause the corporation to have a second class of stock under Section 1361(b)(1)(D), and as such, the corporation's S election was not terminated.

Under the facts of the ruling, an S corporation made disproportionate distributions to its shareholders. It was represented in the ruling, however, that each share in the S corporation had identical rights to liquidation proceeds and distributions, that no provisions existed in the governing documents, regulations, or bylaws that varied those rights and that no other binding agreement existed that varied those rights. Additionally, it was represented that a corrective distribution to the shareholders was made which resulted in distributions proportionate to the S corporation shareholders since its inception as an S corporation.

Under Reg. §1.1361-1(l)(1), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distributions and liquidation proceeds. Reg. §1.1361-1(l)(2) provides that the determination of whether all outstanding shares of stock confer identical rights to distributions and liquidation proceeds is based upon the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distributions and liquidation proceeds (collectively, the "governing provisions"). Thus, with respect to an S corporation's outstanding shares of stock, only governing provisions can cause the corporation to be treated as having a second class of stock.

Additionally, Reg. §1.1361-1(l)(2)(i) specifically provides that non-conforming distributions (disproportionate distributions) will not cause a corporation to be treated as having more than one class of stock, but that distributions which differ in time or amount will be given "appropriate tax effect" in accordance with the facts and circumstances. Thus, the IRS has the power to recharacterize such distributions, but such distributions cannot create a second class of stock.

Based upon the representations made in the ruling, the IRS concluded that the disproportionate distributions did not create a second class of stock for purposes of Section 1361(b)(1)(B). However, the IRS expressly stated that the ruling was contingent upon the S corporation making corrective distributions so that each shareholder has received distributions proportionate to their interests and that the failure to make such corrective distributions would render the ruling void. Conditioning the ruling on the S corporation making corrective distributions should not be required since

the regulations make it clear that disproportionate distributions (that are not the result of a governing provision) cannot cause the corporation to have a second class of stock. This is the same result as reached by the IRS in Ltr. Rul. 200802002. It would have been more appropriate to provide that if corrective distributions were not made, the IRS would have the authority to recharacterize those payments to give them appropriate tax effect, but would in no event result in the corporation having a second class of stock.

10. **Timing of Valid S Election**. In Rev. Rul. 2009-15, 2009-21 IRB 1035, the IRS ruled that a partnership may convert to a corporation in two situations and be eligible to elect S status for its first tax year as a corporation. Although the ruling's conclusion is reasonable and favorable, the analysis with respect to one of the factual situations presented is unclear and may be "clarified" in the future. See comments by William Alexander, Associate Chief Counsel (Corporate), IRS, ABA Tax Section Meeting, May 2009, reported in 2009 TNT 89-19.

Rev. Rul. 2009-15 addresses whether a partnership can move seamlessly (i.e., without an intervening period as a C corporation) to S corporation status under two factual situations:

a. In Situation 1, X, a calendar year taxpayer that is classified as a partnership for federal tax purposes, elects under Reg. 301.7701-3(c)(1)(i) (check-the-box regulations) to be classified as an association for federal tax purposes effective 1/1/2010. On 2/1/2010, X files an election under Section 1362(a) to be taxed as an S corporation effective 1/1/2010. No person who held stock in X on 1/1/2010 does not hold stock at the time the election under Section 1362(a) is made.

b. Situation 2 presents the same facts as Situation 1, except that Y is the calendar-year taxpayer that changes its classification from partnership to corporation, and the classification change is under a state law formless conversion statute rather than under the check-the-box regulations.

Because only an entity that meets the definition of a "small business corporation" for its entire tax year can make a valid S election, the timing and manner of the conversion from partnership to corporate status is central to the determination of whether the corporation satisfies the requirements to be an S corporation for its first tax year.

A review of the relevant provisions of the statute and regulations is helpful in understanding the timing issue with which Rev. Rul. 2009-15 is concerned. Section 1362(a) provides that a "small business corporation" may make an election to be treated as an S corporation. Section 1362(b)(1) provides that the S election may be made for any tax year at

any time during the preceding tax year or at any time during the tax year and on or before the 15th day of the third month of the tax year. Finally, Reg. §1.1362-6(a)(2)(ii)(B) provides that a timely election made by a small business corporation during the tax year for which it is intended to be effective is, nonetheless, treated as made for the following tax year if either:

a. The corporation is not a small business corporation during the entire portion of the tax year that occurs before the date the election is made.

b. Any person who held stock in the corporation at any time during the portion of the tax year that occurs before the time the election is made, and who does not hold stock at the time the election is made, does not consent to the election.

Section 1361(b) defines a "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not:

a. Have more than 100 shareholders.

b. Have as a shareholder a person (other than an estate, a trust described in Section 1361(c)(2), or an organization described in Section 1361(c)(6)) who is not an individual.

c. Have a nonresident alien as a shareholder.

d. Have more than one class of stock.

A partnership is not eligible to be an S corporation shareholder. As a result, if a partnership holds stock in a corporation at any time during a tax year, the corporation does not meet the definition of a "small business corporation" and cannot elect S status for that year.

The two formless conversions addressed in the revenue ruling are the conversion by election under the check-the-box regulations and the conversion under a state statute that permits a partnership (or other entity) to convert to corporate status without actually transferring the entity's assets to a new state-law corporation.

The manner and timing of a check-the-box conversion are prescribed in the check-the-box regulations. Reg. §301.7701-3(a) provides that a business entity that is not classified as a corporation under Regs. §§301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes. Under Reg. §301.7701-3(g)(1)(i), if a partnership elects to be treated as a corporation, the following is deemed to occur:

a. The partnership contributes all of its assets and liabilities to the corporation in exchange for stock in the corporation.

b. Immediately thereafter, it liquidates by distributing its assets (the stock) to its partners.

Reg. §301.7701-3(g)(3)(i) provides that an election that changes the classification of an eligible entity is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur under Reg. §301.7701-3(g) as a result of the change in classification are treated as occurring immediately prior to the close of the day before the election is effective.

As a result of these rules, the analysis of Situation 1 provided in Rev. Rul. 2009-15 is straightforward. When X (an entity classified as a partnership) elects under the check-the-box regulations to be treated as a corporation effective the first day of its tax year, X is treated as having contributed all of its assets and liabilities to a corporation in exchange for stock and liquidating immediately before the close of the day before the election is effective. Thus, the deemed transactions that occur as a result of the check-the-box election occur on the last day of X's partnership tax year, and any tax consequences resulting from the conversion must be reported by X's partners. More importantly, the partnership's momentary ownership of the new corporation's stock occurs on December 31, thus X does not have an ineligible shareholder for any part of X's first tax year as a corporation and is otherwise eligible to be an S corporation for its first tax year as a corporation. Finally, there is no intervening period during which X is treated as a C corporation.

A conversion under a state law formless conversion statute is more problematic. The check-the-box regulations do not technically apply to a state law formless conversion, but in Rev. Rul. 2004-59, 2004-1 CB 1050, the IRS announced that it would treat a formless conversion of a partnership into a corporation as resulting in the same deemed transactions as those provided in the case of a partnership's check-the-box election to be treated as a corporation. Rev. Rul. 2004-59 examined the approach of both the check-the-box regulations and Rev. Rul. 84-111, 1984-2 CB 88, in justifying its conclusions.

In Rev. Rul. 84-111, the IRS dealt with three possible methods for incorporating a partnership and determined that the actual transactions undertaken by the parties to incorporate the partnership would determine the tax consequences. Because no actual transfers occur in a formless conversion, the IRS concluded that Rev. Rul. 84-111 did not apply. In the case of a state-law formless conversion, however, Rev. Rul. 2004-59 concludes that it is appropriate to treat the conversion as occurring "in the same manner" as a formless conversion from partnership to corporation under the check-the-box regulations (i.e., the assets and liabilities are

treated as contributed to a corporation in exchange for stock which is distributed by the partnership in liquidation immediately thereafter).

Rev. Rul. 2004-59 does not address the timing of the transactions that are deemed to occur as a result of a state law formless conversion. For an S corporation, the timing of the deemed transactions is critical. For example, if the deemed transactions are treated as occurring on the date the state law formless conversion is effective, and if the deemed ownership of stock by the partnership is not disregarded, the corporation will briefly have a partnership as a shareholder on the effective date of the conversion.

If the effective date is the last day of the partnership's tax year, the entity may have a short period as a C corporation that will implicate Section 1374 as well as potential additional filing requirements. If Section 1374 applies to the assets held by the corporation when it becomes an S corporation on the following day, an additional tax applies with respect to all "net unrealized built-in gain" in those assets. Section 1374(d)(1) defines net unrealized built-in gain as the amount (if any) by which the fair market value of the assets of the S corporation as of the beginning of its first tax year as an S corporation exceeds the aggregate adjusted bases of such assets at that time. Thus, Section 1374 may apply to all built-in gain in the entity's assets, not just the gain accruing during the C corporation period. If the effective date is the first day of the corporation's tax year, the partnership is treated as a shareholder on that day, and if that transitory ownership is not disregarded, the corporation is not eligible to be an S corporation until its second tax year. Rev. Rul. 2009-15 addresses these timing concerns by concluding that the timing provided in the check-the-box regulations applies to the deemed transactions in a state law formless conversion. In Situation 2, the formless conversion was effective under state law on 1/1/2010. As a result of the timing in Reg. §301.7701-3(g)(3), however, the revenue ruling provides that Y is deemed to contribute all of its assets and liabilities to the corporation in exchange for stock in the corporation and immediately thereafter is deemed to liquidate at the close of the day before the formless conversion is effective. Because the partnership goes out of existence at the end of its tax year and the corporation does not have a corporate shareholder at any time on 1/1/2010 (the first day of its tax year), Y is eligible to make an S election for its first tax year, and there is no intervening period during which Y is a C corporation.

The reliance on the timing provided in the check-the-box regulations for purposes of a transaction that is not subject to check-the-box is somewhat surprising. Prior to publication of the ruling, practitioners generally believed that any deemed transactions occurring as a result of a formless conversion would be treated as occurring on the effective date of the

conversion -- not the day before. In fact, it is unclear whether the IRS has the authority to alter that timing.

Moreover, because parties take timing into account when ordering a series of transactions, IRS officials, William Alexander, Associate Chief Counsel (Corporate), and Curt Wilson, Associate Chief Counsel (Passthroughs and Special Industries), assured members at the ABA Tax Section May 2009 meeting that the timing provided in the ruling does not apply for any purpose other than that addressed in the ruling (Chief Counsel (Passthroughs & Special Industries), IRS, at the May 2009 meeting of the ABA Tax Section, reported in 088 DTR G-4 (5/11/09)). Nevertheless, if the timing assumptions of the ruling are incorrect, it is unclear that the conclusion drawn in Situation 2 is supportable and further clarification would be helpful

III. PARTNERSHIPS, LLCS AND DISREGARDED ENTITIES

A. SERIES LIMITED LIABILITY COMPANIES

1. **IRS Issues Long-Awaited Proposed Regulations on Series Limited Liability Companies**. On September 14, 2010, the IRS issued proposed regulations clarifying that an individual series of a series limited liability company or an individual cell of a cell company formed under local law (or under foreign law if it engages in an insurance business) will generally be treated as a separate corporate entity for federal tax purposes.

   a. The proposed regulations generally classify each series or cell as a separate entity for federal tax purposes even in cases where the entity failed to elect or qualify for the liability limitations under local law. The Preamble to the regulations states that the factors for supporting the separate entity status for series outweigh the factors in favor of disregarding series as entities separate from the series because each series can have separately identified managers and investment objectives.

   b. The regulations define a series as a segregated group of assets and liabilities that are established pursuant to a series statute. Series statutes must permit series members rights or powers with respect to the series, must permit the series to have rights or powers with respect to its property or obligations, and must permit the segregation of assets and liabilities.

   c. Surprisingly, the transition rule set forth in the proposed regulations provide for single-entity treatment for the series and the series organization if the series were established and conducted business or investment activity even before September 14, 2010, and the series and the series organization had a reasonable basis for claiming single-entity classification.

d. The regulations propose a new requirement that each series organization and each series within it create and annually file a statement containing identifying information to ensure the proper assessment and collection of tax. Such a statement would include identifying information of each series and the organization (name, address, and taxpayer identification number), jurisdiction of formation, and ownership details of the series' assets. The statement would be a stand-alone filing due March 15 of each year.

e. The proposed regulations do ***not*** provide guidance on the entity status of the series organization itself, although the Preamble notes that such organizations are generally entities under local law and would thus generally be treated as entities for federal tax purposes. The proposed regulations also do not extend separate entity treatment to all series or cells of organizations established under foreign law. They only do so for those foreign series that conduct an insurance business because an insurance company is classified as a per se corporation under Section 7701(a)(3) regardless of how it otherwise would be treated under Reg. §§ 301.7701-1 through 301.7701-3.

B. CARRIED INTERESTS

1. American Jobs and Closing Tax Loopholes Act of 2010. One of the primary provisions "paying" for the tax extenders set forth in The American Jobs and Closing Tax Loopholes Act of 2010, as well as one of the most controversial provisions, is the so-called "carried interest" provision. This provision would subject partners to ordinary income tax rates on partnership profits they receive pursuant to "carried interest" in real estate, private equity, venture capital, and other investment partnerships. Although proposed to prevent investment fund managers from paying taxes at capital gains rates on investment management services, the proposed bill is not so limited. The bill would require partners to treat 75% of partnership profits attributable to carried interest to be taxed at ordinary income tax rates.

The Senate bill keeps the House's carried interest provision, but modifies it in three ways:

(1) It decreases the amount of carried interest that is recharacterized as ordinary income from 75% to 65%.

(2) For gain attributable to the sale of an asset held for seven or more years, it would treat carried interest as 55% ordinary income and 45% capital gains.

(3) It provides that a non-service individual or widely-held regulated investment company that sells an interest in an

energy-related publicly traded partnership is exempt from recharacterization as ordinary income for that portion of gain or loss attributable to investment services partnership interests held by the publicly traded partnership.

2. **The Jobs Creation and Tax Cuts Act of 2010**. As discussed above, the Jobs Creation and Tax Cuts Act of 2010 introduced by Senator Baucus on September 15, 2010 (which contains numerous extenders to expiring tax provisions) does ***not*** contain the controversial self-employment tax on the pass-through income of certain S corporation shareholders. However, the Jobs Creation and Tax Cuts Act of 2010 does still contain the controversial carried interest provision as one of the provisions paying for the tax extenders contained in the bill. Under the legislation, to the extent that carried interest reflects a return on invested capital, the bill would continue to tax carried interest at capital gain tax rates. However, to the extent that carried interest does not reflect a return on invested capital, carried income tied to assets held for less than five years would be taxed as 25% capital gain, with the remaining 75% of the income on the carried interest taxed as ordinary income beginning January 1, 2011. The amount that would be treated as ordinary income would be reduced to 50% for carried interest that does not reflect a return on invested capital but which is attributable to the sale of assets that are held for five or more years. The lower recharacterization percentage also applies to the gain or loss attributable to the underlying assets held for five or more years when a partnership interest is sold as well as to gain attributable to Section 197 intangibles of an entity providing specific investment management services when the partnership interest has been held for five or more years.

3. **Proposed Carried Interest Legislation Much Broader than Appears**. The proposed legislation, which would add a new Section 710 to the Code, is ostensibly aimed at shutting down a tax loophole enjoyed by managing partners of private equity funds and hedge funds who receive an allocable share of profits, often taxed at long-term capital gains rates, as compensation for services rendered. As will be explained in more detail below, the scope of this potential new provision is much broader than advertised.

   The perception of most people is that new Section 710 would convert the long-term capital gain into ordinary income and, in addition, impose employment taxes on such income. All of this is true, but it does much more.

   a. The proposed legislation has a significant loss deferral aspect to it.

   b. The proposed legislation will "turn off" most non-recognition provisions in the Code and will result in a current taxable transaction in the case of many transactions that previously had not been taxed.

c. It potentially affects a very broad class of partners.

d. It potentially applies to many transactions beyond income allocations in connection with the sale of portfolio investments.

e. There is no grandfathering of existing partnerships.

While proposed legislation on Carried Interests discussed above contained a great deal of complexity, this outline will only focus on some of the basics and is designed to give the tax practitioner a feel for what might be enacted in the near future. Primarily, the proposed legislation addressing Carried Interest is designed to apply to "investment service partnership interests", or ISPI's. An ISPI is defined as a partnership interest held by any person if it was reasonably expected at the time when the person acquired the interest that the person (or a related person) would provide a substantial quantity of investment management services with respect to certain specified assets held by the partnership. Included in the list of management services expected to be impacted by the Carried Interest rules are:

a. Advising with respect to investing in, purchasing or selling any specified asset.

b. Managing, acquiring or disposing of any specified asset.

c. Arranging financing with respect to acquired specified assets; and

d. Any activity in support of these three (3) other activities.

For this purpose, "specified assets" is defined to include securities, ***real estate held for rental or investment, interests in partnerships***, commodities, or options or derivative contracts with respect to such assets.

It is noteworthy that an ISPI is not defined as a Profits Interest or Carried Interest of the applicable partnership. Instead, an ISPI generally includes all of the service provider's partnership interests, meaning it can have even broader application than originally thought.

These new rules would not apply to certain "qualified capital interests" which are defined as interests in a partnership that are received in exchange for the contribution of property (and not in exchange for services). In this regard, the legislation defines a qualified capital interest as so much of a partner's interest in the capital of a partnership that is attributable to

the fair market value of money or other property contributed to the partnership in exchange for the interest,

a. any amounts included in income under section 83 with respect to the transfer of such interest; and

b. the excess of the partner's distributive share of income and gain items over his distributive share of deduction and loss items during the years when Carried Interest provisions are in effect.

The operative provisions of the legislative proposals provide that any net income with respect to an ISPI is treated as ordinary income, notwithstanding the character of the income at the partnership level. Moreover, the proposals treat gain recognized on the disposition of an ISPI as ordinary income and triggers gain on the distribution of property to a holder of an ISPI, which gain is characterized as ordinary income and allocated to the service partner who receives the distribution. To add insult to injury, the Carried Interest proposals would subject any amounts treated as ordinary income under these provisions to the self-employment tax. Also, the proposed legislation includes provisions which defer an ISPI's holder's share of partnership losses by providing that losses allocated to a partner holding an ISPI would be treated as ordinary only to the extent of the aggregate net income with respect to the interest during the years the Carried Interest legislation is in effect. Any additional losses are carried forward and deferred until the partnership allocates future income to the partner or the ISPI is sold or redeemed.

The legislation contains certain anti-abuse rules that apply to "disqualified interests", which generally includes equity investments in entities other than S corporations, domestic C corporations, partnerships or foreign corporations substantially all of the income of which is either effectively connected with a US trade or business or subject to a comprehensive foreign income tax. The rules applicable to disqualified interests apply (i) if a person performs (directly or indirectly) investment management services for an entity in which the person holds a disqualified interest and (ii) the value of that interest is substantially related to the amount of income or gain (realized or not) from the assets with respect to which the investment management services are performed. If applicable, income or gain with respect to a disqualified interest is treated as ordinary income and subject to self-employment tax. Moreover, if such disqualified interest rules are applicable, and the taxpayer does not report such amounts as such, a ***40% strict liability penalty*** would be imposed.

As with other legislation, the proposed legislation includes a grant of broad regulatory authority, giving the IRS authority to provide regulations to carry out the purposes of the legislation, including "to prevent avoidance of the purposes of this section."

So given all the commotion regarding Carried Interests and the various rules and definitions that may be adopted, how will it apply to our clients? Clearly, the proposed legislation relating to Carried Interests will be broad

ranging. Just how broad ranging may be illustrated by the following examples:

Example 1

Assume that Larry and Curly (sorry no "Mo") form a partnership to own and operate rental real estate, with Larry providing management services to the partnership and Curly simply being a passive investor. Further assume that Larry provides management services to the partnership in exchange for an annual fixed fee. Further assume that Larry and Curly each contribute $500 to the partnership capital and agree that the first $833 of profits will be allocated 40% to Larry ($333) and 60% to Curly ($500), after which Curly will recover his entire $500 contribution. Larry will then be allocated the next $167 of profits (which will allow Larry to recover his entire $500 contribution). Thereafter, profits will be allocated 55% to Larry and 45% to Curly. How would the proposed Carried Interest legislation apply? In this scenario, the allocation to Larry's qualified capital interest is not made in the same manner as allocations to Curly's qualified capital interest. Accordingly, it is possible that allocations to Larry's qualified capital interest could represent a higher rate of return and Larry's entire partnership interest could be subject to the proposed Carried Interest legislation even though Larry is not allocated any profits in exchange for his services and depending on partnership profits, allocation to Curly's qualified capital account may end up representing a higher rate of return.

Example 2

Assume that Larry provides management services to the partnership in exchange for a fixed fee and that each of Larry and Curly contribute $500 to the partnership and each is allocated 50% of all partnership profits. Further assume that Curly pays $100 of the partnership's operational expenses, to be repaid by the partnership at a later date. Assuming that Curly's $100 payment of partnership expenses is considered a loan to the partnership, this loan will increase the amount of Curly's qualified capital interest. Since both Larry and Curly are allocated an equal 50% of profits, but Curly's qualified capital interest would be considered to be greater than Larry's, allocations to Curly's qualified capital interest would represent a lower return and, accordingly, at least a portion of Curly's partnership interest would appear to be governed by the proposed Carried Interest rules.

Example 3

Assume that Larry and Curly formed the partnership in 1995 and that Larry performs services for the partnership from 1995-2000 in exchange for a partnership interest. Larry has provided no further services since 2000 and will provide no services in the future. In 2011, after the

effective date of the legislation, gold is discovered on the property owned by the partnership and the partnership sells its property which had only been valued at $50,000 before the gold was discovered for $1,000,000. Larry's interest in the partnership would appear to be governed by the proposed Carried Interest legislation even though he provides no services after the effective date of the legislation. Even though Larry's share of partnership gold profits does not appear to represent compensation to Larry, it would nevertheless be recharacterized as ordinary income and be subject to the self-employment tax.

Example 4

Larry and Curly form a partnership in 2009, with Curly providing $100 of capital and Larry providing no capital. They agree that Curly will receive the first $100 of distributions and then they will share all subsequent distributions equally. In this example, it appears that, even after Curly recovers his $100 contribution and Larry and Curly begin sharing distributions equally, Larry's entire partnership interest would continue to be governed by the legislation. This would apply even if the contribution is recovered before the effective date of the legislation.

C. APPLICATION OF PAL RULES TO LLC MEMBERS VERSUS LIMITED PARTNERS

1. **Tax Court Again Finds Membership Interest Not Equivalent to a Limited Partnership Interest for Purposes of Section 469**. In *Newell v. Comm'r*, TCM 2010-23, the Tax Court held that the managing member interest of the taxpayer in a California limited liability company classified as a partnership for federal income tax purposes did *not* constitute a "limited partnership interest as a limited partner" for purposes of applying the passive activity loss limitation rules of Section 469 and the regulations promulgated thereunder.

   During the years in issue, the taxpayer owned 33% of the membership interests of Pasadera Country Club, LLC, a limited liability company formed under California law in 1999 to engage in the business of owning and operating a golf course, restaurant and country club facility. Pasadera is classified as a partnership for federal income tax purposes. At all relevant times, the taxpayer was the managing member of Pasadera and was responsible for the day-to-day operations of Pasadera.

   The taxpayer deducted his distributive share of the losses of Pasadera for the tax years in issue based on the position that he had materially participated in Pasadera's activities. The IRS determined that the losses from Pasadera had been incurred in a passive activity under Section 469 and that the losses the taxpayer claimed in each of the years in issue "are suspended and not currently deductible" under Section 469(a)(1). Specifically, the IRS contended that under Section 469(h)(2), which sets

forth a special rule for an "interest in a limited partnership as a limited partner," and under Temp. Reg. §1.469-5T(e), the taxpayer's membership interest in Pasadera should be treated as a limited partnership interest as defined under Temp. Reg. §1.469-5T(e)(3)(i)(B), and would therefore be subject to the restriction contained in Temp. Reg. §1.469-5T(e)(1). The taxpayer, on the other hand, argued that his membership interest should not be treated as a limited partnership interest in Pasadera as a limited partner for purposes of the passive activity loss limitation rules. The classification of a membership interest in an LLC as a "limited partnership interest" is important because a limited partner has fewer means by which he can demonstrate his material participation in the business.

Under Section 469(d)(1), a passive activity loss occurs where the aggregate losses from all passive activities for the tax year exceed the aggregate income from all passive activities for such year. Under Section 469(c)(1)(B), a passive activity is any activity which involves the conduct of a trade or business in which the taxpayer does *not* materially participate.

A taxpayer materially participates in the activity only if he is involved in the activity's operations on a regular, continuous and substantial basis. Generally, an individual may establish his participation for a tax year by meeting any of the following seven tests:

(1) The individual participated in the activity for more than 500 hours during such year;

(2) The individual's participation in the activity for the tax year constituted substantially all of the participation in such activity of all individuals … for such year;

(3) The individual participated in the activity for more than 100 hours during the tax year, and such individual's participation in the activity for the tax year was not less than the participation in the activity of any other individual … for such year;

(4) The activity was a significant participation activity … for the tax year, and the individual's aggregate participation in all significant participation activities during such year exceeded 500 hours;

(5) The individual materially participated in the activity … for any five tax years … during the 10 tax years that immediately preceded the tax year;

(6) The activity is a personal service activity … and the individual materially participated in the activity for any three tax years … preceding the tax year; or

(7) Based on all of the facts and circumstances … the individual participated in the activity on a regular, continuous, and substantial basis during such year.

The Code, however, treats limited partners differently, because it assumes that they do *not* materially participate in their limited partnerships. Under Section 469(h)(2) and Temp. Reg. §1.469-5T(e)(2), if a taxpayer holds a limited partnership interest, only three of the seven tests described above -- one, five and six -- can be used by the limited partner to satisfy the material participation requirement.

Temp. Reg. §1.469-5T(e)(3)(i) provides that a partnership interest will be treated as a limited partnership interest if:

a. Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or

b. The liability of the holder of such interest for obligations of the partnership is limited, under the law of the state in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contribution to the partnership and contractual obligations to make additional capital contributions to the partnership).

Additionally, Temp. Reg. §1.469-5T(e)(3)(ii) provides that a partnership interest of an individual will ***not*** be treated as a limited partnership interest if the individual is a general partner in the partnership at all times during the partnership's tax year ending with or within the individual's tax year.

The taxpayer argued that his interest should not be treated as a limited partnership interest because Pasadera was *not* a limited partnership, and/or alternatively, because his membership interest more closely resembled a general partnership interest than a limited partnership interest. The IRS, on the other hand, argued that it was proper to treat the taxpayer's interest in Pasadera as a limited partnership interest because the taxpayer elected to have Pasadera taxed as a partnership for federal income tax purposes and the taxpayer's liability was limited under the laws of the state in which it was organized (California).

The Tax Court, citing its prior decision in *Garnett v. Comm'r*, 132 TC 19 (2009), held that Section 469(h)(2) applies by its terms only if the

taxpayer has an interest in a limited partnership as a limited partner. The court explained that an LLC is a hybrid form of business entity that shares some of the characteristics of a partnership and some of the characteristics of a corporation. Members of a California LLC can participate directly in management, but they also enjoy limited liability for company debts and liabilities under California law. Analogizing a California LLC to a limited partnership, the court concluded that members of a California LLC more closely resemble general partners than limited partners. Additionally, the court found that this was particularly true with respect to the taxpayer, who was the managing member of Pasadera and in that capacity managed the day-to-day operations of Pasadera, functioning just as a general partner would function in a limited partnership. Consequently, the court concluded that the taxpayer came within the general partner exception of Temp. Reg. §1.469-5T(e)(3)(ii) and consequently did not hold his managing member interest in Pasadera as a limited partner. Because Section 469(h)(2) did not apply to taxpayer's membership interest in Pasadera and because the IRS conceded that the taxpayer otherwise met the requirements of the significant participation activity test under Temp. Reg. §1.469-5T(a)(4), the taxpayer's Pasadera activity was a significant participation activity for the years at issue, and his aggregate participation in all significant partnership activities in each of the years at issue exceeded 500 hours. Thus, under the significant participation test of Temp. Reg. §1.469-5T(a)(4), the taxpayer materially participated in Pasadera's activities during the years in issue and therefore properly deducted his distributive share of Pasadera's losses for the tax years in issue.

See also, *Thompson v. U.S.*, 87 Fed. Cl. 728 (Fed. Cl. 2009); and *Garnett v.* Comm'r, 132 TC 19 (2009).

2. **IRS Acquiesces in Result Only in *Thompson* Case**. In an Action on Decision, the IRS announced its acquiescence in result only in *Thompson v. United States*, 87 Fed. Cl. 728 (Fed. Cl. 2009), in which the Court of Federal Claims held that an interest in a limited liability company is *not* a limited partnership interest for purposes of the passive activity loss limitation rules.

On 7/20/2009, the Court of Federal Claims issued a summary judgment opinion in *Thompson*, concluding that LLC interests are not "limited partnership interests" for purposes of Temp. Reg. §1.469-5T(e)(3)(i). *Thompson* joined *Garnett* and *Gregg*, as the third case to rule against the IRS's position that an interest in an LLC is a limited partnership interest under Temp. Reg. §1.469-5T(e)(3)(i). As discussed above, a fourth case, *Newell v. Comm'r*, has also held that an interest in an LLC is not a limited partnership interest under Temp. Reg. §1.469-5T(e)(3)(i).

In light of these cases, the IRS has issued an Action on Decision acquiescing in the result only for *Thompson*. According to Diana Miosi,

special counsel in the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), the AOD was issued "to get the word out that we're not going to be litigating these cases anymore."[24] Additionally, Miosi stated that the string of litigation losses has "gotten our attention," and that "it is important to try to get some guidance out in this area." Finally, Miosi noted that the government has struggled with the issue, not only with respect to Section 469, but also in other areas of the Code as well, such as Sections 464 and 736, and the self-employment tax area.[25]

In light of the new Medicare tax imposed on a partner's distributive share of the operating income of a partnership if the activity of the partnership producing the income is passive with respect to the partner under the passive activity loss limitation rules of Section 469, this distinction between membership interests in limited liability companies and limited partnership interests in limited partnerships will be of even greater significance.

D. APPLICABILITY OF CHARGING ORDER PROTECTION TO FLORIDA LLCS

1. **Florida Supreme Court Rules that Charging Order is Not Exclusive Remedy for LLCs**. In *Olmstead v. Federal Trade Commission* (Supreme Court of Florida, Case # SC08-1009 June 24, 2010), the court held that a court may order a judgment debtor to surrender all right, title and interest in such debtor's single-member limited liability company (LLC) to satisfy an outstanding judgment. As will be discussed below, because of the reasoning used by the Florida Supreme Court, the decision potentially opens the door as to whether a charging order is the exclusive remedy not only with respect to Florida single-member LLCs, but also with respect to multi-member Florida LLCs, and may well affect other jurisdictions having LLC statutes similar to the Florida Statutes.

Under the facts of the case, the debtors "operated an advance-fee credit card scam" and were sued by the Federal Trade Commission ("FTC") for unfair or deceptive trade practices. The debtors assets, which included several single-member Florida LLCs, were frozen and placed in

[24] Ms. Miosi's remarks were made on March 10, 2010 at a BNA Tax Management luncheon.

[25] The issue of whether the members of a multi-member LLC which is taxed as a partnership for federal income tax purposes are treated as general partners or limited partners for purposes of the self-employment tax is unclear at best. Obviously, the IRS could use the same reasoning used against the IRS in the *Thompson, Garnett, Newell* and *Gregg* cases to reach the conclusion that a member's interest in the LLC is ***not*** equivalent to a limited partner's interest in a limited partnership for purposes of self-employment tax. This would result in members of an LLC being subject to the self-employment tax on their distributive share of the income of an LLC (with certain exceptions for interest, dividends, rent and capital gain). However, on January 14, 2010, Diana Miosi reassured practitioners that they may rely on the proposed 1997 regulations in dealing with the application of the self-employment tax to limited liability companies.

receivership. The FTC ultimately obtained a judgment against the debtors and then obtained an order compelling them to transfer to the receiver all of their right, title and interest in their LLCs. The Eleventh Circuit Court of Appeals certified the Florida law issue to the Florida Supreme Count. Specifically, the question certified from the Eleventh Circuit Court of Appeals to the Florida Supreme Court was as follows:

> "Whether, pursuant to Florida Statute Section 608.433(4), a court may order a judgment-debtor to surrender 'right, title and interest' in the debtor's single-member limited liability company to satisfy an outstanding judgment."

a. **Relevant Statute**. Fla. Stat. §608.433(4) provides that a judgment creditor of a member may charge the LLC membership interest of the member with payment of the unsatisfied amount of the creditor's judgment, and to the extent so charged, the judgment creditor has only the rights of an assignee of such interest. Fla. Stat. §608.432 provides that unless other provided in the Articles of Organization or the Operating Agreement, an LLC membership interest is assignable in whole or in part, and an assignee of such limited liability company interest has no right to participate in the management of the business and affairs of the LLC, unless such assignee is admitted as a member of the LLC by all of the members of the LLC other than the transferring member or as otherwise provided in the Articles of Organization and/or the Operating Agreement of the LLC. Fla. Stat. §608.433 provides that, unless otherwise provided in the Articles of Organization or the Operating Agreement, an assignee of an LLC membership interest may become a member only if all other members of the LLC consent to the transferring member assigning his or her membership interest. Based on §608.433(4), it was generally believed that a creditor of a debtor-member of an LLC holding a charging order could not reach the assets of the LLC or participate in the LLC's business, but would only be entitled to any profits, distributions and tax attributes to which the debtor-member was entitled.

(1) **The Majority Opinion**. The court noted that the statutory language of §608.433 did not expressly provide that a charging order is the exclusive remedy of a creditor, which the court noted was in contrast to the charging order provisions under the Florida Revised Uniform Partnership Act and the Florida Revised Uniform Limited Partnership Act. Both of those statutes expressly provide that a charging order is the exclusive remedy by which a judgment creditor of a partner or partner's transferee can satisfy a judgment of the judgment-debtor's partnership interest in

the partnership. The court failed to note, however, that the Florida charging order rules that apply to general partnerships and limited liability partnerships actually allow a foreclosure on the partnership interest that is subject to the charging order, unlike the charging order provisions that apply to limited partnerships and limited liability limited partnerships.

The Florida Supreme Court focused primarily on the distinction between the Florida LLC charging order statute and the Florida general partnership and limited partnership charging order statutes in concluding that the legislature did not intend for a charging order to be the exclusive remedy of a judgment creditor with respect to a debtor's membership interest in a limited liability company. In concluding that the charging order is not the exclusive remedy for judgment creditors as to a Florida LLC membership interest, the court specifically stated the following:

> "In this regard, the charging order provision in the LLC Act stands in stark contrast to the charging order provisions in both the Florida Revised Uniform Partnership Act §620.81001-.9902, Fla. Stat. (2008), and the Florida Revised Uniform Limited Partnership Act, §620.1101-.2205, Fla. Stat. (2008)."
>
> Although the core language of the charging order provisions in each of the three statutes is strikingly similar, the absence of an exclusive remedy provision sets the LLC Act apart from the other two statutes. With respect to partnership interests, the charging order remedy is established in §620.8504, which states that it "provides the exclusive remedy by which a judgment creditor of a partner or partner's transferee may satisfy a judgment out of the judgment debtor's transferable interest in the partnership." §620.8504(5), Fla. Stat. (2008) (emphasis added). With respect to limited partnership interests, the charging order is established in §620.1703, which states that it "provides the exclusive remedy which a judgment creditor of a partner or transferee may use to satisfy a judgment out

> of the judgment debtor's interest in the limited partnership or transferable interest." §620.1703(3), Fla. Stat. (2008) (emphasis added).

Based on the differences in these statutes, the Florida Supreme Court concluded that a charging order is not the exclusive remedy for judgment creditors as to a Florida LLC interest.

It should also be noted that in three Florida District Courts of Appeal opinions, *Myrick v. Second National Bank of Clearwater*, 335 So.2d 343 (Fla. 2nd DCA 1976), *Atlantic Mobile Homes, Inc. v. LeFever*, 481 So.2d 1002 (Fla. 2nd DCA 1986), and *Givens v. National Loan Investors L.P.*, 724 So.2d 610 (Fla. 5th DCA 1998), the courts found that the charging order was the exclusive remedy under the 1973 partnership statute (which did ***not*** contain the exclusive remedy language of the later limited partnership statute). The legislature used the language from the 1973 partnership statute in drafting the 1993 limited partnership charging order statute and the 1993 LLC charging order statute, thus clearly intending that LLC charging order protection would be equivalent to partnership protection. Although the limited partnership statutes were updated in 2005 to include the "exclusive remedy" language, this should not be viewed as changing the opinion of the District Courts of Appeal that the prior language supported the proposition that the charging order was the exclusive remedy under the prior version not containing the "exclusive remedy" language.

(2) **<u>The Dissent</u>**. A strong dissent attacked a number of points set forth in the majority's opinion. First and foremost, the dissent noted that the majority did not answer the question as certified by the Eleventh Circuit, as to whether a court should apply the charging order remedy ***to single-member LLCs***. The dissent argued that the provisions of the Florida LLC Act apply uniformly to all Florida LLCs, regardless of whether the LLC is a single-member LLC or a multiple-member LLC. Consequently, the dissent states that the majority opinion may have opened the door for judgment creditors to successfully argue that the charging order remedy is not the creditor's exclusive remedy in the context of multiple-member LLCs, and specifically stated the following:

> "The majority opinion now eliminates the charging order remedy for multi-member LLCs under its theory of 'nonexclusivity' which is a disaster for those entities."

Finally, the dissent noted that the change to the limited partnership statute in 2005 to add the "exclusive remedy" language did not change the result previously reached by the three Florida District Courts of Appeal cases that the charging order was the exclusive remedy under the statutes as previously in effect as discussed above.

(3) **Observation**. While it was not a surprise that the Florida Supreme Court concluded that a charging order is not the sole and exclusive remedy for a creditor with respect to a debtor's membership interest in a single-member LLC, it is surprising that the Supreme Court's analysis was based upon the conclusion that the charging order is not the exclusive remedy for a creditor in the context of a multi-member Florida limited liability company. Quite clearly, the court could have reached the same result by using different reasoning that would not have thrown into question the exclusivity of the charging order as the sole remedy for multi-member LLCs.

For instance, in *In Re Albright*, the court allowed a bankruptcy trustee to become a "substituted member" of a Colorado single-member LLC. In that case, the court reasoned that the restriction of a creditor to only a charging order remedy is designed to protect the non-debtor members of the LLC. Because there are no non-debtor members to protect in the context of a single-member LLC, restricting a creditor to a charging order remedy serves no purpose in that context. Thus, the bankruptcy trustee could receive all of the debtor's rights in the single-member LLC. The court specifically went on to provide that the result would be different if there were other legitimate non-debtor members in the LLC, such that the bankruptcy trustee would only be entitled to the distributions, profits, and tax attributes to which the debtor-member would otherwise have been entitled.

Despite the flawed reasoning of the Florida Supreme Court in the *Olmstead* decision, it certainly throws into question as to whether the charging order is the exclusive remedy for multi-member Florida LLCs, as well as LLCs in other states having statutes similar to the Florida Statutes. Consequently, it may be prudent to consider converting

Florida LLCs into Florida limited partnerships or Florida limited liability limited partnerships, or domesticating Florida LLCs in other jurisdictions that have well-settled charging order law with respect to multiple-member LLCs.

Multi-Member LLC with Spouse and Other Legal Fictions.

- Tenants by the Entirety.
- Community Property.

Just as with Shareholder Agreements for corporations, additional protections can be provided in the Operating Agreement, such as restrictions on transfers and buy-backs of membership interests upon the occurrence of specified triggering events

E. APPLICATION OF 6-YEAR STATUTE OF LIMITATIONS TO OVERSTATEMENTS OF BASIS

1. **IRS Issues Regulations and Guidance Providing that Overstatements of Basis Constitute Omissions from Gross Income in Response to Conflicting Cases**. On 9/24/2009, in TD 9466, the IRS published temporary and proposed regulations defining an omission from gross income for purposes of the six year minimum period for assessment of tax attributable to partnership items and the six year period for assessing tax.

   Under Section 6501(e)(1)(A), if a taxpayer omits from gross income an amount properly includable therein that is in excess of 25% of the amount of gross income stated in the return, then the tax may be assessed, or a proceeding in a court for the collection of the tax may be begun without assessment, at any time within six years (rather than three years) after the return was filed. The regulations will affect any taxpayer who overstates basis in a sold asset creating an omission from gross income exceeding 25% of the income stated in the return. In Chief Counsel Notice CC-2010 001, the IRS has explained the procedures for handling docketed tax court cases in which an entity has claimed an overstated basis in a sold asset resulting in an omission from gross income exceeding 25% of the income stated on the return.

   The regulations resolve a conflict among various courts as to whether an overstatement of basis in a sold asset results in an omission from gross income. In *Bakersfield Energy Partners, LP v. Comm'r*, 128 TC 207 (2007), *aff'd* 568 F.3d 767 (9th Cir. 2009) and in *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009), *rev'g* 79 Fed. Claims 189 (2007), *reh'g denied*, Fed. Cir. No. 2008-5053 (Nov. 19, 2009), the Tax Court and the Federal Circuit, respectively, held that the six year assessment period did ***not*** apply to a basis overstatement based on the plain meaning of the word "omission." Other courts, however, held in the

government's favor on this issue. See *Home Concrete & Supply, LLC v. United States*, 599 Fed. Supp. 2d 678 (E.D.N.C. 2008); *Brandon Ridge Partners v. United States*, 2007-2 USTC (CCH) ¶50,573, 100 AFTR 2d (RIA) 5347 (M.D. Fla. 2007) and *Brooks v. United States*, No. 06-1747, 2009 WL 2600358 (N.D. Tex. June 13, 2008) (order granting in part motion for summary judgment) *appeal docketed*, No. 09-11061 (5th Cir. 2009).

The Chief Counsel Notice provides that the temporary regulations apply to tax years with respect to which the applicable period of limitations for assessing tax do not expire before 9/24/2009. Accordingly, the temporary regulations apply to any docketed Tax Court case in which the period of limitations under Section 6229(c)(2) and Section 6501(e)(1)(A), as interpreted in the temporary regulations, do not expire with respect to the tax year at issue before 9/24/2009, and in which no final decision has been entered.

The Chief Counsel Notice goes on to provide that for taxpayers having a docketed Tax Court case in which the temporary regulations may apply, such taxpayers must contact the Office of Associate Chief Counsel (Procedure and Administration), Branch One or Branch Two, as soon as possible to coordinate the taxpayer's position on this issue with respect to such case.

2. **Tax Court Holds that Temporary and Proposed Regulations are Invalid**. In *Intermountain Insurance Service of Vail, LLC v. Comm'r*, 134 TC No. 11 (May 6, 2010), the Tax Court denied the IRS's motion for reconsideration of its prior decision in the case (TC Memo. 2009-195), based on the issuance of the proposed and temporary regulations discussed above. In its decision, the Tax Court first determined that the plain meaning of the regulations' effective/applicability date provisions demonstrated that they did not apply because the period of limitations in the case had expired before September 24, 2009 (the date of issuance of the regulations). Additionally, and more importantly, the Tax Court also concluded that the decision of the Supreme Court in *Colony, Inc. v. Comm'r*, 357 U.S. 28 (1958), invalidated the regulations because that decision clearly foreclosed the IRS's interpretation of Section 6501(e)(1)(A).

F. LATE ENTITY CLASSIFICATION RELIEF

1. **Rev. Proc. 2009-41**. The IRS has issued Rev. Proc. 2009-41, 2009-39 IRB 439, which supersedes Rev. Proc. 2002-59, 2002-2 CB 615, and provides broader relief for entities seeking relief for late entity classification elections.

Generally, under the check-the-box regulations (Regs. §301.7701-1 through 3), an eligible entity can elect its federal tax classification. An

eligible entity with two or more owners can elect to be classified as either a corporation or as a partnership; an eligible entity with one owner can elect to be classified as either a corporation or a disregarded entity. The check-the-box regulations provide default classifications for both domestic and foreign eligible entities if an election is not made. The default classification for a single-member eligible entity is that the entity is disregarded as separate from its owner; for entities with two or more owners, the default is partnership status.

The default classification of foreign eligible entities is distinctly different. A foreign eligible entity is a partnership if it has two or more members and at least one member does not have limited liability, a corporation if all members have limited liability, and disregarded as separate from its owner if it has a single owner that does not have limited liability.

Reg. §301.7701-3(c)(1)(v) provides that certain entities are deemed to have elected corporate status. The following entities are deemed to have filed an election to be treated as a corporation for federal tax purposes:

a. An eligible entity that claims to be tax-exempt under Section 501(a).

b. A real estate investment trust.

c. An entity that elects to be an S corporation.

Under Reg. §301.7701-3(c), the eligible entity must elect to be classified as other than its default classification by filing a Form 8832, Entity Classification Election, with the service center designated on the form within the time limits specified in Reg. §301.7701-3(c)(1)(iii). In general, an entity classification election is timely if it is filed no more than 75 days after the desired effective date or within 12 months before the desired effective date. The taxpayer identification number of the eligible entity must be included on Form 8832 and the form must be signed by those designated in Reg. §301.7701-3(c)(2).

A copy of the Form 8832 must be attached to the federal tax or information return of the entity if it is required to file a federal tax or information return. If the entity is not required to file a federal tax or information return, a copy of the Form 8832 must be attached to the federal income tax or information return of any direct or indirect owner of the entity for the tax year of the owner that includes the date on which the election was effective. Reg. §301.7701-3(c)(1)(ii) provides, however, that failure to attach a copy of the Form 8832 to the tax or information return does not invalidate the election.

If an eligible entity fails to elect its classification timely, Rev. Proc. 2009-41 provides new procedures for qualifying for administrative relief from

the IRS service centers. If the entity qualifies for administrative relief, the Revenue Procedure provides the exclusive means to obtain late election relief. To qualify under Rev. Proc. 2009-41, the following requirements must be satisfied:

(1) The eligible entity failed to obtain its requested classification as of the date of formation or on the entity's classification becoming relevant (within the meaning of Reg. §301.7701-3(d)) solely because the Form 8832 was not timely filed under Reg. §301.7701-3(c)(1)(iii), or the entity failed to obtain its requested change in classification solely because Form 8832 was not filed timely under Reg. §301.7701-3(c)(1)(iii).

(2) The eligible entity seeking an extension of time to make an election has not filed any tax or information return for the year in which the election is to be effective because the due date of the applicable return has not passed, or the eligible entity timely filed all required federal tax and information returns consistent with its requested classification and no inconsistent tax or information returns have been filed by or with respect to the entity during any of the tax years for which the entity intended the requested election to be effective (Consistent Filing Requirement).

(3) The eligible entity has reasonable cause for its failure to make the entity classification election in a timely manner.

(4) Three years and 75 days from the requested date of the classification election have not passed.

For entities that are electing to change their classification, the Consistent Filing Requirement includes filing returns consistent with the deemed treatment of elective changes under Reg. §301.7701-3(g). For example, if an entity classified as a partnership elects to be treated as a corporation, under Reg. §301.7701-3(g)(1), the partnership is treated as contributing all of its assets and liabilities to the corporation in exchange for stock and immediately distributing the stock in liquidation to its partners. The analysis of Situation 1 in Rev. Rul. 84-111, 1984-2 CB 88, describes the tax effects of these deemed transactions.

Moreover, if the eligible entity is not required to file a federal tax or information return, the Consistent Filing Requirement mandates that each affected person who is required to file a federal tax or information return must have timely filed all returns consistent with the entity's requested classification and that no inconsistent tax or information returns have been filed during any of the years for which the entity intended the requested classification to be effective. For this purpose, "timely" means that the

return was filed within six months after its due date, excluding extensions, and an "affected person" is the person who would have been required under Reg. §301.7701-3(c)(1)(ii) to attach a copy of the Form 8832 to its federal tax or information return.

The Revenue Procedure provides that the procedural requirements for relief are that, within three years and 75 days of the requested effective date, the eligible entity must file with the applicable IRS service center a completed Form 8832, signed as required by Reg. §301.7701-3(c)(2). The Form 8832 must include a statement at the top of the form that it is being filed in accordance with Rev. Proc. 2009-41, and it must also include a declaration that the elements required by the Revenue Procedure are satisfied and a statement explaining the reason for failure to file a timely entity classification election. The statement and declaration must be signed under penalty of perjury by an authorized representative of the eligible entity who has personal knowledge of the facts and circumstances related to the election and all affected persons.

On receipt of the request for relief, the IRS service center will determine whether the requirements for relief have been satisfied and will notify the entity of the results of its determination. If relief is granted, the entity is treated as having made a timely entity classification election as of the requested effective date of the election.

The Revenue Procedure includes additional requirements for entities that do not satisfy all of the elements required by Rev. Proc. 2009-41 and who request a letter ruling under Reg. §301.9100 for late entity classification relief.

The Revenue Procedure is effective on 9/28/09. It applies to requests pending with the IRS service center pursuant to Rev. Proc. 2002-59, and requests received thereafter, as well as all letter ruling requests pending at the National Office of the IRS on 9/28/09, and to those received thereafter.

Section 5.02 explains that an entity may rely on Rev. Proc. 2009-41 to withdraw a pending letter ruling and receive a refund of the user fee. To do so, the notification of reliance on the Revenue Procedure and request to withdraw the request for a letter ruling must be received by the National office prior to the earlier of 11/12/09, or the issuance of the letter ruling.

G. MISCELLANEOUS PARTNERSHIP, LLC AND DISREGARDED ENTITY DEVELOPMENTS

1. **Proposed and Temporary Regulations Relating to Disregarded Entities and Excise Taxes**. On 9/11/09, the IRS released final and temporary regulations (TD 9462) and proposed regulations (REG-116614-08) to clarify that a single-owner eligible entity that is disregarded as an entity separate from its owner (disregarded entity) for tax administration

purposes -- but is regarded as a separate entity for certain excise tax purposes -- is treated as a corporation for tax administration purposes related to federal excise taxes. The regulations also make conforming changes to the tax liability rule for disregarded entities and the treatment of entity rule for disregarded entities with respect to employment taxes.

Under existing regulations, a disregarded entity is treated as a separate entity for purposes of employment taxes and the related reporting requirements. A disregarded entity also is treated as a separate entity for purposes of certain excise tax reporting purposes as well as for claims for excise tax refunds and excise tax registrations. Although liability for excise taxes does not depend on an entity's classification, classification is relevant for certain tax administration purposes (e.g., for determining the proper location for filing a notice of federal tax lien and the place for hand-carrying a return).

The temporary regulations clarify that disregarded eligible entities are treated as corporations for tax administration purposes. The temporary regulations also make conforming changes to the tax liability rule for disregarded entities in Reg. §301.7701-2(c)(2)(iii) and the treatment of entity rule for disregarded entities with respect to employment taxes in Reg. §301.7701-2(c)(2)(iv)(B).

The temporary regulations apply and are effective on 9/14/09. Comments and requests for a public hearing with respect to the proposed regulations must be received within 90 days after the effective date.

2. **First Circuit Affirms Tax Court on Check-the-Box Regulations and Sole LLC Member's Liability for Employment Taxes**. In *Medical Practice Solutions, LLC, Carolyn Britton, Sole Member v. Comm'r*, 1010 TNT 165-13 (1st Cir. 2010), *aff'g* 132 TC 125 (2009), the First Circuit, in an unpublished *per curiam* opinion, affirmed a Tax Court decision that upheld the validity of the check-the-box regulations and held that the sole member of a limited liability company is liable for the LLC's unpaid employment taxes.

3. **Transfers of Single-Member LLC Interests Were Not Transfers of Underlying Assets**. The U.S. Tax Court in *Pierre v. Comm'r*, 133 TC No. 2 (Aug. 24, 2009), has held that a taxpayer's transfers of her membership interests in a single-member LLC should ***not*** be treated as part-gifts, part-sales of the underlying assets that were contributed to the LLC prior to the transfer.

The taxpayer, Suzanne Pierre, received a $10,000,000 cash gift and wanted to transfer $4,500,000 of it to her son and granddaughter. To facilitate the transfer, she formed a single-member LLC (Pierre LLC) under New York law and established trusts for her son and granddaughter. Two months later, she transferred $4,500,000 in cash and securities to

Pierre LLC. Twelve days after capitalizing Pierre LLC, she transferred 100% of the Pierre LLC membership interest to the trusts. The transfer was accomplished in two phases. First, she made a gift of a 9.5% interest in Pierre LLC to each of the trusts to use a portion of her then-available unified credit and GST exemption. Second, she sold a 40.5% interest in Pierre LLC to each of the trusts in exchange for secured promissory notes. The sales price for the interests was determined by an independent third-party valuation that applied lack-of-control and lack-of-marketability discounts.

The IRS argued that because Pierre LLC was a single-member LLC that was treated as a disregarded entity under the check-the-box regulations, the taxpayer's transfer of the LLC interests should be treated as the transfer of the LLC's underlying assets for purposes of valuing the transfers to determine gift tax liability. The IRS contended that the taxpayer made gifts equal to the value of Pierre LLC's assets less the value of the promissory notes that she received from the trusts.

The Tax Court first considered the historical development of the gift tax regime, looking to relevant statutes, regulations, and U.S. Supreme Court case law. After summarizing its findings related to the roles of federal and state law in determining valuation, the court noted that although federal law defines the tax treatment of property rights, the property rights themselves are created by state law. Relying on this basic principle, the court found that under New York law, the taxpayer did not have a property interest in the underlying assets of Pierre LLC for tax state purposes. Thus, the taxpayer's gift tax liability could be determined only by considering the value of the transferred interests in Pierre LLC, not by the hypothetical transfer of the underlying assets of Pierre LLC. The court added that nothing in the check-the-box regulations required a departure from this conclusion.

4. **Investors Receiving State Tax Credits from Partnership are Partners for Federal Tax Purposes; Their Contributions were Not Disguised Sales**. In *Virginia Historic Tax Credit Fund L.P. v. Comm'r,* TCM 2009-295, the Tax Court held that the investors in partnerships formed to rehabilitate historic property were partners of the partnerships for federal income tax purposes, and their contributions to the partnerships were not disguised sales under Section 707.

   a. **Background.** The Commonwealth of Virginia enacted a program to provide state tax credits to individuals and businesses for expenses incurred in the preservation and rehabilitation of historic buildings. To receive the credits, taxpayers needed to submit an application showing their eligible expenses. If approved, they would receive a certificate to be submitted with their Virginia tax return for the year in which the rehabilitation project was completed. The credits were not transferable, but could be granted

to a partnership and then allocated among the partners either in proportion to their ownership interests or as the partners mutually agreed.

(1) A few individuals with expertise in the areas of tax credits and historic rehabilitation (Principals) set up partnerships (Virginia Historic Funds) that would pool capital to acquire interests in a diverse selection of partnerships and limited liability companies involved in rehabilitation projects eligible for the credits (developer partnerships). A number of investors contributed capital to the Virginia Historic Funds in exchange for limited partnership interests or LLC interests and expected to receive thereby an allocation of the state tax credits. In general, the investors expected to receive a dollar of state tax credit for every 74 cents contributed.

(2) The government determined that, in substance, the investors were not partners in the Virginia Historic Funds and the Virginia Historic Funds' allocation of state tax credits to them should be treated as sales for federal income tax purposes. In the alternative, the government argued that the transactions between the investors and the Virginia Historic Funds were disguised sales under Section 707. The Tax Court disagreed with both arguments.

b. **<u>Substance of the parties' relationship</u>**. The court found that nothing in the partnership documents, the parties' conduct, or the testimony of the parties and other witnesses indicated any intent other than for the investors and the Principals to join together, in good faith, as a partnership. The investors' ability to contribute capital complemented the Principals' ability to make good business decisions regarding the rehabilitation projects. Without the investors' contributions, the Virginia Historic Funds could not have acquired the credits they eventually allocated to the investors. From this evidence, it appeared to the court that the parties had the requisite intent to form a partnership.

(1) The court also determined that the Victoria Historic Funds' purpose of pooling capital for supporting developer partnerships and earning state tax credits was a valid business purpose. The court clarified that reduction of state taxes may be a valid business purpose, even though reduction of federal taxes may not. The court found that the partnership structure of the Virginia Historic Funds was required by the nature of the state tax credit program and by practical necessity. Also, the investors bore an appreciable risk that the projects would not succeed or

would fail to qualify for the credit and the Virginia Historic Funds would be unable to refund their contributions. For these reasons, the court determined that the investors and the Principals had joined together in good faith with a valid business purpose, and, therefore, the investors were, in substance, partners of the Virginia Historic Funds.

c. **Disguised sale analysis**. The court also rejected the government's argument that the allocation of credits to the investors was a disguised sale under Section 707(a)(2)(B). In addition to finding that the substance of the transactions reflected valid contributions and allocations, the court noted that no disguised sale takes place when the transactions are not simultaneous and the subsequent transfer is subject to the entrepreneurial risks of the partnership's operations. Because the investors contributed capital at various times during the years at issue and would not receive the credits until the Virginia Historic Funds reported them on their respective Schedules K-1, the court found that the transfers were not simultaneous. The court further found that the investors had no guarantee that the Virginia Historic Funds would pool sufficient credits to allocate the promised amounts of credits to the investors. The court therefore concluded that the transactions were not disguised sales.

Asset Protection and Estate Planning: Why Not Have Both? Hot Topics in Estate Planning and Asset Protection

Barry A. Nelson, Esq.

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Barry A. Nelson, a Florida Bar Board Certified Tax and Wills and Trusts and Estates Attorney, is a shareholder in the North Miami Beach law firm of Nelson & Nelson, P.A. He practices in the areas of tax, estate planning, asset protection planning, probate, partnerships and business law. He provides counsel to families focusing on income, estate and gift tax planning and assists business owners to most effectively pass their ownership interests from one generation to the next. He assists physicians, other professionals and business owners in tax, estate and asset protection planning. As the father of a child with autism, Mr. Nelson combines his legal skills with compassion and understanding in the preparation of Special Needs Trusts for children with disabilities.

Mr. Nelson is a Fellow of the American College of Trust and Estate Counsel and serves as Chairman of its Asset Protection Committee. He has been listed consecutively in *The Best Lawyers in America* since 1995 and is a Martindale-Hubbell AV-rated attorney. He has been listed as a top Florida attorney in *Florida Super Lawyers* since 2006, *The South Florida Legal Guide* since 2005 and *Florida Legal Elite* since 2004. Mr. Nelson served as an adjunct professor for the University of Miami School of Law LL.M. in Taxation program from 1998 to 2009 and at the University of Miami's Graduate Department of Accounting from 1978 to 1995.

Mr. Nelson is active in professional organizations and frequently serves as a consultant for other attorneys and certified public accountants on complex tax issues. He lectures extensively for the Florida Bar, Florida Institute of Certified Public Accountants and has presented at the University of Miami Heckerling Institute on Estate Planning, the Notre Dame Tax and Estate Planning Institute and the American College of Trusts and Estates Counsel. He has published numerous articles in professional publications. As the Founding Chairman of the Asset Preservation Committee of the Real Property, Probate and Trust Law Section of the Florida Bar from 2004 to 2007 he introduced and coordinated a project to write a new treatise authored by committee members entitled *Asset Protection in Florida* (Florida Bar CLE 2008). Mr. Nelson wrote Chapter 5 entitled "Homestead: Creditor Issues." He is a past President of the Greater Miami Tax Institute.

Mr. Nelson is a co-founder of the Victory Center for Autism and Behavioral Challenges (a not-for-profit corporation) and served as Board Chairman from 2000-2008. He served as the Mayor of the Town of Golden Beach, Florida from 1993 through 1995.

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ORLANDO, FL
NOVEMBER 5, 2010

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Asset Protection & Estate Planning: Why Not Have Both?

Hot Topics in Estate Planning and Asset Protection

By Barry A. Nelson, Esq.

SECTION I ……………………………………………………ESTATE TAX UPDATE: RECENT DEVELOPMENTS
SECTION II …………………………………………… CURRENT DEVELOPMENTS IN ASSET PROTECTION STRATEGIES
SECTION III ……………PROPOSED STRUCTURE FOR ASSET PROTECTED LIMITED PARTNERSHIP WITH LLC SUBSIDIARIES

SECTION I

Estate Tax Update: Recent Developments

Legacy for One Billionaire: Death, but No Taxes

The New York Times, David Kocieniewski (June 9, 2010)

Forbes' 74th richest man in the world from Houston dies in late March of 2010:

- Net worth: $9,000,000,000
- Estate tax liability: $0.00
- The look on his beneficiaries' faces: PRICELESS!!!!

Legacy for One Billionaire: Death, but No Taxes

The New York Times, David Kocieniewski (June 9, 2010)

- "The Senate Finance Committee is now trying to forge a compromise that would reinstate the tax, but even if that effort succeeds, it is unclear whether any changes might be retroactive and applied to those who have died so far in 2010."
- One "stock involved includes more than 100 million shares in Enterprise GP Holdings, which closed at $43.23 the last trading day before Mr. Duncan died. That asset alone could have resulted in a $2 billion estate tax."
- "Should the family trust sell these inherited shares, capital gains taxes would presumably be owed on the difference between Mr. Duncan's original cost, which could be quite low, and their market value when sold. Capital gains taxes are capped at 15 percent."

Estate Tax Options

Jane G. Gravelle, Senior Specialist in Economic Policy, 4/23/10

Percentage of Decedents Subject to Estate Tax Based on Exemption Amount

Exemption Level	2011	2019
$1 million	1.76%	3.00%
$3.5 million	0.25%	0.46%
$3.5 million (indexed for inflation)	0.24%	0.32%
$5 million	0.14%	0.23%
$5 million (indexed for inflation)	0.14%	0.18%

EXHIBIT 1

Estate Tax Options

Jane G. Gravelle, Senior Specialist in Economic Policy, 4/23/10

Estate Tax Liability Under Alternative Proposals

Exemption Level / Tax Rate	2011 (in billions)	2019 (in billions)
$1 million / 55% rate	$34.4	$62.2
$3.5 million / 45% rate	18.1	31.5
$3.5 million (indexed for inflation) / 45% rate	17.9	28.9
$5 million / 35% rate	11.2	20.9
$5 million (indexed for inflation) / 35% rate	11.2	17.9

EXHIBIT 1

Estate Tax Options

Jane G. Gravelle, Senior Specialist in Economic Policy, 4/23/10

Estate Tax Liability 2011: Exemption and Rate

Exemption Level	55% Rate (in billions)	45% Rate (in billions)	35% Rate (in billions)
$1 million	$34.4	$28.1	$21.8
$3.5 million	22.1	18.1	14.1
$5 million	17.4	14.2	11.2

EXHIBIT 1

Estate Tax Options

Jane G. Gravelle, Senior Specialist in Economic Policy, 4/23/10

Percentage Distributions of Taxable Estate Tax Returns by Size of Estate, 2011

Size of Estate (in millions)	$1 Million Exemption 55% Rate	$3.5 Million Exemption 45% Rate	$5 Million Exemption 35% Rate
No. of Returns	44,230 Returns	6,420 Returns	3,560 Returns
1-2	52.2%	0.0	0.0
2-3.5	26.0	0.0	0.0
3.5-5	9.1	23.7%	0.3%
5-10	7.6	44.7	45.2
10-20	2.8	18.7	31.7
Over 20	2.2	12.8	22.5
Total	100.0	100.0	100.0

2022 Returns

1929 Returns

EXHIBIT 1

Estate Tax Options

Jane G. Gravelle, Senior Specialist in Economic Policy, 4/23/10

Percentage Distributions of Estate Tax Revenues by Type of Return, 2011

Size of Estate (in millions)	$1 Million Exemption 55% Rate	$3.5 Million Exemption 45% Rate	$5 Million Exemption 35% Rate
Total Revenues	$34.4 billion total	$18.1 billion total	$11.2 billion total
1-2	7.5%	0.0	0.0
2-3.5	15.9	0.0	0.0
3.5-5	10.8	2.4%	0.0
5-10	18.3	16.1	9.5%
10-20	13.9	18.3	18.0
Over 20	33.7	62.3	72.5
Total	100.0	100.0	100.0

$6.295 B **$16.37 B** **$14.588 B** **$11.2 B**

EXHIBIT 1

Scroggin Sample Client Letter
Describing Estate Tax Legislation and Repeal

Steve's Leimberg's Estate Planning Email Newsletter – Archive Message #1605
February 16, 2010

- Sample letter informing the clients of changes to estate tax laws in 2010 and 2011, and encouraging clients to contact their advisors to discuss what steps should be adopted.

EXHIBIT 2

Nelson & Nelson: Tax Update – March 9, 2010

Federal Estate Tax Legislation: Inaction by Congress Creates Planning Opportunities and Pitfalls

- Making gifts at the reduced 35% gift tax rate
- Repeal of the GST tax
- Formula provision concerns
- IRA conversions

EXHIBIT 3

Nelson & Nelson: Tax Update – December 21, 2009

Year-End Estate and Gift Tax Planning for 2009

- Extension of $3.5 Million Unified Credit
- Use Gift Tax Exemptions to Reduce Estate and Gift Tax
- Review of Estate Planning Documents
- Easy Planning for Intra-Family Loans
- Possible Changes in Estate Tax Laws
- Roth IRA Conversions

EXHIBIT 4

Should Clients Consider Gifting Before the End of 2010?

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1668
July 1, 2010

- Lifetime gifting of assets in 2010 offers both transfer tax and income tax advantages.
- Since transfer tax rates are increasing in future years, and with an effective transfer tax rate as low as 25.93% (if the donor survives the gift by three years), every affluent client needs to consider the idea of gifting in 2010.

EXHIBIT 5

Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal

- President Obama seeks to modify and make permanent the Estate, Gift and Generation Skipping Transfer Taxes after 2009.
- The proposal generally makes permanent the estate, gift, and generation skipping transfer tax laws in effect for 2009, retroactive to the beginning of 2010. Under the proposal, the applicable exclusion amount for estate tax purposes generally is $3.5 million for decedents dying during 2010 and later years. The applicable exclusion amount for gift tax purposes is $1 million for 2010 and later years. The highest estate and gift tax rate under the proposal is 45 percent, as under 2009 law.

EXHIBIT 6

Republican Estate Tax Proposal

- Would provide permanent estate tax relief by making the estate tax exemption $5 million and the maximum estate tax rate 35% .
- Introduced on September 13, 2010, by Senate Minority Leader Mitch McConnell of Kentucky.

2010 S. 3773

EXHIBIT 7

Democrat Estate Tax Proposal

- The bill would have amended the Internal Revenue Code by reinstating the estate and generation-skipping taxes.
- Would have included an estate tax exemption of $3.5 million and a maximum estate tax rate of 55% (for those estates over $50 million).
- Introduced on July 15, 2010, by Representative Linda T. Sanchez (D-CA).

2010 H.R. 5764

EXHIBIT 8

Nelson & Nelson: Tax Planning Letter for 2010 – Planning for Terminally Ill Client Based Upon Repeal

- Annual Exclusion Gifts
- Gifts of Assets from Client's Spouse to Client with Terminal Illness
- Roth IRA Conversion
- Charitable Giving – Creation of Foundation or Donor Advised Fund
- Gifts Using Actuarial Tables
- Additional Gifts to Grandchildren

EXHIBIT 9

Seven Steps for Coping with Carryover Basis

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1701
September 27, 2010

- "During the one-year 'gap'--and presumably only for inheritances received this year--there are income tax issues to contend with. What's new: Heirs now must use the original price paid for an asset when computing the income taxes they will owe if they sell inherited assets. Previously, they could use the market value at the time of the owner's death. Each estate is permitted to exempt $1.3 million of gains from this carryover basis rule. An additional $3 million exemption applies to assets inherited from a spouse."

EXHIBIT 10

7520 Interest Rates and AFRs (October 2010)

Applicable Federal Mid-Term 120% Annual Rates

1989	10.10%	2000	7.33%
1990	10.63%	2001	5.52%
1991	9.08%	2002	4.16%
1992	6.96%	2003	4.39%
1993	6.02%	2004	4.36%
1994	8.56%	2005	4.91%
1995	7.59%	2006	5.79%
1996	8.09%	2007	5.23%
1997	7.63%	2008	3.81%
1998	6.16%	2009	3.20%
1999	7.25%	2010	2.0%

EXHIBIT 11

Rev. Rul. 2010-24 Table 1

Applicable Federal Rates for October 2010
Period for Compounding

AFR	Annual	Semiannual	Quarterly	Monthly
Short -term	.41%	.41%	.41%	.41%
Mid-term	1.73%	1.72%	1.72%	1.71%
Long-term	3.32%	3.29%	3.28%	3.27%

EXHIBIT 11

Intra-Family Loans and AFRs – October 2010 Example

- Short Term Rate – 0.41%
- Mid Term Rate – 1.73%
- Long Term Rate – 3.32%

For Example: Consider a loan of $1 million to your children or a trust for your children. If the money grows by 7% annually, your children or the trust for their benefit will earn $70,000 per year and yet only owe $4,100 in interest (assuming a 3 year loan in October of 2010). The additional growth of $ $65,900 is a tax-free gift to your children (or to their trust).

EXHIBIT 12

The GRAT Rush of 2010 – Short Term GRAT Planning May be Prohibited

Steve Leimberg's Estate Planning Email Newsletter – Archive Message #1626
April 8, 2010

- The House of Representatives legislation, if enacted, would eliminate the low-risk short-term grantor retained annuity trust or GRAT. H.R. 4849 passed the House on March 24, 2010.

- Before the law goes into effect by similar action in U.S. Senate, there is a window of opportunity to tap into the huge gift-tax savings now associated with GRATs.

EXHIBIT 13

New Florida Statute Gives Courts Flexibility to Construe Formula Dispositions

Steve Leimberg's Estate Planning Email Newsletter – Archive Message #1659
June 17, 2010

- Many wills contain formula dispositions geared to the estate tax exempt amount, or to the GST exemption amount.
- At least nine states have enacted legislation construing these provisions as if the Federal estate tax and GST tax law in effect in 2009 remained in effect.
- Florida enacted a broader and more flexible statute that allows the court to construe the will based upon the intention of the testator.

Fla. Stat. § 733.1051

EXHIBIT 14

Pierre – Valuation of Gifts of Single Member LLC Interests (Pierre 2)

- July 13, 2000 - Taxpayer forms single member New York LLC
- July 24, 2000 - Taxpayer forms two New York irrevocable trusts
- September 15, 2000 - Taxpayer transfers $4.25 million in cash and marketable securities to the LLC
- September 27, 2000 - Taxpayer makes a donation of 9.5% LLC interests to each trust and sells the remainder of her LLC interest to the trusts in equal portions in exchange for secured promissory notes, and the percentage interests of the donations and the sales of the LLC interests were determined by an appraisal that opined that a 30% discount was appropriate

Pierre v. Commissioner, T.C. Memo 2010-106, May 13, 2010

EXHIBIT 15

Pierre – Valuation of Gifts of Single Member LLC Interests (Pierre 2)

Taxpayer formed an LLC and part gifted and part sold her entire 100% interest 12 days later.

- The court addressed whether the step transaction required the gift/sale (on the same day) to be treated as a transfer of an aggregate 50% interest or whether the gift could be valued separately than the sale to each trust thereby creating a larger discount.
- The Court held that gifts are valued as gifts of the LLC interests, not as gifts of the underlying assets; and that sale and gift on same day should be valued as one interest. The Court held aggregate but still allowed combined 36.5% discount.

Pierre v. Commissioner, T.C. Memo 2010-106, May 13, 2010

EXHIBIT 15

Ludwick: A Wake-up Call for Lawyers

Steve Leimberg's Estate Planning Email Newsletter – Archive Message #1642
August 17, 2010

The Tax Court decided that the proper discount for a gift of a fractional interest in real estate was 17%; the taxpayer had claimed 30%.

- The conclusion was based on the Court's projected costs of partition and discount for time to market.

Ludwick v. Commissioner, T.C. Memo 2010-104.
Filed May 10, 2010.

EXHIBIT 16

Forum Shopping For Favorable FLP and LLC Law: Part VI

Steve Leimberg's Asset Protection Planning Email Newsletter – Archive Message #15
May 25, 2010

The table depicts the following four key areas regarding charging order protection:

1. Whether a creditor may petition the court for a judicial dissolution of an LLC;
2. Whether state law allows for the judicial foreclosure sale of the member's interest;
3. Whether a state law allows or prohibits a broad charging order; and
4. Whether a state law permits or prevents equitable remedies.

EXHIBIT 17

Forum Shopping For Favorable FLP and LLC Law: Part VII

Steve Leimberg's Asset Protection Planning Email Newsletter – Archive Message #162
September 14, 2010

- Unlike the Uniform Limited Liability Company Act of 1996, the uniform limited partnership acts never allowed a creditor to petition for the judicial dissolution of a limited partnership…However, the Uniform Limited Liability Company Act ("ULLC 2006") as well as the Uniform Limited Partnership Act of 2001 ("ULPA 2001") allow for the judicial foreclosure sale of a member's interest.

EXHIBIT 18

Robertson v. Deeb – Inherited IRAs Not Asset Protected Under Interpretation of FL Law

Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter – Archive Message #524 ; April 20, 2010

The Florida Second District Court of Appeals held that inherited IRAs were not exempt from creditors since the IRA did not originate with the debtor and was not something established by the debtor to defer taxation on income or preserve assets for retirement.

See also In re: Ard, 2010 Bankr. LEXIS 2659 (Bankr. M.D. Fla. Aug. 18, 2010).

Robertson v. Deeb, 34 Fla. L. Weekly D1661a (Fla. 2nd Dist 2009); Decided August 14, 2009.

EXHIBIT 19

Nessa – Inherited IRAs Protected Under Bankruptcy Law

Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter – Archive Message #518; March 15, 2010

- The U.S. Bankruptcy Court in the District of Minnesota held that inherited IRAs were protected from creditors up to $1 million.
  - The Court relied on the new language in the 2005 Federal Bankruptcy law
  - The Court viewed an inherited IRA as still being a retirement account that should be protected from creditors in the hands of the beneficiaries thereof.

In re Nessa, (2010, Bktcy Ct. MN) 105 AFTR 2d 2010-609; Decided January 11, 2010.

EXHIBIT 20

Chilton – Inherited IRAs Not Protected Under Bankruptcy Law

Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter – Archive Message #520; March 29, 2010

- Three months after the *Nessa* decision, the U.S. Bankruptcy Court in Texas took the opposite view.
  - Focusing on the same 2005 Federal Bankruptcy law relied on by the *Nessa* Court, the Texas Court held that "the funds contained in an inherited IRA are not funds intended for retirement purposes."
  - Accordingly, the Texas Court held that such funds are not protected from the claims of creditors

In re Chilton, 105 AFTR 2d 2010-1271 (Bktcy. Ct. TX);
Decided March 5, 2010.

EXHIBIT 21

Holman v. Commissioner – Dell Stock Owned by Partnership Limited to Discounts of Less Than 25%

Steve Leimberg's Estate Planning Email Newsletter – Archive Message #1628
April 13, 2010

- IRC Section 2703-style restrictions may properly collar valuation.
- "[M]aintenance of family ownership and control of [a] business" may be a bona fide business purpose – but *not* in a case in which there is no business

Holman v. Commissioner, 105 AFTR 2d 2010-1802 (8th Cir. Ct. of App.); Decided April 7, 2010.

EXHIBIT 22

PLR 201025021: IRS Grants Extension of Time to Make QTIP Election for Inter Vivos Transfer

Steve Leimberg's Estate Planning Email Newsletter – Archive Message #1699
September 16, 2010

- Requests for relief under §§ 301.9100-2 and 301.9100-3 will be granted when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government.
- Section 301.9100-3(b)(1)(v) provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.
- Based on the facts submitted and the representations made, we conclude that the requirements of § 301.9100-3 have been satisfied because Grantor acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government.

Private Letter Ruling 201025021, 2/19/2010

EXHIBIT 23

Price v. Commissioner – Annual Exclusion Gift of FLP Interests

Steve Leimberg's Estate Planning Email Newsletter – Archive Message #1572
January 5, 2010

- The Court addressed the issue of the taxpayer's utilization of the annual exclusion to make gifts of discounted FLP interests to his three children.
- The Court found that the outright transfer of an equity interest in a business or property is not enough to overcome the "present interest" requirement for the annual exclusion, since restrictions attached to the interests.

Price v. Commissioner, T.C. Memo 2010-2 (January 4, 2010).

EXHIBIT 24

Black v. Commissioner –
Graegin Loan not Respected in Combination with FLP

Steve Leimberg's Estate Planning Email Newsletter – Archive Message #1566
December 22, 2009

- Decent transferred corporate stock to an FLP, and made gifts of FLP interests to various trusts.
- Lack of liquidity at the time of the decedent's death forced the decedent's son to take out a *Graegin* loan.
- The Tax Court determined that the partnership could have redeemed the estate's partnership interest shortly after the partner's death in order to satisfy the estate tax burden, thereby rendering the loan unnecessary. However, had the estate and partnership done that, the IRS would have certainly argued that the partnership itself was simply a ruse to reduce the estate tax.

Black v. Commissioner, 133 T.C. No. 15 (December 15, 2009).

EXHIBIT 25

Petter v. Commissioner –
Defined Value Clause Respected in Combination with LLC

Steve Leimberg's Estate Planning Email Newsletter – Archive Message #1562
December 16, 2009

- The Court upheld the validity for federal gift tax purposes of a defined value formula gift which specifically transferred units in an LLC to trusts for the benefit of two of the donor's children with the value that exceed a specific amount being gifted to a publicly supported charitable organization.
  - The Court concluded that Petter did not create a condition subsequent and was not contrary to public policy.

Petter v. Commissioner, T.C. Memo 2009-280; Decided December 7, 2009.

EXHIBIT 26

Estate of Christiansen: Formula Gift in Favor of Noncharitable Beneficiaries Respected

Steve Leimberg's Estate Planning Email Newsletter – Archive Message #1560
December 14, 2009

- Eighth Circuit Upholds Formula Disclaimer Over Public Policy Objections
- The Court approved the ability of a taxpayer to establish a charitable lead annuity trust estate plan activated by a formula clause disclaimer.

Estate of Christiansen v. Commissioner, 104 AFTR 2d 2009-7352 (8th Cir. Nov. 13, 2009, corrected Nov. 18, 2009).

EXHIBIT 27

Berall: Problems Caused by Absence of Estate & GST Taxes and Reinstitution of Carryover Basis

Steve Leimberg's Estate Planning Email Newsletter – Archive Message #1705
October 5, 2010

- The U.S. government may be missing out on its opportunity to collect estate and generation skipping taxes for 2010 deaths, including those of at least four multi-billionaires.
  - There may be a possibility of a remedy in a post-election lame duck session.
  - Despise demanding higher income taxes on the rich, President Obama has not addressed these problems
- No serious attempts have been made by Congress to deal with the carryover basis rules.

EXHIBIT 28

OLMSTEAD

FTC v. Peoples Credit First, LLC

Facts

Defendants mailed consumers over ten million solicitations that created the impression that the consumer could receive a “platinum” credit card like a VISA or MasterCard in exchange for a payment of $45 or $49.

However, consumers received a platinum-colored card…usable ONLY for purchasing products from Defendants’ merchandise catalog or website.

FTC v. Peoples Credit First, LLC, 2010 U.S. App. LEXIS 20082 (11th Cir. Sept. 29, 2010).

OLMSTEAD

FTC v. Peoples Credit First, LLC

- Appealed from the United States District Court for the Middle District of Florida
- The district court entered a judgment for injunctive relief and for more than $10 million in restitution.

FTC v. Peoples Credit First, LLC, 2010 U.S. App. LEXIS 20082 (11th Cir. Sept. 29, 2010).

OLMSTEAD

FTC v. Peoples Credit First, LLC

- FTC moved to compel Defendants to surrender their membership interests in their non-party single-member LLCs to the receiver.

FTC v. Peoples Credit First, LLC, 2010 U.S. App. LEXIS 20082 (11th Cir. Sept. 29, 2010).

OLMSTEAD

FTC v. Peoples Credit First, LLC

- Defendants objected, arguing that the FTC only has the rights of an assignee under Florida law.

FTC v. Peoples Credit First, LLC, 2010 U.S. App. LEXIS 20082 (11th Cir. Sept. 29, 2010).

OLMSTEAD

FTC v. Peoples Credit First, LLC

- The Florida Supreme Court concluded that Florida law permits a court to order a judgment-debtor to surrender all right, title, and interest in the debtor's single member LLC to satisfy an outstanding judgment

FTC v. Peoples Credit First, LLC, 2010 U.S. App. LEXIS 20082 (11th Cir. Sept. 29, 2010).

OLMSTEAD

FTC v. Peoples Credit First, LLC

- Because the plain language of this provision draws no distinction between single-member and multiple-member LLCs, Defendants argue that charging order is the only remedy that a judgment-creditor may obtain against the membership interest of an LLC member, even if that member is the sole member of the LLC.

FTC v. Peoples Credit First, LLC, 2010 U.S. App. LEXIS 20082 (11th Cir. Sept. 29, 2010).

OLMSTEAD

Olmstead v. FTC

- A charging order is a statutory procedure whereby a creditor of an individual member can satisfy its claim from the member's interest in the limited liability company as a protection of the other partners of the partnership or other member of the LLC.

Olmstead v. FTC, 35 Fla. L. Weekly S 357 (Fla. June 24, 2010).

OLMSTEAD

FTC v. Peoples Credit First, LLC

- Where, in contrast, an LLC has a single member, "the set of ' all members other than the members assigning the interest' is empty" and the assignee of the membership interest is entitled to take the "full right, title, and interest of the transferor – without consent of anyone other than the transferor."

FTC v. Peoples Credit First, LLC, 2010 U.S. App. LEXIS 20082 (11th Cir. Sept. 29, 2010).

OLMSTEAD

FTC v. Peoples Credit First, LLC

- For these reasons, we affirm the district court's order compelling the Defendants to surrender all "right, title, and interest, in their single-member LLCs. AFFIRMED.

FTC v. Peoples Credit First, LLC, 2010 U.S. App. LEXIS 20082 (11th Cir. Sept. 29, 2010).

OLMSTEAD

Olmstead v. FTC

- Inconsistent Treatment for Limited Partnerships, General Partnerships, and LLCs may have Caused Confusion in the Majority Opinion

- Fla. Stat. § 608.433 (4) for LLCs: On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the limited liability company membership interest of the member with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the right of an assignee of such interest.

- Fla. Stat. § 620.1703 (1) for LPs: On application to a court of competent jurisdiction by any judgment creditor of a partner or transferee, the court may charge the partnership interest of the partner or transferable interest of a transferee with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of a transferee of the partnership interest… (3) for LPs: This section **provides the exclusive remedy**…

Olmstead v. FTC, 35 Fla. L. Weekly S 357 (Fla. June 24, 2010).

OLMSTEAD

Olmstead v. FTC

Compare to: Wyoming

- Wyo Stat. 17-29-503(e) ("A limited liability company or one (1) or more members whose transferable interests are not subject to the charging order may pay to the judgment creditor the full amount due under the judgment and thereby succeed to the rights of the judgment creditor, including the charging order").

- (g) This section **provides the exclusive remedy** by which a person seeking to enforce a judgment against a judgment debtor, including any judgment debtor who may be the sole member, dissociated member or transferee, may, in the capacity of the judgment creditor, satisfy the judgment from the judgment debtor's transferable interest or from the assets of the limited liability company. **Other remedies**, including foreclosure on the judgment debtor's limited liability interest and a court order for directions, accounts and inquiries that the judgment debtor might have made are not available to the judgment creditor attempting to satisfy a judgment out of the judgment debtor's interest in the limited liability company and may not be ordered by the court.

Olmstead v. FTC, 35 Fla. L. Weekly S 357 (Fla. June 24, 2010).

OLMSTEAD

Olmstead v. FTC

Prior attempt to create continuity between Charging Order Protection for LLC Partnerships was Unsuccessful

- The proposal was withdrawn when opposition to the policy being extended was expressed by those representing creditors, and this issue was never considered by the Florida Legislature.

Olmstead v. FTC, 35 Fla. L. Weekly S 357 (Fla. June 24, 2010).

OLMSTEAD

Olmstead v. FTC

What Should States do Now?

- Carter Bishop:
  - The sensible statutory restrictions applicable to transfers of a membership in a multiple member limited liability company are justified and intuitive. Specifically, the rules that permit a member to freely transfer economic rights to future distributions while at the same time requiring the consent of the remaining members to admit the transferee as a member are appropriate to balance the reasonable expectations of members of a close business association.
  - However, when applied to a SMLLC ["single-member LLC"], the same rules create a perverse and unexpected result….There are no other remaining partners to protect as in the case of a muti-member limited liability company. …Ultimately, these perverse results are best cured by statutory amendment. Preferably, every state would amend its SMLLC legislation to provide that upon the voluntary or involuntary transfer of the only economic interest in the SMLLC, the transferee will be admitted as a substituted member, with or without the consent of the only member.

Olmstead v. FTC, 35 Fla. L. Weekly S 357 (Fla. June 24, 2010).

OLMSTEAD

Olmstead v. FTC

- Currently, only Wyoming specifically provides exclusive remedy protection to a judgment debtor who is **the sole LLC member by stating that its protection includes "any judgment debtor who may be the sole member" of an LLC.**

Olmstead v. FTC, 35 Fla. L. Weekly S 357 (Fla. June 24, 2010).

OLMSTEAD

Olmstead v. FTC

Potential Abuse if Single-Member LLCs are Provided Equal Protection

- **Example 1:** Mike is the sole owner of a manufacturing business that has been operating as a single-member LLC for the past five years. The LLC elects to be taxed as an S Corporation. The single-member LLC has annual sales of $50 Million and net profits of $5 Million.

- **Example 2:** Sal, a real estate developer, forms multiple single-member LLCs to hold various commercial real estate properties valued in the aggregate at $10 Million. Each single-member LLC owns a separate property.

- **Example 3:** Jose, a surgeon practicing without malpractice insurance, has no existing or known contingent creditors. He forms a single-member LLC and conveys title to his entire $5 Million marketable security portfolio thereto. Jose forms a second single-member LLC and conveys his $4 Million Aspen ski condominium thereto. He forms a third single-member LLC and conveys his art collection, his jewelry and his collection of sports memorabilia (having an aggregate value of $3 Million thereto).

Olmstead v. FTC, 35 Fla. L. Weekly S 357 (Fla. June 24, 2010).

OLMSTEAD

Olmstead v. FTC

Olmstead Patch

- Approved September 25, 2010, by the Executive Council of the Real Property, Probate and Trust Law Section of the Florida Bar.

- "[T]he sole remedy of a creditor seeking to enforce a judgment against the interest owned by a member of a **multiple-member LLC** is a charging order against the member's transferable interest in the LLC. **Foreclosure on the judgment debtor's interest and all other remedies a creditor could have are not available and may not be ordered by a court**."

Olmstead v. FTC, 35 Fla. L. Weekly S 357 (Fla. June 24, 2010).

Revisions to Florida Statutes Section 736.0505

Revisions to Florida Statutes § 736.0505 Creditors Claims Against Settlor

IT IS HEREBY PROPOSED THAT SECTION 736.0505, FLORIDA STATUTES, BE AMENDED TO READ AS FOLLOWS:

736.0505 Creditors' claims against settlor…

(3) Subject to the provisions of s. 726.105, for purposes of this section, the assets in

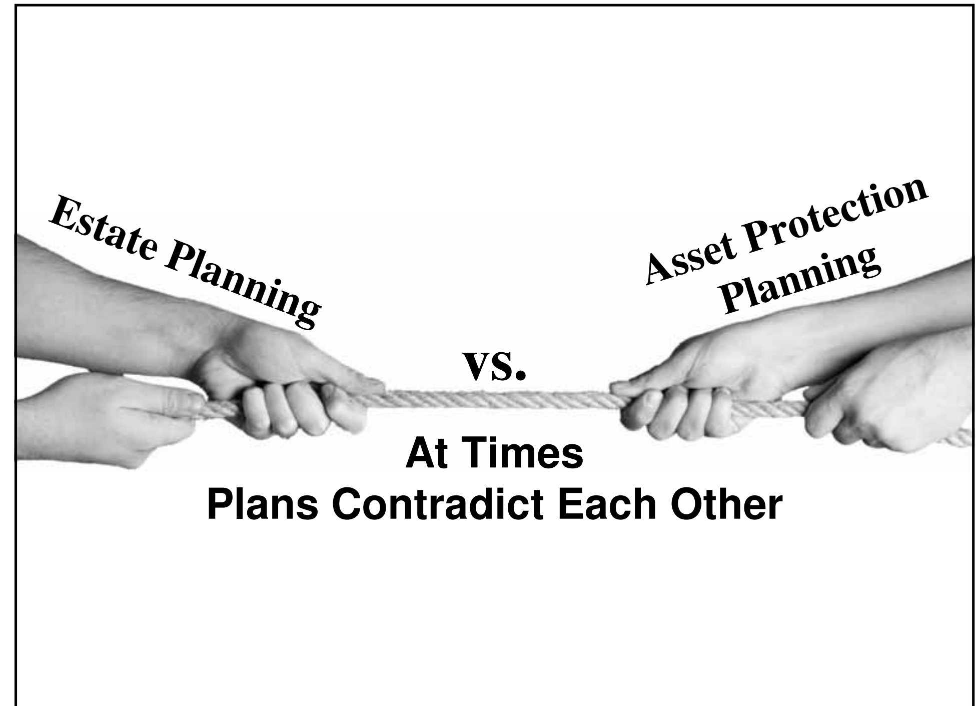
(a) a trust described in section 2523(e) of the Internal Revenue Code of 1986, or a trust for which the election described in section 2523(f) of the Internal Revenue Code of 1986 has been made; and

(b) another trust, to the extent that the assets in the other trust are attributable to a trust described in (a),

shall, after the death of the settlor's spouse, be deemed to have been contributed by the settlor's spouse and not by the settlor.

Inter Vivos QTIP Legislation Approved in Florida

- If and when federal estate taxes are reinstated, it will remain an important planning consideration that both husband and wife have sufficient assets to utilize their respective exemptions from the estate tax.



Inter Vivos QTIP Legislation Approved in Florida

- One common example of planning that may be favorable for estate tax savings and probate avoidance but that may needlessly subject family wealth to creditor's claims, is the division of assets so each spouse owns, and has testamentary control over, approximately one-half of their combined wealth.

Inter Vivos QTIP Legislation Approved in Florida

- If a spouse owns his or her share of the family’s wealth in his or her own name, the assets comprising the share are not creditor-protected.

Inter Vivos QTIP Legislation Approved in Florida

- Under the Uniform Trust Code, holding significant assets in a revocable trust does not enhance the situation because assets in a revocable trust are not protected from claims of the settlor’s creditors.

Inter Vivos QTIP Legislation Approved in Florida

- An alternative that is effective both for estate tax and asset protection planning is an Inter Vivos QTIP Trust.

White Paper on Proposed Revision to Florida Statutes Section 736.0505

Bob and Judy – Tenancy by the Entireties Plan
Part 1

	Bob	Judy	T by E
House – Protected Homestead			$3.5 M
Brokerage			$10 M
TOTAL			$13.5 M
Bob's Gross Estate Assuming He Dies First			$6.75 M
MARITAL DEDUCTION			$6.75 M
Bob's Taxable Estate			$0
Bob's Tax			$0

Bob and Judy – Tenancy by the Entireties Plan
Part 2

	Bob	Judy	T by E
UPON JUDY'S DEATH			
Judy's Gross Estate			$13.5 M
Less Unified Credit Equivalent Amount			($3.5 M)
Judy's Taxable Estate			$10 M
Judy's Tax			$4.5 M
Assets subject to creditors while both married and living			$0
Assets subject to creditors upon death of 1st spouse or divorce			$10 M

Bob and Judy – Tax Savings Plan Part 1

	Bob's Revocable Trust	Judy's Revocable Trust	T by E
House – Protected Homestead			$3.5 M
Brokerage	$5 M	$5 M	
TOTAL	$5 M	$5 M	$3.5 M
Bob's Gross Estate Assuming He Dies First	$6.75 M		
Bob's Share of Homestead to Judy Outright	($1.75 M)		
Marital Trust	($1.5 M)		
MARITAL DEDUCTION	$3.25 M		
Bob's Taxable Estate	$3.5 M		
Less Unified Credit Equivalent Amount	($3.5 M)		
Bob's Tax	$0		

Bob and Judy – Tax Savings Plan Part 2

	Bob's Revocable Trust	Judy's Revocable Trust	T by E
UPON JUDY'S DEATH			
Judy's Gross Estate	$10 M		
Less Unified Credit Equivalent Amount	($3.5 M)		
Judy's Taxable Estate	$6.5 M		
Judy's Tax	$2.925 M		
Savings Compared to Tenancy by the Entireties	$1.575 M		
Assets subject to creditors while both married and living			$10 M
Assets subject to creditors upon death of 1st spouse or divorce Assuming assets pass into spendthrift trust for surviving spouse upon death of 1st spouse			$5 M

Bob and Judy – Inter Vivos QTIP Trust Part 1

	Bob's QTIP	**Judy's QTIP**	**T by E**
House – Protected Homestead			$3.5 M
Brokerage	$5 M	$5 M	
TOTAL	$5 M	$5 M	$3.5 M
Bob's Gross Estate Assuming He Dies First	$6.75 M		
Bob's Share of Homestead to Judy's Marital Deduction	($1.75 M)		
QTIP Marital Gift to Judy	($1.5 M)		
MARITAL DEDUCTION	$3.25 M		
Bob's Taxable Estate	$3.5 M		
Less Unified Credit Equivalent Amount	($3.5 M)		
Bob's Tax	$0		

Bob and Judy – Inter Vivos QTIP Trust Part 2

	Bob's QTIP	**Judy's QTIP**	**T by E**
UPON JUDY'S DEATH			
Homestead	$3.5 M		
Marital Trust	$1.5 M		
QTIP Trust from Bob	$5 M		
Judy's Gross Estate	$10 M		
Less Unified Credit Equivalent Amount	($3.5 M)		
Judy's Taxable Estate	$6.5 M		
Judy's Tax	$2.925 M		
Savings Compared to Tenancy by the Entireties	$1.575 M		
Assets subject to creditors while both married and living			$0
Assets subject to creditors upon death of first spouse or divorce			$0 M

Comparison of Benefits of Inter Vivos QTIP Trust

	Tenancy by the Entirety Plan	**Tax Plan**	**Winner & New Champion (QTIP Plan)**
Technique	T by E	Tax Savings Plan	Funded Inter Vivos QTIP
Securities Protected While Both Living	$10 M	$0	$10 M
Securities Protected Upon Death of 1st Spouse	$0	$5 M	$10 M
Tax Paid Upon Death of Spouse	$4.5 M	$2.925 M	$2.925 M

SEC v. Solow

- **Mrs. Solow retained asset protection lawyer four days after a $6 million verdict was entered against Mr. Solow.**

Securities and Exchange Commission v. Jamie L. Solow, 682 F. Supp. 2d 1312 (S.D. Fla.,2010) (Decided January 14, 2010).

SEC v. Solow

- **Days later, Mr. and Mrs. Solow commenced a series of money-shuffling transactions**
  - Execution of a mortgage on Ft. Laud. residence for a CD to be assigned to Mrs. Solow's Cook Island Trust.
  - Execution of a mortgage on Hillsboro Beach residence in the amount of $5,261,289.
  - The lender for both mortgages was a Nevis LLC identified in the Cook Island Trust scheme.

SEC v. Solow

- **Mr. Solow claimed he had a "negative net worth."**
- **The District Court found that Mr. Solow's "depleted net worth was the result of a purposeful campaign of asset dissipation" and that "[t]he Solows (and their attorneys) have worked very hard to give their assets an opaque appearance."**

SEC v. Solow

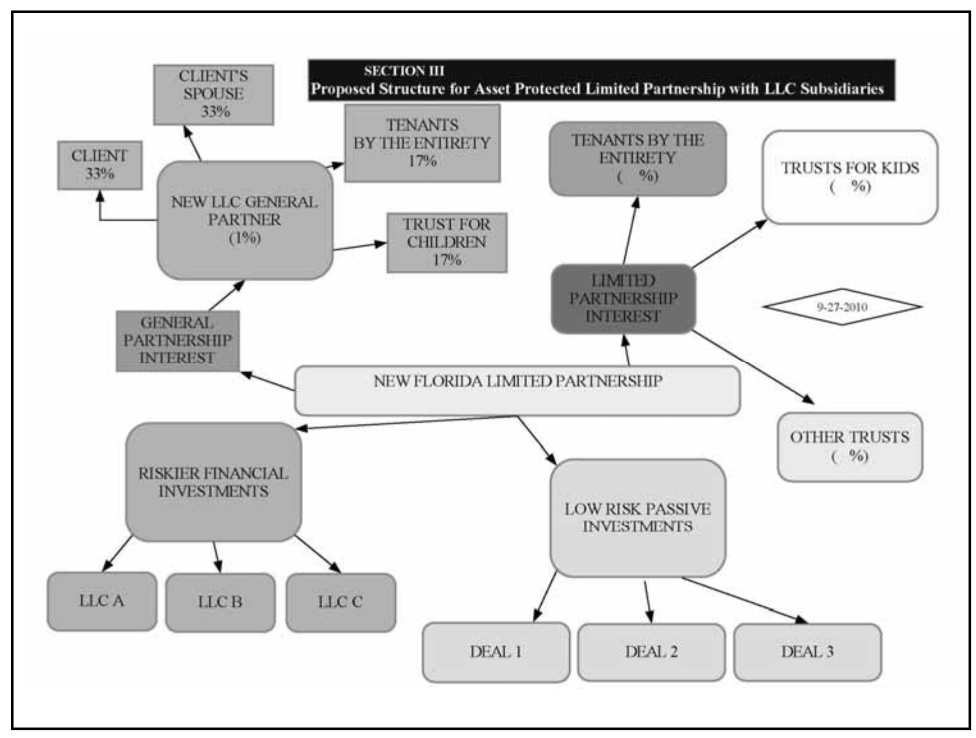
- **The Court held Mr. Solow in contempt.**
- **Mr. Solow was incarcerated on January 25, 2010.**
- **On the Solows' counsel's website, their attorney begs the question: "Have Debtor's prisons returned to the United States?"**

SEC v. Solow

- **Update:** *Case No. 06-81041-CIV-MIDDLEBROOKS/JOHNSON*
  - **On June 4, 2010, Mr. Solow was released from incarceration.**
    - **The release was based on Mr. Solow's expression of remorse and pledge to make his best efforts to meet his obligations.**
    - **Mr. Solow promised to make partial payment upon the sale of his Highland Beach Property.**

SECTION III

Proposed Structure for Asset Protected Limited Partnership with LLC Subsidiaries



PRESENTED TO:
FICPA: FLORIDA INSTITUTE ON FEDERAL TAXATION CONFERENCE (FIFT)

ORLANDO, FL
NOVEMBER 5, 2010

NELSON & NELSON, P.A.
WWW.ESTATETAXLAWYERS.COM

Thank you!

Planning to Declare Bankruptcy

R. Lawrence Heinkel, Esq., JD, LL.M., EA

R. Lawrence Heinkel, Esq., JD, LL.M

Tax and Bankruptcy Attorney
Heinkel Law Group, P.L.

Larry Heinkel is an attorney practicing throughout the State of Florida helping businesses and individuals resolve their state and federal tax problems. Mr. Heinkel has a bachelor's in Accounting (B.S.), a law degree (J.D.) and a master's in tax law (LL.M), all with honors and all from the University of Florida in Gainesville, Florida. While in the undergraduate program, Mr. Heinkel was an officer in Beta Alpha Psi, and was elected to both Omicron Delta Kappa and Florida Blue Key honoraries. During his law school career, Mr. Heinkel served as treasurer of the John Marshall Bar Association and was a member of the Law Review. His law review paper, "The Impact of the Installment Sales Revision Act of 1982 on Starker-type Exchanges" was published in the Journal of Real Estate Taxation. While pursuing his LL.M., Mr. Heinkel was a research assistant for Professor Oberst and published his article, "Section 338 – An Analysis and Proposals for Reform" in the Notre Dame Law Journal.

After spending about a dozen years dealing with corporate transactions and estate planning, Mr. Heinkel focused his career on resolving tax problems including the use of the bankruptcy laws to discharge older income taxes. Mr. Heinkel is a frequent lecturer for the Florida Institute of Certified Public Accountants (FICPA) at its various conferences around the state, and for various local chapters of the FICPA, the FSEA, and The Florida Bar.

In addition to this, Larry Heinkel has been an adjunct professor of business law and taxation at the graduate level at the University of Central Florida and Rollins College. He also has served on various boards of government entities, private schools, churches and other non-profit organizations.

Larry takes great pride in being able to bring a high-level of service and quality representation to individuals and small business owners who might not otherwise be able to afford help from the "big boys". And he enjoys being able to spread the word about some of the techniques he uses so more professionals can help more taxpayers with these major problems in these trying times.

IRS COLLECTION ALTERNATIVES:

- *DO NOTHING*
- *CURRENTLY NOT COLLECTIBLE*
- *INSTALLMENT AGREEMENTS*
- *OFFERS IN COMPROMISE*
- *BANKRUPTCY*
- *LITIGATION*

November 5, 2010
2010 Federal Institute on Federal Taxation
Presented by:
Florida Institute of Certified Public Accountants

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COLLECTION ALTERNATIVES - Internal Revenue Manual Part 5

I. IRS Financial Analysis[1] - (whether it is Currently Not Collectible, Installment Agreement or Offer in Compromise, and what IRS does after bankruptcy.)

1. Forms required:

   a. 433A - Collection Information Statement for Individuals
   b. 433B - Collection Information Statement for Businesses
   c. 433F - abbreviated CIS for Individuals used by ACS
   d. Business taxpayer's own financial statement

2. How the information is used:[2]

   a. Payment in full or in part from assets
   b. Lien filing determination
   c. Enforcement action
   d. Installment agreement
   e. Explain Offer in Compromise
   f. Report Currently Not Collectible

3. Other Sources of guidance:

   a. National and Local Standards and Guidelines (see Exhibit A)

4. Variance from Standards/Guidelines [3]

   a. Based on facts and circumstances, deviation from standards IF economic hardship

   b. Substantiation of hardship - verbal, written documentation, bank statements, credit card vouchers, rent receipts, lease agreements, payment coupons, court orders, contracts, future expenses, (i.e. birth of child, needed car replacement)

   c. NOT affluent, luxurious lifestyle

5. Statutory/Regulatory Variance from Standards/Guidelines

a. IRC ¶ 7122(d)(2)(B): IRS employees "shall determine based on the facts and circumstances of each taxpayer, whether the use of the schedules...is appropriate and **shall not** use the schedules to the extent such use would result in the taxpayer not having adequate means to provide for basic living expenses."[4]

b. 26 CFR 301.7122-1(c)(2): "The determination of the amount of such basic living expenses will be founded upon an evaluation of the individual facts and circumstances presented by the taxpayer's case. To guide this determination, guidelines published by the Secretary on national and local living expense standards will be taken into account."[5]

c. 26 CFR 301.6343-1(b)(4): "The determination for the reasonable amount for basic living expenses will be made by the director and will vary according to the unique circumstances of the individual taxpayer. Unique circumstances, however, do not include the maintenance of an affluent or luxurious standard of living."[6]

6. Information should not be older than the prior six month. [7]

7. The Revenue Officer should get, review and discuss the CIS in person when possible.[8]

a. A face to face meeting with the taxpayer at the residence or business is preferred

b. Verification of business assets is required, in the presence of the taxpayer and/or representative.

c. Does this override the power of attorney?

8. The taxpayer who cannot full pay within 5 years, can have one year to modify living expenses. [9]

9. If taxpayer can pay within 5 years, all expenses can be allowed. [10]

10. NOT NEED TO SUBSTANTIATE EXPENSES UNLESS EXCEED NATIONAL STANDARDS(food, clothing, misc and medical).[11]

11. Must substantiate Local Standards (car, housing).[12]

12. Shared Expenses - but not joint liability. [13]

  a. Taxpayer is allowed only expenses they must pay

  b. Assets and income of non-liable person excluded from ability to pay (except commercial property).

  c. How to compute:

    i. Total actual household income and expenses

    ii. % of taxpayer's income

    iii. Allowable expenses

    iv. Shared expense - apply TP %

    v. Expenses paid only by TP (child support, education loan, union, court ordered)

    vi. TP's income, less % shared expenses, less actual TP sole expenses.

  d. example: share expenses with roommate -

    TP gets full National Std for one person and full out of pocket medical; TP gets actual amount of local housing and car up to one person

  e. Non-liable spouse can refuse to have income considered in repayment.
    Use % of household income
    % of TP for housing, transportation

health - get greater of one person or %

II. Do Nothing or IRS Determination: Currently Not Collectible

1. If your client and/or you decide that you are going to do nothing

   A. The IRS can and may file federal tax liens

   B. The IRS can and may levy bank accounts, wages, etc.

   C. The IRS can and may seize physical assets, including exempt property - house, IRA, 401K

   D. One of the downsides to this approach is that you may relinquish some collection due process rights

   E. Another downside is that ignoring the IRS sometimes causes them to take drastic measures to "get your attention".

2. If the taxpayer has no assets and no ability to pay

   A. The IRS can determine the tax to be currently not collectible (CNC) ("53" the account)[14]

   B. This determination will usually require providing a Form 433a (or 433f) and, if appropriate a Form 433b to the IRS with appropriate documentation. See Exhibit A

   C. The IRS has 14 different reasons for determining an account to be CNC. [15]

   D. The dollar amount and type of case govern the extent of the investigation.[16] Can include full credit report, vehicle registrations, real estate records, wage and income information, business licenses, open audits, passports)

   E. The statute of limitations on collection dictates various IRS actions[17]

3. Pre-requisites if you request CNC

   A. Must be in compliance with all filing requirements.[18]

   B. Must liquidate available assets

   C. Usually will request copies of recent tax returns

   D. No transfer of assets after the tax at issue became due

4. Review of CNC status

   A. Certain CNC cases will systematically be reviewed (hardship, unable to locate)

5. What is a "hardship" CNC[19]

   A. Taxpayer can't pay reasonable basic living expenses

   B. IRS uses 433A and 433B

   C. Usually no income or assets, or equity in assets to make payment without hardship

   D. IRS does not need to verify 433A and B info if tax is under certain amount and numbers appear reasonable.

   E. No 433 information is needed if:[20]
      a. terminal illness or excessive medical bills
      b. taxpayer is incarcerated
      c. taxpayers only source of income is social security, welfare, unemployment
      d. taxpayer is unemployed with no source of income

6. What if new liability after CNC determination?

A. IRS can automatically determine new amount CNC if less than 12 months[21]

7. What about LLC's?

A. If single member and liabilities of LLC are before January 1, 2008

a. IRS takes the position that the entity is disregarded

b. Can collect against individual owner for LLC liabilities

c. All determinations are based on individuals assets/ability pay

B. If single member and liabilities of LLC are after January 1, 2008

a. IRS can only collect from LLC

b. All determinations are based on LLC's ability to pay

8. CNC requires manager approval[22]

III. INSTALLMENT AGREEMENT:

Table of Contents:

A. Types:

a. Full paid with the statute of limitations.

b. Partial Pay Installment Agreement

B. Requirements:

a. Full Paid with the SOL:

1. File Form 433A or 433F with the Service

2. Be in current compliance (filing and estimated payments)

3. Provide all requested financial information.

4. Pay $52 fee if an auto debit IA, $105 for all others

5. IRS must enter into an IA if liability is less than $10,000 and it will be full paid within 3 year, and you can't full pay now. IRC §6159(c).

b. Partial Pay Installment Agreement

1. File Form 433A or 433F with the Service

2. Be in current compliance (filing and estimated payments)

3. Provide all requested financial information.

4. Pay $52 fee if you are requesting an auto debit IA, $105 for all others

5. Give IRS equity in all assets, unless

i. Minimal equity and no loan potential

ii. T by E and spouse won't consent to loan/sale

iii. The assets will generate future income to make IA payments

iv. Economic hardship

v. any loan payment will exceed disposable income and won't qualify

6. Make effort to get financing and fail.

INSTALLMENT AGREEMENT: - Outline

I.R.C. Section 6159 authorizes the IRS to enter into installment agreements. An Installment Agreement ("IA") is a written agreement to satisfy tax liabilities in installment payments. [23] For an IA to be acceptable,

the following requirements must be met: (a) the liability must be full-paid within the statute of limitations, except as described below in the "partial pay" IA;[24] (b) the taxpayer must be in full compliance during the term of the agreement;[25] (c) the taxpayer must provide updated financial information upon request;[26] and (d) the taxpayer must pay a $52 fee[27] for IAs that include automatic bank debit form of payment, and $105 for other IAs. In addition, the fee to re-instate a defaulted IA $45.

Although the taxpayer is bound by the terms of the IA, the IRS can terminate or change the agreement if: (a) the taxpayer defaults in a payment;[28] (b) the taxpayer fails to file or pay a subsequent tax, including estimated tax payments;[29] (c) the taxpayer fails to provide requested updated financial information;[30] (d) the IRS determines that the taxpayer provided incorrect information prior to the IA;[31] (e) the IRS believes collection is in jeopardy;[32] or (f) the IRS determines that the taxpayer's financial position has changed.[33] It is much more difficult for a taxpayer to change the terms of the IA if his financial position deteriorates subsequent to the IA.

The IRS MUST enter into an installment agreement if certain criteria are met. Those criteria include: (a) the liability is not more than $10,000; (b) the taxpayer has filed all returns due in the past 5 years; (c) the taxpayer has either paid all taxes due in the past five years on time, or was in an IA; (d) the IRS determines the taxpayer can't pay in full; (e) the taxpayer can pay in full within 3 years; and, (f) the taxpayer agrees to be in compliance during the 3 years.[34] If the IRS intends to terminate or alter an IA, they must provide the taxpayer 30 days written notice, unless a jeopardy exists.[35] Failure to provide notice might be subject to damages under I.R.C. Section 7433.[36]

If a taxpayer has some ability to pay, but cannot full pay within the statute of limitations,[37] the IRS can grant a Partial Pay IA (PPIA).[38] Normally, the IRS will want whatever equity in available assets of the taxpayer as payment toward the liability.[39] In some cases, the taxpayer may keep this equity in assets. Those cases include: if there is minimal equity and no loan potential; if the property is tenants by the entirety and the spouse won't consent to a loan or sale; the asset is unmarketable; the assets will generate future income for the PPIA; economic hardship; or, any loan payment would exceed the taxpayer's disposable income and they

wouldn't qualify for a loan.[40] To qualify for a PPIA, the taxpayer must make a good faith effort to obtain financing and be unsuccessful.[41]

Prior to entering into an IA, the IRS makes a determination as to the monthly amount that the taxpayer can afford to pay. To compute this monthly amount, the taxpayer's financial information is submitted to the IRS with Form 433F, 433A, and/or 433B. In some instances, this information can be provided by telephone and facsimile. The taxpayer's gross income and actual expenses are computed. Then, based on the gross income and number of dependents, the IRS allowable expenses are computed using the IRS National Standard Expenses (NSE) for food, clothing, misc., the Local Standard Expenses (LSE) for housing, and the allowable transportation expenses. Other actual allowable expenses include court ordered payments, taxes, insurance, etc. Although the IRS is supposed to use the NSE and LSE as a guide rather than as an absolute, there are few instances that actual expenses in excess of the IRS allowable standards are allowed. The monthly payment amount is the difference between the gross income and the allowable necessary expenses.

In certain circumstances, a taxpayer may qualify for a "Streamlined" IA, which expedites the processing of the IA. The Streamlined IA skips the requirements for financial analysis and managerial approval.[42] To qualify for a Streamlines IA, the following criteria must be met: the balance of the assessed amounts (not including accruals) must be $25,000 or less; the amount must be paid in full within 5 years, or prior to the statute of limitations, whichever is earlier; and the taxpayer must be in full filing compliance prior to the IA.[43]

The benefits and/or consequences of entering into an IA are: the taxpayer keeps his assets; the taxpayer pays the tax in full over time (except for the partial pay IA); the IRS will not pursue enforced collection;[44] the statute of limitations on collection is not extended during the time the IA is in effect;[45] the SOL is extended during the time the IA is "pending" (from the time the taxpayer formally requests an IA until it is accepted);[46] and a federal tax lien will usually be filed unless there is justification to forego a lien.[47] The most significant disadvantages facing a taxpayer with respect to an IA are: the taxpayer must live on a small budget during the term of the IA; interest and penalties continue to accrue; and the taxpayer must stay in

compliance or face enforced collection.

IV. OFFERS IN COMPROMISE:

Table of Contents:

(A) Types:

1. Doubt as to Liability, IRC §7122(c)(3)(B).
2. Doubt as to Collectability, IRM ¶5.8.11.2; IRM ¶5.8.1-1.
    a. Lump Sum offers
    b. Periodic payment offers
3. Effective Tax Administration Offer, IRM ¶5.8.11.2; IRM ¶5.8.1-1.

(B) Requirements:

1. Doubt as to Liability
    a. File Form 656L
    b. NO Financial statement (433A, 433B)
    c. Include proof to support basis for doubt as to liability
    d. Be in full compliance for all periods after the Offer years.
    e. EX. Innocent spouse, incorrect deficiency, trust fund taxes.
2. Doubt as to Collectability, IRM
    a. File Form 656
    b. Fully complete Forms 433A/433B

c. Attach all requested documents

d. Cannot include years for which the SOL has expired

e. Be in full compliance for all periods after the Offer years.

f. Pay $150 processing fee (unless low income taxpayer)

g. If lump sum - 20% of the offered amount with the Offer.

h. If periodic payment - first payment with the Offer and continue to make payments while pending.

i. IRS uses the national standards to evaluate the acceptability of these Offers.

3. Effective Tax Administration Offer

Same as #2 above, AND: show exceptional circumstances that show collection of full amount:

a. would create a hardship, (the taxpayer would not be able to meet living expenses if paid the tax), or

b. is detrimental to voluntary compliance.

OFFERS IN COMPROMISE - Outline:

I.R.C. Section 7122 authorizes the Secretary of the Treasury to compromise tax liabilities for an amount that is less than the full amount owed. An Offer in Compromise is a written agreement entered into between the taxpayer and the Internal Revenue Service, ("IRS"), to satisfy unpaid tax liabilities for less than the full amount due.[48] The objectives outlined by the IRS in accepting OIC's are: to collect the most amount, at the earliest time, with the least cost to the IRS; to reach resolution in the best interests of the IRS and the taxpayer; to provide the taxpayer with a fresh start toward voluntary compliance; and to collect money otherwise not available.[49]

There are three types of OIC. First, there is an OIC that is based on doubt as to liability wherein the taxpayer does not really owe the tax. Examples include innocent spouse, incorrect deficiency, trust fund recovery penalty incorrectly assessed, or payments not properly applied.[50] The second class of OIC is based on doubt as to collectability. The taxpayer in this second class cannot pay the full liability from assets and income, or there are special circumstances that allow the taxpayer to make a "hardship offer", even though he may be able to pay.[51] The final type of OIC is entitled "effective tax administration." In this type of OIC, the taxpayer may be able to full pay the tax, but such payment would cause an economic hardship or there are special circumstances.[52]

Each class of OIC is subject to its own requirements. The least rigorous is the first class, based on doubt as to liability. For this offer, the taxpayer must file a Form 656L, but there is no requirement for a financial statement (Form 433-A or 433-B). Included with the OIC must be proof to support the bases for doubt as to liability. In addition, the taxpayer must be in full compliance for all periods subsequent to those included in the OIC.[53] The OIC cannot be rejected under the compliance requirement just because the IRS may not be able to locate a return.[54]

OIC's based on doubt as to collectability are the most prevalent. To meet the initial requirements for this type of offer, the taxpayer must file Form 656 (Offer in Compromise), and fully completed financial statements, Forms 433-A and/or 433-B, with all attached documentation. The OIC must include all outstanding liabilities, including assessed and unassessed liabilities. It cannot include those taxes for which the collection statute ("SOL") has already expired. [55]

The amount offered must be equal to the quick sale value of the equity in the taxpayer's assets[56] plus the present value of the monthly amount the IRS could collect (usually 48xIA monthly amount, unless there is a short SOL).[57] And, just as in the first type of OIC, the taxpayer must be in full compliance for all periods after those covered in the OIC. The taxpayer must remain in compliance for 5 years after OIC accepted.[58] In addition, the taxpayer must pay a $150.00 processing fee, unless he or she can qualify as a low income taxpayer.[59]

The final class of OIC is entitled "effective tax administration" offer ("ETA"). The filing requirements for this type of OIC are the same as those listed above for an OIC based on doubt as to collectability.[60] The only difference is that there must be exceptional circumstances which result in a determination that collection of the full amount of tax due would either: (a) create a hardship; or (b) be detrimental to voluntary compliance. That is, in the former, even though the taxpayer has the money to full pay the tax, if the tax were collected, the taxpayer would not be able to meet reasonable basic living expenses. With respect to the latter, collection would be so unfair and inequitable that other taxpayers would lose confidence in the system.[61]

Notwithstanding the unwieldy amount of paper required to process a successful OIC, the odds of acceptance are weighted against the taxpayer from the get-go. The IRS will reject an OIC if: (1) all of the documents are not properly submitted; (2) the taxpayer fails to submit any additional requested documents; (3) the amount offered is less than what could be expected to be collected; or (4) there is a public policy reason to reject.[62] In addition, even though the IRS is supposed to use the National Standard Expenses ("NSE") (food, clothing, and miscellaneous), and the Local Standard Expenses ("LSE") (housing) as a guide, rather than an absolute maximum, there are very few instances in which any variance is allowed. According to the National Taxpayer Advocate's Report for 2003, the IRS must justify acceptance of an OIC. On the other hand, rejection needs no support, merely a rejection letter.

TIPRA amended I.R.C. Section 7122 to require the submission of partial payments with offers in compromise. With respect to lump-sum offers in compromise,[63] TIPRA requires the taxpayer to submit with the application a partial payment of 20% of the offer amount.[64] For periodic payment offers,[65] the taxpayer is required to submit the first installment payment with the application and thereafter to comply with the taxpayer's proposed payment schedule while the Service is considering the offer.[66]

TIPRA provides that, if a taxpayer fails to submit the required initial payment with the offer, the Service may return the offer to the taxpayer as unprocessable.[67] In the case of a periodic payment offer, the Service may treat a taxpayer's failure to comply with the proposed installment payment schedule while the offer is pending as a withdrawal of that offer.[68]

None of the partial payments are refundable, but the taxpayer can designate their application. TIPRA authorizes the Secretary of the Treasury to issue regulations waiving the partial payment requirements.[69] Low income taxpayers may qualify for waiver of these payments. Under TIPRA, an OIC is deemed "accepted" if it is not withdrawn, returned, or rejected with 24 months of IRS receipt. The 24 months does not include any time during which the liability at issue is the subject of a dispute in any judicial proceeding.[70]

Once the OIC is accepted (unless it is a "doubt as to liability" OIC), if the taxpayer "defaults" during the five years following acceptance, the IRS will re-instate the tax, interest and penalties and re-commence enforced collection.

V. CONSIDERATIONS AND ISSUES RE: BANKRUPTCY:

Table of Contents:

A. Are the taxes dischargeable in Bankruptcy?

1. 3 year rule for due date of return, §507(a)(8)(A)(i).

2. 2 year rule for late filed returns, §523(a)(1)(B)(ii).

3. 240 day rule for assessments, §507(a)(8)(A)(ii).

4. No fraud on return or evasion to pay, §523(a)(1)(C).

5. No unassessed taxes, §507(a)(8)(A)(iii).

6. No trust fund taxes, §507(a)(8)(C).

7. Watch out for any extensions of these time periods. §507(a)(8) hanging paragraph.

B. Can the IRS still collect on taxes after Bankruptcy?

1. YES - if the taxes were not discharged.

2. YES - if the debtor owned property before the bankruptcy. IRC §§632, 6322

C. When does the debtor get his discharge?

D. Are these taxes about to expire by statute anyway?

E. Who can file bankruptcy?

F. What are the different types of bankruptcy?

G. What happens to the taxes in bankruptcy?

CONSIDERATIONS AND ISSUES RE: BANKRUPTCY - Outline

A. Are the taxes dischargeable in Bankruptcy?

1. The pre-requisites to dischargeability of taxes in bankruptcy are:

a. The tax return must be DUE (with extensions) more than 3 years before the bankruptcy. §507(a)(8)(A)(i).

b. The tax must be ASSESSED at least 240 days before the bankruptcy. The 240 days is extended anytime an offer in compromise is in effect during the 240 days, plus 30 days, and any time the IRS was precluded from collection during the 240 days, plus 90 days. §507(a)(8)(A)(ii).

c. UNASSESSED taxes are not dischargeable. §507(a)(8)(A)(iii).

d. Trust fund taxes are not dischargeable. §507(a)(8)(C).

e. Taxes due from UNFILED returns are not discharged. §523(a)(1)(B)(i).

f. Late-filed return must be filed at least 2 years before

bankruptcy. §523(a)(1)(B)(ii).

g. Tax due to fraudulent returns, or unpaid as a result of evasion to pay. §523(a)(1)(C).

***All of the periods in §507(a)(8) are extended anytime the IRS is precluded from collection as a result of the debtor requesting a hearing and an appeal of collection action, plus 90 days, and during any time the automatic stay was in effect during a prior bankruptcy plus 90 days , and during any time collection was precluded because of a confirmed plan, plus 90 days. §507(a)(8) hanging paragraph.

B. Even if the taxes are discharged, can the IRS still collect? YES, IF

1. If the Debtor owns property prior to the bankruptcy and the IRS has filed a federal tax lien, or perfected their interest in the property:

a. The tax lien survives the bankruptcy because it continues to attach to the debtor's property. IRC §§ 6321, 6322.

b. The tax lien attaches to all pre-bankruptcy property, including exempt property.

Exempt property can include: homestead, life insurance, IRA's, 401(k)'s.

c. The IRS can seize this property, or demand payment of the value of the property.

d. IRC §6334 provides a list of property that is exempt from IRS levy certain items, including up to $6,250 of personal property. Presumably this Code section should prevent the IRS from levying pre-bankruptcy assets pursuant to an IRS lien after the taxes have been discharged.

C. If dischargeable, when are the taxes discharged in a bankruptcy?

1. Chapter 7 - when the court enters the discharge order, §727.

2. Chapter 13 - after the last plan payment is made, unless there is hardship.§1328

3. Chapter 11 - after the last plan payment is made, unless the Debtor requests it earlier and has paid unsecured creditors more than they would get in a Chapter 7. §1141

D. When does the statute of limitations on collection expire for the taxes?

1. The IRS generally has 10 years to collect taxes. IRC §6502(a).

2. This period can be extended for various events:

a. taxpayer is outside the US for at least 6 months. IRC §6503(c)

b. taxpayer is in bankruptcy. IRC §6503(h).

c. anytime the IRS is precluded from levy. IRC §6503(i)(5).

During OIC, IRC §6503(k)(1).

While an offer of an installment agreement is pending, IRC §6503(k)(2).

During CDP proceeding. IRC §6503(i)(5).

During innocent spouse claim.

3. Look at each of the tax periods at issue to determine if the statute of limitations for collection is about to expire.

E. Who can file bankruptcy?

1. A. An Individual

a. Can file a Chapter 7

- if pass means test, when required

- if they take the credit counseling courses

b. Is the only one who can file a Chapter 13

- with regular income

- with unsecured debt less than $307,675

- with secured debt less than $922,975

- if they take the credit counseling courses

c. Can file a Chapter 11

- if they take the credit counseling courses

d. Can file a Chapter 12 - if he is a family farmer/fisherman

- with regular annual income

- if they take the credit counseling courses

2. A Corporation

a. Can file a Chapter 7

b. Can file a Chapter 11

3. A city

a. Can file a Chapter 9

F. What are the different types of bankruptcy?

1. Chapter 7 - Liquidation of the debtor's assets

a. A trustee is appointed by the Court

b. The trustee administers the assets of the bankruptcy estate

c. The creditors only receive money if there are non-exempt assets for the trustee to administer.

2. Chapter 13 - Payment of creditors through a Chapter 13 Plan

a. A standing trustee is appointed

b. The trustee administers the Chapter 13 plan and payments

c. The creditors receive payments under the Plan through the Chapter 13 trustee

d. The trustee is paid a fee to administer the Plan.

e. The debtor makes payments from disposable income.

f. There is no separate taxable entity created.

g. The debtor's post-petition income is an asset of the bankruptcy estate.

3. Chapter 11 - Payment of creditors through a Chapter 11 Plan of Reorganization.

a. The debtor is his own trustee (debtor-in-possession) unless one is appointed

b. The debtor-in-possession administers the Chapter 11 plan

c. The debtor makes payments from disposable income - as determined by the Court without application of the IRS national standards.

d. There is a separate taxable entity created upon the filing of the bankruptcy.

e. The debtor's post-petition income is an asset of the bankruptcy estate

f. The debtor must pay quarterly fees to the US Trustee's office during the pendency of the bankruptcy.

g. The debtor must file monthly income and expense reports with the US Trustee until confirmation, then affidavits of expenses until the case is closed.

4. Chapter 12 - Payment of creditors of a family farmer/fisherman through a Chapter 12 Plan.

G. What happens to the taxes in bankruptcy?

1. Chapter 7 taxes.

a. Priority/Non-dischargeable taxes must be paid even after bankruptcy.

i. Due less than 3 years before bankruptcy, §507(a)(8)(A)(i).

ii. Assessed within 240 days of bankruptcy, §507(a)(8)(A)(ii).
(Adding any extensions for pending OIC's)

iii. Unassessed taxes. §507(a)(8)(A)(iii).

iv. Trust fund taxes §507(a)(8)(C).

b. Nonpriority/Non-dischargeable taxes must be paid even after bankruptcy.

i. Unfiled returns. §523(a)(1)(B)(i).

ii. Late filed returns, filed within 2 years of bankruptcy. §523(a)(1)(B)(ii).

iii. Fraudulent returns or unpaid tax due to evasion to pay. §523(a)(1)©. (Exhibit B recent case on dischargeability)

c. Nonpriority/Dischargeable taxes may be discharged in bankruptcy. BUT - the tax liens for these taxes would still attach to post-bankruptcy property. AND - the IRS could still seize and sell that property or demand payment for the value of the property.

2. Chapter 13 taxes

a. Secured taxes:

i. by surrendering the property to the IRS.

ii. Selling the property and surrendering the proceeds to the IRS.

iii. Paying the amount of the secured claim in full with interest through the Plan.

b. Priority taxes:

i. must be paid in full over the life of the Plan.

c. Unsecured - Dischargeable/Non-priority taxes:

i. a monthly payment in the plan equal to the disposable income for either 36 or 60 months. Disposable income doesn't include certain items, and is reduced by expenditures for secured payments, priority payments, IRS national standards, US Trustee fees and other items.

ii. These creditors must receive more than they would have in a Chapter 7.

d. Any non-dischargeable taxes which remain unpaid at the conclusion of the Plan would still be collectible by the IRS.

e. The discharge is not entered until the last payment is made.

3. Chapter 11 taxes:

a. Secured taxes:

i. same as Chapter 13

b. Priority taxes:

i. must be paid in full in regular installment payments over the life of the Plan, plus interest, within 5 years of the bankruptcy filing date. §1129(a)(9)(C) and (D).

c. Unsecured taxes:

i. monthly payment equal to the disposable income, which is determined to be reasonable by the court.

ii. The IRS must receive more than it would have in a Chapter 7.

d. The discharge is not entered until the last payment is made, unless requested earlier and the unsecured creditors have received more than they would have in a Chapter 7.

VI. CONCLUSION:

Each taxpayer's situation must be thoroughly analyzed, using IRS literal transcripts of account to make a preliminary determination with respect to the most appropriate of these collection alternatives. The interplay between the Internal Revenue Code and the Bankruptcy Code make such an analysis essential prior to any Installment Agreement, Offer in Compromise, or bankruptcy. Clearly, if the taxes are dischargeable and the taxpayer passes the means test, bankruptcy still provides the most certainty with respect to time frame, consequences, procedural burden, and outcome. A survey of the most recent cases involving the exception to discharge because of evasion is attached hereto.

1.I.R.M.¶5.15.1

2.2. I.R.M.¶5.15.1.1(3)

3.I.R.M.¶5.15.1.1(6)

4.I.R.C. ¶ 7122(d)(2)(B)

5. 26 C.F.R. ¶301.7122-1(c)(2)

6.26 C.F.R.¶ 301.6343-1((b)(4)

7.I.R.M.¶5.15.1.1(8)

8.I.R.M.¶5.15.1.1(9)

9.I.R.M.¶5.15.1.1(10)(4)

10.I.R.M.¶5.15.1.2(10)(5)

11.I.R.M.¶5.15.1.3(5)

12.I.R.M.¶5.15.13(6)

13. I.R.M.¶5.15.1.4

14.I.R.M. ¶5.16.1; Policy Statement P-5-71.

15.I.R.M.¶5.16.1.1(2).

16.I.R.M.¶5.16.1.1(3)

17.I.R.M.¶5.16.1.2

18.I.R.M.¶5.16.1.1(6)

19.I.R.M.¶5.16.1.2(9)

20.I.R.M.¶5.16.1.2(3)

21.I.R.M.¶5.16.1.3(1)

22.I.R.M.¶5.16.1.5

23. 26 CFR 301.6159-1(a).

24.I.R.C. Section 6159(a); IRM ¶ 5.14.1.7.

25. I.R.C. Section 6159(b)(4)(a)(B).

26. I.R.C. Section 6159(b)(4)(a)(C).

27. 26 CFR 300.1(b).

28. I.R.C. Section 6159(b)(4)(a)(A).

29. I.R.C. Section 6159(b)(4)(a)(B).

30. I.R.C. Section 6159(b)(4)(a)(C).

31. I.R.C. Section 6159(b)(2)(A).

32. I.R.C. Section 6159(b)(2)(B).

33. I.R.C. Section 6159(b)(3).

34. I.R.C. Section 6159(c).

35. I.R.C. Section 6159(b)(5)(A).

36. Grant v. United States, 92 AFTR 2d (RIA) 5600 (S.D. Fla. 2003).

37.The IRS has 10 years to collect the tax from the date of assessment, absent certain events that might extend the 10 years. I.R.C. Section 6502(a)(1).

38. I.R.M. ¶ 5.14.2.2.

39. I.R.M. ¶ 5.14.2.2(2).

40. I.R.M. ¶ 5.14.2.2.2(2).

41. I.R.M. ¶ 5.14.2.2.2(3).

42. I.R.M. ¶ 5.14.5.1.

43. I.R.M. ¶ 5.14.5.2(1).

44. I.R.C. Section 6331(k)(2).

45. I.R.C. Section 6331(k)(2) and (3).

46. I.R.C. Section 6331(k)(2) and (3).

47. I.R.C. Section 6323(j).

48. I.R.M. ¶ 5.8.1.1.1(1).

49. I.R.M. ¶ 5.8.1.1.4.

50. I.R.C. Section 7122(c)(3)(B).

51. I.R.M. ¶ 5.8.11.2; I.R.M. ¶ 5.8.1-1.

52. I.R.M. ¶ 5.8.11.2; I.R.M. ¶ 5.8.1-1.

53. Form 656.

54. I.R.C. Section 7122(c)(3)(B)(i).

55.I.R.M. ¶ 5.8.1.2; I.R.M. ¶ 5.8.1.7.3.

56.The Service has added another "asset" to this ability to pay which includes any assets that the Service has deemed the taxpayer "dissipated". This could make the amount required for the OIC to include assets the taxpayer no longer owns or to which he has access.

57. I.R.M. ¶ 5.8.5; I.R.M. ¶ 5.8.1.1.3(3); ¶ 5.8.1-1; Form 656.

58. Form 656.

59. 26 C.F.R. Part 300 (11/1/03). User fees made in conjunction with an offer in compromise will be treated as payments against tax, interest, and penalties to which the offer relates. I.R.C. Section 7122(c)(2)(B)

60. Form 656; 26 C.F.R. Part 300 (11/1/03).

61. I.R.M. ¶ 5.8.11.2.

62.Public policy is only supposed to be used to reject an OIC if acceptance is detrimental to the interest of the IRS, even though the amount offered is greater than the collectible amount. However, it is not to be used merely because public interest might be generated or the taxpayer was criminally prosecuted. I.R.M. ¶ 5.8.7.6.1.

63. Defined as any offer of payment made in five or fewer installments. I.R.C. Section 7122(c)(1)(a)(ii).

64. I.R.C. Section 7122(c)(1)(A)(i).

65. Defined as any offer of payment made in six or more installments.

66. I.R.C. Section 7122(c)(1)(B).

67. I.R.C. Section 7122(d)(3)(C).

68. I.R.C. Section 7122(c)(1)(B)(ii).

69. I.R.C. Section 7122(c)(2)(C).

70. I.R.C. Section 7122(f).

Not-for-Profit Entities

David C. Moja, CPA

David C. Moja, CPA

Principal, National Director of Not-for-Profit Tax Services
CapinCrouse, LLP

Dave is on the firm's leadership team for not-for-profit tax services. His goal is to provide our clients with the highest quality tax services so they can focus on advancing their mission. He is an expert on emerging issues such as the new Form 990, Unrelated Business Income issues, Board Governance, and tax credits and incentives.

Before joining CapinCrouse, Dave was the tax director and the not-for-profit tax lead in Florida for the accounting firm RSM McGladrey. He provided tax consulting services to more than 450 clients, including transitioning them to the new Form 990. He has also spoken extensively at accounting and tax seminars across the country, including the Christian Leadership Alliance National Conference and the Florida Institute of CPA's Annual Not-for-Profit Conference.

With 24 years of accounting experience, Dave has worked both inside not-for-profit organizations and for public accounting firms, including PricewaterhouseCoopers LLP and BKD LLP. He earned his B.S. degree from Florida State University.

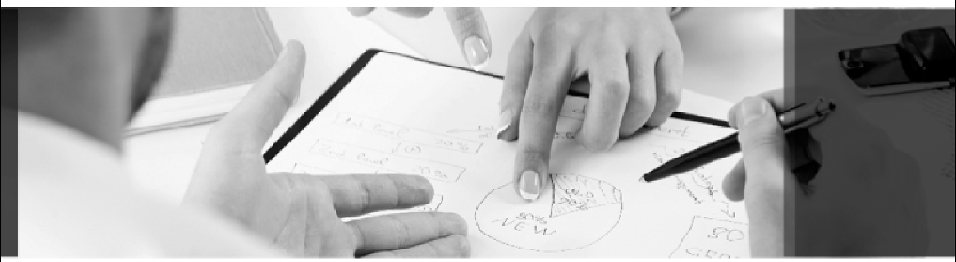
Dave serves on the board of the Brevard Cultural Alliance and is the co-chair of the FSU Accounting Conference Committee. He is a member of the AICPA and the Florida Institute of CPA's.

dmoja@capincrouse.com

Not-for-Profit Tax Update

Florida Institute on Federal Taxation

November 5, 2010



Dave Moja, National Tax Director
dmoja@capincrouse.com
(321) 258-9907

A NEW DAY FOR NON-PROFITS…

Form 990 will increase scrutiny and enforcement efforts will be made easier.

- Increased transparency and disclosure will make it easier to **follow the money** (e.g., Part IV)
- Compliance will improve because pointed questions will **create more awareness** of the many tax laws that apply to tax-exempt organizations (e.g., Part V)
- The focus on governance highlights the policies that **responsible persons** should have in place to exercise their fiduciary duty
- Many answers need to be explained and certain practices need to be described; accordingly, **much more disclosure** (e.g., Part VI)
- **Internal consistency** will drive the filing of a complete and accurate return

2010 Not-for-Profit Issues

May 17, 2010 – Death Penalty for Charities?

- Shulman notice 5/18/10…
- BEYOND 10/15/10 "Safety Valve"…

The H.I.R.E. Act

Updated IRS User Fees

1099-MISC under Health Care Reform**

FBAR Update

Small Business Health Care Credit

CUCP – Interim Report

www.irs.gov/charities

The IRS has posted the names and last-known addresses of at-risk organizations, along with guidance about how to come back into compliance. The organizations on the list have return due dates between May 17 and Oct. 15, 2010, but the IRS has no record that they filed the required returns for any of the past three years.

http://www.irs.gov/charities/article/0,,id=225889,00.html

H.I.R.E. Act

- Effective March 19, 2010 for individuals hired after February 3, 2010, and before January 1, 2011.
- Employers entitled to a credit of 6.2% against the payroll tax (FICA) they paid for previously unemployed /qualified employees
- Up to $1,000 General Business credit for 2011

H.I.R.E. - Qualifying Individual

Hired between 2/3/10 and 1/1/11

- Wages paid after 3/18/10
- Newly hired must sign affidavit:
  Form W-11
- Not a “replacement employee
- Not a family member of the employer

Small Business Health Care Credit

Providing health care coverage. A qualifying employer must cover at least 50 percent of the cost of health care coverage for some of its workers based on the single rate.

Firm size. A qualifying employer must have less than the equivalent of 25 full-time workers (for example, an employer with fewer than 50 half-time workers may be eligible).

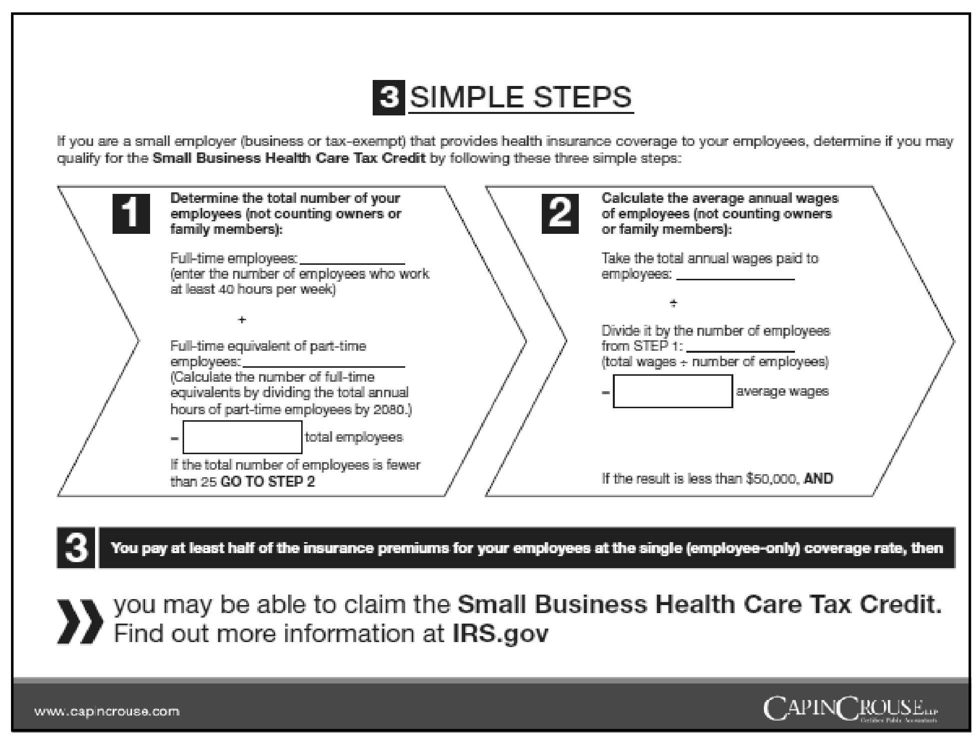
Average annual wage. A qualifying employer must pay average annual wages below $50,000.

Both taxable (for profit) and tax-exempt firms qualify.

Small Business Health Care Credit

Maximum Amount. The credit is worth up to 35 percent of a small business' premium costs in 2010. On Jan. 1, 2014, this rate increases to 50 percent (35 percent for tax-exempt employers).

Phase-out. The credit phases out gradually for firms with average wages between $25,000 and $50,000 and for firms with the equivalent of between 10 and 25 full-time workers.


3 SIMPLE STEPS
If you are a small employer (business or tax-exempt) that provides health insurance coverage to your employees, determine if you may qualify for the Small Business Health Care Tax Credit by following these three simple steps:
1
Determine the total number of your employees (not counting owners or family members):
Full-time employees:
(enter the number of employees who work at least 40 hours per week)
+
Full-time equivalent of part-time employees:
(Calculate the number of full-time equivalents by dividing the total annual hours of part-time employees by 2080.)
= total employees
If the total number of employees is fewer than 25 GO TO STEP 2
2
Calculate the average annual wages of employees (not counting owners or family members):
Take the total annual wages paid to employees:
÷
Divide it by the number of employees from STEP 1:
(total wages ÷ number of employees)
= average wages
If the result is less than $50,000, AND
3
You pay at least half of the insurance premiums for your employees at the single (employee-only) coverage rate, then
you may be able to claim the Small Business Health Care Tax Credit. Find out more information at IRS.gov
www.capincrouse.com
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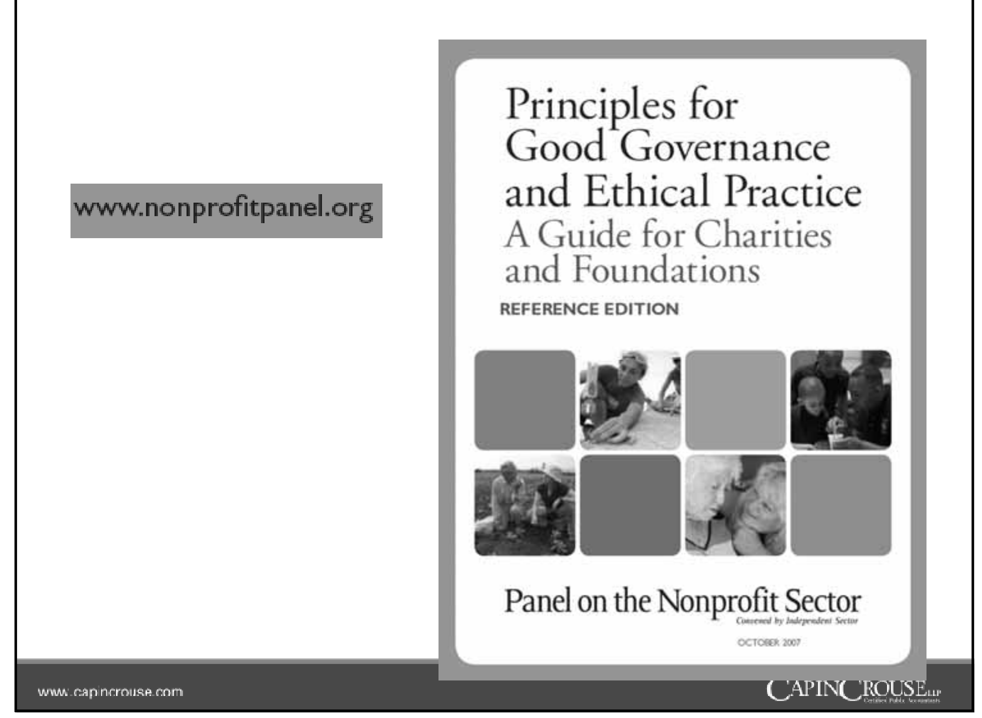
www.nonprofitpanel.org
Principles for Good Governance and Ethical Practice
A Guide for Charities and Foundations
REFERENCE EDITION
Panel on the Nonprofit Sector
Convened by Independent Sector
OCTOBER 2007
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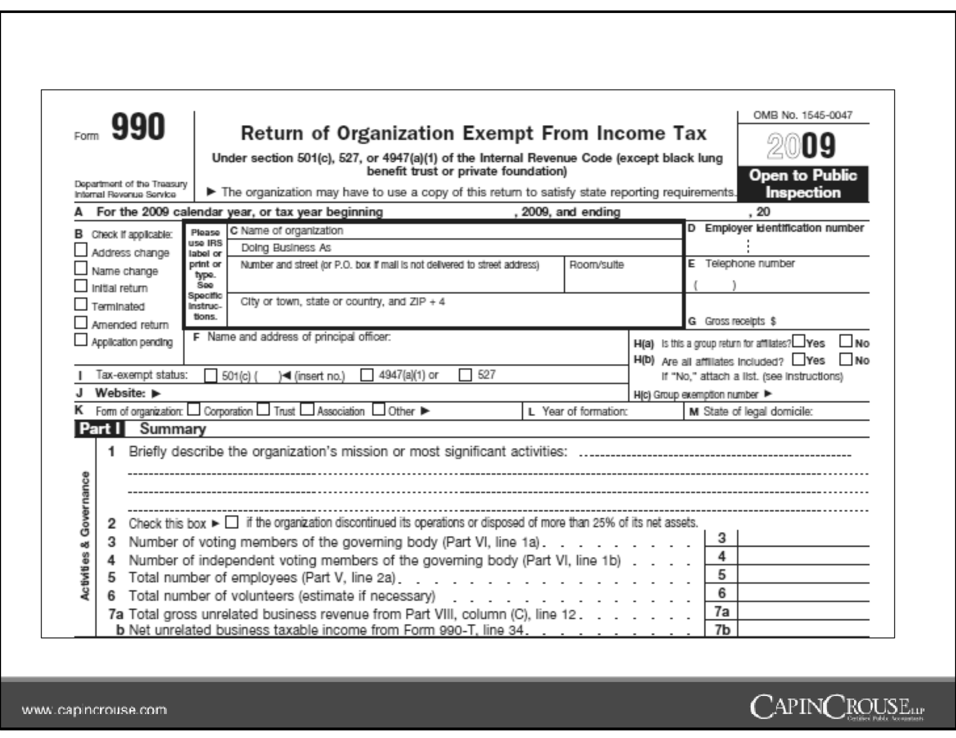
FORM 990 – MOST-MISSED ITEMS

Top 15 Form 990 Things Missed

1. Part I, Lines 3,4 (Part VI, Line 1a, 1b)
2. Part I, Line 6 - Volunteers
3. Part I, Line 7/8 – Unrelated Business Income
4. Part IV, Line 4a
5. Part VI, Line 11A
6. Part VI, Line 12-15 (Policies)
7. Part VII, Section A – Directors, Officers

Top 15 Form 990 Things Missed

8. Part VII, Section A – Key Employees
9. Part VII, Section A – Former…
10. Part VII, Section A – Related Organization
11. Part VII, Section A – Column (F) ($10,000)
12. Part IX, Line 11
13. Schedule J, Part I, Line 4a
14. Schedule L, Part IV
15. Schedule M, Column (c)



Form **990**

Department of the Treasury
Internal Revenue Service

Return of Organization Exempt From Income Tax

Under section 501(c), 527, or 4947(a)(1) of the Internal Revenue Code (except black lung benefit trust or private foundation)

▶ The organization may have to use a copy of this return to satisfy state reporting requirements.

OMB No. 1545-0047

2009

Open to Public Inspection

A For the 2009 calendar year, or tax year beginning , 2009, and ending , 20

B Check if applicable:
☐ Address change
☐ Name change
☐ Initial return
☐ Terminated
☐ Amended return
☐ Application pending

Please use IRS label or print or type. See Specific Instructions.

C Name of organization

Doing Business As

Number and street (or P.O. box if mail is not delivered to street address) | Room/suite

City or town, state or country, and ZIP + 4

D Employer identification number

E Telephone number

G Gross receipts $

F Name and address of principal officer:

H(a) Is this a group return for affiliates? ☐Yes ☐No

H(b) Are all affiliates included? ☐Yes ☐No
If "No," attach a list. (see instructions)

I Tax-exempt status: ☐ 501(c) ( ) ◀ (insert no.) ☐ 4947(a)(1) or ☐ 527

J Website: ▶

H(c) Group exemption number ▶

K Form of organization: ☐ Corporation ☐ Trust ☐ Association ☐ Other ▶ | L Year of formation: | M State of legal domicile:

Part I Summary

Activities & Governance

1 Briefly describe the organization's mission or most significant activities:

2 Check this box ▶ ☐ if the organization discontinued its operations or disposed of more than 25% of its net assets.

3 Number of voting members of the governing body (Part VI, line 1a)	3	
4 Number of independent voting members of the governing body (Part VI, line 1b)	4	
5 Total number of employees (Part V, line 2a)	5	
6 Total number of volunteers (estimate if necessary)	6	
7a Total gross unrelated business revenue from Part VIII, column (C), line 12	7a	
b Net unrelated business taxable income from Form 990-T, line 34	7b	

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Part I - Boards and Volunteers

Reconciliation of Board Size

Independent Voting Members

- **See rules**

Volunteers

Independent Board Member, defined

- Not compensated as an officer or other employee of the organization or of a related organization
- $10,000 compensation rule
- Family member compensation rule
- Not part of any transaction required to be reported on Schedule L

Section B. Policies *(This Section B requests information about policies not required by the Internal Revenue Code.)*

			Yes	No
10a	Does the organization have local chapters, branches, or affiliates?	10a		
b	If "Yes," does the organization have written policies and procedures governing the activities of such chapters, affiliates, and branches to ensure their operations are consistent with those of the organization?	10b		
11	Has the organization provided a copy of this Form 990 to all members of its governing body before filing the form?	11		
11A	Describe in Schedule O the process, if any, used by the organization to review this Form 990.			
12a	Does the organization have a written conflict of interest policy? *If "No," go to line 13*	12a		
b	Are officers, directors or trustees, and key employees required to disclose annually interests that could give rise to conflicts?	12b		
c	Does the organization regularly and consistently monitor and enforce compliance with the policy? *If "Yes," describe in Schedule O how this is done*	12c		
13	Does the organization have a written whistleblower policy?	13		
14	Does the organization have a written document retention and destruction policy?	14		
15	Did the process for determining compensation of the following persons include a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision?			
a	The organization's CEO, Executive Director, or top management official	15a		
b	Other officers or key employees of the organization	15b		
	If "Yes" to line 15a or 15b, describe the process in Schedule O. (See instructions.)			
16a	Did the organization invest in, contribute assets to, or participate in a joint venture or similar arrangement with a taxable entity during the year?	16a		
b	If "Yes," has the organization adopted a written policy or procedure requiring the organization to evaluate its participation in joint venture arrangements under applicable federal tax law, and taken steps to safeguard the organization's exempt status with respect to such arrangements?	16b		

Form 990, Part VI, Line 11, 11A

Was a copy of the Form 990 provided to the organization's governing body before it was filed?

All organizations must describe in Schedule O the process, if any, the organization uses to review the Form 990

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Part VI - Policies

"Required" Policies

- **Conflict of Interest**
- **Whistleblower**
- **Document Retention and Destruction**
- **Gift Acceptance (and Refusal)***

Form 990 (2009) Page 7

Part VII Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees, and Independent Contractors

Section A. Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees

1a Complete this table for all persons required to be listed. Report compensation for the calendar year ending with or within the organization's tax year. Use Schedule J-2 if additional space is needed.

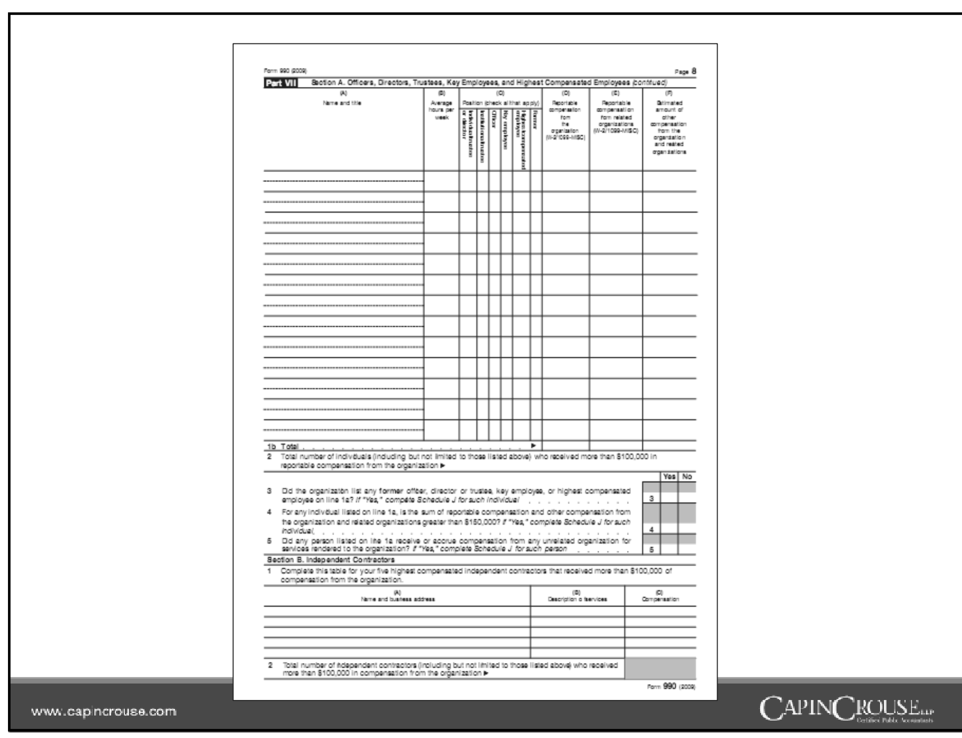
- List all of the organization's **current** officers, directors, trustees (whether individuals or organizations), regardless of amount of compensation. Enter -0- in columns (D), (E), and (F) if no compensation was paid.
- List all of the organization's **current** key employees. See instructions for definition of "key employee."
- List the organization's five **current** highest compensated employees (other than an officer, director, trustee, or key employee) who received reportable compensation (Box 5 of Form W-2 and/or Box 7 of Form 1099-MISC) of more than $100,000 from the organization and any related organizations.
- List all of the organization's **former** officers, key employees, and highest compensated employees who received more than $100,000 of reportable compensation from the organization and any related organizations.
- List all of the organization's **former directors or trustees** that received, in the capacity as a former director or trustee of the organization, more than $10,000 of reportable compensation from the organization and any related organizations.

List persons in the following order: individual trustees or directors; institutional trustees; officers; key employees; highest compensated employees; and former such persons.

☐ Check this box if the organization did not compensate any current officer, director, or trustee.

(A) Name and Title	(B) Average hours per week	(C) Position (check all that apply)						(D) Reportable compensation from the organization (W-2/1099-MISC)	(E) Reportable compensation from related organizations (W-2/1099-MISC)	(F) Estimated amount of other compensation from the organization and related organizations
		Individual trustee or director	Institutional trustee	Officer	Key employee	Highest compensated employee	Former			

Form 990 (2009)


Form 990 (2009) Page 8

Part VII Section A. Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees *(continued)*

(A) Name and title	(B) Average hours per week	(C) Position (check all that apply) Individual trustee or director	Institutional trustee	Officer	Key employee	Highest compensated employee	Former	(D) Reportable compensation from the organization (W-2/1099-MISC)	(E) Reportable compensation from related organizations (W-2/1099-MISC)	(F) Estimated amount of other compensation from the organization and related organizations
1b Total . . . . . ▶										

2 Total number of individuals (including but not limited to those listed above) who received more than $100,000 in reportable compensation from the organization ▶

		Yes	No
3 Did the organization list any former officer, director or trustee, key employee, or highest compensated employee on line 1a? *If "Yes," complete Schedule J for such individual*	3		
4 For any individual listed on line 1a, is the sum of reportable compensation and other compensation from the organization and related organizations greater than $150,000? *If "Yes," complete Schedule J for such individual*	4		
5 Did any person listed on line 1a receive or accrue compensation from any unrelated organization for services rendered to the organization? *If "Yes," complete Schedule J for such person*	5		

Section B. Independent Contractors

1 Complete this table for your five highest compensated independent contractors that received more than $100,000 of compensation from the organization.

(A) Name and business address	(B) Description of services	(C) Compensation

2 Total number of independent contractors (including but not limited to those listed above) who received more than $100,000 in compensation from the organization ▶

Form 990 (2009)

Compensation Issues

Erroneous Reporting

- Officers
- Key Employees

Reportable Compensation

Benefits

President's Compensation – Averages**

“Officer”

- New definition of officer – now includes
  - top “management official” is the person with:
    - ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization
  - top “financial officer” is the person with:
    - ultimate responsibility for managing the organization’s finances

Key Employee - Definition

In general, the three part key employee definition will require reporting as a key employee only those employees, other than officers, directors, and trustees, who -

1. **Had reportable compensation exceeding $150,000 for the year (the “$150,000 Test”);**
2. **Had or shared organization-wide control or influence similar to that of an officer, director, or trustee, or managed or had authority or control over at least 10 percent of the organization’s activities (the “Responsibility Test”); and**
3. **Were within that group of the organization’s top 20 highest paid employees for the year who satisfied both the $150,000 test and the Responsibility Test (“Top 20 Test”).**

Form 990, Part IX, Line 11
Fees for services

11 Fees for services (non-employees):				
a Management				
b Legal				
c Accounting				
d Lobbying				
e Professional fundraising services. See Part IV, line 17				
f Investment management fees				
g Other				

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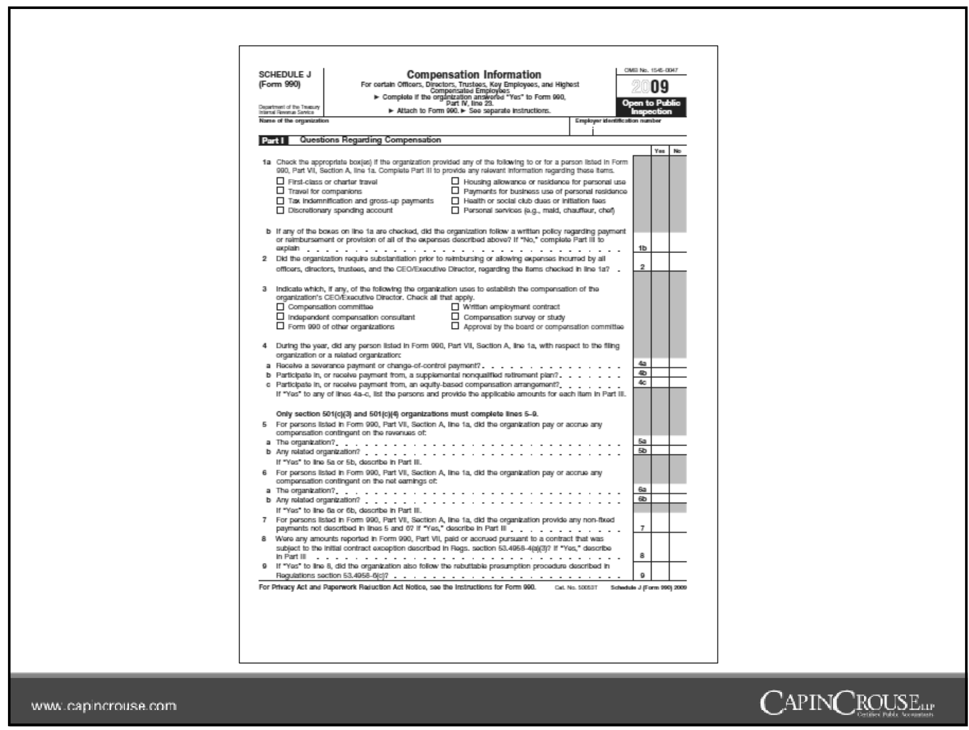

SCHEDULE J (Form 990)

Department of the Treasury Internal Revenue Service

Compensation Information

For certain Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees

► Complete if the organization answered "Yes" to Form 990, Part IV, line 23.

► Attach to Form 990. ► See separate instructions.

OMB No. 1545-0047

2009

Open to Public Inspection

Name of the organization | Employer identification number

Part I Questions Regarding Compensation

		Yes	No
1a Check the appropriate box(es) if the organization provided any of the following to or for a person listed in Form 990, Part VII, Section A, line 1a. Complete Part III to provide any relevant information regarding these items. ☐ First-class or charter travel ☐ Housing allowance or residence for personal use ☐ Travel for companions ☐ Payments for business use of personal residence ☐ Tax indemnification and gross-up payments ☐ Health or social club dues or initiation fees ☐ Discretionary spending account ☐ Personal services (e.g., maid, chauffeur, chef)			
b If any of the boxes on line 1a are checked, did the organization follow a written policy regarding payment or reimbursement or provision of all of the expenses described above? If "No," complete Part III to explain	1b		
2 Did the organization require substantiation prior to reimbursing or allowing expenses incurred by all officers, directors, trustees, and the CEO/Executive Director, regarding the items checked in line 1a?	2		
3 Indicate which, if any, of the following the organization uses to establish the compensation of the organization's CEO/Executive Director. Check all that apply. ☐ Compensation committee ☐ Written employment contract ☐ Independent compensation consultant ☐ Compensation survey or study ☐ Form 990 of other organizations ☐ Approval by the board or compensation committee			
4 During the year, did any person listed in Form 990, Part VII, Section A, line 1a, with respect to the filing organization or a related organization:			
a Receive a severance payment or change-of-control payment?	4a		
b Participate in, or receive payment from, a supplemental nonqualified retirement plan?	4b		
c Participate in, or receive payment from, an equity-based compensation arrangement? If "Yes" to any of lines 4a–c, list the persons and provide the applicable amounts for each item in Part III.	4c		
Only section 501(c)(3) and 501(c)(4) organizations must complete lines 5–9.			
5 For persons listed in Form 990, Part VII, Section A, line 1a, did the organization pay or accrue any compensation contingent on the revenues of:			
a The organization?	5a		
b Any related organization? If "Yes" to line 5a or 5b, describe in Part III.	5b		
6 For persons listed in Form 990, Part VII, Section A, line 1a, did the organization pay or accrue any compensation contingent on the net earnings of:			
a The organization?	6a		
b Any related organization? If "Yes" to line 6a or 6b, describe in Part III.	6b		
7 For persons listed in Form 990, Part VII, Section A, line 1a, did the organization provide any non-fixed payments not described in lines 5 and 6? If "Yes," describe in Part III	7		
8 Were any amounts reported in Form 990, Part VII, paid or accrued pursuant to a contract that was subject to the initial contract exception described in Regs. section 53.4958-4(a)(3)? If "Yes," describe in Part III	8		
9 If "Yes" to line 8, did the organization also follow the rebuttable presumption procedure described in Regulations section 53.4958-6(c)?	9		

For Privacy Act and Paperwork Reduction Act Notice, see the Instructions for Form 990. Cat. No. 50053T **Schedule J (Form 990) 2009**

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Form 990, Schedule J, Part I

- **First class travel or charter travel?**
- **Travel for companions?**
- **Tax indemnification and gross-up payments?**
- **Discretionary spending account?**
- **Housing allowance or residence for personal use?**
- **Payments for business use of personal residence?**
- **Health or social club dues or initiation fees?**
- **Personal services? (e.g. maid, chauffeur, chef)**
- **WRITTEN POLICY AND SUBSTANTIATION!!**
- **Description on Part III**

Schedule J - Compensation Information More questions about compensation practices

Check the boxes to **indicate how the compensation** for the CEO/Executive Director was established

- compensation committee, independent consultant,
- other Form 990s, written contract, salary survey,
- approval by the board or compensation committee

For those listed in Part VII

- Did you provide **severance** payments or **change of control** payments?
- Did you provide a **nonqualified** retirement plan or an **equity-based compensation** arrangement?

Rebuttable Presumption

- The arrangement was approved by a board of directors or trustees (or a committee of the board) of an applicable tax-exempt organization that was composed entirely of individuals who were unrelated to, and not subject to the control of, the disqualified person or persons involved in the arrangement;
- The board obtained and relied on appropriate data as to comparability; and
- The board adequately documented the basis for its determination (Treas. Reg. §53.4958-6(a)).

SCHEDULE L (Form 990 or 990-EZ)

Department of the Treasury Internal Revenue Service

Transactions With Interested Persons

► Complete if the organization answered "Yes" on Form 990, Part IV, line 25a, 25b, 26, 27, 28a, 28b, or 28c, or Form 990-EZ, Part V, line 38a or 40b.

► Attach to Form 990 or Form 990-EZ. ► See separate instructions.

OMB No. 1545-0047

2009

Open To Public Inspection

Name of the organization | Employer identification number

Part I **Excess Benefit Transactions** (section 501(c)(3) and section 501(c)(4) organizations only).
Complete if the organization answered "Yes" on Form 990, Part IV, line 25a or 25b, or Form 990-EZ, Part V, line 40b.

1 (a) Name of disqualified person	(b) Description of transaction	(c) Corrected? Yes	No

2 Enter the amount of tax imposed on the organization managers or disqualified persons during the year under section 4958 . . . . . ► $

3 Enter the amount of tax, if any, on line 2, above, reimbursed by the organization . . . . . ► $

Part II **Loans to and/or From Interested Persons.**
Complete if the organization answered "Yes" on Form 990, Part IV, line 26, or Form 990-EZ, Part V, line 38a.

(a) Name of interested person and purpose	(b) Loan to or from the organization?		(c) Original principal amount	(d) Balance due	(e) In default?		(f) Approved by board or committee?		(g) Written agreement?	
	To	From			Yes	No	Yes	No	Yes	No
Total . . . . . ► $										

Part III **Grants or Assistance Benefiting Interested Persons.**
Complete if the organization answered "Yes" on Form 990, Part IV, line 27.

(a) Name of interested person	(b) Relationship between interested person and the organization	(c) Amount and type of assistance

Part IV **Business Transactions Involving Interested Persons.**
Complete if the organization answered "Yes" on Form 990, Part IV, line 28a, 28b, or 28c.

(a) Name of interested person	(b) Relationship between interested person and the organization	(c) Amount of transaction	(d) Description of transaction	(e) Sharing of organization's revenues?	
				Yes	No

For Privacy Act and Paperwork Reduction Act Notice, see the Instructions for Form 990 or 990-EZ. Cat. No. 50056A Schedule L (Form 990 or 990-EZ) 2009

Schedule L – Transactions with Interested Persons

Part I, Excess Benefit Transactions (no threshold for reporting).

Part II, Loans to and from Interested Persons (only if outstanding balance at year end).

- **Exceptions to Part II reporting**

Part III, Grants or Assistance Benefitting Interested Persons

Part IV – Business Transactions with Interested Persons (thresholds apply for reporting).

- **What business transactions?**
- **Reasonable effort standard.**
- **Examples (Family employees, Law Firm)**

Family member/Family relationship…

Unless specified otherwise, the family of an individual includes only his or her spouse, ancestors, brothers and sisters (whether whole or half blood), children (whether natural or adopted), grandchildren, great grandchildren, and spouses of brothers, sisters, children, grandchildren, and great grandchildren.

Reasonable effort.

The organization is not required to provide information about a business transaction with an interested person if it is unable to secure the information regarding interested person status after making a reasonable effort to obtain it.

An example of a reasonable effort for Part IV is for the organization to distribute a questionnaire annually to each current or former officer, director, trustee, and key employee listed in Form 990, Part VII, Section A that includes the name, title, date, and signature of each person reporting information and contains the pertinent instructions and definitions for Schedule L, Part III. The organization is not required to distribute such a questionnaire to organizations or individuals with which it does business, but who are not current or former officers, directors, trustees, or key employees of the organization, in order to have made a reasonable effort for this purpose.

“Insider” Reporting Requirements

- **Compile a list of “Insiders”**
- **Review reporting sections of the new Form 990**
- **Construct/re-construct a Conflict of Interest Policy**
- **Create a UNIQUE “Insider” Questionnaire (1-page)**
- **“Administer” the Questionnaire**
- **Follow up on “Yes” answers**

SCHEDULE M
(Form 990)

Department of the Treasury
Internal Revenue Service

Noncash Contributions

► Complete if the organizations answered "Yes" on Form 990, Part IV, lines 29 or 30.
► Attach to Form 990.

OMB No. 1545-0047

2009

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Name of the organization | Employer identification number

Part I Types of Property

	(a) Check if applicable	(b) Number of contributions	(c) Revenues reported on Form 990, Part VIII, line 1g	(d) Method of determining revenues
1 Art—Works of art				
2 Art—Historical treasures				
3 Art—Fractional interests				
4 Books and publications				
5 Clothing and household goods				
6 Cars and other vehicles				
7 Boats and planes				
8 Intellectual property				
9 Securities—Publicly traded				
10 Securities—Closely held stock				
11 Securities—Partnership, LLC, or trust interests				
12 Securities—Miscellaneous				
13 Qualified conservation contribution—Historic structures				
14 Qualified conservation contribution—Other				
15 Real estate—Residential				
16 Real estate—Commercial				
17 Real estate—Other				
18 Collectibles				
19 Food inventory				
20 Drugs and medical supplies				
21 Taxidermy				
22 Historical artifacts				
23 Scientific specimens				
24 Archeological artifacts				
25 Other ► (..................)				
26 Other ► (..................)				
27 Other ► (..................)				
28 Other ► (..................)				

29 Number of Forms 8283 received by the organization during the tax year for contributions for which the organization completed Form 8283, Part IV, Donee Acknowledgement 29

		Yes	No
30a During the year, did the organization receive by contribution any property reported in Part I, lines 1–28 that it must hold for at least three years from the date of the initial contribution, and which is not required to be used for exempt purposes for the entire holding period?	30a		
b If "Yes," describe the arrangement in Part II.			
31 Does the organization have a gift acceptance policy that requires the review of any non-standard contributions?	31		
32a Does the organization hire or use third parties or related organizations to solicit, process, or sell noncash contributions?	32a		
b If "Yes," describe in Part II.			
33 If the organization did not report revenues in column (c) for a type of property for which column (a) is checked, describe in Part II.			

For Privacy Act and Paperwork Reduction Act Notice, see the Instructions for Form 990. Cat. No. 51227J Schedule M (Form 990) 2009

Form 990 (2009) Page 9

Part VIII Statement of Revenue

			(A) Total revenue	(B) Related or exempt function revenue	(C) Unrelated business revenue	(D) Revenue excluded from tax under sections 512, 513, or 514
Contributions, gifts, grants and other similar amounts	1a Federated campaigns . . .	1a				
	b Membership dues	1b				
	c Fundraising events	1c				
	d Related organizations . . .	1d				
	e Government grants (contributions)	1e				
	f All other contributions, gifts, grants, and similar amounts not included above	1f				
	g Noncash contributions included in lines 1a-1f: $					
	h **Total.** Add lines 1a–1f . . . . ►					
Program Service Revenue		Business Code				
	2a					
	b					
	c					
	d					
	e					
	f All other program service revenue					
	g **Total.** Add lines 2a–2f . . . . ►					

IRS CUCP – INTERIM REPORT

Figure 2. Number of Respondents

	Small	Medium	Large	Total
Private Institutions	139	30	8	177
Public Institutions	20	64	83	167
Total	**159** (of 200)	**94** (of 100)	**91** (of 100)	**344** (of 400)

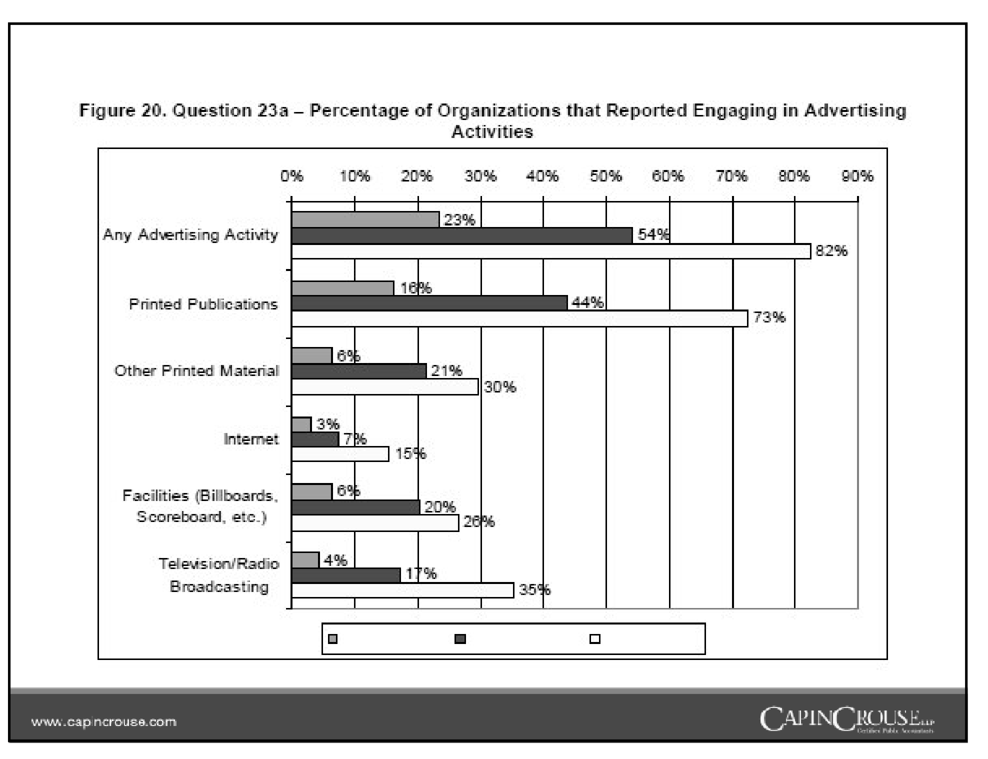
Figure 20. Question 23a – Percentage of Organizations that Reported Engaging in Advertising Activities
0%
10%
20%
30%
40%
50%
60%
70%
80%
90%
Any Advertising Activity
23%
54%
82%
Printed Publications
16%
44%
73%
Other Printed Material
6%
21%
30%
Internet
3%
7%
15%
Facilities (Billboards, Scoreboard, etc.)
6%
20%
26%
Television/Radio Broadcasting
4%
17%
35%
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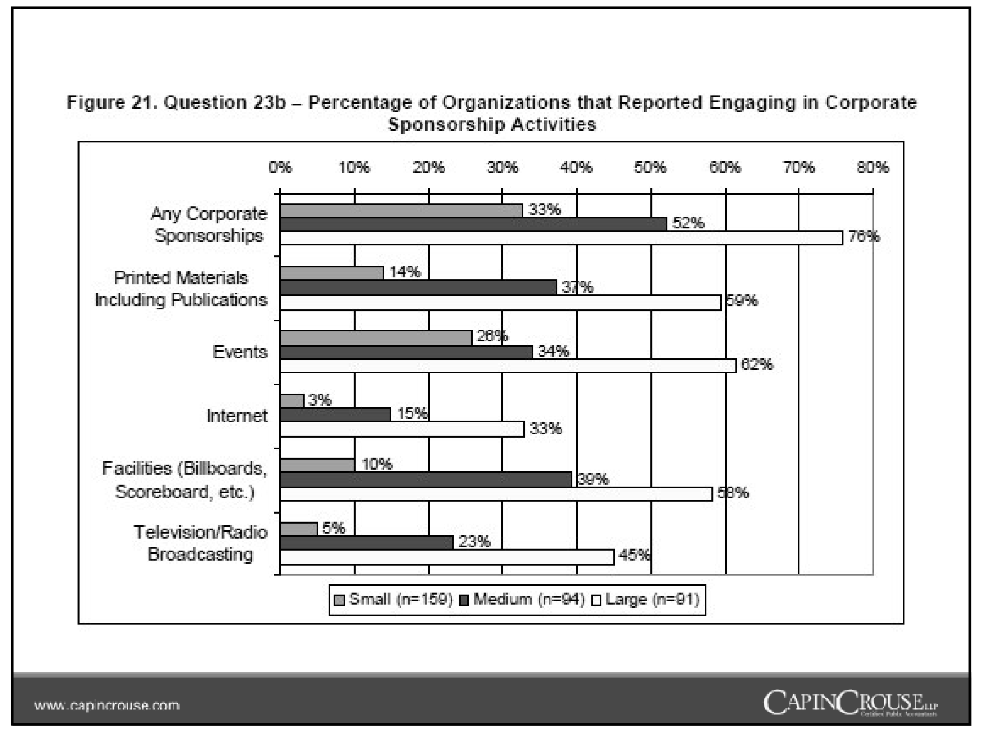
Figure 21. Question 23b – Percentage of Organizations that Reported Engaging in Corporate Sponsorship Activities
0%
10%
20%
30%
40%
50%
60%
70%
80%
Any Corporate Sponsorships
33%
52%
76%
Printed Materials Including Publications
14%
37%
59%
Events
26%
34%
62%
Internet
3%
15%
33%
Facilities (Billboards, Scoreboard, etc.)
10%
39%
58%
Television/Radio Broadcasting
5%
23%
45%
Small (n=159)
Medium (n=94)
Large (n=91)
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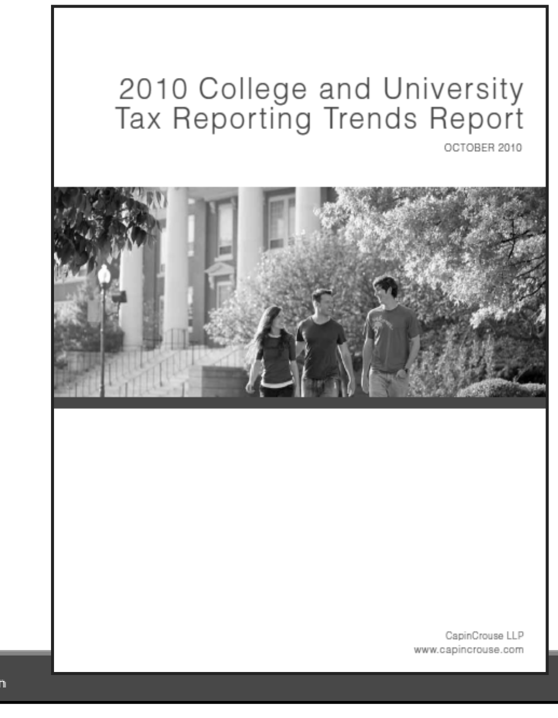
Figure 25. Question 26 – Percentage of Organizations Reporting They Never Filed a Form 990-T[16]

	Small	Medium	Large
Organizations That Reported Never Filed a Form 990-T	48% (n=159)	29% (n=94)	4% (n=91)

	Small (n=159)	
Activity	Percent Reporting Activity	Percent Reporting Activity on Form 990-T
Advertising	23%	6%
Facility Rental	57%	11%
Arena Rental	4%	≤2%
Recreation Center Usage	14%	7%
Athletic Facilities Usage	26%	5%
Personal Property Rental	9%	2%
Telecommunications Related Rental	9%	3%
Catalog Sales	≤3%	≤2%
Internet Sales	6%	2%
Travel Tours	6%	2%
Working Interest in Oil and Gas	2%	3%
Exclusive Use Contracts	6%	≤2%
Commercial Research	3%	2%
Patents	3%	≤2%

Intellectual Property	2%	≤2%
Hotel Operation	3%	3%
Conference Center Operation	6%	6%
Restaurant Operation	2%	2%
Catering Services	19%	7%
Food Services	43%	2%
Credit Card Promotions	≤2%	≤2%
Computer Services	3%	2%
Bartering	≤2%	≤2%
Parking Lots	16%	2%
Power Generation	≤2%	2%
Bookstore	53%	7%
Golf Course	≤2%	≤2%
Partnership Allocations	8%	7%
S-corporation Allocations	0%	≤2%
Income from Controlled Organizations	6%	3%



WEB SURVEY	Responses to Question	Total Survey	Category A Universities	Category B Universities	Category C Universities
What is your current enrollment? (average)	79	1,549	3,167	1,148	271
Does your institution receive income classified as "Corporate Sponsorship" income?	79	26.6%	48.1%	19.2%	11.5%
Has your college filed Form 990-T in the past five years?	79	43.0%	66.7%	42.3%	19.2%
Have you sought the advice of a CPA or attorney about unrelated business income issues?	79	73.4%	85.2%	61.5%	73.1%
Does your college report any bookstore sales on Form 990-T?	79	10.1%	11.1%	11.5%	7.7%
Do you sell apparel adorned with your college logo via the Internet?	79	39.2%	51.9%	46.2%	19.2%
Does your college conduct a web-based "distance learning" program?	79	64.6%	81.5%	61.5%	50.0%
Do you plan to seek the advice of a CPA, attorney, or other professional with regard to the reporting requirements of Health Care Reform?	79	73.4%	92.6%	57.7%	69.2%
FORM 990					
Number of voting members of the governing body	64	24	30	25	15
Number of independent voting members of the governing body	64	23	28	24	14
Percentage of independent voting members of the governing body	64	95.0%	95.8%	94.4%	93.7%
Average number of volunteers (estimate if necessary)	64	235	499	61	35
Did you report gross unrelated business revenue on Form 990?	64	42.9%	53.8%	42.9%	25.0%
Did the institution correctly report the number of independent voting members of the governing body on Form 990, Part VII?	64	39.7%	53.8%	38.1%	18.8%
Does the organization have a written conflict of interest policy?	64	96.8%	100.0%	95.2%	93.8%
Does the organization have a written whistleblower policy?	64	76.2%	92.3%	71.4%	56.3%
Does the organization have a written document retention and destruction policy?	64	76.2%	88.5%	71.4%	62.5%
Average tuition and fees	64	$34,796,350	$65,480,245	$20,723,233	$3,405,986
Average program service expense percentage	64	84.7%	86.1%	79.4%	78.6%
Average management and general expense percentage	64	12.6%	11.3%	17.7%	17.4%
Average fundraising expense percentage	64	2.7%	2.6%	2.9%	4.0%
Average fees for services – accounting and auditing	56	$72,841	$112,080	$66,095	$25,595
Did you report "gaming" revenue?	64	0.0%	0.0%	0.0%	0.0%
Did the institution file Form 990, Schedule L? ("insider" transactions)	64	55.6%	76.9%	47.6%	31.3%
Did the institution file Form 990, Schedule M? (non-cash contributions)	64	52.4%	73.1%	33.3%	43.8%
Does the college/university have a related, separate foundation?	64	41.3%	42.3%	42.9%	37.5%
Average CEO/President compensation	59	$222,774	$314,079	$175,169	$108,255
Average number of "officers" reported on Form 990, Part VII	64	6	7	5	4

2010 DRAFT FORM 990

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2010 Form 990 Draft - Changes

- "Check boxes" for Schedule O reporting
- Part III
- Part V
- Part VI
- Part VII
- Part XI
- Part XII
- Part VII, line numbering
- Part XI, Reconciliation of Net Assets

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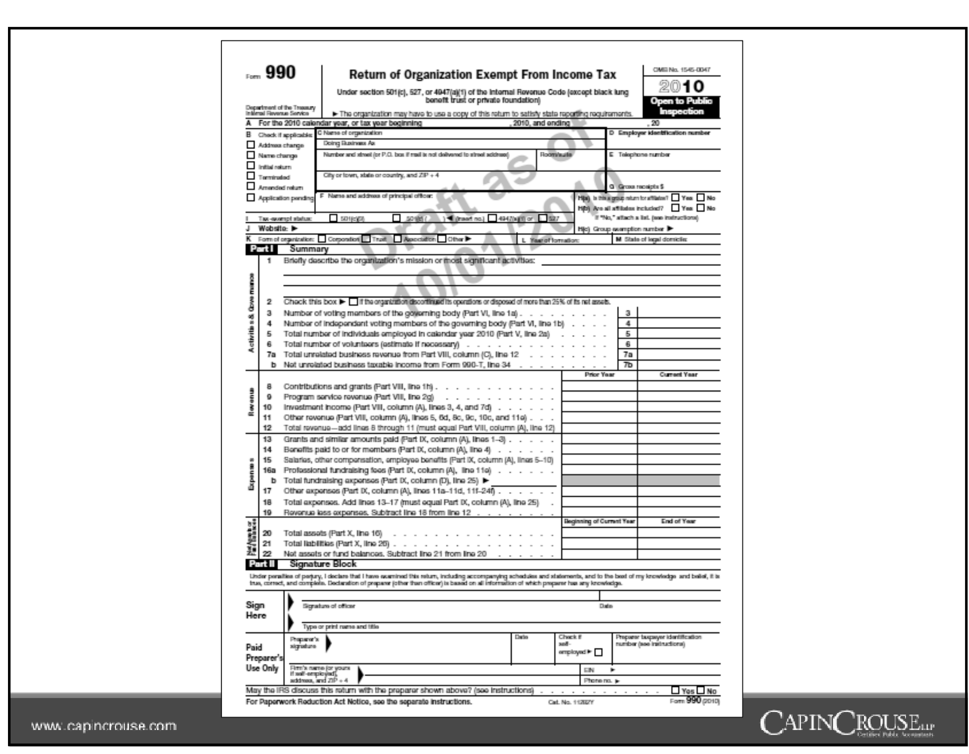

Form **990**

Department of the Treasury
Internal Revenue Service

Return of Organization Exempt From Income Tax

Under section 501(c), 527, or 4947(a)(1) of the Internal Revenue Code (except black lung benefit trust or private foundation)

▶ The organization may have to use a copy of this return to satisfy state reporting requirements.

OMB No. 1545-0047

2010

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A For the 2010 calendar year, or tax year beginning , 2010, and ending , 20

B Check if applicable: ☐ Address change ☐ Name change ☐ Initial return ☐ Terminated ☐ Amended return ☐ Application pending

C Name of organization

Doing Business As

Number and street (or P.O. box if mail is not delivered to street address) | Room/suite

City or town, state or country, and ZIP + 4

D Employer identification number

E Telephone number

G Gross receipts $

F Name and address of principal officer:

H(a) Is this a group return for affiliates? ☐ Yes ☐ No

H(b) Are all affiliates included? ☐ Yes ☐ No
If "No," attach a list. (see instructions)

I Tax-exempt status: ☐ 501(c)(3) ☐ 501(c) ( ) ◀ (insert no.) ☐ 4947(a)(1) or ☐ 527

J Website: ▶

H(c) Group exemption number ▶

K Form of organization: ☐ Corporation ☐ Trust ☐ Association ☐ Other ▶ | L Year of formation: | M State of legal domicile:

Part I Summary

	Line	Description		
Activities & Governance	1	Briefly describe the organization's mission or most significant activities:		
	2	Check this box ▶ ☐ if the organization discontinued its operations or disposed of more than 25% of its net assets.		
	3	Number of voting members of the governing body (Part VI, line 1a)	3	
	4	Number of independent voting members of the governing body (Part VI, line 1b)	4	
	5	Total number of individuals employed in calendar year 2010 (Part V, line 2a)	5	
	6	Total number of volunteers (estimate if necessary)	6	
	7a	Total unrelated business revenue from Part VIII, column (C), line 12	7a	
	b	Net unrelated business taxable income from Form 990-T, line 34	7b	

	Line	Description	Prior Year	Current Year
Revenue	8	Contributions and grants (Part VIII, line 1h)		
	9	Program service revenue (Part VIII, line 2g)		
	10	Investment income (Part VIII, column (A), lines 3, 4, and 7d)		
	11	Other revenue (Part VIII, column (A), lines 5, 6d, 8c, 9c, 10c, and 11e)		
	12	Total revenue—add lines 8 through 11 (must equal Part VIII, column (A), line 12)		
Expenses	13	Grants and similar amounts paid (Part IX, column (A), lines 1–3)		
	14	Benefits paid to or for members (Part IX, column (A), line 4)		
	15	Salaries, other compensation, employee benefits (Part IX, column (A), lines 5–10)		
	16a	Professional fundraising fees (Part IX, column (A), line 11e)		
	b	Total fundraising expenses (Part IX, column (D), line 25) ▶		
	17	Other expenses (Part IX, column (A), lines 11a–11d, 11f–24f)		
	18	Total expenses. Add lines 13–17 (must equal Part IX, column (A), line 25)		
	19	Revenue less expenses. Subtract line 18 from line 12		

	Line	Description	Beginning of Current Year	End of Year
Net Assets or Fund Balances	20	Total assets (Part X, line 16)		
	21	Total liabilities (Part X, line 26)		
	22	Net assets or fund balances. Subtract line 21 from line 20		

Part II Signature Block

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than officer) is based on all information of which preparer has any knowledge.

Sign Here ▶ Signature of officer | Date

▶ Type or print name and title

Paid Preparer's Use Only Preparer's signature ▶ | Date | Check if self-employed ▶ ☐ | Preparer taxpayer identification number (see instructions)

Firm's name (or yours if self-employed), address, and ZIP + 4 ▶ | EIN ▶ | Phone no. ▶

May the IRS discuss this return with the preparer shown above? (see instructions) ☐ Yes ☐ No

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11282Y Form **990** (2010)

Form 990 (2010) Page **2**

Part III **Statement of Program Service Accomplishments**

Check if Schedule O contains a response to any question in this Part III . . . . . ☐

1 Briefly describe the organization's mission:

2 Did the organization undertake any significant program services during the year which were not listed on the prior Form 990 or 990-EZ? . . . ☐ Yes ☐ No

If "Yes," describe these new services on Schedule O.

3 Did the organization cease conducting, or make significant changes in how it conducts, any program services? . . . ☐ Yes ☐ No

If "Yes," describe these changes on Schedule O.

4 Describe the exempt purpose achievements for each of the organization's three largest program services by expenses. Section 501(c)(3) and 501(c)(4) organizations and section 4947(a)(1) trusts are required to report the amount of grants and allocations to others, the total expenses, and revenue, if any, for each program service reported.

4a (Code: ________) (Expenses $ ____________ including grants of $ ____________) (Revenue $ ____________)

4b (Code: ________) (Expenses $ ____________ including grants of $ ____________) (Revenue $ ____________)

4c (Code: ________) (Expenses $ ____________ including grants of $ ____________) (Revenue $ ____________)

4d Other program services. (Describe in Schedule O.)
(Expenses $ including grants of $) (Revenue $)

4e **Total program service expenses ►**

Form **990** (2010)

Draft as of 10/01/2010

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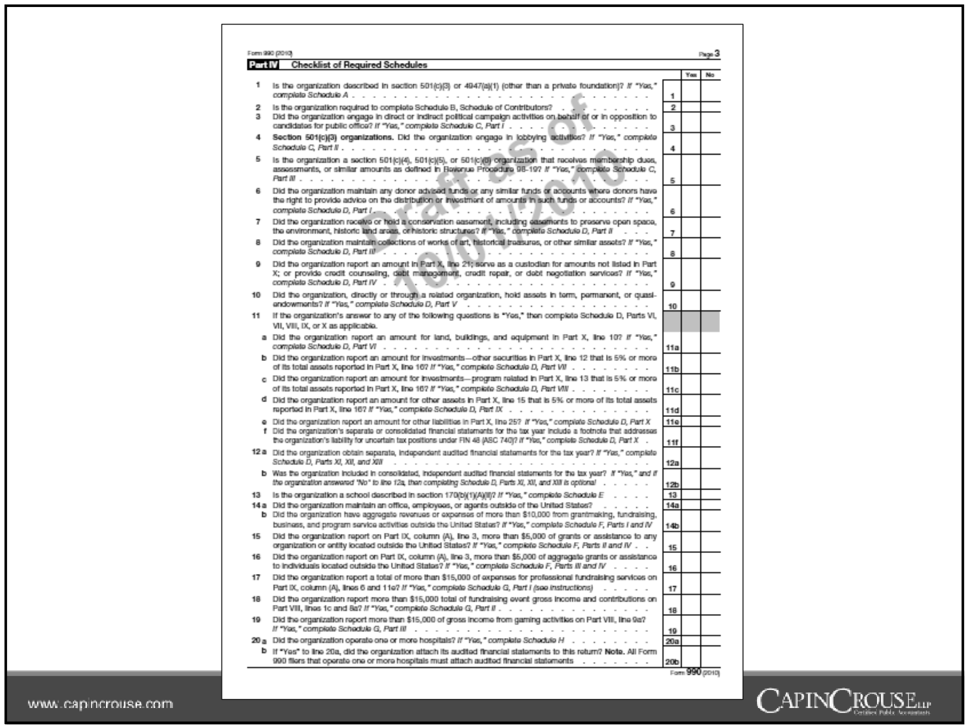

Form 990 (2010) Page **3**

Part IV **Checklist of Required Schedules**

		Line	Yes	No
1	Is the organization described in section 501(c)(3) or 4947(a)(1) (other than a private foundation)? *If "Yes," complete Schedule A*	1		
2	Is the organization required to complete Schedule B, Schedule of Contributors?	2		
3	Did the organization engage in direct or indirect political campaign activities on behalf of or in opposition to candidates for public office? *If "Yes," complete Schedule C, Part I*	3		
4	**Section 501(c)(3) organizations.** Did the organization engage in lobbying activities? *If "Yes," complete Schedule C, Part II*	4		
5	Is the organization a section 501(c)(4), 501(c)(5), or 501(c)(6) organization that receives membership dues, assessments, or similar amounts as defined in Revenue Procedure 98-19? *If "Yes," complete Schedule C, Part III*	5		
6	Did the organization maintain any donor advised funds or any similar funds or accounts where donors have the right to provide advice on the distribution or investment of amounts in such funds or accounts? *If "Yes," complete Schedule D, Part I*	6		
7	Did the organization receive or hold a conservation easement, including easements to preserve open space, the environment, historic land areas, or historic structures? *If "Yes," complete Schedule D, Part II*	7		
8	Did the organization maintain collections of works of art, historical treasures, or other similar assets? *If "Yes," complete Schedule D, Part III*	8		
9	Did the organization report an amount in Part X, line 21; serve as a custodian for amounts not listed in Part X; or provide credit counseling, debt management, credit repair, or debt negotiation services? *If "Yes," complete Schedule D, Part IV*	9		
10	Did the organization, directly or through a related organization, hold assets in term, permanent, or quasi-endowments? *If "Yes," complete Schedule D, Part V*	10		
11	If the organization's answer to any of the following questions is "Yes," then complete Schedule D, Parts VI, VII, VIII, IX, or X as applicable.			
a	Did the organization report an amount for land, buildings, and equipment in Part X, line 10? *If "Yes," complete Schedule D, Part VI*	11a		
b	Did the organization report an amount for investments—other securities in Part X, line 12 that is 5% or more of its total assets reported in Part X, line 16? *If "Yes," complete Schedule D, Part VII*	11b		
c	Did the organization report an amount for investments—program related in Part X, line 13 that is 5% or more of its total assets reported in Part X, line 16? *If "Yes," complete Schedule D, Part VIII*	11c		
d	Did the organization report an amount for other assets in Part X, line 15 that is 5% or more of its total assets reported in Part X, line 16? *If "Yes," complete Schedule D, Part IX*	11d		
e	Did the organization report an amount for other liabilities in Part X, line 25? *If "Yes," complete Schedule D, Part X*	11e		
f	Did the organization's separate or consolidated financial statements for the tax year include a footnote that addresses the organization's liability for uncertain tax positions under FIN 48 (ASC 740)? *If "Yes," complete Schedule D, Part X*	11f		
12 a	Did the organization obtain separate, independent audited financial statements for the tax year? *If "Yes," complete Schedule D, Parts XI, XII, and XIII*	12a		
b	Was the organization included in consolidated, independent audited financial statements for the tax year? *If "Yes," and if the organization answered "No" to line 12a, then completing Schedule D, Parts XI, XII, and XIII is optional*	12b		
13	Is the organization a school described in section 170(b)(1)(A)(ii)? *If "Yes," complete Schedule E*	13		
14 a	Did the organization maintain an office, employees, or agents outside of the United States?	14a		
b	Did the organization have aggregate revenues or expenses of more than $10,000 from grantmaking, fundraising, business, and program service activities outside the United States? *If "Yes," complete Schedule F, Parts I and IV*	14b		
15	Did the organization report on Part IX, column (A), line 3, more than $5,000 of grants or assistance to any organization or entity located outside the United States? *If "Yes," complete Schedule F, Parts II and IV*	15		
16	Did the organization report on Part IX, column (A), line 3, more than $5,000 of aggregate grants or assistance to individuals located outside the United States? *If "Yes," complete Schedule F, Parts III and IV*	16		
17	Did the organization report a total of more than $15,000 of expenses for professional fundraising services on Part IX, column (A), lines 6 and 11e? *If "Yes," complete Schedule G, Part I (see instructions)*	17		
18	Did the organization report more than $15,000 total of fundraising event gross income and contributions on Part VIII, lines 1c and 8a? *If "Yes," complete Schedule G, Part II*	18		
19	Did the organization report more than $15,000 of gross income from gaming activities on Part VIII, line 9a? *If "Yes," complete Schedule G, Part III*	19		
20 a	Did the organization operate one or more hospitals? *If "Yes," complete Schedule H*	20a		
b	If "Yes" to line 20a, did the organization attach its audited financial statements to this return? **Note.** All Form 990 filers that operate one or more hospitals must attach audited financial statements	20b		

Form **990** (2010)

Draft as of 10/01/2010

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Form 990 (2010) Page **4**

Part IV Checklist of Required Schedules *(continued)*

Draft as of 10/01/2010

			Yes	No
21	Did the organization report more than $5,000 of grants and other assistance to governments and organizations in the United States on Part IX, column (A), line 1? *If "Yes," complete Schedule I, Parts I and II*	21		
22	Did the organization report more than $5,000 of grants and other assistance to individuals in the United States on Part IX, column (A), line 2? *If "Yes," complete Schedule I, Parts I and III*	22		
23	Did the organization answer "Yes" to Part VII, Section A, line 3, 4, or 5 about compensation of the organization's current and former officers, directors, trustees, key employees, and highest compensated employees? *If "Yes," complete Schedule J*	23		
24a	Did the organization have a tax-exempt bond issue with an outstanding principal amount of more than $100,000 as of the last day of the year, that was issued after December 31, 2002? *If "Yes," answer lines 24b through 24d and complete Schedule K. If "No," go to line 25*	24a		
b	Did the organization invest any proceeds of tax-exempt bonds beyond a temporary period exception?	24b		
c	Did the organization maintain an escrow account other than a refunding escrow at any time during the year to defease any tax-exempt bonds?	24c		
d	Did the organization act as an "on behalf of" issuer for bonds outstanding at any time during the year?	24d		
25a	**Section 501(c)(3) and 501(c)(4) organizations.** Did the organization engage in an excess benefit transaction with a disqualified person during the year? *If "Yes," complete Schedule L, Part I*	25a		
b	Is the organization aware that it engaged in an excess benefit transaction with a disqualified person in a prior year, and that the transaction has not been reported on any of the organization's prior Forms 990 or 990-EZ? *If "Yes," complete Schedule L, Part I*	25b		
26	Was a loan to or by a current or former officer, director, trustee, key employee, highly compensated employee, or disqualified person outstanding as of the end of the organization's tax year? *If "Yes," complete Schedule L, Part II*	26		
27	Did the organization provide a grant or other assistance to an officer, director, trustee, key employee, substantial contributor, or a grant selection committee member, or to a person related to such an individual? *If "Yes," complete Schedule L, Part III*	27		
28	Was the organization a party to a business transaction with one of the following parties (see Schedule L, Part IV instructions for applicable filing thresholds, conditions, and exceptions):			
a	A current or former officer, director, trustee, or key employee? *If "Yes," complete Schedule L, Part IV*	28a		
b	A family member of a current or former officer, director, trustee, or key employee? *If "Yes," complete Schedule L, Part IV*	28b		
c	An entity of which a current or former officer, director, trustee, or key employee (or a family member thereof) was an officer, director, trustee, or direct or indirect owner? *If "Yes," complete Schedule L, Part IV*	28c		
29	Did the organization receive more than $25,000 in non-cash contributions? *If "Yes," complete Schedule M*	29		
30	Did the organization receive contributions of art, historical treasures, or other similar assets, or qualified conservation contributions? *If "Yes," complete Schedule M*	30		
31	Did the organization liquidate, terminate, or dissolve and cease operations? *If "Yes," complete Schedule N, Part I*	31		
32	Did the organization sell, exchange, dispose of, or transfer more than 25% of its net assets? *If "Yes," complete Schedule N, Part II*	32		
33	Did the organization own 100% of an entity disregarded as separate from the organization under Regulations sections 301.7701-2 and 301.7701-3? *If "Yes," complete Schedule R, Part I*	33		
34	Was the organization related to any tax-exempt or taxable entity? *If "Yes," complete Schedule R, Parts II, III, IV, and V, line 1*	34		
35	Is any related organization a controlled entity within the meaning of section 512(b)(13)?	35		
a	Did the organization receive any payment from or engage in any transaction with a controlled entity within the meaning of section 512(b)(13)? *If "Yes," complete Schedule R, Part V, line 2* ☐ Yes ☐ No			
36	**Section 501(c)(3) organizations.** Did the organization make any transfers to an exempt non-charitable related organization? *If "Yes," complete Schedule R, Part V, line 2*	36		
37	Did the organization conduct more than 5% of its activities through an entity that is not a related organization and that is treated as a partnership for federal income tax purposes? *If "Yes," complete Schedule R, Part VI*	37		
38	Did the organization complete Schedule O and provide explanations in Schedule O for Part VI, lines 11 and 19? **Note.** All Form 990 filers are required to complete Schedule O	38		

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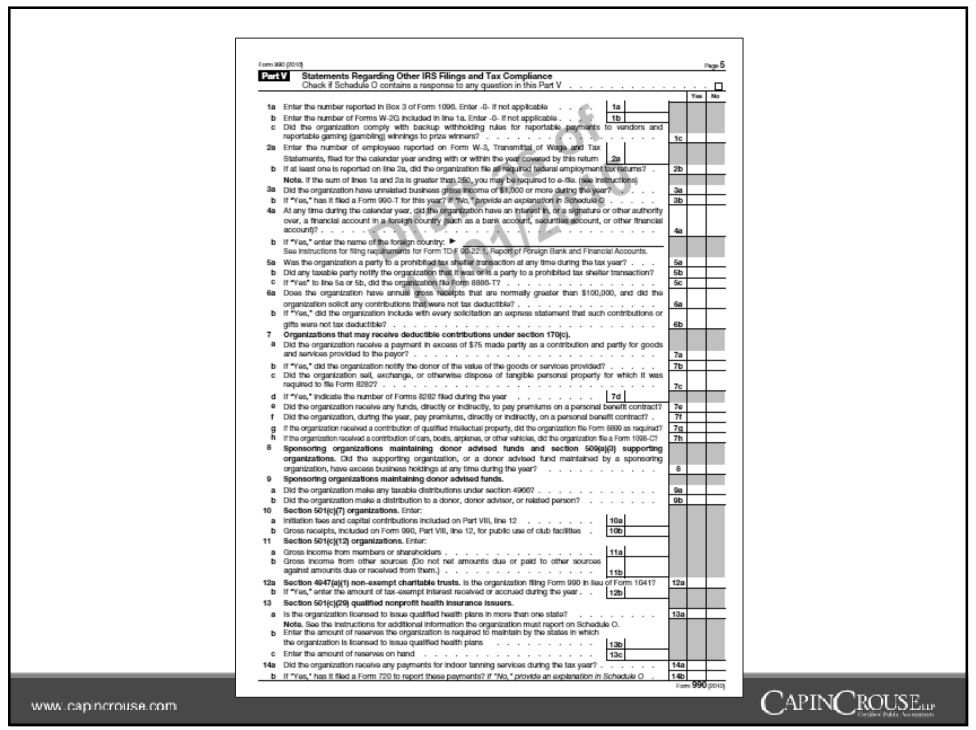

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Part V Statements Regarding Other IRS Filings and Tax Compliance

Check if Schedule O contains a response to any question in this Part V ☐

Draft as of 10/01/2010

				Yes	No
1a	Enter the number reported in Box 3 of Form 1096. Enter -0- if not applicable	1a			
b	Enter the number of Forms W-2G included in line 1a. Enter -0- if not applicable	1b			
c	Did the organization comply with backup withholding rules for reportable payments to vendors and reportable gaming (gambling) winnings to prize winners?		1c		
2a	Enter the number of employees reported on Form W-3, Transmittal of Wage and Tax Statements, filed for the calendar year ending with or within the year covered by this return	2a			
b	If at least one is reported on line 2a, did the organization file all required federal employment tax returns?		2b		
	Note. If the sum of lines 1a and 2a is greater than 250, you may be required to e-file. (see instructions)				
3a	Did the organization have unrelated business gross income of $1,000 or more during the year?		3a		
b	If "Yes," has it filed a Form 990-T for this year? *If "No," provide an explanation in Schedule O*		3b		
4a	At any time during the calendar year, did the organization have an interest in, or a signature or other authority over, a financial account in a foreign country (such as a bank account, securities account, or other financial account)?		4a		
b	If "Yes," enter the name of the foreign country: ▶ See instructions for filing requirements for Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts.				
5a	Was the organization a party to a prohibited tax shelter transaction at any time during the tax year?		5a		
b	Did any taxable party notify the organization that it was or is a party to a prohibited tax shelter transaction?		5b		
c	If "Yes" to line 5a or 5b, did the organization file Form 8886-T?		5c		
6a	Does the organization have annual gross receipts that are normally greater than $100,000, and did the organization solicit any contributions that were not tax deductible?		6a		
b	If "Yes," did the organization include with every solicitation an express statement that such contributions or gifts were not tax deductible?		6b		
7	**Organizations that may receive deductible contributions under section 170(c).**				
a	Did the organization receive a payment in excess of $75 made partly as a contribution and partly for goods and services provided to the payor?		7a		
b	If "Yes," did the organization notify the donor of the value of the goods or services provided?		7b		
c	Did the organization sell, exchange, or otherwise dispose of tangible personal property for which it was required to file Form 8282?		7c		
d	If "Yes," indicate the number of Forms 8282 filed during the year	7d			
e	Did the organization receive any funds, directly or indirectly, to pay premiums on a personal benefit contract?		7e		
f	Did the organization, during the year, pay premiums, directly or indirectly, on a personal benefit contract?		7f		
g	If the organization received a contribution of qualified intellectual property, did the organization file Form 8899 as required?		7g		
h	If the organization received a contribution of cars, boats, airplanes, or other vehicles, did the organization file a Form 1098-C?		7h		
8	**Sponsoring organizations maintaining donor advised funds and section 509(a)(3) supporting organizations.** Did the supporting organization, or a donor advised fund maintained by a sponsoring organization, have excess business holdings at any time during the year?		8		
9	**Sponsoring organizations maintaining donor advised funds.**				
a	Did the organization make any taxable distributions under section 4966?		9a		
b	Did the organization make a distribution to a donor, donor advisor, or related person?		9b		
10	**Section 501(c)(7) organizations.** Enter:				
a	Initiation fees and capital contributions included on Part VIII, line 12	10a			
b	Gross receipts, included on Form 990, Part VIII, line 12, for public use of club facilities	10b			
11	**Section 501(c)(12) organizations.** Enter:				
a	Gross income from members or shareholders	11a			
b	Gross income from other sources (Do not net amounts due or paid to other sources against amounts due or received from them.)	11b			
12a	**Section 4947(a)(1) non-exempt charitable trusts.** Is the organization filing Form 990 in lieu of Form 1041?		12a		
b	If "Yes," enter the amount of tax-exempt interest received or accrued during the year	12b			
13	**Section 501(c)(29) qualified nonprofit health insurance issuers.**				
a	Is the organization licensed to issue qualified health plans in more than one state?		13a		
	Note. See the instructions for additional information the organization must report on Schedule O.				
b	Enter the amount of reserves the organization is required to maintain by the states in which the organization is licensed to issue qualified health plans	13b			
c	Enter the amount of reserves on hand	13c			
14a	Did the organization receive any payments for indoor tanning services during the tax year?		14a		
b	If "Yes," has it filed a Form 720 to report these payments? *If "No," provide an explanation in Schedule O*		14b		

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Part VI **Governance, Management, and Disclosure** *For each "Yes" response to lines 2 through 7b below, and for a "No" response to line 8a, 8b, or 10b below, describe the circumstances, processes, or changes in Schedule O. See instructions.*

Check if Schedule O contains a response to any question in this Part VI . . . . . ☐

Draft as of 10/01/2010

Section A. Governing Body and Management

			Yes	No
1a	Enter the number of voting members of the governing body at the end of the tax year . . . 1a			
b	Enter the number of voting members included in line 1a, above, who are independent . . 1b			
2	Did any officer, director, trustee, or key employee have a family relationship or a business relationship with any other officer, director, trustee, or key employee?	2		
3	Did the organization delegate control over management duties customarily performed by or under the direct supervision of officers, directors or trustees, or key employees to a management company or other person?	3		
4	Did the organization make any significant changes to its governing documents since the prior Form 990 was filed?	4		
5	Did the organization become aware during the year of a significant diversion of the organization's assets?	5		
6	Does the organization have members or stockholders?	6		
7a	Does the organization have members, stockholders, or other persons who may elect one or more members of the governing body?	7a		
b	Are any decisions of the governing body subject to approval by members, stockholders, or other persons?	7b		
8	Did the organization contemporaneously document the meetings held or written actions undertaken during the year by the following:			
a	The governing body?	8a		
b	Each committee with authority to act on behalf of the governing body?	8b		
9	Is there any officer, director, trustee, or key employee listed in Part VII, Section A, who cannot be reached at the organization's mailing address? *If "Yes," provide the names and addresses in Schedule O*	9		

Section B. Policies *(This Section B requests information about policies not required by the Internal Revenue Code.)*

			Yes	No
10a	Does the organization have local chapters, branches, or affiliates?	10a		
b	If "Yes," does the organization have written policies and procedures governing the activities of such chapters, affiliates, and branches to ensure their operations are consistent with those of the organization?	10b		
11a	Has the organization provided a copy of this Form 990 to all members of its governing body before filing the form?	11a		
b	Describe in Schedule O the process, if any, used by the organization to review this Form 990.			
12a	Does the organization have a written conflict of interest policy? *If "No," go to line 13*	12a		
b	Are officers, directors or trustees, and key employees required to disclose annually interests that could give rise to conflicts?	12b		
c	Does the organization regularly and consistently monitor and enforce compliance with the policy? *If "Yes," describe in Schedule O how this is done*	12c		
13	Does the organization have a written whistleblower policy?	13		
14	Does the organization have a written document retention and destruction policy?	14		
15	Did the process for determining compensation of the following persons include a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision?			
a	The organization's CEO, Executive Director, or top management official	15a		
b	Other officers or key employees of the organization If "Yes" to line 15a or 15b, describe the process in Schedule O. (See instructions.)	15b		
16a	Did the organization invest in, contribute assets to, or participate in a joint venture or similar arrangement with a taxable entity during the year?	16a		
b	If "Yes," has the organization adopted a written policy or procedure requiring the organization to evaluate its participation in joint venture arrangements under applicable federal tax law, and taken steps to safeguard the organization's exempt status with respect to such arrangements?	16b		

Section C. Disclosure

17 List the states with which a copy of this Form 990 is required to be filed ▶

18 Section 6104 requires an organization to make its Forms 1023 (or 1024 if applicable), 990, and 990-T (501(c)(3)s only) available for public inspection. Indicate how you make these available. Check all that apply.

☐ Own website ☐ Another's website ☐ Upon request

19 Describe in Schedule O whether (and if so, how), the organization makes its governing documents, conflict of interest policy, and financial statements available to the public.

20 State the name, physical address, and telephone number of the person who possesses the books and records of the organization: ▶

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Part VII **Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees, and Independent Contractors**

Check if Schedule O contains a response to any question in this Part VII . . . . . ☐

Draft as of 10/01/2010

Section A. Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees

1a Complete this table for all persons required to be listed. Report compensation for the calendar year ending with or within the organization's tax year.

- List all of the organization's **current** officers, directors, trustees (whether individuals or organizations), regardless of amount of compensation. Enter -0- in columns (D), (E), and (F) if no compensation was paid.
- List all of the organization's **current** key employees, if any. See instructions for definition of "key employee."
- List the organization's five **current** highest compensated employees (other than an officer, director, trustee, or key employee) who received reportable compensation (Box 5 of Form W-2 and/or Box 7 of Form 1099-MISC) of more than $100,000 from the organization and any related organizations.
- List all of the organization's **former** officers, key employees, and highest compensated employees who received more than $100,000 of reportable compensation from the organization and any related organizations.
- List all of the organization's **former directors or trustees** that received, in the capacity as a former director or trustee of the organization, more than $10,000 of reportable compensation from the organization and any related organizations.

List persons in the following order: individual trustees or directors; institutional trustees; officers; key employees; highest compensated employees; and former such persons.

☐ Check this box if neither the organization nor any related organizations compensated any current officer, director, or trustee.

(A) Name and Title	(B) Average hours per week (describe hours for related organizations in Schedule O)	(C) Position (check all that apply): Individual trustee or director	Institutional trustee	Officer	Key employee	Highest compensated employee	Former	(D) Reportable compensation from the organization (W-2/1099-MISC)	(E) Reportable compensation from related organizations (W-2/1099-MISC)	(F) Estimated amount of other compensation from the organization and related organizations
(1)										
(2)										
(3)										
(4)										
(5)										
(6)										
(7)										
(8)										
(9)										
(10)										
(11)										
(12)										
(13)										
(14)										
(15)										
(16)										

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Part VII **Section A. Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees** *(continued)*

Draft as of 10/01/2010

(A) Name and title	(B) Average hours per week (describe hours for related organizations in Schedule O)	(C) Position (check all that apply): Individual trustee or director	Institutional trustee	Officer	Key employee	Highest compensated employee	Former	(D) Reportable compensation from the organization (W-2/1099-MISC)	(E) Reportable compensation from related organizations (W-2/1099-MISC)	(F) Estimated amount of other compensation from the organization and related organizations
(17)										
(18)										
(19)										
(20)										
(21)										
(22)										
(23)										
(24)										
(25)										
(26)										
(27)										
(28)										
1b **Sub-total** . . . ▶										
c **Total from continuation sheets to Part VII, Section A** . . . ▶										
d **Total (add lines 1b and 1c)** . . . ▶										

2 Total number of individuals (including but not limited to those listed above) who received more than $100,000 in reportable compensation from the organization ▶

		Yes	No
3 Did the organization list any **former** officer, director or trustee, key employee, or highest compensated employee on line 1a? *If "Yes," complete Schedule J for such individual*	3		
4 For any individual listed on line 1a, is the sum of reportable compensation and other compensation from the organization and related organizations greater than $150,000? *If "Yes," complete Schedule J for such individual*	4		
5 Did any person listed on line 1a receive or accrue compensation from any unrelated organization or individual for services rendered to the organization? *If "Yes," complete Schedule J for such person*	5		

Section B. Independent Contractors

1 Complete this table for your five highest compensated independent contractors that received more than $100,000 of compensation from the organization.

(A) Name and business address	(B) Description of services	(C) Compensation

2 Total number of independent contractors (including but not limited to those listed above) who received more than $100,000 in compensation from the organization ▶

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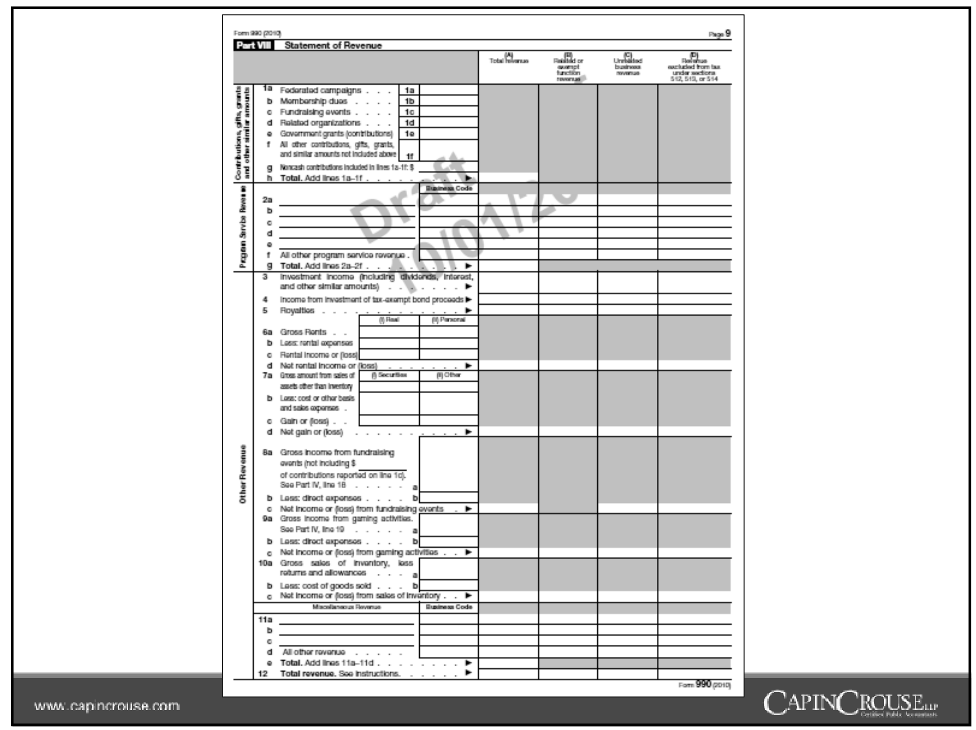

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Part VIII **Statement of Revenue**

Draft as of 10/01/20

			(A) Total revenue	(B) Related or exempt function revenue	(C) Unrelated business revenue	(D) Revenue excluded from tax under sections 512, 513, or 514
Contributions, gifts, grants and other similar amounts	1a Federated campaigns . . .	1a				
	b Membership dues	1b				
	c Fundraising events	1c				
	d Related organizations . . .	1d				
	e Government grants (contributions)	1e				
	f All other contributions, gifts, grants, and similar amounts not included above	1f				
	g Noncash contributions included in lines 1a-1f: $					
	h **Total.** Add lines 1a–1f . . . ▶					
Program Service Revenue		Business Code				
	2a					
	b					
	c					
	d					
	e					
	f All other program service revenue .					
	g **Total.** Add lines 2a–2f . . . ▶					
Other Revenue	3 Investment income (including dividends, interest, and other similar amounts) . . . ▶					
	4 Income from investment of tax-exempt bond proceeds ▶					
	5 Royalties . . . ▶					
		(i) Real / (ii) Personal				
	6a Gross Rents . .					
	b Less: rental expenses					
	c Rental income or (loss)					
	d Net rental income or (loss) . . . ▶					
	7a Gross amount from sales of assets other than inventory	(i) Securities / (ii) Other				
	b Less: cost or other basis and sales expenses .					
	c Gain or (loss) . .					
	d Net gain or (loss) . . . ▶					
	8a Gross income from fundraising events (not including $ ____ of contributions reported on line 1c). See Part IV, line 18 . . . a					
	b Less: direct expenses . . . . b					
	c Net income or (loss) from fundraising events . . ▶					
	9a Gross income from gaming activities. See Part IV, line 19 . . . a					
	b Less: direct expenses . . . . b					
	c Net income or (loss) from gaming activities . . ▶					
	10a Gross sales of inventory, less returns and allowances . . . a					
	b Less: cost of goods sold . . . b					
	c Net income or (loss) from sales of inventory . . ▶					
	Miscellaneous Revenue	Business Code				
	11a					
	b					
	c					
	d All other revenue . . .					
	e **Total.** Add lines 11a–11d . . . ▶					
	12 **Total revenue.** See instructions. . . . ▶					

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Part IX Statement of Functional Expenses

Section 501(c)(3) and 501(c)(4) organizations must complete all columns.
All other organizations must complete column (A) but are not required to complete columns (B), (C), and (D).

Do not include amounts reported on lines 6b, 7b, 8b, 9b, and 10b of Part VIII.	(A) Total expenses	(B) Program service expenses	(C) Management and general expenses	(D) Fundraising expenses
1 Grants and other assistance to governments and organizations in the U.S. See Part IV, line 21				
2 Grants and other assistance to individuals in the U.S. See Part IV, line 22				
3 Grants and other assistance to governments, organizations, and individuals outside the U.S. See Part IV, lines 15 and 16				
4 Benefits paid to or for members				
5 Compensation of current officers, directors, trustees, and key employees				
6 Compensation not included above, to disqualified persons (as defined under section 4958(f)(1)) and persons described in section 4958(c)(3)(B)				
7 Other salaries and wages				
8 Pension plan contributions (include section 401(k) and section 403(b) employer contributions)				
9 Other employee benefits				
10 Payroll taxes				
11 Fees for services (non-employees):				
a Management				
b Legal				
c Accounting				
d Lobbying				
e Professional fundraising services. See Part IV, line 17				
f Investment management fees				
g Other				
12 Advertising and promotion				
13 Office expenses				
14 Information technology				
15 Royalties				
16 Occupancy				
17 Travel				
18 Payments of travel or entertainment expenses for any federal, state, or local public officials				
19 Conferences, conventions, and meetings				
20 Interest				
21 Payments to affiliates				
22 Depreciation, depletion, and amortization				
23 Insurance				
24 Other expenses. Itemize expenses not covered above (List miscellaneous expenses in line 24f. If line 24f amount exceeds 10% of line 25, column (A) amount, list line 24f expenses on Schedule O.)				
a				
b				
c				
d				
e				
f All other expenses				
25 **Total functional expenses.** Add lines 1 through 24f				
26 **Joint costs.** Check here ▶ ☐ if following SOP 98-2 (ASC 958-720). Complete this line only if the organization reported in column (B) joint costs from a combined educational campaign and fundraising solicitation				

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Part X Balance Sheet

		(A) Beginning of year		(B) End of year
Assets	1 Cash—non-interest-bearing		1	
	2 Savings and temporary cash investments		2	
	3 Pledges and grants receivable, net		3	
	4 Accounts receivable, net		4	
	5 Receivables from current and former officers, directors, trustees, key employees, and highest compensated employees. Complete Part II of Schedule L		5	
	6 Receivables from other disqualified persons (as defined under section 4958(f)(1)), persons described in section 4958(c)(3)(B), and persons described in section 4976(a) (see instructions)		6	
	7 Notes and loans receivable, net		7	
	8 Inventories for sale or use		8	
	9 Prepaid expenses and deferred charges		9	
	10a Land, buildings, and equipment: cost or other basis. Complete Part VI of Schedule D — 10a			
	b Less: accumulated depreciation — 10b		10c	
	11 Investments—publicly traded securities		11	
	12 Investments—other securities. See Part IV, line 11		12	
	13 Investments—program-related. See Part IV, line 11		13	
	14 Intangible assets		14	
	15 Other assets. See Part IV, line 11		15	
	16 **Total assets.** Add lines 1 through 15 (must equal line 34)		16	
Liabilities	17 Accounts payable and accrued expenses		17	
	18 Grants payable		18	
	19 Deferred revenue		19	
	20 Tax-exempt bond liabilities		20	
	21 Escrow or custodial account liability. Complete Part IV of Schedule D		21	
	22 Payables to current and former officers, directors, trustees, key employees, highest compensated employees, and disqualified persons. Complete Part II of Schedule L		22	
	23 Secured mortgages and notes payable to unrelated third parties		23	
	24 Unsecured notes and loans payable to unrelated third parties		24	
	25 Other liabilities. Complete Part X of Schedule D		25	
	26 **Total liabilities.** Add lines 17 through 25		26	
Net Assets or Fund Balances	**Organizations that follow SFAS 117, check here ▶ ☐ and complete lines 27 through 29, and lines 33 and 34.**			
	27 Unrestricted net assets		27	
	28 Temporarily restricted net assets		28	
	29 Permanently restricted net assets		29	
	Organizations that do not follow SFAS 117, check here ▶ ☐ and complete lines 30 through 34.			
	30 Capital stock or trust principal, or current funds		30	
	31 Paid-in or capital surplus, or land, building, or equipment fund		31	
	32 Retained earnings, endowment, accumulated income, or other funds		32	
	33 Total net assets or fund balances		33	
	34 Total liabilities and net assets/fund balances		34	

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Part XI **Reconciliation of Net Assets**

Check if Schedule O contains a response to any question in this Part XI . . . . ☐

1	Total revenue (must equal Part VIII, column (A), line 12)	1	
2	Total expenses (must equal Part IX, column (A), line 25)	2	
3	Revenue less expenses. Subtract line 2 from line 1	3	
4	Net assets or fund balances at beginning of year (must equal Part X, line 33, column (A)) . . .	4	
5	Other changes in net assets or fund balances (explain in Schedule O)	5	
6	Net assets or fund balances at end of year. Combine lines 3, 4, and 5 (must equal Part X, line 33, column (B))	6	

Part XII **Financial Statements and Reporting**

Check if Schedule O contains a response to any question in this Part XII . . . . ☐

			Yes	No
1	Accounting method used to prepare the Form 990: ☐ Cash ☐ Accrual ☐ Other ______ If the organization changed its method of accounting from a prior year or checked "Other," explain in Schedule O.			
2a	Were the organization's financial statements compiled or reviewed by an independent accountant? . . .	2a		
b	Were the organization's financial statements audited by an independent accountant?	2b		
c	If "Yes" to line 2a or 2b, does the organization have a committee that assumes responsibility for oversight of the audit, review, or compilation of its financial statements and selection of an independent accountant? If the organization changed either its oversight process or selection process during the tax year, explain in Schedule O.	2c		
d	If "Yes" to line 2a or 2b, check a box below to indicate whether the financial statements for the year were issued on a separate basis, consolidated basis, or both: ☐ Separate basis ☐ Consolidated basis ☐ Both consolidated and separate basis			
3a	As a result of a federal award, was the organization required to undergo an audit or audits as set forth in the Single Audit Act and OMB Circular A-133?	3a		
b	If "Yes," did the organization undergo the required audit or audits? If the organization did not undergo the required audit or audits, explain why in Schedule O and describe any steps taken to undergo such audits	3b		

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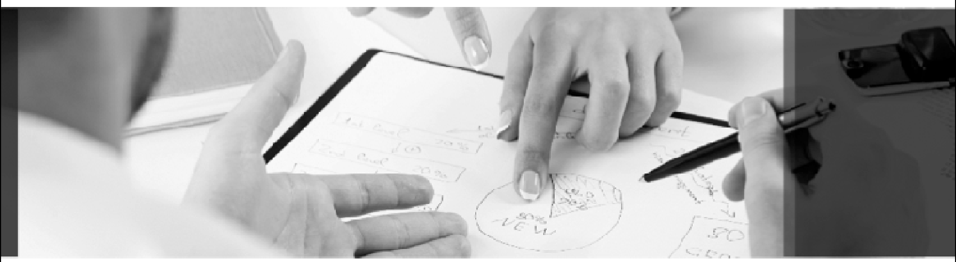
THANKS!

For your time and attention.



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Tax Planning for Millionaires

Alan D. Campbell, PhD, CPA, CMA, CFP®

Alan D. Campbell, PhD, CPA, CMA, CFP®

Associate Professor of Accounting
Troy University

Dr. Alan D. Campbell is a native of Paragould, Arkansas. He now lives in Deatsville, Alabama. He serves as an associate professor of accounting for the Montgomery campus of Troy University. In addition, he is self-employed as a writer and tax consultant.

He earned a Bachelor of Science degree with a major in accounting in 1978 and a master of business administration degree in 1982, both from Arkansas State University. He earned a Ph.D. in accounting from the University of North Texas in 1988. He is a certified public accountant in Arkansas and Florida, a certified management accountant, and a certified financial planner licensee. In addition, he is admitted to practice before the United States Tax Court.

Dr. Campbell served as the revision editor of the 13th, 14th, and 15th editions of the *CCH Financial and Estate Planning Guide.* He is a co-author of the books *Tax Strategies for the Self-Employed* and *Federal Tax Course 2008*, both of which are published by CCH Incorporated. Dr. Campbell has also published numerous articles in various professional and academic journals including *Trusts & Estates*, *The Tax Adviser*, *Taxes—The Tax Magazine*, *Taxation for Accountants*, *Tax Notes*, *Accounting Historians Journal*, *Journal of Petroleum Accounting*, and *The CPA Journal*.

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MEMBERS ADD UP!

Refer a FRIEND to the FICPA and earn a chance to WIN

Members Add Up is a fun and easy way for you to share the benefits of FICPA membership with your friends and colleagues. Just refer one new member and receive a chance to win a grand prize valued at $2,500!

Reach out to that new person in the office, or encourage a long-time colleague to finally join... just do it before June 30, 2009 for a chance to win! Each member you refer will put your name in the hat for chances for the grand prize, so start today!

How Does It Work?

It's easy. Any FICPA member can participate in **Members Add Up**. Simply recruit a colleague to join the FICPA, and when he/she processes a new member application with your name as a referral, we'll credit you with points toward the grand prize. The more points you have, the greater your chances for winning the grand prize. Go to www.ficpa.org for more details about the program or to download a member application.

Why Should You Participate?

It's simple. The more members the FICPA has, the stronger our voice is in the Legislature, where we work hard to promote and protect the CPA designation that is so valuable to you. We need the support of every CPA in Florida to make our message known, and you can help!

It's fun. The Chapter that has the highest percentage of participation will win funds towards a Chapter event, so joining in today could really pay off!

It's easy. Just make sure that anyone you refer puts your name on their application and we will take care of the rest.

START ADDING UP THOSE MEMBERS TODAY!

(850) 224-CPAS (2727) • (800) 342-3197 (within Florida only) • www.ficpa.org

Visit **www.ficpa.org** and take advantage of your membership benefits, or contact the Member Service Center (MSC) at (800) 342-3197 (within Florida only) or (850) 224-2727, or e-mail **membership@ficpa.org**.

NOT SURE WHERE TO START?

Remember these benefits when talking to a friend about the FICPA.

1. Networking with other CPA professionals

FICPA provides many opportunities to meet peers and share ideas and best practices.

2. Leadership development

Joining a committee is a great way to influence the future of the FICPA, as well as gain leadership skills that will boost your resume. The FICPA will help you become a better-rounded professional!

3. Continuing Professional Education

We are absolutely committed to providing the highest-quality CPE available in Florida. Stay current with advances in technology, best practices, and timely updates on accounting issues—and save money as a member, too!

4. Join a Section

See how others are handling the same challenges you face by just logging on to the Internet. Professional interest Sections provide members the opportunity to ask questions and get advice from colleagues around the state. Each Section has a private members-only Listserv where members share and communicate ideas with each other any time of the day.

5. Stay informed

Information is power. As a member you will receive *Florida CPA Today* magazine and a bi-weekly "Newsflash" electronic newsletter to keep you up to date on industry trends and news.

6. Give back to your profession

The FICPA helps to sustain the future of the profession through legislative advocacy and its Educational Foundation, which provides scholarships to accounting students.

7. Safeguard YOUR profession

You worked hard to become a CPA, and we work hard to make sure that designation means something. The FICPA represents Florida's accounting professionals before the state Legislature to protect the CPA license. When you support the FICPA, you support your professional future.

START ADDING UP THOSE MEMBERS TODAY!

(PLACE ON YOUR COMPANY'S LETTERHEAD)

Attention: Business Editor

For Immediate Release

Contact: (CONTACT NAME)
(CONTACT'S TITLE)
(FIRM NAME)
Phone ____________________
E-Mail ____________________
(WEB ADDRESS, IF APPLICABLE)

(MEMBER'S NAME), CPA, Completes course on (SUBJECT AREA)

(MEMBER'S CITY), (DATE), 2008 -- _______(MEMBER'S FULL NAME)____________, CPA, of _____(FIRM NAME)______ in ________(CITY)______________________, completed a course, "________(COURSE TITLE)______," on ____(DATE)____. This continuing-education course covered the topic of_____________________(SUBJECT AREA)_____________________.

___(MEMBER'S LAST NAME)_________ is a ______(POSITION TITLE)___________ practicing in the area of (MEMBER'S AREA OF PRACTICE – TAS, AUDIT, ETC.) with the firm.

In addition to (MEMBER'S LAST NAME)'S professional responsibilities, HE/SHE is also active in (LIST ANY OTHER PROFESSIONAL/CIVIC/ VOLUNTEER/COMMUNITY ACTIVIES – OPTIONAL). HE/SHE is an active member of the Florida Institute of Certified Public Accountants, the professional association representing the interests of more then 18,400 CPAs with over 4,400 offices throughout Florida.

(MEMBER NAME) can be reached by telephone at _____(PHONE NUMBER)____, or via e-mail at _______(E-MAIL ADDRESS)_______.

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