EXIT STRATEGIES IN ESTATE PLANNING
(And Pertinent Tax Issues Related Thereto)

by Robin Klomparens & Douglas L. Youmans

I. EXIT STRATEGIES.

A. Sale of Stock or Assets.

1. Stock. A stock sale is simpler than an asset sale, and will result in one level of tax to the selling shareholders of a C-corporation. With an S-corporation that does not have C-corporation earnings and profits, or in the case of an unincorporated business treated as a partnership for federal income tax purposes, the tax consequences are the same regardless of whether interests in the entity or the assets are sold. However, purchasers are more interested in buying assets than stock or the ownership interests of an unincorporated business because of potential contingent liabilities that would remain with the business.

2. Assets. Selling a company's assets generally results in two levels of tax if the business is a C-corporation. In contrast, if the business is in an S-corporation, a partnership, or a limited liability company ("LLC") treated as a partnership for tax purposes, there will be only one level of tax on the unrealized appreciation.

B. Tax-Deferred Reorganizations.

In some cases, it may be possible to engage in a tax-deferred reorganization. One possibility is to divide a business in a tax-free division (See IRC §355). This may be useful when there are sibling rivalries but the siblings are interested in participating in the business.

Dividing a business into two or more separate entities may allow the founder to pass ownership in a particular business to children interested in participating in that business. At the end of the day, the children interested in a particular business would not have ownership interests in the other businesses, thereby minimizing potential conflicts.

C. Sale to an ESOP.

In certain circumstances, a sale to an ESOP may carry out the income tax objectives of the founder, particularly where a benefit of the tax-free rollover of the sale proceeds is possible. However, the family must be willing to have a "non-family member" shareholder -- the ESOP. The benefits of an ESOP are illustrated in Appendix A, Example 6.

D. Sale to Key Employees.

Selling the owner's interest to key employees may be appropriate when there are no family members who are interested in or capable of taking over the management. This strategy will only work if the key employees are able financially to buy the business.

E. Sale to Family Members.

A sale to family members will usually incur taxable gain, which may not be palatable to the current owners. However, a sale may be a way to treat children equally when not all of them are active in the business. In this regard, a sale to a grantor trust in which the active family members are beneficiaries of the trust would avoid recognizing gain upon the sale (but the beneficiaries would receive a carryover basis). The sale to a grantor trust technique is illustrated in Appendix A, Example 7.

F. Bequest.

Possibly the simplest way to dispose of the business is to leave the ownership to one or more family members. Here, the issues here will be (i) payment of the estate tax with respect to the business interest if not all of the decedent's children are receiving interests, and (ii) treating the "other" children fairly.

II. 706 ISSUES.

A. Valuation.

As a result of the dual tax structure of the corporate income tax, there can be estate tax valuation issues where a (closely-held) corporation owns significantly appreciated assets. Because no step-up is afforded for the corporation's ("inside") basis, valuing interests in the corporation solely by reference to the value of its assets, without giving effect to future capital gains tax on the built-in gain ("BIG Tax"), arguably overinflates the value of the corporation, increasing the estate tax payable. Most frequently, this is seen in the context of a closely held corporation which owns stock or other capital assets (a "holding company") where the corporation's value is premised on asset value (which lends itself to application of a discount for the contingent BIG Tax liability).

1. BIG Tax Discounts. Since the statutory repeal of the *General Utilities* doctrine, this issue has arisen several times. While it seems generally accepted that the BIG Tax discount is warranted, the calculation of the discount remains unresolved:

a. *Eisenberg v. Comm'r*, 155 F.3d 50, 98-2 USTC ¶60,322 (2d Cir. 1998). In this case, the corporation owned only improved realty. The 2d Circuit concluded that, although no liquidation of the corporation was planned at the time of the gift of corporate stock, the Tax Court should have allowed the taxpayer a valuation adjustment for her stock to account for the corporation's potential income tax liability relating to its appreciated real estate holdings.

b. *Estate of Jameson v. Comm'r*, 267 F.3d 366 (5th Cir. 2001). At issue in this case was not the applicability of the BIG Tax discount, but the magnitude of the discount. The IRS essentially argued that the discount itself should be discounted to present value, premised on the notion that the corporation would recognize gains continuously in the future, rather than immediately pursuant to a liquidation of its assets. Finding that, because the expected rate of return was too low for the ongoing production of timber, a buyer would prefer liquidating the investment, the 5th Circuit held that discounting the discount was inappropriate. Accordingly, the Court held that the full amount of the BIG Tax would be allowed as a discount from the value of the corporation.

c. *Estate of Jelke [III] v. Comm'r*, 507 F.3d 1317, 2007-2 USTC ¶60,552 (11th Cir. 2007). The estate held a 6.44 percent interest in Commercial Chemical Co. ("CCC"), a closely held investment holding company. The IRS issued the estate a notice of deficiency based on its determination that the interest in CCC had been undervalued. The estate challenged the deficiency notice in Tax Court, arguing that the IRS used an incorrect net asset value for CCC. The Tax Court computed the net asset value of CCC for purposes of determining the value of the estate's interest using a method set forth by the IRS expert.

The 11th Circuit rejected the valuation used by the Tax Court, finding the valuation theory advocated by the estate to be the better method. The method argued for by the estate was set forth by the 5th Circuit in *Estate of Dunn v. Commissioner* 301 F.3d 339 (5th Cir. 2002), which involved a 100%, dollar-for-dollar discount for CCC's contingent $51 million capital gains tax liability. The theory assumed the company would be liquidated on the date of Jelke's death with no restrictions on liquidation. The court noted that the method provides "practical certainty to tax practitioners, appraisers, and financial planners alike." The case was remanded to the Tax Court for a recalculation of the net asset value of CCC based on the circuit court's opinion.

2. S-Corporations. Whether this discount would/should apply to an S-corporation has not been addressed. Conceptually, a buyer would be just as concerned with the BIG Tax in an S-corporation as in a C-corporation (as there is no inside basis step-up for an S-corporation's basis in its assets (as there is in a partnership), any future sale or liquidation of those assets is going to trigger tax to the shareholders). That the tax will be imposed directly on the shareholder rather than separately at the corporate level should not be determinative given the fact that the issue is really the value of the corporation (assets and liabilities), not how those tax liabilities are ultimately imposed.

B. Deductions – "New Proposed Regs Under Section 20.2053-4.

1. Background. IRC §2053(a)(3) states, in relevant part, that, "[f]or purposes of [the federal estate tax], the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts . . .for claims against the estate . . .as are allowable by the law of the jurisdiction . . .under which the estate is being administered."[1]

Interestingly, while §2053(a)(3) is silent as whether and, to what extent, if any, post-death events

should be considered for purposes of determining the validity and/or value of claims against an estate, the Treasury regulations under that section, which have not been amended since 1958, provide guidance. Treasury Reg. §20.2053-4 states, in relevant part, that "[t]he amounts that may be deducted as claims against a decedent's estate are such only as represent personal obligations of the decedent *existing at the time of his death, whether or not then matured* . . ."[2]

Over the years, 2 lines of case law have developed with respect to the analysis of whether and to what extent, if any, post-death events should be considered in determining the validity and/or value of claims under §2053. One line of cases, following *Jacobs v. Commissioner*,[3] concludes that post death events are relevant and only amounts actually paid are deductible. The other, better reasoned, more widely accepted line[4] follows the Supreme Court's opinion in *Ithaca Trust Co. v. U.S.*,[5] which concludes that post death events are irrelevant and deductions under §2053 should be based on the value of the pertinent claims at the date of death, rather than being based on those amounts which actually happen to have been paid before the estate tax return (or a claim for refund with respect thereto) is filed.

a. Summary of Proposed Regulations. On April 23, 2007, the IRS issued proposed regulations amending the existing regulations under Treasury Reg. §20.2053.[6] Part of the IRS' explanation of why, after 50 years, they felt compelled to amend the regulations under §2053, states the proposed regulations were enacted, "[t]o clarify that events occurring after a decedent's death are to be considered when determining the amount deductible under all provisions of §2053; that deductions under §2053 are limited to amounts actually paid by the estate in satisfaction of deductible expenses and claims" and if a claim is "potential, unmatured or contested at the time that the return is filed," the executor may not claim a deduction.[7] Rather, the personal representative must wait until the eve of the expiration of the statute of limitations to make a protective refund, explaining the reasons delaying payment. The IRS will then act when notified that the contingency has been resolved and the claim has been paid.

Thus, the proposed regulations are clearly adopting a "bright line" test that, if no payment is made, no deduction is allowed. Unfortunately, among the problems associated with making claims deductible only when paid is the statute of limitations. If the claim remains unresolved when the statute of limitations is due to expire, the executor may, under the proposed regulations, file a protective claim for refund to preserve the right to claim a deduction under Treasury Reg. §20.2053-4(b). In this claim for refund, the executor must explain the reasons and contingencies delaying actual payment. The IRS will only act on the claim after the executor notifies them that the contingency has been resolved and payment has been made. The estate must also notify the IRS and pay additional taxes or file a refund claim for overpaid taxes if, after the filing of the estate tax return, the estate receives a tax refund or other adjustment to a paid claim.[8]

Proposed Treasury Reg. §20.2053-4(b)(4) goes on to establish a rebuttable presumption that claims by a family member of a decedent, a related entity, or a beneficiary of the decedent's estate or revocable trust are not legitimate and bona fide and, therefore, are not deductible.

C. Basis Issues.

1. Corporations.

a. Outside Basis. Under Internal Revenue IRC ("IRC") §1014, a devisee or legatee of property receives a basis in the property equal to the fair market value of the property on the date of the decedent's death.

b. Inside Basis. Notwithstanding the step up of the legatees' basis in corporate stock, the corporate tax structure is a dual-tax, and the corporation is recognized as a separate entity. As a result the corporation's basis in corporate assets will remain the same even after death of the owner. This has the significant effect of making a liquidation of the corporation, even post-death, potentially costly tax consequences. On the other hand, this does have some benefit in the estate tax area.

c. S-Corporations. Even though S-corporation income is taxed directly to its shareholders, the separate existence of an S-corporation is still recognized for tax purposes. Thus, the legatee of S-corporation stock will get the basis step-up, but no adjustment will be made to the inside basis. Again, this has significant tax consequences on liquidation.

2. Passthrough Entities. Passthrough entities also have an inside / outside basis distinction. But the partnership's status as a hybrid entity for tax purposes has caused Congress to allow a partnership to elect to step-up inside basis attributable to the interest transferred by reason of death. (IRC §754.) Because of the need to coordinate a partner's outside basis with the partnership's inside basis, this election ensures that the intent of the basis step-up at death and the single-level of tax for passthrough entities are both recognized.

3. Result to Shareholder. As a consequence of the basis step-up, a devisee shareholder liquidating his interest in a corporation will recognize little or no gain because the basis in the stock will be stepped up to is fair market value on the date of the decedent's death. This presupposes that the shareholder will recognize sale or exchange, rather than dividend, treatment on the distribution.

III. ESTATE TAX PAYMENT ISSUES AND OPPORTUNITIES.

A. IRC §303 – Corporate Redemptions to Pay Estate Tax.

1. Introduction. IRC §303 provides that, in certain cases, a redemption of stock, the value of which has been included in a decedent's gross estate for estate tax purposes, shall be treated as a sale of the stock, even though it would, but for §303, be taxed as a dividend under §301.

2. Conditions and Limitations. §303 contains the following conditions and limitations:

a. The value of the redeemed stock must be included in determining the gross estate of the decedent for estate tax purposes. This requirement is satisfied if the stock:

(i) Was owned by the decedent at the time of his death.

(ii) Was not owned by the decedent at death, but was included in his gross estate because, for example:

(A) it was transferred in contemplation of death;

(B) the decedent had a power of appointment over it; or

(C) it was held in joint tenancy with the decedent.

b. The value of stock included in the decedent's estate must be more than 35% of his "adjusted gross estate" (the "adjusted gross estate" for this calculation being the gross estate reduced by deductions allowable under §§2053 and 2054, for claims, expenses, debts, taxes and losses).

(i) Where the gross estate includes at least 20% of the outstanding stock in 2 or more corporations, the stock in those corporations is treated as stock in a single corporation for purposes of this 35% rule. (IRC §303(b)(2)(B).)

c. The total application of §303 cannot exceed the sum of (a) the death taxes imposed because of the decedent's death and (b) the funeral and administrative expenses allowable as deductions for estate tax purposes.

d. The benefits of §303 are available only to amounts distributed by the corporation within a limited period after the death of the decedent--If the distributions are made more than 4 years after death, §303(b)(4) limits the amount of qualifying distributions to the lesser of the unpaid death taxes and expenses at such time, or taxes and expenses paid within one year of the distribution.

3. Basis. Because the basis in inherited stock is stepped-up to the death time value, where §303 applies, there will generally be little or no gain recognized on the exchange of the stock. Conversely, a dividend would often be subject to income tax to the full extent of the amount of the dividend.

a. If only part of the redemption qualifies for §303 sale treatment (the rest constituting a dividend under §301), part of the shareholder's basis for the redeemed stock should be allocated to that portion of the transaction constituting a sale. Possible alternative methods of making that allocation could include:

(i) By analogy to the "part gift-part sale" rules of Regs. §1.1001-1(e), one

possibility would be to apply the total basis against the §303 "sale" proceeds in computing gain. If the basis is not fully recovered, loss would not be allowed; and the unrecovered basis presumably would stay with the stock retained by the redeeming shareholder, as would be the case in a §301(c)(2) distribution.

(ii) Another method would be to allocate the basis in proportion to the relative value of the sale and dividend portions of the distribution. Thus, if 25% of the distribution qualified for §303 treatment, the shareholder would be entitled to apply 25% of his basis to that part of the transaction.

(iii) Substantially the same result would be achieved by allocating basis in proportion to the relative basis of the stock qualifying for §303 treatment, since the stock, having been inherited, would have a basis equal to its fair market value at the time of death by virtue of §1014.

4. Definition of "Property" Under §303.

a. "Property" for purposes of §303 includes money, securities, or other property; provided that the term does not include stock in the corporation making the distribution or rights to acquire such stock.

b. Bona fide indebtedness of the corporation has been confirmed as "property" for purposes of §303. (Rev. Rul. 65-289 (promissory note).)

c. Similarly, a redeeming corporation's cancellation of a decedent's promissory note in exchange for shares owned by the estate has been ruled to be a §303 distribution of property. (PLR 8330071.)

5. **Note:** There is no requirement that the "Section 303" distribution actually be necessary or used to pay taxes or administration expenses. In other words, IRC §303 provides estates or legatees of an interest in a corporation the opportunity to partially liquidate their interest and avoid having to pay tax on a distribution which, but for §303, would otherwise be treated as a dividend.

B. IRC §6166 – Estate Tax Installment Payments for Closely Held Businesses.

1. Benefits of IRC §6166.

a. If an estate qualifies under IRC §6166, liability for payment of the estate tax attributable to the closely held business interest can be spread out over up to 15 years. Payment terms can be selected by the estate within the maximums allowed.

b. The maximum deferral allows annual interest-only payments due on each anniversary of the date the estate tax return was due to be filed. Fully amortized principal and interest payments begin on the 5th anniversary of the due date of that return and can continue until the 14th anniversary of that due date. Interest on the first $1.28 million in taxable value attributable to a closely held

business is set at 2%.[9] The remaining amount bears interest at a rate equal to 45% of the annual underpayment rate established under §6621 (7%), or 3.15%.

2. Statutory Requirements of IRC §6166. Generally speaking, for an estate to avail itself of IRC §6166, the following 2 requirements must be met:

a. The decedent was, as of the date of his death, a citizen or resident of the United States; and

b. The decedent's estate includes an interest in a closely held business the estate tax value of which exceeds 35% of the decedent's "adjusted gross estate" – by deducting from the gross estate only those items permitted under §§2053 and 2054, namely, funeral expenses, administration expenses, claims against the estate, unpaid mortgages and indebtedness on property and casualty losses.

Note: The Adjusted Gross Estate is Determined Prior to the Application of any Charitable or Marital Estate Tax Deduction.

(i) *Example*: assume a decedent dies in 2008 with an estate valued at $15 million, comprised of (i) $500,000 cash that will be used to pay debts and expenses of the estate, (ii) $10 million of additional cash and marketable securities that will pass to a charity, and (iii) a closely held business valued at $4.5 million, 100% of which will pass to the decedent's children. The decedent's estate plan provides that taxes are charged against the assets includable in the decedent's taxable estate.

At first glance, this would appear to be the perfect example of an estate that §6166 is intended to benefit -- the decedent's entire taxable estate is comprised of a closely held business that will pass to his children. This estate, however, does not qualify for §6166 deferral because the 35% test is not applied to the taxable estate of $4.5 million (after the deductions for debts, expenses, and the charitable gift). Rather, it is applied to the adjusted gross estate of $14.5 million (after the deductions for debts and expenses, but before the charitable deduction). Hence, the executors will be faced with an estate tax of $1,125,000, but the only assets available to pay such taxes are illiquid. Thus, the executors will be forced to obtain third party financing to pay estate taxes or consider a forced sale of the family business.

3. §6166 Planning. Planning can alleviate some §6166 qualification issues. Inter vivos gifts of cash or other non-closely held business assets can increase the relative size of the closely held business as compared to the client's other assets. By making such gifts, the client can be sure that his or her interest in the closely held business comprises over 35% of the client's adjusted taxable estate.

a. *Example*: If the above-described decedent had made $2 million of charitable gifts more than three years before his death, his gross estate would have been valued at $13 million (and such lifetime gifts presumably would have qualified for a valuable income tax charitable deduction). Because the closely held business valued at $4.5 million is more than 35% of the adjusted gross estate of $12.5 million, the decedent's estate would have qualified for §6166 deferral, allowing his executors to defer $405,000 of the

$1,125,000 in estate taxes.

4. The Business Need Not Pass to Any Particular Beneficiary. The closely held business can pass to a spouse or charity, and the estate may qualify for §6166 deferral notwithstanding that no estate tax is directly attributable to the closely held business.

a. Because §6166 deferral is based on the adjusted gross estate rather than the taxable estate, §6166 can create an apparent windfall if the closely held business is distributed to a charity or spouse. For example, assume that a decedent dies in 2008, with an estate valued at $13 million, comprised, in part, of cash and securities of $5 million. From this amount, $500,000 will be used to pay debts and expenses of the estate, and $4.5 million will pass to the decedent's children. Assume the remainder of the estate is comprised of a closely held business valued at $8 million, all of which will pass to the decedent's spouse. The decedent's estate plan provides that taxes are charged against the assets includable in the decedent's taxable estate, which pass to the children.

In this example, none of the decedent's taxable estate is comprised of the closely held business. Instead, all estate taxes are attributable to the cash and marketable securities passing to the children. Notwithstanding that the executors clearly have sufficient cash and liquid assets to pay the total estate taxes due of $1,125,000, and that none of the estate taxes are attributable to the closely held business, §6166 permits the executors to defer $720,000 of the total estate taxes.

5. Special Rule. IRC §6166(c) provides a special rule for estates owning an interest in more than one closely held business. If 20% or more of the total value of each closely held business is held by the estate, the aggregate of all such holdings is treated as an interest in a single closely held business for purposes of §6166.

6. Closely Held Business Defined. An interest in a closely held business is defined in §6166(b) as any of the following:

a. an interest as a proprietor in a trade or business carried on as a proprietorship;

b. an interest as a partner in a partnership carrying on a trade or business, if:

(i) 20% or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or

(ii) such partnership had 45 or fewer partners; or

c. stock in a corporation carrying on a trade or business if:

(i) 20% or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or

(ii) such corporation had 45 or fewer shareholders.

7. Exclusion of Passive Assets. IRC §6166(b)(9) excludes "passive assets" from the estate tax value of an interest in a closely held business used in determining whether the estate qualifies for estate tax deferral and when determining the portion of estate tax that can be deferred pursuant to §6166. A "passive asset" is any asset other than an asset used in carrying on an active trade or business.

a. The IRS has provided that to qualify for §6166 deferral, the business must consist of a manufacturing, mercantile, or a service enterprise rather than the mere management of passive assets.

b. The IRS has scrutinized whether a decedent's real estate holding will be considered a closely held business for purposes of §6166. If the holdings are considered mere passive investments, they will not be considered a closely held business. If, however, the decedent's activities rise to the level of managing an active business rather than a passive investment, the estate may qualify for §6166 deferral.

Revenue Ruling 2006-34 addresses whether a decedent's interest in real estate will qualify as a closely held business for purposes of §6166. Specifically, the ruling provides that the IRS will consider the following nonexhaustive list of factors:

(i) Whether an office was maintained from which the activities of the decedent, partnership, LLC, or corporation were conducted or coordinated, and whether the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) maintained regular business hours for that purposes;

(ii) The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation);

(A) was actively involved in finding new tenants and negotiating and executing leases;

(B) provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;

(C) personally made, arranged for, performed, or supervised repairs and maintenance to the property (whether or not performed by independent contractors), including without limitation painting, carpentry, and plumbing; and

(D) handled tenant repair requests and complaints.

Further, the ruling provides 5 examples that illustrate the application of §6166. In example 2, the decedent

owned an office park and hired an unrelated property manager to handle most day-to-day activities relating to the management of the real estate. The contractor and its employees provided all necessary services for the decedent's office park. In example 4, strip malls were owned and managed through a limited partnership, of which the decedent was a limited partner. The partnership, acting through its general partner, handled the day-to-day operations and management of the strip malls. The activities of the general partner on behalf of the limited partnership included (either personally or with the assistance of employees or agents) performing daily maintenance of and repairs to the strip malls (or hiring, reviewing and approving the work of third party independent contractors for such work), collecting rental payments, negotiating leases, and making decisions regarding periodic renovations of the strip malls.

With respect to example 2, the IRS determined that, because the decedent, who owned no interest in the independent contractor, was not involved in the management or oversight of the property, the office park did not appear to be an active trade or business. On the other hand, with respect to example 4, the limited partnership's management by a general partner and its employees was imputed to the decedent. Accordingly, as described in the Ruling, although the activities of an employee are imputed to the decedent, the activities of an independent contractor are not.

As a corollary to the rule that only an active business may qualify for Section 6166 deferral, the value of the business's passive assets are not taken into account for purposes of meeting the 35% qualification test. Further, such passive assets are disregarded when determining the amount of tax that can be deferred under §6166(a)(2).

Accordingly, the balance sheet of the client's closely held business must be carefully examined to determine which assets are considered passive assets for purposes of §6166. The retention of raw land, personal use assets, or other assets that bear no relation to the business will be considered passive assets. Reducing the value of the business by the value of these passive assets will not only reduce the amount of the estate tax that qualifies for §6166 deferral, but may jeopardize §6166 qualification for the estate depending on the value of such assets. Finally, if the client wishes to have greater certainty regarding the estate's qualification for §6166 deferral or the computation of such deferral, the client may want to consider segregating his or her personal assets from business assets, and titling such assets accordingly.

c. Business Structure And Subsidiaries. Generally, under §6166, stock held by one corporation in another corporation is deemed a passive asset. Accordingly, if a client owns a corporation with several corporate subsidiaries, the majority of the parent company's assets (stock in the subsidiaries) may be deemed passive, rendering §6166 deferral unavailable to the estate. §6166 provides 2 exceptions to this general rule.

(i) First, under §6166(b)(8), an estate may make a holding company election if the holding company does not carry on an active business, but its subsidiaries carry on active businesses. However, by making this election, neither the 5-year time period for deferral of estate tax payments nor the preferential 2% interest rate on a portion of the deferred estate taxes is available.

(ii) Second, under §6166(b)(9)(B)(iii), if both the parent company and its subsidiary are active businesses, meaning that 80% or more of the value of the assets of each corporation is attributable to assets used in carrying on its trade or business, then such corporations are treated as one corporation for purposes of §6166(b)(9)(B)(ii). Unlike §6166(b)(8), if §6166(b)(9)(B)(iii) is relied upon to qualify for §6166 deferral, no benefits are lost. However, the 80% test may be difficult to meet.

d. Planning. Many estates simply cannot meet the §6166(b)(9)(B)(iii) test. Other estates either may not qualify under §6166(b)(8) or do not wish to accept the reduced benefits of that provision. To avoid the application of these rules, when feasible, the client should consider converting the subsidiaries of a closely held business from corporations to single-member LLCs. By converting subsidiaries from corporations to LLCs during the client's lifetime, the owner of a closely held business may enable his or her estate to qualify for §6166 deferral -- if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

IV. LIQUIDATING THE CORPORATION – TAX EFFECTS.

A. *General Utilities* and its Repeal – Tax Effects to Corporation on Liquidation.

1. *General Utilities* Doctrine[10] – Historical Background. Prior to the Tax Reform Act of 1986 ("TRA"), no gain or loss was recognized to a corporation on in-kind distributions to its shareholders in liquidation of the corporation. Rather, the corporation distributed appreciated property to its shareholders which the shareholders, in turn, sold. In this way, only one level of tax was imposed—the tax on the gain to the shareholders. Had the corporation sold the property and distributed the proceeds, the corporation would have been taxed on the sale and the shareholders would have been taxed on the distribution.

2. Repeal of *General Utilities* - TRA 86. The TRA 86 effectively repealed the *General Utilities* doctrine. IRC §§311 and 336 were amended to require the corporation to recognize gain to the extent that the fair market value of distributed property exceeded the corporation's basis in that property. Since a corporation does not get to "step up" its (inside) basis upon the death of a shareholder, the result is that corporations will generally have to recognize gain on post-death distributions to the estate or a devisee.

a. IRC §336(a) provides that gain and loss is recognized to a corporation on a distribution of property to a shareholder. The gain or loss is measured by the fair market value of the property at the time of the distribution.

b. IRC §311(a) provides that gain or loss is not recognized to a corporation on a nonliquidating distribution to its shareholder of the corporation's stock or other property. IRC §311(b), however, requires gain recognition, effectively meaning that the rule is only one of non-recognition of loss to the corporation (except as provided below).

(i) Liabilities. If property distributed in a liquidation is subject to a liability or the shareholder assumes a liability of the liquidating corporation in connection with the distribution, the fair

market value of the property shall be treated as not less than he amount of the liability. (IRC §336(b).)

(ii) Reorganizations. If the transfer is part of a reorganization under §368(a)(1)(B), the corporation is afforded non-recognition treatment under §361(c), no gain or loss is recognized.

(iii) Nonrecognition of Losses. Losses will not be recognized where the property is distributed to a related party (as defined in §267(b)), and either:

(A) the distribution is not pro rata; or

(B) the distribution is "disqualified property."

Disqualified property is property acquired by the liquidating corporation in a §351 transfer during in the prior 5-year period.

c. Because a liquidating distribution of corporate assets will subject the corporation to the tax on its gains, courts have begun to recognize that a discount is appropriate to the extent of the corporation's contingent BIG Tax liability. (See §II.A.1, above.)

B. Tax Effects to Shareholder on Liquidation.

IRC §331(a) provides that a distribution in complete liquidation of a corporation is treated as full payment in exchange for stock. Thus, the shareholder will recognize capital gain or loss when the corporation liquidates. Inherited property will be treated as long-term capital property irrespective of the decedent's and/or the devisee's holding period. (IRC §1223(9).) The shareholder's basis in the property received is its fair market value on the date of distribution.

V. USE OF S-CORPORATIONS.

A. S-Corporation Eligibility Requirements.

1. An S-corporation is a corporation that (i) satisfies certain eligibility requirements; and (ii) makes an election.

a. The corporation must be a domestic corporation, having as its shareholders:

(i) Individuals;

(ii) Estates during the period of administration;

(iii) Voting trusts;

(iv) "Grantor" trusts;

(v) Trust treated under §678 as owned by individuals other than the grantors;

(vi) Qualified subchapter S trusts ("QSSTs");

(vii) Testamentary trusts with respect to stock transferred pursuant to the terms of a will (a "will recipient trust"), but only for the two-year period beginning on the day on which the stock is transferred in;

(viii) Electing small business trusts ("ESBTs"), as defined in §1361(e);

(ix) Qualified tax-exempt shareholders, as defined in §1361(c)(6), i.e., qualified retirement plan trusts described in §401(a) or a §501(c)(3) charities, in taxable years beginning after 1997; and/or

(x) S-corporations, if a Qsub.

b. The corporation may not:

(i) Have more than 100 shareholders;

(ii) Have nonresident aliens as shareholders; or

(iii) Have more than one class of stock.

B. Election of S-Corporation Status (IRS Form 2553).

1. A corporation may elect subchapter S status at any time during the tax year immediately preceding the tax year for which the election is to be effective, or on or before the 15th day of the third month of the taxable year for which the election is to be effective.

a. Guidance for C-corporations that wish to change to S-corporation status has been posted on the IRS website at www.irs.gov/businesses/corporations/article/0,,id=179841,00.html). The IRS guidance lists four steps that corporations should take when converting to S-corporation status:

(i) Timely file Form 2553, Election by a Small Business S-Corporation (which is due no more than 2 months and 15 days after the beginning of the tax year in which the election is to take effect).[11]

(ii) Follow up with the Service if acknowledgment and approval of the S-

Corporation election are not received.

(iii) File the final Form 1120, U.S. Corporation Income Tax Return, by the due date or extended due date.

(iv) File a Form 1120S, U.S. Income Tax Return for an S-Corporation, by the due date or extended due date of the "new" S-Corporation's first taxable year.

2. Each person who is a shareholder or is treated as a shareholder under §1361(c)(2)(B) must consent to the election. Each owner of jointly held stock must consent to the election, even if the joint owners are husband and wife (who are counted, under §1361(c)(1), as one shareholder for purposes of determining the number of shareholders).

3. Once made, an S election may be terminated in 3 ways:

a. First, the corporation may cease to meet either the shareholder or corporate level eligibility requirements. In this situation, the S election automatically terminates as of the date of the S-corporation ceases to qualify as such.

b. Secondly, the S election may be revoked at any time with the consent of shareholders owning more than half of the company's stock (including voting and nonvoting stock).

c. Thirdly, if a corporation has both (i) Subchapter C accumulated earnings and profits for 3 consecutive years, and (ii) excess passive investment income for 3 consecutive years, its S-corporation status is terminated effective the beginning of the following taxable year.

C. Transfer of S-Corporation Stock.

1. Shareholders' Agreement--Suggested Provisions:

a. That the corporation has made (or will make) an S election, and that the election shall continue until they unanimously agree to terminate their election;

b. How the various elections that may be made by S-corporation shareholders for tax purposes will be made;

c. Whether distributions from the S-corporation to pay any income tax incurred by the shareholders by virtue of the allocation of S-corporation income will be required;

d. Provisions to prevent the inadvertent termination of the corporation's S election, such as prohibitions against transfers to ineligible shareholders (declaring any such attempted transfers as void and ignition, or giving the corporation or the non-transferring shareholders rights of first

refusal);

e. Provisions ensuring that the corporation will only have one class of stock; and

f. There should be a legend on the stock certificates prohibiting transfer of shares except in compliance with the agreement.

2. Gifts of Subchapter S Stock During Life.

a. Estate Tax Planning. An S-corporation shareholder may with to make gifts of the stock to (1) reduce the value of the shareholder's gross estate for estate tax purposes; and (2) transfer control of the business to a younger generation.

(i) Outright. Gifts of S-corporation stock should only be made to persons who are permitted S-corporation shareholders.

(ii) In Trust. A trust used as a vehicle for gifting S-corporation stock must (1) be an eligible S-corporation shareholder; and (2) must not contain any provision that would cause the trust assets to be included in the donor's estate for estate tax purposes.

b. Shifting of Income. S-corporation income flows through to the shareholders. By giving family members S-corporation stock, an S-corporation shareholder can shift income to them. However, the so-called "kiddie tax" makes income-splitting less effective.

3. Transfer of Subchapter S Stock Upon Death.

a. Income in Respect of a Decedent ("IRD"). A person acquiring stock in an S-corporation from a decedent is required to treat as IRD under §691 his or her pro rata share of any item of income of the corporation that would have been IRD if that item had been acquired directly from the decedent. Additionally, the §1014 "stepped-up" basis in the stock acquired from the decedent is reduced by the portion of the value of the stock attributable to IRD items. However, under §691(c), an income tax deduction for the estate tax attributable to the IRD item generally will be allowable.

b. Transfer by Will. If no buy-sell agreement is in place upon the death of a shareholder, stock that the shareholder held individually (or as a tenant in common) will be distributed as provided in the decedent's will (or revocable trust). Thus, an S-corporation shareholder should ensure that the S election will not be jeopardized as a result of his or her death--discretion should be given to the personal representative to deal with the stock, and they should be given the authority to enter into agreements with the other shareholders regarding elections, distributions, transfer restrictions, and other S-corporation matters.

If the S-corporation stock is to be distributed to a QSST, (precatory or mandatory) language in the will

should authorize or direct the trust income beneficiary to make the QSST election. If a testamentary QTIP trust will hold S-corporation stock, the beneficiary (surviving spouse) should be authorized—but not directed—to make a QSST election.

D. Estate Administration Considerations—S Elections.

1. The estate of a deceased shareholder need not file a consent to an existing S election, nor does it have the power to revoke the election, unless it owns more than 50% (or such greater percentage as may be required by the shareholders' agreement) of the outstanding shares.

2. The executor should determine if it is advantageous to retain the S-corporation's tax status. If termination is desirable, the executor must determine how and when the election can be terminated.

3. Considerations such as the pass-through of income items and distributions of previously taxed income may make timing of a revocation important.

4. Unless prohibited by the terms of a shareholders' agreement, the executor may also cause the election to terminate without the consent of the other shareholders by either transferring stock to an ineligible shareholder, or by transferring the stock to a sufficient number of transferees so that the number of shareholders exceeds 100. In either case, the corporation's S status will end immediately.

5. Before terminating an S election, the executor should consider whether or not the termination will be advantageous to the beneficiaries later; an S-corporation status cannot be re-elected for 5 years without IRS consent.

E. Tax Consequences of Liquidation of an S-Corporation.

The shareholder consequences of a complete liquidation of an S-corporation are governed by §§331 and 1001. The dividend rules that otherwise apply to corporate distributions are not applicable to distributions in complete liquidation. Distributions received by the shareholder are treated as payment in full for the exchange of stock. The shareholder's adjusted basis in the stock is subtracted from the cash and fair market value (FMV) of other property received from the corporation. If the shareholder assumes known corporate liabilities or receives corporate property subject to a liability (such as the distribution of mortgaged land), the amount realized is reduced by the amount of the liability (*Ford*, 311 F.2d 951 (Ct. Cl. 1963)).

The general rule is that a shareholder's stock basis is determined as of the end of the S-corporation's tax year. It appears that the adjusted basis of stock held in a liquidating corporation is adjusted for current-year passthrough items prior to determination of gain or loss from the receipt of the liquidating distributions (see Regs. §1.1367-1(d)(1) and Letter Ruling 200106009).

If the shareholder has different bases in different blocks of stock, the computation of gain or loss

depends on whether there is a single distribution or a series of liquidating distributions (Rev. Ruls, 68-348 and 85-48). The shareholder recognizes gain when the adjusted basis of each block has been recovered, while loss is not recognized until the corporation has made its final distribution.

Example 1:

T holds 30 shares of stock in an S-Corporation, represented by two blocks of stock. T has a basis of $10,000 in Block 1 (which represents 10 shares) and a basis of $40,000 in Block 2 (which represents 20 shares). The corporation distributes $45,000 cash to T in return for his stock.

The $45,000 is allocated pro rata to the two blocks, so $15,000 is allocated to Block 1 (10 ÷ 30 x $45,000) and $30,000 to Block 2 (20 ÷ 30 x $450,000). T recognizes a $5,000 gain on Block 1 ($15,000 - $10,000 basis) and a $10,000 loss on Block 2 ($30,000 - $40,000 basis).

If T receives $45,000 in 2007 and an additional $135,000 in 2008, each distribution is allocated ratably between the blocks based on the number of shares in each block. The 2007 distribution is allocated the same as before. T recognizes a $5,000 gain on Block 1 ($15,000 - $10,000 basis), which reduces his basis in that block to zero. T recognizes no gain or loss on Block 2 ($30,000 - $40,000 basis) and has a remaining basis of $10,000 in Block 2.

The 2008 distribution is allocated $45,000 to Block 1 (10 ÷ 30 x $135,000) and $90,000 to Block 2 (20 ÷ 30 x $135,000). T recognizes a $45,000 gain on Block 1 ($45,000 - $0 basis) and an $80,000 gain on Block 2 ($90,000 - $10,000 basis).

1. Determining the Character of Gain of Loss. The character of gain or loss recognized by the S shareholder depends on whether the stock is a capital asset in the shareholder's hands and whether the transaction constitutes a complete or a partial liquidation. Long-term or short-term classification of a liquidation that qualifies for capital gain treatment depends on the shareholder's holding period, with long-term status having significant importance due to the 15% tax rate cap on long-term capital gains. Shareholders in the 35% tax bracket achieve a 57.1% ((35% - 15%) ÷ 35%) tax savings on capital gain versus ordinary income. For tax years beginning in 2008, 2009 and 2010, the savings is even greater for taxpayers in the 10% and 15% brackets because their net capital gain is taxed at 0% in those tax years.

a. Planning Tip. If the stock surrendered in the liquidation qualifies as §1244 stock, the shareholder may be able to claim an ordinary loss rather than a capital loss.

Distributions in complete liquidation of an S-Corporation are treated as payments in exchange for the shareholders surrendered stock (§331(a)). The ordinary distribution rules of §1368 do not apply. Thus,

accumulated earnings and profits ("AE&P") or accumulated adjustments accounts ("AAA") are not relevant to the characterization of the liquidating distribution. Since the existence of AE&P has no impact on the characterization of a liquidating distribution, an S-Corporation with AE&P should identify liquidating distributions as such (for example, in a board resolution adopting the plan of complete liquidation).

In addition, during the liquidation of an S-Corporation, it may be difficult to predict the ending balance of AAA. This may, in turn, make it difficult to accurately determine the AAA available for ordinary distributions and make inadvertent dividend distributions from AE&P more likely to occur. If the S-Corporation has AE&P, the shareholders may want to forgo distributions prior to commencement of the liquidating distributions, because once the AAA is exhausted, preliquidation distributions are treated as dividend income to the extent of AE&P.

2. Determining the Basis of Property Received. The shareholder's basis in assets received is their FMV at the time of the distribution. Basis is not affected by the shareholder's assuming corporation liabilities or receiving corporate property that is subject to a liability (§334(a); see also *Ford, supra*).

3. Structuring a Partial Liquidation for Best Tax Results. A distribution in partial liquidation of an S-Corporation will also qualify for sale or exchange treatment under §302 if the distribution is pursuant to a plan and occurs within the tax year the plan is adopted or the following tax year and the "safe harbor" of §302(e)(2) is met. Under the safe harbor, the assets, or proceeds from the sale of the assets, of a trade or business conducted by the S-corporation during the previous 5-year period must be distributed to the terminating shareholder, and the S-corporation must continue conducting a trade or business that it conducted during the same prior 5-year period.

A distribution in partial liquidation that does not qualify for sale or exchange treatment will be governed by the usual S-corporation distribution rules of §1368. In certain cases, this treatment is preferable to sale or exchange treatment. If the shareholder prefers §1368 treatment, the sale or exchange rules can be easily avoided, for example, by failing to adopt a plan of liquidation or delaying the distribution until 2 years after the tax year the plan is adopted.

If the S-corporation has a large AE&P amount but a nominal AAA balance, a §1368 distribution will result in dividend income, while sale or exchange treatment allows a partial stock basis offset and capital gain treatment. Conversely, if the corporation has little or not AE&P or the distribution is less than the AAA balance, a §1368 distribution allows full stock basis offset at the shareholder level, while sale or exchange treatment allows only part of the shareholder's stock basis to offset the distribution.

4. Handling Passthrough Items in the Year of Liquidation. The liquidation process itself does not terminate the company's S election. Therefore, passthrough items in the year of liquidation are allocated under the normal per-share, per-day rule of §1377(a)(1). However, a bunching of income can occur in the year of liquidation of a fiscal-tax-year S-corporation if the final liquidating distribution occurs on a date other than the last day of the fiscal year. This can result in the shareholders reporting more than 12 months of passthrough income in a single year.

For example, if an S-corporation with an April 30 year-end makes its final liquidating distribution on October 31, 2007, the shareholders will report 18 months of passthrough items on their 2007 returns. This bunching problem can be avoided if the corporation delays making its final distribution from October 31, 2007, to a date in 2008 (after the end of the shareholders' calendar tax year).

An additional timing problem can arise from the S-corporation's selling appreciated assets and distributing the proceeds to the shareholders, rather than distributing the assets directly to the shareholders. The taxable gain from the sale passes through to the shareholders and increases their stock basis, which in turn reduces the gain (or increases the loss) the shareholders recognize from the distribution of the sale proceeds. If the sale and distribution do not occur in the same tax year, a shareholder may report capital gain from the sale of the asset but report a capital loss (which cannot be carried back) in a later year when the sale proceeds are distributed. If the sale and distribution occur in the same year but the sale of the asset results in ordinary income, the shareholder may report some or all of the asset sale as ordinary income, which cannot be offset against a capital loss recognized when the proceeds from the sale are distributed.

Example 2:

As part of its complete liquidation, a calendar-year S-corporation sells its assets in 2007, for $120,000 in cash but does not distribute the proceeds to SS, its sole shareholder, until early 2008. The 2007 sale generates a $50,000 capital gain that passes through to SS and increases her stock basis from $100,000 to $150,000. As a result of the distribution of the $120,000 sales proceeds in 2008, SS realizes a capital loss of $30,000 ($120,000 distribution - $150,000 stock basis).

Thus, SS reports a $50,000 capital gain in 2007, but in the absence of other offsetting capital gains in 2008, her $30,000 realized capital loss will be limited to a $3,000 capital loss deduction in 2008.

5. Deducting Suspended Passthrough Losses. In a complete liquidation, passthrough losses suspended because of basis limitations that remain after the basis of the redeemed stock has been reduced to zero do not reduce gain or increase loss resulting from the liquidation. Since suspended passthrough losses are lost, the shareholder should consider creating additional basis before the final distribution through additional capital contributions or loans. (See Regs. §1.1366-2(a)(5).) While there is no authority on point, it appears that the shareholder is not entitled to restore basis after the liquidation has been completed in a manner similar to the post-termination transition period rules of §1366(d)(3).

Losses limited by the at-risk rules are also eligible for indefinite carryover (§465(a)(2)). Unlike the basis limitation rules, at-risk basis is increased by gain recognized from disposition of the stock. Accordingly, it appears that suspended losses arising from the at-risk rules can be claimed by the shareholder to the extent of gain recognized. (Prop. Regs. §1.465-66(a) specifically states that this rule applies to the liquidation of a

partner's interest and the complete redemption of an S shareholder's interest.)

Losses limited by the passive activity rules are also suspended at the shareholder level and carry forward indefinitely to offset future passive income. While a taxpayer who disposes of his or her entire interest in a passive activity can deduct suspended passive losses (and any loss from the disposition) against current passive and nonpassive income, an exception to this rule postpones the deduction if the passive activity is transferred to a related party (§§267(b)(2) and 469(g)(1)(B)). While a corporation and a 50%-or-more shareholder are related for this purpose, it seems that this exception would not prevent a less-than-50% shareholder from recognizing suspended passive losses due to the liquidation of the corporation.

VI. PARTNERSHIPS AND LLCs.

A. Basic Rules Post Death.

1. Closing the Partnership's Books. Under IRC §706(c)(2)(A), the taxable year of a partnership closes when a partner dies. When a partner dies and terminates his interest in a partnership, 2 different methods are used to allocate items of partnership income. The first is an interim "closing of the books; which effectively separates the partnership year into 2 segments. The first segment is the period prior to the partner's death, the second is the period after the partner's death. Income realized in each segment is then allocated to the persons who were partners during each of those segments.

The second method for allocating partnership income for the year a partner dies is the proration method. Under the proration method, all items of partnership income for the year a partner dies are allocated amongst the partners based on the number of days that year the partner was a partner. Under this method, a deceased (former) partner is allocated a portion of partnership income for the year regardless of when the partnership realizes the income.

Because of the differences in the way each of these methods allocate income between the partners, depending on the particular circumstances, one method may be "better" than the other. Thus, it is imperative that the executor work with the partnership's accountant in selecting the best method of allocating partnership income between the estate and the other partners.

Regardless of which method is chosen, cash basis partnerships must use the accrual method to allocate interest, taxes, payments for services or the use of property other than guaranteed payments under IRC §83, and any other items specified in the regulations. The partnership is required to assign a portion of these items to each day in the period to which it is attributable. This "daily portion" is then further assigned to the partners in proportion to their respective partnership interests at the close of each day. This mitigates against a partner's ability to time payment of large cash basis expenses (such as real estate taxes and payments for services) for tax purposes. (IRC §706(b)(2).)

2. Holding Period and Basis. The holding period of a partnership interest automatically becomes long-term by virtue of the basis determination rule under IRC §1014. (IRC §1223(11).) Thus,

inherited partnership interests have a long-term holding period. However, this rule does not apply to the assets owned by the partnership or within the partnership (inside basis), since the holding period for inherited assets under IRC §1223(11) does not apply to individual partnership assets. Thus, a partnership must still meet the 1-year holding period to achieve long-term capital gains treatment for the sale of any asset on hand on the day of the decedent's death.

The (inside) basis of partnership assets is determined:

(i) with respect to contributed assets, by the basis of the contributing partner; and

(ii) in a purchase, by the purchase price.

A question exists as to whether a different holding period results when a partnership makes an IRC §754 election. Pursuant to a §754 election, the inside basis of the decedent's share of partnership assets is adjusted to equal the fair market value at date of death. In this instance, the decedent's basis in his or her share of partnership assets is determined by IRC §1014. According to IRC §1223(11), where a property's basis is determined under IRC §1014, it is automatically considered to be held for more than 1 year. Thus, the decedent's long-term holding period should "tack" to the partnership assets when an IRC §754 election has been made.

The (outside) basis of a decedent's partnership interest is adjusted to the date-of-death value.

3. Determining Value and Basis. Although, as discussed above, a deceased partner does not adjust his share of basis in partnership assets to fair market value upon his death, there are exceptions to this rule. Therefore, it is imperative that the executor and the partnership coordinate and discuss the fair market value of the partnership assets on the date of death. This information is essential when analyzing whether to make an IRC §754 election, discussed in more detail below. It is also necessary in determining whether the partnership is subject to the new mandatory basis and adjustment rules added by the American Jobs Creation Act of 2004 (the "Jobs Act"). Typically, the accountant prepares an analysis of the basis of each partnership asset versus its date of death fair market value. Additionally, if discounts for lack of marketability or minority interests are being utilized, they need to be evaluated as well.

4. IRC §704(c). As a general rule, whenever a partner contributes property to a partnership, IRC §704(c)(1)(A) requires the partnership to measure the difference between the property's cost basis and its fair market value. This difference is referred to as "built-in gains and losses." Under the Regulations, these "built-in gains and losses" must be tracked on a property-by-property and partner-by-partner basis.[12] When the partnership disposes of property which contains built-in gains or losses, they must be specifically allocated to the contributing partner. Only after this allocation may any remaining gain or loss be allocated among the (other) partners according to their partnership interests. Because this can cause a severe recordkeeping burden, particularly with multiple properties, partners, etc., some types of property can be aggregated. Additionally, the regulations allow certain "small disparities" between value and basis to be ignored. These rules are discussed under Treas. Regs. 1.704-3(e)(1), (2).

Obviously, if an IRC §754 election is made when a partner dies, the tracking of built-in gains and losses is no longer necessary for the deceased partner. This is because this election causes the decedent's basis in the partnership assets to be adjusted to their date of death values, causing the deceased partner's inside and outside basis to be the same. In effect, this election "wipes out" any built-in gains or losses. Note, however, this is only as to the deceased partner -- the §754 election has absolutely no effect on the other partners.

On gifts of partnership interests, the donee receives a carryover basis. This means that the donee receives the same outside and inside basis of the donor. Similarly, any built-in gains that the donor had attributable to his or her interest under IRC §704(c) also transfers to the donee. The same rule applies for the transfer of built-in losses, but only for contributions of built-in loss property on or before October 22, 2004. (See IRC §704(c)(1)(C), added by the Jobs Act, discussed below.)

A partner's profit and loss sharing ratio and his or her allocation of built-in gains and losses may differ when the partner acquires his or her interest partly by gift and partly by personal contributions. After October 22, 2004, built-in losses on assets are subject to special rules and need to be tracked separately. IRC §704(c)(1)(C) allows only the contributing partner to use pre-contribution losses on property contributed after October 22, 2004. This means the partnership must track built-in-loss property contributed after October 22, 2004. There is no de minimus exception for small built-in losses. These rules are discussed in more detail below.

B. More On Basis And Distribution Rules.

Generally, neither the partner nor the partnership recognizes gain or loss on the distribution of money or property to a partner. There are, however, many exceptions. These are discussed in more detail below.

1. Built-in Loss Rules. The Jobs Act implemented 3 mandatory basis adjustment rules designed to prevent partners and partnerships from duplicating losses. They were designed to prevent a technique whereby a partnership would distribute low basis property to liquidate a high basis partner's interest, leaving the high basis property in the partnership. The partner who was liquidated would step-up his or her basis in the property distributed to equal his or her outside basis (which was high). This would leave both the partnership and the partner with high basis property that either could sell, reducing the gain. In these cases, no downward adjustment was required unless the partnership had previously made an IRC §754 election. Partnerships, in effect, could pick and choose whether to elect or not, and when to make the downward election, all to their advantage. Thus, 3 rules were implemented which will affect family entities. Bear in mind, however, these rules in and of themselves do not trigger recognition of gain or loss; they merely require the partnership to make certain adjustments to the bases of its assets.

a. IRC §743. The first rule applies when a partner dies or transfers an interest in a partnership and the partnership has built-in losses greater than $250,000 (a "substantial built-in loss"—measured by netting all the built-in gains or losses in the partnership) (IRC §§743(a) and (b)). Thus, if a partnership has built-in gains to offset built-in-losses, reducing the built-in-losses below $250,000, the rule will

not apply. If the rule applies, the partnership must adjust (up and down), the partnership properties' basis with respect to the transferee to equal the transferee's outside basis in his or her partnership interest. There is no de minimis rule. Hence a transfer of any size due to sale, exchange or death requires that an adjustment be made.

The estate must notify the partnership in writing within 1 year of the partner's death. (In a sale or exchange, the transferee has only 30 days from the transfer to so notify.) The partnership must attach a statement to its return for the appropriate year outlining the adjustment. This adjustment must be allocated among the assets as if a direct purchase by the transferee had been made. In effect, it is a "forced" §754 election (even if the partnership did not so elect).

This rule creates problems and uncertainties with family entities. Due to the use of discounts, even though the deceased partner's basis is irrelevant under the IRC §732(d) rules, and does not affect the $250,000 floor, discounts may affect the size of the (mandatory) basis adjustment. This becomes more problematic due to the chance that values may change on audit (leaving the partnership in a quandary as to the size of the adjustment). There are also many unanswered questions that need guidance from the IRS such as how to count basis for built-in loss property contributed post October 22, 2004, and whether prior 754 adjustments count as part of the basis.

b. IRC §734(b). The second rule under IRC §734(b) requires basis adjustments in 2 situations:[13]

(i) The first situation involves liquidating distributions where a partner recognizes a loss because the cash received is less than the partner's (outside) basis in his or her partnership interest. In this case, under IRC §734(b)(2)(A), the partnership is required to adjust the basis of its other assets.

(ii) The second situation involves liquidating distributions of property, where the partner steps-up his or her basis of property received in the distribution to equal his or her basis in his or her partnership interest. Under IRC §734(b)(2)(B), the partnership is required to make a positive adjustment to the basis of distributed property on liquidating distributions exceeding $250,000.

The typical scenario under which these "new" §734(b) rules apply is where a liquidating distribution of cash or property is made to a high basis partner. Under the prior rules, a basis adjustment was elective. The "new" rules now mandate a reduction in the basis of partnership property, effectively forcing a §754 election.

Note, however, positive adjustments are not required.

For partnerships that have not already made §754 elections, it may be advisable to make one in the year that a distribution under the rules forces the partnership to make a negative basis adjustment, as it would give the partnership the opportunity to elect to make positive adjustments as well.

Another scenario that comes into play is when a partner's adjusted basis increases due to a death, but no election is in effect and the partnership subsequently distributes cash or low basis property to that partner to liquidate his or her interest. This is a trap for the unwary because the new rule incorporates the step-up under IRC §1014. Since the "new" basis reduction rules apply, there is a lower downward basis adjustment on the asset distributed than there would have been had a §754 election been made. If a §754 election is made on low basis property, the inside basis and outside basis stepped-up under §1041 are closer and less of a downward adjustment occurs.

Obviously, if a §754 election is made as soon as the issue arises, then the "extra" basis reduction in the current year is avoided. Additionally, the partnership can then increase the basis of its property for use at a later time when high basis property is distributed to a low basis partner. In any event, the election must be fully analyzed since, once made, it will impact all future transfers, deaths and distributions (which causes increased cost). One must weigh the cost of a §754 election with the timing issues if no §754 election is made.

c. Multiple Rules. The third rule involves several Code sections—IRC §§704(c)(1)(B), 737 and 731(c). These sections impact family entities even though such entities were not "targeted." The rules were actually aimed at transactions where partners arranged to pool their assets in a partnership, then made allocations or distributions in a manner that effectuated a shift in tax attributes. To most taxpayer's surprise, these rules tax the contributing partner, not the partner who receives the distribution.

(i) IRC §704 (c)(1)(B). Under IRC §704(c)(1)(B), if a partnership distributes to a non-contributing partner, within 7 years of contribution, property in which a contributing partner has built-in gain or loss, the contributing partner must recognize gain or loss. The partner who receives the property has no recognition. The gain or loss recognized is limited to the contributing partner's pre-contribution gain or loss, and the basis in his or her partnership interest is adjusted accordingly. The gain or loss recognized by the contributing partner has the same character as if the partnership had sold the property to the distributee. These rules require the partnership to track, property by property, all pre-contribution gains and losses for 7 years from date of contribution (to date of distribution).

(ii) IRC §737. This section taxes a partner that receives a distribution of any partnership property within 7 years of when that partner contributes any other appreciated property to the partnership. The purpose of this section was to ensure that partners did not avoid recognizing their IRC §704(c) gains by "cashing out" their interest in the partnership with other property while continuing ownership of the IRC §704(c) property of the partnership. Unlike IRC §704(c), this section taxes the partner who actually receives the distribution. Gain under this section is limited to the difference between the property's fair market value over the partner's basis in his or her partnership interest. Section 704(c) ignores the contributing partner's basis in his or her partnership interest. IRC §737 does not apply to distributions of property that a partner previously contributed to the partnership, and it cannot result in a loss. The character of gain recognized by the distributee partner is determined at the partnership level, as if the partnership sold the property in question to an unrelated third party. (It is likely that most property in a family entity will be characterized as long-term capital gain.)

(iii) IRC §731(c). For distributions of marketable securities made after December 8, 1994, some or all of the securities may be treated as money under either of 2 circumstances:

(1) The first is for purposes of determining whether a partner recognizes any gain under IRC §731(c) when the amount of money received is greater than his or her (outside) partnership basis.

(2) The second is where securities are distributed to a partner with pre-contribution gain within 7 years of that partner's contribution of the IRC §704(c) property.

Here, IRC §731(c) applies before IRC §737, and only the portion of securities not treated as money under §731(c) is taken into consideration under §737.

The "marketable security" definition under IRC §731(c)(2) is more narrow than the definition under IRC §351(e). IRC §731(c) is targeting cash equivalents, while §351(e) targets all stocks and securities.

If the fair market value of a distributed security is greater than the partner's basis in the partnership interest, then the portion treated like a cash equivalent is reduced by the partner's share of unrealized gain in those securities. The regulations state that all the partnership's marketable securities are in the same class. Thus, the difference between the partner's unrealized gain in securities before and after the distribution reduces the value of the distributed securities treated like cash.

There are 3 exceptions under IRC §731(c)(3)(A):

(1) Securities are not treated as money if distributed to the contributing partner.

(2) Securities are not treated as money if the property was not a security when the partnership acquired it.

(3) Securities are not treated like money when distributed by an "investment partnership" (engaged in a trade or business other than investing) to an "eligible partner" (one who has only contributed investment-type assets).

(iv) Mixing Sections. It is possible to invoke §§704(c)(1)(B), 731(c) and 737 at the same time, i.e., if a security with a built-in gain or loss on contribution is distributed to a partner who has a built-in gain or loss account created within the last seven years. In this case, IRC §704(c)(1)(B) will tax the contributing partner as if the property were sold at fair market value on the date of distribution. IRC §731(c) taxes the distributee partner to the extent that the money exceeds the partner's basis in his partnership interest. Last but not least, IRC §737 taxes the distributee partner to the extent the fair market value of the property portion of the securities is greater than his basis in the partnership. These statutes are applied in the following order: §704(c)(1)(B), §731(c) then §737.

C. §754 Elections.

When a partner dies, his or her basis in the partnership is adjusted to equal the fair market value at date of death, reduced by income in respect of a decedent attributable to that interest. In essence, the partner receives a step-up on his outside basis but none on his or her inside basis unless the partnership makes a 754 election. If a §754 election is made, however, that partner's share of the inside basis is similarly stepped-up. The decision as to whether this election should be made is difficult and complex.

The election is made by attaching a statement signed by any partner to the partnership tax return in the year of the partner's death. The election is irrevocable without IRS consent to revoke. (Treas. Regs. §1.754-1(b) and (c).)

A late election can be made by filing a return, attaching the election, and stating at the top of Form 1065 or the election statement, preferably both, "this is filed pursuant to Treas. Reg. §301.9100-2." Late elections must be filed within 12 months of the due date (including extensions) of the partnership return filed in the year of the decedent's death. For example, if a partner dies in 2006, the election must be made by April 15, 2008, unless the partnership return for 2006 was extended.

In weighing whether an election should be made, all issues must be considered (there are pros and cons). Since the election really only causes a timing difference, one needs to determine whether the burdensome recordkeeping cost is outweighed by a looming benefit. If the partnership has no intention of selling any significant assets in the near future, no tax savings will result until the property is sold. Similarly, if the deceased partner's estate sells out, then only the outside basis will be used and the inside basis is not needed. On the other hand, if the partnership itself is contemplating a sale of a larger asset, then it may be advisable. Once the election is made, it will apply at each partner's death and when the partnership makes other distributions.

The election should not be made if the value of the partnership's assets will be less than the partnership's cost basis in the assets as, if such an election was made, a reduction in basis will occur. This can happen where discounts are utilized in valuing partnership assets. Unfortunately, under the Jobs Act, this election may be "mandatory" if the inside basis of all partnership property exceeds its fair market value by more than $250,000. This test uses the fair market value of partnership property, not a discounted basis of the outside interest.

It is advisable to postpone the §754 election decision if there is an estate tax audit. Prior to audit, the election may cause a step-down in basis. However, if an audit raises values, then the election may increase basis post-audit. Additionally, amended returns may be needed depending on the outcome of the audit and the §754 decision.

If the §754 election is made, the regulations lay out the allocation rules and the method of allocating a transferee's basis in his or her partnership interest among his or her share of the partnership assets. The

regulations attempt to achieve the desired goal of bringing uniformity between a partner's inside and outside bases. The regulations provide a 3-step process:

(1) Calculate the difference between the partner's basis of his partnership interest and his or her share of the adjusted basis of partnership property (the "743 adjustment").

(2) Allocated all assets into 2 categories—ordinary and capital gain. Apply the adjustment, first, to make all ordinary income property equal to its fair market value. Once ordinary income property has been adjusted to its fair market value, the balance is allocated to the capital gain assets.

(3) Within each class, allocate the step-up or step-down on an asset-by-asset basis, based on the taxable gain or loss that would be allocated to the transferee from a hypothetical sale of each asset. (Treas. Regs. §1.743-1 and 755-1.)

The regulations are silent on how to allocate discounts based on lack of marketability and minority interest assumptions to the value of partnership assets. One may be able to use an example in the regulations involving the sale of a partner's interest for less than his pro rata share of the fair market value of the underlying assets. In this example (Treas. Reg. §1.744-1(b)(3)(iii)2), the ordinary income asset receives a full step-up and the capital gains assets bear the reduction. Thus, in a family partnership, it would appear that partnership discounts should be allocated among the capital gain assets based on their relative value.

A final consideration is the impact in a community property state. Although §754 seems, on its face, to not apply to the surviving spouse, IRS has ruled otherwise. In Rev. Rul. 79-124, 1979-1 C.B. 224, the IRS has stated that the §754 basis adjustment also applies to the surviving spouse's share in a community property state. This is favorable to taxpayers, simplifies bookkeeping between the deceased and surviving spouse, and is another factor in determining whether such an election should be made.

An alternative to §754 is IRC §732(d). If a partnership which has not made a §754 election distributes property to a partner within 2 years of when that partner acquired his or her interest by purchase or death, the distributee partner may elect to calculate the basis of distributed property under IRC §743 as if a §754 election had been made. Without the §732(d) election, the distributee calculates the basis of distributed property under the rules of §§732(b) and 732(c). Although both methods allocate a partner's outside partnership basis to the distributed property, the rules for allocation among the assets differ. Generally, §743 allocates based on fair market values, whereas §732(c) allocates according to basis. In the event that the partnership could benefit from an allocation under it, an added advantage is that the §732(d) election imposes no obligation on the partnership to adjust the basis of its other assets, as does the §754 election.

D. Liquidation – General Rules.

Unlike corporate distributions, distributions to a partner by a partnership are generally not taxable. Instead, the partner takes a carryover basis in the property and any built-in gain or loss is preserved until the partner disposes of the property. This difference in treatment lends itself to the potential for eliminating one

level of tax.

E. Circumventing *General Utilities*?

One method involves (i) a corporation contributing appreciated property to a partnership in exchange for an interest in the partnership; and (ii) another person exchanging stock of the corporate partner for the remaining interest in the partnership. Since the partnership will receive a carryover basis in the corporate assets, the built-in gain in the property will stay preserved until the partnership disposes of the property. In addition, since partnerships are allowed flexibility in how they choose to allocate profits and losses, the non-corporate partner(s) in such a partnership can recognize passthrough gain and only incur one level of tax on a sale of the property.

The problem with the above transaction is that, absent more, it is a mere change in form of ownership while the economic effect would be tantamount to a redemption of the stock by the corporation to the other partner(s). Such treatment is particularly true where the disposition of the property is close in time to the contribution or where there is no business purpose for the change in ownership.

1. Proposed Regulations. In 1989, the IRS issued Prop. Regs. §1.337(d)-3 to address this situation and provide that such circumstances result in a deemed redemption and a deemed distribution. These regulations remain on the books, although they have not been finalized. Nevertheless, via administrative pronouncement, they may be relied upon to the same extent as a Revenue Ruling or Revenue Procedure.

a. Deemed Redemption. Under the deemed redemption rule, a partner would recognize gain at the time of and to the extent that any transaction has the economic effect of a corporate partner exchanging its interest in appreciated property for an interest in its own stock. The economic effect of an exchange of property for stock may occur when:

(i) A partner contributes money to a partnership;

(ii) A partnership acquires stock of a partner;

(iii) A partnership makes disproportionate distributions; or

(iv) A partnership agreement is amended to provide for different sharing ratios.

b. Deemed Distribution. The deemed distribution rule of the Proposed Regulations provides that a partnership distribution to a partner of its own stock would be treated as a redemption of the partner's stock in exchange for all or part of the partner's partnership interest. Thus, rather than the nonrecognition rule of §731, §311 or §1001 will apply to the distribution.

3. Other Risks. Even if the IRS interpretation of the proposed regulations is incorrect, the types of transactions contemplated by it are risky from the perspective of judicial doctrines (substance over form, etc.) or the disguised sales rules of §707(a)(2)(B).

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[1] I.R.C. §2053(a).

[2] Treasury Reg. §20.2053-4 (emphasis added).

[3] Jacobs v. Commissioner, 34 F.2d 233 (8th Cir. 1929), cert. den'd 280 U.S. 603 (1929).

[4] As adopted by the Fifth, Seventh, Ninth, Tenth and Eleventh Circuits.

[5] Ithaca Trust Co. v. United States (1929) 279 U.S. 151.

[6] 72 F.R. 20080.

[7] Id.

[8] Proposed Reg. § 20.2053-4.

[9] IRC §6166 increased the amount eligible for the 2% interest rate from $1.25 million in 2007 to 1.28 million in 2008. (See IRC §§6601(j)(3) and 1(f)(3).)

[10] The *General Utilities* Doctrine was codified in 1954. IRC §311(a) provided that, subject to certain exceptions, no gain or loss was recognized by a corporation on a nonliquidating distribution of its assets to shareholders. IRC §336(a) similarly imposed non-recognition in the case of a liquidating distribution. To maintain consistency with §336, §337(a) provided that a corporation did not recognize gain or loss on the sale or exchange of qualifying property that was sold within 12 months of the date the corporation adopted a plan of reorganization.

[11] The guidance also discusses relief available to corporations that have not timely filed their S-Corporation election request.

[12] The IRS wanted to prevent manipulation of tax or shifting tax benefits or burdens among the partners. (Treas. Regs. 1.704-3(a)(1), (2).)

[13] Prior to the Jobs Act, unless a 754 election was in effect, either of these sorts of distributions required the partnership to adjust the basis of its assets.

APPENDIX A

COMPARISONS AND EXAMPLES

COMPARISON OF CHARACTERISTICS OF PARTNERSHIPS (LLCS) AND CORPORATIONS

A. OPERATING CONSIDERATIONS – TAX

	C CORPORATION	S CORPORATION	GENERAL PARTNERSHIP (LLC)	LIMITED PARTNERSHIP
1. INCOME SPLITTING ADVANTAGES – **EXAMPLE 2**				
	Maximum income splitting available is $7,718 annually (not available to personal service corporations)	No income splitting is possible.	No income splitting is possible.	No income splitting is possible.
B. STRUCTURAL CONSIDERATIONS – TAX				
	C CORPORATION	S CORPORATION	GENERAL PARTNERSHIP (LLC)	LIMITED PARTNERSHIP
1. TAX CONSEQUENCES OF LIQUIDATIONS – **EXAMPLE 3**				
a. Entity Corporation/ Partnership	34% tax on gain	No tax	No tax	No tax
b. Owner Shareholder/ Partner	15% tax on gain	15% tax on gain	No tax	No tax
c. Combined	43.9% tax on gain	15% tax on gain	No tax	No tax
2. TAX CONSEQUENCES OF REDEMPTIONS – **EXAMPLE 4**				
a. Entity Corporation/ Partnership	34% tax	No tax	No tax	No tax
b. Owner Shareholder/ Partner	15% tax	1) The retiring shareholder will pay a 15% tax on any recognized gain. 2) The remaining shareholders will incur a tax on the payments of 15%. The remaining shareholders will receive a basis increase equal to the before-tax income which will be deductible on sale of liquidation of the corporation.	1) No tax on property redemptions; 15% tax on cash redemptions. 2) No tax to remaining shareholders is possible (§ 736).	1) No tax on property redemptions; 15% tax on cash redemptions. 2) No tax to remaining shareholders is possible (§ 736).
c. Combined	43.9% tax	48.2% tax on cash redemption; 15% tax on property redemptions.	15% tax on cash redemptions; 0% on property redemptions.	15% tax on cash redemptions; 0% on property redemptions.
3. BASIS CONSEQUENCES ON THE DEATH OF AN OWNER – **EXAMPLE 5**				
	There is no increase in the basis of the entity's assets, only the shareholder's stock.	There is no increase in the basis of the entity's assets, only the shareholder's stock.	The assets of the partnership may be increased to fair market value.	The assets of the partnership may be increased to fair market value.

EXAMPLE 1

DOUBLE TAXATION[1]

	C Corporation		Flow-Thru* Individual/Owner
Entity			
Income	$100,000		$100,000
Tax (34.00%)	(34,000)		N/A
	$66,000		$100,000
Individual			
Income	$66,000		$10,000
Tax (39.60%)	(26,196)	39.60%	(39,196)
NET CASH TO OWNER	$39,864		$60,864

Benefit of single level of tax: $21,000

[1] As tax rates for individuals are fluctuating over the next several years, and the "marginal" rate for corporations fluctuates by income level (see Appendix, EXAMPLE 5), these examples assume the following rates:

Individuals		Corporation	
Income Tax	39.6%	Income Tax	34%
Capital Gains	15.0%	Capital Gains	34%

EXAMPLE 2

INCOME SPLITTING ADVANTAGES

Assume: **$200,000 Worth of Income, Single Taxpayer, 2007 Rates**[1]

	C CORPORATION		S CORPORATION
	Corporation	**Shareholder**	**Sole Proprietor**
Taxable Income	$100,000	$100,000	$200,000
Federal Income Tax	(22,250)	(22,111)	(52,069)
Net Cash	$77,750	$77,899	$147,931
Net Cash to C Corp		$77,750	N/A
Net Cash to Entity and Owner		$155,649	$147,931
Net Cash to S Corp. Sole Prop.		(147,931)	

Income Splitting Advantage of C Corp $ 7,718

[1] As tax rates for individuals are fluctuating over the next several years, and the "marginal" rate for corporations fluctuates by income level (see Appendix, EXAMPLE 5), these examples assume the following rates:

Individuals		Corporation	
Income Tax	39.6%	Income Tax	34%
Capital Gains	15.0%	Capital Gains	34%

EXAMPLE 3

TAX CONSEQUENCES OF LIQUIDATION

Assume: **$1,000,000 worth of Value, $0 Entity Basis, $0 Individual Basis; Tax Rates[1]**

	C CORPORATION	S CORPORATION	SOLE PROPRIETORSHIP
Entity Level Tax			
Value	$1,000,000	$1,000,000	$1,000,000
Basis of Assets	(0)	(0)	(0)
Gain	$1,000,000	$1,000,000	$1,000,000
Federal Tax	(340,000)	(0)	(0)
After Tax Net	$ 660,000	$1,000,000	$1,000,000
Shareholder/Proprietor Level			
Liquidation Proceeds	$ 660,000	$1,000,000	$1,000,000
Basis	(0)	(0)	(0)
Gain	$ 660,000	$1,000,000	
Federal Tax	(99,000)	(150,000)	
After Tax Net	$ 561,000	$ 850,000	$1,000,000

ADVANTAGE:

	C CORPORATION	S CORPORATION	SOLE PROPRIETORSHIP
C Corporation v. S Corporation	N/A	$289,000	N/A
C Corporation v. Sole Proprietor	N/A	N/A	$439,000
S Corporation v. Sole Proprietor	N/A	N/A	$150,000

[1] As tax rates for individuals are fluctuating over the next several years, and the "marginal" rate for corporations fluctuates by income level (see Appendix, EXAMPLE 5), these examples assume the following rates:

Individuals		Corporation	
Income Tax	39.6%	Income Tax	34%
Capital Gains	15.0%	Capital Gains	34%

EXAMPLE 4

TAX CONSEQUENCES OF REDEMPTION USING APPRECIATED ASSETS

Assume: **Redemption Price $1,000,000; $0 Entity Basis / $0 Owner Basis; Tax Rates[1]**

	C CORPORATION	S CORPORATION	SOLE PROPRIETORSHIP
Entity Level			
Value	$1,000,000	$1,000,000	$1,000,000
Federal Tax (34%)	(340,000)	N/A	N/A
After Tax Net	$ 660,000	$1,000,000	$1,000,000
Shareholder/Proprietor Level			
Pass-Three Income	N/A	$1,000,000	N/A
Federal Tax	---	(150,000)	See Below
After Tax Net	See Below	(850,000)	None
Redemption Proceeds	$660,000	$1,000,000	$1,000,000
Basis	None	(1,000,000)	None
Gain on Redemption	$660,000	None	$1,000,000
Federal Tax (15%)	99,000	N/A	(150,000)
After Tax Net	$561,000	See Above	$850,000
Total Taxes Paid			
Entity	$340,000	N/A	N/A
Owner-Seller	99,000	$150,000	$150,000
Total Taxes Paid	$439,000	$150,000	$150,000
Net Redemption Proceeds	$561,000	$850,000	$850,000

ADVANTAGE:

	C CORPORATION	S CORPORATION	SOLE PROPRIETORSHIP
C Corporation v. S Corporation	N/A	$289,000	N/A
C Corporation v. Sole Proprietor	N/A	N/A	$289,000
S Corporation v. Sole Proprietor	N/A	N/A	N/A

[1] As tax rates for individuals are fluctuating over the next several years, and the "marginal" rate for corporations fluctuates by income level (see Appendix, EXAMPLE 5), these examples assume the following rates:

Individuals		Corporation	
Income Tax	39.6%	Income Tax	34%
Capital Gains	15.0%	Capital Gains	34%

EXAMPLE 5

TAX CONSEQUENCES OF AN OWNER'S DEATH OR THE PURCHASE OF AN INTEREST

Assume: **Value of Inventory at Date of Death is $1,000,000; Tax Rates[1]**

	C CORPORATION	S CORPORATION	PARTNERSHIP, LLC OR SOLE PROPRIETORSHIP
Gross Entity Sales	$1,000,000	$1,000,000	$1,000,000
Less: Entity Basis (34%)	(0)*	(0)	(1,000,000)**
Gain	$1,000,000	$1,000,000	$ (0)
Federal Tax	($340,000)	($396,000)	$ (0)

ADVANTAGE:

	C CORPORATION	S CORPORATION	PARTNERSHIP, LLC OR SOLE PROPRIETORSHIP
C Corporation v. S Corporation	$56,000	N/A	N/A
C Corporation v. Sole Proprietor	N/A	N/A	$340,000
S Corporation v. Sole Proprietor	N/A	N/A	$396,000

* There is no increase in the (inside) basis of the entity's assets, only the (outside basis of the) shareholder's stock.

** Basis of assets increases to fair market value on death, assuming an IRS § 754 election is made.

[1] As tax rates for individuals are fluctuating over the next several years, and the "marginal" rate for corporations fluctuates by income level, these examples assume the following rates:

Individuals		Corporation	
Income Tax	39.6%	Income Tax	34%
Capital Gains	15.0%	Capital Gains	34%

TAX RATES

Individual Income Tax Rate Changes Beyond 2007

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (P.L. 107-16), implemented a staged decrease in the tax rates that began in 2001 and was accelerated by the Jobs and Growth Tax Relief Reconciliation Act of 203 (JGTRRA) (P.L. 108-27).

Without further congressional action, the pre-2001 rates will return in 2011 as indicated.

Tax Years	
2007-2010	27% rate reduced to 25%
	30% rate reduced to 28%
	35% rate reduced to 33%
	38.6% rate reduced to 35%
2011 and after	25% rate goes back up to 28%
	28% rate goes back up to 31%
	33% rate goes back up to 36%
	35% rate goes back up to 39.6%

Capital Gain Rates

Generally, gain from the sale of long-term capital assets is subject to the following maximum capital gains rates:

- Individuals: 15% (5% for individuals in the 10% or 15% tax bracket) (Code § 1(h)(1)). However, a 0% rate will replace the 5% rate for tax years beginning after December 31, 2007. Capital gains on collectibles are subject to a maximum rate of 28%, and unrecaptured Section 1250 gain is subject to a maximum rate of 25%.
- Corporations: 35%

Corporate Income Tax Rates for 2007apital Gain Rates

Taxable Income		Pay	Plus % on Excess	of the Amount
Over	But Not Over			Over--
$0	$50,000	$0	15%	$0
$50,000	$75,000	$7,500	25%	$50,000
$75,000	$100,000	$13,750	34%	$75,000
$100,000	$335,000	$22,250	39%	$100,000
$335,000	$10,000,000	$113,900	34%	$335,000
$10,000,000	$15,000,000	$3,400,000	35%	$10,000,000
$15,000,000	$18,333,333	$5,500,000	38%	$15,000,000
$18,333,333	……		35%	$0

EXAMPLE 6

SALE TO AN ESOP

An ESOP is a qualified retirement plan, designed to invest primarily in employer securities, in the form of a stock bonus plan or a combination of a stock bonus and money purchase pension plan that satisfies certain requirements. In 2007, an employer could contribute up to $45,000 per employee to an ESOP, plus interest on a qualifying loan. (IRC §415(c), (d).) A loan to an ESOP is exempt from the prohibited transaction rules if the proceeds are used within a reasonable time to acquire qualifying employer securities and it meets certain other requirements. (IRC §4975(d)(3); Treas. Reg. §54.4975-7(b)(4).) A C-corporation may deduct dividends paid on its stock held by the ESOP. (IRC §404(k).) A shareholder of a C-corporation may defer gain on the sale of stock to an ESOP if the ESOP holds at least 30% of the stock after the sale and the shareholder reinvests the proceeds in stock or securities issued by a domestic corporation within a 15-month period beginning three months before the sale. (IRC §1042.) If replacement securities are held until the selling shareholder dies, the gain will be eliminated altogether under current law. (IRC §1014.)

Example:

Value of Company	$40,000,000
ESOP Loan buy 51% of the Company's stock	*$20,400,000*
Value of the Company after deducting the loan	$19,600,000
ESOP Loan Income Tax Benefit	*$4,000,000*
Ownership Control Value of the Equity	$23,600,000
Less 30% Lack of Control Discount	*$7,080,000*
Marketable, non-controlling interest	$16,520,000
Less a 35% Lack of Marketability Discount	*$5,782,000*
Fair Market Value of the Equity for Transfer Tax Purposes	$10,738,000
Value of 49% of Equity	*$5,261,620*
2 x $1,000,000 (gift tax applicable exclusion for 2007)	$2,000,000
4 x $24,000 (annual exclusion for couple for 2008)	*$96,000*
Total Tax-Free Gift	$2,096,000
Amount of Equity Left after Gifts to Four Children	$3,165,620
Percentage of Equity Remaining after Gift ($3,165,000 divided by $23,600,000)	13.41%

Note that the value of the remaining equity is less than the remaining estate tax applicable exclusion amounts available to a married couple once the exclusion reaches $3,500,000, scheduled to occur in 2009. Note also that after the company borrows the money from a bank and re-lends it to the ESOP to enable the ESOP to purchase 51% of the company stock from the entrepreneur, the value of the company is reduced by the amount of the loan, but increased by the potential tax benefits of the ESOP loan. Finally, note that the 30% lack of control discount and 35% lack of marketability discount may be higher or lower than would be available in a particular case.

EXAMPLE 7

SALE TO A GRANTOR TRUST

A grantor trust is a trust where the grantor (generally the person who contributed the assets to the

trust) is treated as owning the assets for income tax purposes. Consequently, transactions between the grantor and the trust, including sales, are not recognized for income tax purposes. However, because transfers to a properly structured trust are recognized for gift and estate tax purposes, assets transferred to the trust will not be included in the grantor's estate for estate tax purposes. Transfers to the trust will not be taxable gifts if the grantor receives fair market value for the transferred asset. If the grantor takes back an installment note, there will not be a taxable gift so long as the principal is equal to the fair market value and the interest rate charged is equal to the applicable federal rate.

Example:

Mr. Entrepreneur owns 100 shares of the stock of an S-corporation having a fair market value of $20,000,000. He also owns commercial real estate having a fair market value of $20,000,000. Mr. Entrepreneur has 4 children, 2 active in the business and 2 not active in the business. He wants to treat the children equally, but does not want the children who are inactive in the business to have any ownership in the business.

To carry out his desires, Mr. Entrepreneur could do the following:

- Recapitalize the corporation to create 10 shares of voting stock and 90shares of nonvoting stock.
- Sell 90 shares of nonvoting stock to a grantor trust having as its beneficiaries the two children who are active in the business.
  - Assuming a 50% combined discount for lack of control and marketability, the value of the stock sold to the trust would be $9,000,000 (90% times $20,000,000 = $18,000,000 times 50% = $9,000,000).
- Transfer the commercial real estate to a limited liability company (LLC).
- Sell 90% of the membership interest in the LLC to a grantor trust having as its beneficiaries the other two children.
  - Assuming a 50% combined discount for lack of control and marketability, the value of the LLC interests sold to the trust would be $9,000,000 (90% times $20,000,000 = $18,000,000 times 50% = $9,000,000).
- To avoid a number of potential tax problems, Mr. Entrepreneur should contribute $1,000,000 to each of the trusts, using the combined gift tax applicable exclusion amounts of him and his wife ($1,000,000 each).
- At his death or the death of the survivor of him and his wife, Mr. Entrepreneur would leave the voting stock in the corporation to the two children active in the business and the remaining membership interests in the LLC to the other two children.

APPENDIX B
RECENT VALUATION CASES

1. ***Estate of Josephine T. Thompson***

a. *Thompson*: Tax Court--TC Memo 2004-174 (July 26, 2004)

Tax Court Found Both Parties' Valuations Deficient and Unpersuasive - See 1.b, below, for 2nd Circuit Ruling

The decedent, Josephine, owned a 20.57 percent block of the stock of Thomas Publishing Co., Inc. (TPC), a closely-held corporation formed in 1898. The decedent's block was the largest block of TPC's common stock held by any one shareholder. Capital Cities/ABC, Inc. owned a l2.656 percent block of the stock, and the rest was owned by various members of Josephine's extended family. None of the shares had been traded in the ten years before Decedent's death. TPC's primary business is the production and sale of industrial and manufacturing business guides and directories, though it also published and sold a variety of news magazines, software comparison guides, and a magazine relating to factory automation, and it owned a product information exchange service and a custom publishing group. TPC also maintained a leading business-to-business website. The business was located in New York and the Decedent also resided there.

TPC had a long history of paying annual cash dividends. The estate's tax return valued the estate's 20.57 percent interest at $1.75 million, or $3.59 a share. This valuation was based on a determination that the undiscounted value of the entire company was $25,784,000, which was then multiplied by the estate's percentage of ownership and discounted by 40 percent to take into account the minority interest and another 45 percent of the remaining value to take into account lack of marketability.

A professional appraiser employed by the IRS valued the decedent's stock at $35.273 million, or $72.36 per share, using the comparable public company method and the discounted cash flow method, and applying a 30 percent discount for lack of marketability, and no discount for lack of control. The IRS assessed a deficiency and penalty for understatement of values. Shortly before trial, the IRS reduced its valuation to $32.388 million, because of errors in the original appraisal report.

The Tax Court valued the 20.77 percent block of stock at $13.525 million, or $27.75 per share, and refused to impose a penalty for undervaluation. The court found both parties' valuations to be "deficient and unpersuasive." The court noted that the estate's appraisers had relatively little valuation experience, that they valued the interest aggressively and overstated the risks associated with the Internet and technology and by applying excessive discounts. The IRS expert, the court noted, used a "sterile approach" that was concerned only with numbers, and that did not value TPC as a real company, and the companies selected by the IRS expert as comparable were not, the court stated, very similar to TPC. The court noted that "the fact that two companies are both part of the same general industry does not, as respondent's expert implies, make them comparable per se." The court valued TPC by capitalizing its earnings at an l8.5 percent rate, and allowing a 15 percent minority interest discount and a 30 percent lack of marketability discount. Although IRC §6662 allows a 40 percent penalty if the reported value is less than 40 percent of the determined value, the court held that an exception applied. The court refused to allow a penalty for substantial valuation understatement, because the taxpayer's valuation, while wrong, was based on reasonable cause and the taxpayer had acted in good faith. The court noted that the valuation of the stock of TPC was particularly difficult, comparable companies did not exist, and capitalization of income and the discounted cash flow methods involved a number of difficult judgment calls.

In its decision the court seemed to be irritated that the estate, the executors, and the company whose stock was being valued, were all headquartered and based in New York City, and yet the estate hired a lawyer and accountant from Alaska, in an apparent attempt to have the estate audited in Alaska, rather than in New York City. The court stated that the estate's experts were "only marginally credible . . . [and] barely qualified to value a highly successful and well-established New York City-based company with annual income in the millions of dollars." The result of this case seems to be quite favorable to the estate.

b. *Thompson*: 2d Circuit--TC Memo 2007-174 (August 23, 2007).

The Estate valued its 20 percent interest in the Thompson Publishing Company ("TPC") at $1.75 million. This valuation, which took place in 1998, considered the proliferation of the internet to be a "substantial threat to TPC's viability as a business." The Service valued the Estate's interest at $32 million, which included a 30 percent discount to reflect a lack of marketability. The Tax Court rejected both valuations and arrived at a value of $13.5 million, including discounts of 15 percent for minority interest and 30 percent for lack of marketability.

Under IRC § 7491, the Service had the burden of proof on the issue of valuation. On Appeal to the Second Circuit, the Estate argued that since the Tax Court rejected the valuation proffered by the Service, the Tax Court was required to adopt the Estate's valuation. The Second Circuit disagreed, stating that "the burden of disproving the taxpayer's valuation can be satisfied by evidence in the record that impeaches, undermines, or indicates error in the taxpayer's valuation." The Second Circuit further noted that the Tax Court is not bound by the opinions proffered by expert witnesses, and that it may reach its own analysis based on the evidence in the record. However, the Second Circuit held, the Tax Court erred in determining its own value by double-counting certain assets in the valuation.

With regard to the undervaluation penalty, the Second Circuit noted that IRC § 6662 requires the Estate to pay an accuracy-related penalty the value if claims are not more than 25 percent of the amount determined to be correct. With respect to the "reasonable cause" exception, the Second Circuit concluded that the Estate did not show "reasonable cause" for its underpayment, and thus it was required to pay a penalty equal to 40 percent of its underpayment. Reliance on an appraiser will not automatically insulate the taxpayer from undervaluation penalties.

2. *Estate of Jelke v. Commissioner*

a. *Jelke*: Tax Court--TC Memo 2005-131 (May 31, 2004)

Tax Court Rejects Dunn and Allows Discount Equal to 41 Percent of BIG Tax, See 2b, below, for 11th Circuit Decision

Commercial Chemical Co. ("CCC") was incorporated in the 1920's and operated a chemical manufacturing business until it sold the business assets in 1974. From that date until the death of Mr. Jelke on March 4, 1999, CCC held investment assets, primarily marketable securities. At issue in the case was the fair market value of 6.44 percent of the shares of CCC. CCC invested mostly in large-cap domestic equity securities with an investment objective of long-term capital growth. Consistent with the investment objective, CCC's

asset turnover averaged just under 6 percent over the five years prior to the valuation date, and CCC had a dividend payout of 0.8 percent of net assets at the valuation date. Substantial unrealized capital gains from highly appreciated long-term holdings produced a built-in gains tax ("BIG" tax) of $52 million, representing 27 percent of the net assets of $189 million, on the valuation date.

The taxpayer's expert valued the estate's interest in CCC at $4.3 million, but the estate had filed with a value of $4.6 million and did not seek a lower value. The expert's calculation started with $189 million net asset value, minus the entire $52 million BIG tax, times 6.44 percent interest, less discounts of 25 percent for lack of control and 35 percent for lack of marketability. The IRS' expert valued the same interest at $9.2 million (slightly above the IRS' $9.1 million value on its notice of deficiency) calculating $189 million net asset value, minus $21 million present value of BIG tax, times 6.44 percent interest, less discounts of 5 percent for lack of control and 10 percent for lack of marketability.

The Tax Court agreed with the IRS' expert on the BIG tax issue, but raised the discounts to 10 percent for lack of control and 15 percent for lack of marketability. The resulting value was $8,254,696. The Court stated that the taxpayer's expert based his decision to subtract the entire BIG tax primarily on the Dunn case, in which the Fifth Circuit stated that, as a matter of law, the BIG tax must be subtracted when an asset approach is used. The Court rejected this argument because the *Jelke* case was not appealable to the Fifth Circuit, and "more significantly," because the facts of the two cases can be distinguished because a minority interest is being valued in *Jelke* but a majority interest was valued in Dunn." The Court stated that "unlike the situation in [Dunn], decedent's 6.44 percent interest in CCC would be insufficient to cause liquidation."

The taxpayer's secondary argument in support of subtraction of the entire BIG tax was that, even if the tax on currently unrealized appreciation was deferred, additional appreciation was likely to occur. The taxpayer argued that it could be shown mathematically that the expected appreciation and the deferral offset each other, so that it would not matter when the BIG tax came due, the present value of the total tax would be the same. The IRS' expert countered this argument with an analogy to discounting tax carry forward losses. The Court accepted this analogy without discussion and thereby rejected the position of the taxpayer's expert, noting that the logic of the taxpayer's expert would imply a discount even if the corporation's assets had a tax basis equal to their current market value. "Such an approach would establish an artificial liability."

Ultimately, the Court rejected the methodology of the taxpayer's expert in favor of the methodology of the IRS' expert. The latter noted that the corporation's long-term hold objective had resulted in an average asset turnover of just under 6 percent annually over the prior five years. Based on this, he projected that the current BIG tax would be realized over the next 16 years (which implies turnover of 6.25 percent per year). He then calculated the present value of the tax using a 13.2 percent discount rate. The Court accepted not only the methodology, but also the timeframe and the discount rate. The timeframe was supported by historical turnover, and the estate had agreed in post-trial briefs that 13.2 percent was a reasonable rate. The calculation resulted in a present value for the BIG tax of $21 million, which is 41 percent of the total BIG tax. Under this methodology, a higher turnover rate will result in a higher present value (larger discount), and a higher discount rate will result in a lower present value (lower discount).

The Court, in reaching discounts of 10 percent for lack of control and 15 percent for lack of marketability (23.5 percent total discount when combined sequentially) found many problems with the analyses of both experts. In particular, the Court found the position of the taxpayer's expert in subtracting the BIG tax on the assumption of liquidation on the valuation date inconsistent with his premise that CCC would not be liquidated for 20 years or more. "In each instance, the approaches, although internally inconsistent, produce the best results for his client (the estate)."

The Tax Court has reasserted its position that discounts for BIG tax should be determined by a present value method. The Court did not accept the implicit argument that there is a disadvantage to holding investment assets in a C-Corporation independent of any future liability for unrealized appreciation that has already occurred. In the current instance, where the BIG tax is expected to occur gradually over the next 16 years, the BIG tax discount was determined by the Court to be equal to 41 percent of the BIG tax. (The Tax Court was later reversed and remanded.)

b. *Jelke*: 11th Circuit--1507 F.3d 1317 (11th Cir. 2007)

Estate Tax Value of Holding Company Stock Reduced by Full Built-in Capital Gain Tax

The Eleventh Circuit has vacated the Tax Court's valuation and has held that the Tax Court used an inappropriate valuation method. The court further held that in determining the estate tax value of stock in a holding company, the value will include a reduction for the amount of the tax liability attributable to built-in gains ("BIGs") in the stock owned by the corporation. Thus, the court has ordered the tax court to use the valuation method set forth by the Fifth Circuit. Even more favorable to taxpayers, the decision allows for a reduction in the amount of the entire amount of the tax rather than discounting the amount of the reduction to a present value based on when the sale would be reasonably expected to occur.

Facts

Decedent was an individual who owned a 6.44% interest, through a revocable trust, in a closely-held C-Corporation at the time of his death. (The remaining interests in the corporation were owned by taxpayer's relatives.) Although the corporation had ceased doing business several years prior to decedent's death, it continued to operate as a holding company. The investment strategy of the corporation was targeted at achieving long-term growth with low asset turnover and large unrealized capital gains.

The decedent's estate and the IRS agreed to allow for a discount in determining the value of the decedent's stock ownership for estate tax valuation purposes, however they disagreed as to the proper amount of the discount. While the estate argued for a reduction in the value by the full amount of the BIG on the date of decedent's death, the IRS argued that the amount of the reduction attributable to the tax had to be reduced to present value.

The IRS calculation used the average turnover rate for the corporate ownership interests and a discount rate based on the average stock appreciation and computed the present value of the capital gain tax. This discount to present value resulted in a larger value of the corporation's stock and thus a larger tax due.

Issue

What is the appropriate treatment of the BIGs with respect to their influence in the value of the corporate stock owned by decedent?

Law

The Tax Court reasoned that a hypothetical seller would not accept a reduced price knowing that only a small percentage of the corporation's portfolio would be sold each year. Accordingly, the Tax Court agreed with the IRS and adopted the IRS's figures, holding that the value of the stock can only be reduced by the BIG tax based on the present value of the tax.

The Eleventh Circuit overruled the Tax Court and allowed a BIG tax reduction based on the full amount of the BIG at the time decedent died. The Eleventh Circuit's rationale was essentially based on practicality and judicial efficiency. The majority rationale stated that the appropriate valuation method is to take a "snapshot" of the assets at the time of death. Accordingly, the Eleventh Circuit stated that it was more logical and appropriate to value the stock based on the fiction that liquidation occurred on the date of death rather than speculating on what might happen in the future. The Circuit noted that this decision will provide greater certainty regarding valuation and that the approach it adopted would provide for a more efficient use of judicial resources by virtue of the certainty of the approach.

Result

Based on its analysis, the Eleventh Circuit allowed a reduction for 100% what the tax would have been to the corporation if it had sold all of the stock on the date of the decedent's death.

The Author's Take

While other Circuits have allowed similar reductions to the value of closely-held corporation stock for estate tax purposes, *Jelke* was the first in which a reduction of the full amount of the tax was allowed. As there are now differing opinions among the Circuits with regard to how to determine the discount, the matter may have to be finally resolved by the Supreme Court if the IRS continues to litigate this issue.

Notably, the lynchpin of this decision was the fact that the BIGs were held at the corporate level. Although the stock owned by the decedent at death got a step-up in basis, the stock held by the corporation itself did not.

How this may apply to S-Corporations is not clear. S-Corporations may have a separate BIG tax imposed at the corporate level under section 1374. This tax is applicable where an S-Corporation owns property which has built in gains which gains are attributable to a time before the corporation elected subchapter S treatment. This BIG tax (if otherwise applicable) disappears if the property is not sold within 10 years after the S election.

To date the only cases addressing this issue have been in the context of C-Corporations. Although the issue has not been presented with respect to S-Corporations, it would seem that the same reasoning that

applies to a C-Corporation should apply to S-Corporation stock held by a decedent. In fact, the reasoning of *Jelke* could be applied to an interest in any entity holding BIG property.

As a matter of economic reality, an entity-level BIG should affect the price a rational buyer would pay for an interest in the S-Corporation irrespective of the fact that S-Corporations are not doubly taxed as are C-Corporations. This becomes clearer when contrasting an S-Corporation's characteristics with those of a partnership or LLC—upon the sale of an interest in one of those entities or upon the death of a member, the partners may elect to step up the inside basis in partnership assets with respect to the deceased / seller member's share of inside basis. S-Corporation assets do not get the same basis step-up when a shareholder dies, and so the tax remains built into the asset. This difference in basis adjustment should provide a good basis to argue that a buyer would consider the BIG tax in purchasing S-Corporation stock just as one would in considering the purchase of C-Corporation shares.

Most importantly, practitioners outside of the Eleventh Circuit are warned to determine the status of the law in their Circuit to determine the applicable rule in their jurisdiction. While the Fifth and Second Circuits have provided for a discount in similar situations, the Eleventh is the only one to allow for a reduction of the full amount of the tax. However, in jurisdictions in which no rule has been adopted, the *Jelke* decision will provide practitioners with a basis for asserting the full discount amount.

3. *Estate of Virginia A. Bigelow v. Commissioner*

a. *Bigelow*: Tax Court--TC Memo 2005-65 (March 30, 2005)

The decedent, Virginia A. Bigelow, created a revocable trust and transferred her residence to that trust in 1991. In 1992 she suffered a stroke and moved out of her home. Prior to and after her stroke she made gifts of a fractional interest in the residence to her three children. In 1993, the trust exchanged the decedent's former residence for investment real estate. The trust borrowed $350,000 against the new property to pay off the existing loans on the former residence and it also obtained a $100,000 equity line of credit secured by the new property.

In 1994, the trust contributed the investment property (but not the debt secured by the property) to a family limited partnership. The trust was the sole general partner of the family limited partnership and the trust owned the majority of the limited partnership units. Even though the decedent had maintained liability for the loans on the property, the partnership made the monthly mortgage payments. In addition, the partnership paid some of the decedent's living expenses. The decedent's son made forty transfers between the partnership and the trust during a period of a little over two years. In December of 1994 and 1995, the son, as agent under the decedent's power of attorney, made gifts of partnerships units to himself, his siblings, and the decedent's grandchildren. The decedent died in 1997 and the partnership was terminated approximately one year later.

The Court held that §2036 applied because there was an implied agreement between the decedent and the decedent's son for her to retain the income and enjoyment of the rental property after it was contributed to the FLP. The Court further held that the parties failed to respect partnership formalities – they

did not maintain partnership or partner's capital accounts, the partnership balance sheet improperly showed the $350,000 mortgage as a partnership liability, and the partnership capital accounts were not adjusted to account for the lifetime distributions on behalf of the taxpayer.

b. *Bigelow*: 9th Circuit--503 F.3d 955 (9th Cir. 2007)

The Ninth Circuit affirmed the Tax Court's decision that section 2036 applied because (1) the transferor continued to enjoy the economic benefits of the transferred property, (2) the transferor and her children impliedly agreed that transferor would retain income from the transferred property, and (3) the transfer did not fall within the bona fide sale exception to the estate tax statute requiring inclusion in the value of the gross estate of the transferred property as to which the transferor retained economic benefits.

4. *Estate of Charles Porter Schutt, Deceased v. Commissioner*, TC Memo 2005-126 (May 26, 2005)
Decedent's Transfers to Trusts were Bona Fide Sales for Adequate Consideration, so Transferred Property Escaped Estate Tax

The decedent was married to Phyllis DuPont, an heiress of the DuPont family. The decedent and Mrs. Schutt had four children, each of whom had children of his or her own. During 1940, Mrs. Schutt's father established a trust with Wilmington Trust Company as Trustee. This trust was funded with DuPont stock and Exxon stock. Upon Mrs. Schutt's death in 1989, the trust was divided into separate shares for the benefit of her children for their respective lives. Upon the death of each child, the corpus of the separate share was distributable outright to such child's decedents, subject to age restrictions. Decedent controlled the investments of the trusts as consent adviser.

In early 1976, the decedent had established a revocable trust funded with his life insurance policies and various holdings in common stock. In early 1997, the decedent and his advisors began discussions concerning transfer of assets out of the revocable trust to another investment vehicle. Through correspondence among the advisors and decedent, *Schutt* I and II were designed to perpetuate the decedent's buy and hold investment philosophy over family assets, develop another vehicle for decedent to make annual exclusion gifts (decedent's units in his family limited partnership had been exhausted), have the possibility of valuation discounts, and have decedent as the initial trustee. The outline of *Schutt* I and II was for the decedent's revocable trust to contribute less than 50% of the assets and for the children and grandchildren's trusts (from the 1940 trust) to contribute the balance. *Schutt* I would primarily hold DuPont stock ($68 million) and *Schutt* II would primarily hold Exxon stock ($24 million). Decedent owned assets outside of *Schutt* I and II totaling approximately $30 million.

The Tax Court and found that decedent's transfers to *Schutt* I and II by his revocable trust satisfied the "bona fide sale for adequate and full consideration" exception because (1) the contributed property was actually transferred to the DBTs in a timely manner; (2) the decedent's assets were not commingled with the assets of the DBTs; (3) the decedent retained sufficient assets to support his lifestyle and needs; and (4) the DBTs were formed as a result of arm's-length negotiations. Further, the decedent and the trust company received interest in the DBTs representing adequate and full consideration because (1) the interests received

were proportionate to the value of the property contributed; (2) the respective assets contributed by the decedent and the trust company were properly credited to the appropriate capital accounts; (3) distributions from the DBTs required a negative adjustment in the distributee's capital account; and (4) a legitimate and significant nontax reason existed for creating the DBTs.

The Court found that *Schutt* I and II advanced decedent's non-tax objectives in a meaningful way and that the decedent's concern about wealth dissipation due to outright trust distributions was not merely testamentary. Particularly important to the Court was that the events that triggered outright distributions from the trust did not turn on decedent's own death. Further, in correspondence from his lawyer to decedent to update his client on the progress of negotiations with Wilmington Trust, transfer tax issues were nearly absent.

Because *Schutt* I and II were formed to perpetuate a buy and hold investment strategy of the DuPont and Exxon stock, the IRS pressed an argument from the Harper case that a "recycling of value" evidenced by an untraded portfolio of securities does not qualify as a significant non-tax reason. The Court recognized that holding an untraded portfolio of marketable securities is normally a negative factor in finding a non-tax reason. However, this case was distinguished from other "recycling of value" cases where the securities were contributed almost exclusively by one person.

5. *Estate of Concetta H. Rector v. Commissioner*, T.C. Memo 2007-367
Inclusion and 20% Penalty

When there is an implied understanding that the decedent would retain possession, income, and the right to economic enjoyment from the transferred property, the Tax Court has held that the value of the real property transferred to a limited partnership (LP) is includible in a decedent's gross estate.

Decedent and her two sons created an LP in 1999 and funded it with all of the assets in the decedent's revocable trust which consisted primarily of cash and securities. In exchange for the assets, the trust received a 98-percent limited partner interest. The decedent also became a two-percent general partner. No other parties contributed to the LP.

After the transfer, the decedent's only other significant source of income was a life estate in the income of an irrevocable trust. The irrevocable trust distributions supplied only one-third of her support. After the transfer, the decedent distributed funds to herself from the LP to cover her remaining expenses. In fact, over 29 checks were written from the partnership to pay her expenses.

Over the following three years, the decedent's trust transferred approximately a 28-percent interest in the LP to her sons. The last gift was the week before her death. On the federal estate tax return, the estate claimed approximately a 72-percent interest in the LP and then applied a 19-percent discount for lack of control and marketability.

The Tax Court held that the decedent retained the rights to the transferred property within the

meaning of Code Sec. 2036(a) because, through her revocable trust, the decedent had both a majority interest in the LP and retained complete control over the LP's assets as the general partner. In addition, the court found that there was an implied agreement between the decedent and her sons that she would continue to utilize the assets in the LP for her benefit. The court determined that, although the decedent's sons, as co-trustees, had the power to invade the corpus of the irrevocable trust for her "care, comfort, and support," they intended for the decedent to distribute funds from the LP to cover her expenses instead.

The court also found that the transfer of the property to the LP was not a bona fide sale for adequate and full consideration under Code Sec. 2036(a) because the creation of the LP did not cause either a change in the underlying assets or a potential for profit. Moreover, the transfer was not in good faith as required by Treas. Reg. § 20.2043-1(a) as the estate's stated purposes of benefiting from estate tax savings, gift giving, and protection and diversification of assets were not legitimate non-tax purposes. The court also held that the actions between the decedent and her sons during the formation of the LP were not those of unrelated parties negotiating at arm's length in that: the parties did not negotiate the terms of the LP; they did not retain independent counsel; the decedent was the sole contributor and contributed the bulk of her wealth; the decedent and the revocable trust were the only initial partners; and the LP was not founded until three months after its creation. Therefore, the transfer to the LP was not a bona fide sale for full and adequate consideration, and the decedent had retained an interest in the property. Accordingly, the LP was includible in the decedent's gross estate.

In addition, the court held that the estate was subject to a 20-percent accuracy related penalty under Code Sec. 6662 because it negligently failed to report $595,000 in prior gifts on the estate's federal tax estate return. The decedent's son, a co-executor of the estate, had expertise in financial matters and was a recipient of one-half of the unreported gifts. The court found that he made no showing of reasonable cause or good faith with respect to the omission.

6. *Estate of Anna Mirowski*, TC Memo 2008-74

Bad Facts Make Good Law

The recent tax court case, *Estate of Anna Mirowski*, makes clear that even with bad facts, we can have good law. Dr. Mirowski was one of the scientists responsible for developing the cardio defibrillator. This left his wife with an extremely large estate. Thus, in 2000, U.S. Trust advised Ms. Mirowski that she should consolidate her accounts and contribute them to an LLC for estate planning purposes. She waited for the next family meeting, which occurred in 2001, to discuss the matter with her family and proceed with the plan. Although she understood the tax benefits, her primary reasons were nontax driven. These included (1) joint management of the family assets by her daughters and eventually her grandchildren, (2) maintenance of the bulk of the family's assets in a single pot to maximize investment opportunities, (3) providing for her daughters and eventually her grandchildren equally, and (4) providing additional protection from potential creditors.

In 2001, Ms. Mirowski executed the Articles of Organization of the LLC and proceeded to fund the LLC with patents, royalty rights and securities totaling over Seventy Million Dollars ($70,000,000). The bulk of the

value of the LLC was in publicly traded securities. Since it was a single member LLC, she owned a one hundred percent (100%) interest in the LLC. Shortly after formation, she made three (3) sixteen percent (16%) member gifts of membership interest to her three (3) daughters.

Although Ms. Mirowski suffered from diabetes, she was in good health. Her health, however, deteriorated around the time of the gifts due to a foot ulcer. This tragically caused an infection in her blood stream, and in September of 2001, only three (3) days after completing the gifts, Ms. Mirowski passed away.

The IRS contends that: (i) there was no transfer of property to the LLC; and (ii) if there was a transfer of property, it was not a bona fide sale for adequate and full consideration in money or money's worth, and if the transfer of property was not a bona fide sale, she retained possession or use and enjoyment of the right to the income from the property transferred, or retained either alone or in conjunction with any other person the right to designate the persons who would possess or enjoy the property or income therefrom. The court stated that the transfers made from Ms. Mirowski to the LLC were indeed transfers of property.

The Service then argued there was no legitimate, significant nontax reason for forming and transferring assets to the LLC. The court, however, concluded that they believed the testimony of the daughters who testified as to the nontax reasons. Note, the court found the daughters' testimony to be "candid, sincere and credible" which has often not happened in many of the 2036 cases in family testimony.

IRS further argued that the LLC lacked legitimacy because (1) taxpayer failed to retain sufficient assets outside of the LLC, (2) LLC lacked sufficient functioning business operation, (3) forming and funding of the LLC was delayed, (4) taxpayer stood on both sides of the transaction, (5) there was a large, non-pro rata, one-time distribution to pay the gift and estate taxes, and (6) taxpayer made a deathbed transfer. The court concluded that IRS' contentions were not supported by the facts. They found that some assets had been kept outside of the LLC (even though these were not enough to pay estate and gift taxes), the activities of the LLC did not rise to that of a "business" under federal tax law, but there were no express or implied agreements between the members and there was no co-mingling of assets. Further, taxpayer's death was extremely unexpected.

Thus, the court held that the bona fide sale exemption for adequate and full consideration of money or money's worth applied to the taxpayer's transfers of property to the LLC. One should note that Judge Chieche gives an extremely detailed opinion (90-page) analyzing issues with transfers to a LLC. It is clear that in addition to the fact that he found the daughters' testimony credible, he also gave weight to the family's history of financial planning, involvement of the junior generation, scheduling and holding annual family meetings with professionals present and running the LLC as a real business. Since the transfers to the LLC were found to be bona fide sales, the court did not need to even address whether the taxpayer retained possession or enjoyment of or the right to income from the property transferred.

The second transfer in question was the gift of the LLC units to the three (3) daughters. Once again, the court agreed that property had been transferred. On this issue, the taxpayer and IRS stipulated that the transfers were not bona fide sales for adequate consideration and, hence, the analysis turned to the question of possession or enjoyment of or the right to income from the property transferred. IRS' primary argument

hinged on the fact that the taxpayer retained a fifty-two percent (52%) managing member interest and, as managing member, had the right (along with other rights) to decide over the distributions of the LLC. They analyzed since she had decision making over distributions, she thereby controlled the use, enjoyment and income. The court addressing this issue stated that the discretion, power and authority that the operating agreement granted the taxpayer as general manager did not require them to find that there was an express agreement that she retain an interest or a right described in 2036(a)(1) or (2) with respect to the sixteen percent (16%) gifts to her daughters' trusts. They reached the same conclusion with regard to IRC Section 2038 and hence did not need to address IRC Section 2035.

In conclusion, this case is extremely beneficial to tax practitioners as it is a case that has some bad facts, i.e., deathbed formation, distributions to pay estate and gift tax, retention of a majority managing interest and entity composed of predominantly marketable securities, yet the court found in the taxpayer's favor. The judge distinguished several other 2036 cases which once again is quite helpful. Previous to this case, the Service's position had been that if bad facts existed, the law was well enough settled that they could win any bad fact 2036 case. The court also upheld valuation discounts of over forty percent (40%) for the minority LLC interest and a discount of over twenty percent (20%) for the majority managing member interest. One must note, however, that there were significant nontax reasons as well as a history of family involvement in business affairs.

7. *Holman v. Commissioner*, 130 T.C. 12 (2008)
Gifts Upheld

Thomas and Kim Holman are the parents of four children. Mr. Holman was employed by Dell Computer Corporation and acquired a substantial block of Dell stock during the Internet boom in the late 1990s. The Holmans moved to Minnesota in 1997 and created the Holman Family Limited Partnership (HFLP) on November 3, 1999. The Holmans transferred 70,000 shares of Dell stock to the HFLP on that date. Five days later, they transferred limited partnership interests to trusts for their four daughters. Similar FLP gifts to their daughters' trusts were made in 2000 and 2001. With additional transfers of Dell stock, HFLP owned 111,100 shares of stock by 2001.

The four goals of the HFLP were long-term growth, asset preservation, asset protection, and education. The Holmans filed IRS Form 709 Gift Tax Returns and claimed combined discounts for lack of marketability and minority interests of approximately 49%.

The IRS contested the valuation discounts and made four arguments. First, the IRS claimed that there was a gift not of FLP interests but of Dell shares to the daughters under the theory of Senda v. Commissioner; T.C. Memo. 2004-160, affd. 433 F.3d 1044 (8th Cir. 2006). Second, the IRS claimed that there was no operating business and so the valuation should be based on a trust and not an active business. Third, the restrictions on transfers within the partnership agreement should be disregarded under IRC § 2703(a). Fourth, the valuation discounts should be reduced to 28%.

The Tax Court considered the IRS and taxpayer positions and made three main findings. First, there

was no "Senda" indirect gift. The FLP was created, the stock was transferred to the FLP. And six days passed between the formation of the FLP and the gift. Hence, there was no simultaneous gift on creation. Second, the Court concluded that the restrictions did not constitute a bona fide business arrangement under IRS § 2705(b)(1).

Third, taxpayer appraiser Ingham argued for minority and lack of marketability discounts, with a total discount of approximately 49%. IRS Appraiser Burns generally agreed with the minority interest discounts, but recommended reducing the claimed 35% marketability discount to 12.5%, since the Dell stock was readily tradable. The tax court accepted the 12.5% marketability discount and allowed minority discounts of 11.32%, 14.24%, and 4.63%, respectively. The resulting discount from net asset value for the total gifts was approximately 24%.

8. *Jane Z. Astleford v Commissioner*, T.C. Memo 2008-128

Appraisal Not Upheld; Penalties Imposed

This case addresses fundamental and basic valuation issues. The gifts involved the Astleford Family Limited Partnership (AFLP) that held primarily real estate -- including a fractional interest in a real estate holding general partnership (Pine Bend General Partnership), and one 1,187-acre farmland property in Minnesota.

The taxpayer's expert determined a per-acre value of $3,100, but then reduced this value by 41% for market absorption, using a four-year sales model that assumed annual growth of the property at 7 percent and a discount rate of 25 percent based on development rates.

The Service's expert determined a per-acre value of $3,500 with no market absorption discount based on the strength of two comparable sales and the fact that the property was purchased in a single transaction in 1970.

The Court agreed with the value given by the Service's expert but found a market absorption discount as it was unlikely that all 1,187 acres of the property would be sold in a single year without a price discount. The Judge utilized the four-year sales model, but instead of agreeing with a discount rate based on development rates, the Judge adopted a 10 percent discount rate based on equity returns for farmers in Minnesota. The resulting market absorption discount was 20 percent.

The taxpayer's expert argued that under Minnesota law, the only interest that could be held by AFLP (without the consent of the other partner in the Pine Bend General Partnership) was an assignee interest. The Service on the other hand was applying the substance over form doctrine, arguing that the assignee interest was a limited partner interest.

The Service prevailed because the individual that contributed the general partner interest to AFLP was also the general partner of AFLP, so the management rights of the interest did not change. Further, a written partnership resolution document treated the transfer as a transfer of all of the rights and interests in the Pine

Bend General Partnership, and not as a transfer of an assignee interest.

The potential discount that was lost for moving from an assignee interest to a substitute general partnership interest was 5 percent based on a study involving voting and non voting stock.

With regard to the overall discount applicable to the 50 percent general partner interest, the Court concluded at 30 percent. The data used to arrive at this discount was data coming from real estate holding limited partnerships (RELP) that trade in the secondary market. The Service's expert had dedicated a large portion of his testimony attempting to label the RELP data as generally unreliable and suggesting, instead, the use of real estate investment trust data (REIT). The Court declined to declare either RELP or REIT data superior, noting that courts have accepted expert valuations using both. Considering the size, marketability, management, distribution requirements, and taxation of RELPs and REITs, RELPs more closely resembled AFLP and the Pine Bend General Partnership, and that because that the low trading volume on the RELP secondary market was not so low as to render available RELP data unreliable.

Given that AFLP held a 50 percent fractional interest in the Pine Bend General Partnership (as well as various other properties outright), the Judge had to address the issue of whether two levels of discounts were applicable to the gifted interest in AFLP that held the fractional interest in the Pine Bend General Partnership.

The taxpayer's expert applied a combined discount for lack of control and lack of marketability at the Pine Bend General Partnership level, and subsequently applied another discount at the AFLP level. Given that the value of the General Partnership interest was relatively small compared to the value of the real estate holdings of AFLP, full discounts were taken at the AFLP level in addition to the discount concluded at the Pine Bend General Partnership level.

The Service's expert argued that no separate discount would be appropriate for the Pine Bend General Partnership interest, but rather a slightly increased discount could be taken at the AFLP level to account for the fractional interest in the Pine Bend General Partnership.

The Court concluded that two levels of discounts are indeed appropriate. It did so by pointing out that other courts and the Service have in the past applied two levels of discounts. However, it also warned that when the lower level entity constitutes a significant portion of the assets, care has to be taken to not apply full discounts at both levels. Specifically, the Court stated:

> The 50 percent General Partnership interest constituted less than 16 percent of AFLP's net asset value and was only 1 of 15 real estate investments that were held by AFLP, and lack of control and lack of marketability discounts at both the Pine Bend General Partnership level and the AFLP parent level are appropriate.

The taxpayer's expert AFLP expert also used the RELP data, but had narrowed down his selection where he relied primarily on four individual RELPs that he deemed most comparable. The Judge critiqued the selection, pointing out that two of the selected RELPs had net asset values approximately 5 times the size of

AFLP and the other two RELPs were dissimilar with regard to their debt structure. The Judge stated that where the comparables are relatively few in number, we look for greater similarity between comparables and the subject property.

Two additional strikes against the taxpayer's expert were his own testimony that AFLP was "inherently less risky than his comparables," and the Judge's observation that the distribution ratio of 10 percent was significantly more attractive than the comparables selected. The Judge concluded by stating:

> We conclude that the RELP comparables petition's expert used are too dissimilar to AFLP to warrant the amount of reliance petitioner's expert placed on them, and we conclude that petitioner's lack of control discounts for the gifted AFLP limited partnership interests of 45 percent for 1996 and 40 percent for 1997 are excessive. Rather than sifting through RELP data looking for more appropriate RELPs to serve as comparables in an effort to estimate lack of control discounts for the gifted AFLP interests, we use REIT data used by respondent's expert with adjustments to his methodology.

(On a side note, it may also be that the Judge did not feel comfortable with the size of the aggregate discount resulting from the RELP analysis. The partnership discount was used only to account for lack of control, while a separate discount for lack of marketability of 22 percent was applied subsequently, resulting in a discount of almost 60 percent).

After dismissing the RELP data, the Judge's attention turned to the Service's expert's REIT approach. Having seen the expert's work several times in the past, the Judge knew the weaknesses of his methodology. The basic methodology revolves around the analysis of 75 REITs that, based on a trading price vs. net asset value analysis, had only a 1 percent discount. However, Bajaj argued that REIT have an illiquidity premium that needs to be backed out of the trading price to get the real lack of control discount. Dr. Bajaj's analysis resulted in a lack of control discount of 8 percent. The Judge commented:

> Respondent's expert's 8 percent liquidity premium appears unreasonably low. Our concern rests partly on the fact that other studies cited by Service's expert suggest that liquidity premiums applicable to publicly traded investments are nearly double that used by Service's expert and partly on the fact that respondent's expert's 8 percent liquidity resulted in a discount for lack of control that appears unreasonably low. See Lappo v. Commissioner, T.C. Memo 2003-258, Service's expert's calculation of a liquidity premium rejected for similar reasons.

The Court proceeded to perform its own calculation of the liquidity premium and concluded at a lack of control discount of 17 percent.

Very little discussion was needed for the quantification of the marketability discount, as the Service's

expert concluded a discount similar to that of the taxpayer's expert. The resulting discount of 22 percent was adopted, resulting in a combined discount of 35 percent at the AFLP level.

9. *Gross v. Commissioner*, T.C. Memo 2008-221, September 29, 2008

How to Avoid Indirect-Gift Treatment Under the Step Transaction Doctrine

Ms. Gross formed a limited partnership (Dimar) in July and contributed marketable securities from early October to early December. She then made limited partnership gifts to her two daughters in mid-December. The gifts were reported with a 35 percent discount. The IRS claimed the formation, funding, and gifting all occurred on the same day. Accordingly, the IRS considered the gifts to be gifts of the marketable securities, not the entity, with no valuation discounts. They assessed a gift tax deficiency of over $120,000.

Judge Halpern, who decided Holman v. Commissioner (130 T.C. No. 12, May 27, 2008), a similar case, stated that, despite a mix of good and bad facts on both sides, he was respecting the entity and discount.

The Court analyzed four prior cases: Jones, Shepherd, Senda and Holman, and then looked first at whether Dimar was properly formed.

According to the taxpayer, the facts were as follows:

1. After several discussions, on or before July 15, 1998, Ms. Gross and her daughters agreed to form a family limited partnership with initial funding of $100 from Ms. Gross and $10 each from her two daughters. The terms were negotiated and certain terms were agreed to, including control by Ms. Gross and restrictions on transfer and dissolution.

2. On July 15, 1998, Ms. Gross caused the Dimar certificate of limited partnership to be filed with the New York Department of State. Certain other steps were subsequently taken to address formation requirements, such as publishing notices of the formation in New York newspapers.

3. On July 31, 1998, Ms. Gross and her daughters wrote checks payable to Dimar in the amount of $100, $10 and $10, respectively.

4. From early October through December 4, 1998, Ms. Gross transferred ownership of the marketable securities from her name to Dimar's name, and maintained records of the transfers in a notebook.

5. On December 15, 1998, Ms. Gross and her daughters executed the Dimar partnership and executed a "Deed of Gift", transferring to each daughter a 22.25 percent limited partner interest in Dimar.

6. Dimar filed a Form 1065 partnership tax return showing that Dimar commenced business on July 15, 1998.

7. Ms. Gross filed a gift tax return that included capital account calculations showing the initial contributions, an increase in Ms. Gross's capital account for the entire amount of the securities, a decrease in Ms. Gross's account for the gifts, and an equal increase in the daughters' accounts.

In contrast, the Service's version of events was as follows:

1. Dimar was formed on December 15, 1998, when the limited partnership agreement was signed.

2. Each daughter acquired a 22.25 percent interest in Dimar on the same day.

3. On the same day, Ms. Gross contributed the securities to Dimar, with 22.25 percent of the value of the contribution being credited to each daughter's capital account.

Both sides agreed that the limited partnership agreement was not signed until December 15, 1998, which prevented Dimar from being properly formed as a limited partnership prior to the date of the gifts. The Court did not believe that either party made a compelling argument on their interpretation of New York partnership law. Since no persuasive authority exists, the Court turned to the taxpayer's back-up position, that Dimar had been formed as of July 15, 1998, as a general partnership. Under New York law, when parties seeking to form a limited partnership do not satisfy the requirements necessary to form a limited partnership, they may be deemed to have formed a general partnership if their conduct indicates that they have agreed, whether orally and whether expressly or impliedly, on all the essential terms and conditions of their partnership arrangement. The Court found sufficient evidence existed to conclude that, at the time petitioner caused the Dimar certificate to be filed on July 15, 1998, she and her daughters had agreed to form a partnership essentially on the terms set forth in the Dimar agreement.

In spite of the fact that the limited partnership agreement was not signed until December 15th, the taxpayer still had to establish that the funding was completed by December 4th. The taxpayer's gift tax return included a list of Dimar's securities in a schedule titled "Securities Contributed to Partnership on 12/15/98." The Court noted in a footnote that Dimar's capital account calculations did not allocate any of the $41,107 of net portfolio appreciation up to December 15th to the daughters' accounts. Despite this, Dimar was considered by the Court to have been formed and funded by December 4, 1998.

The Court then focused on the step transaction doctrine using the Holman analysis. This doctrine will not be applied where "the taxpayers bore a real economic risk of a change in value of the partnership" between the funding and the gift. Fortunately for the taxpayer, with the formation and funding issues decided favorably, the facts of the case were now very similar to Holman, which had gone in the taxpayer's favor. The Court concluded: "We reach the same result as in Holman, here, where (1) 11 days passed between petitioner's conclusion of her transfer of the Dimar securities to the partnership and her gifts of interests in the partnership to her daughters, and (2) the Dimar securities were mostly, if not all, common shares of well-known companies."

Also, Ms. Gross seems to have been very careful in outlining her estate planning. For example, she documented the fact that, "because she deemed one of her daughters extravagant, she considered a trust arrangement, but she rejected that because her other daughter declined to serve as a trustee." She kept careful records of such things as the transfer of the securities from her name to Dimar's name in a notebook titled "Dimar."

Since the partnership agreement was not signed until the date of the gift; and the gift tax return referenced the securities being contributed on December 15, 1998, but no allocation of gains to the daughters' accounts, this could have caused a major problem for the taxpayer. Even though the taxpayer ultimately prevailed, the mistakes landed Ms. Gross in Tax Court.

The parties stipulated that the 35 percent valuation discounts would apply if the gifts were upheld as limited partnership interests. Even though they were not, the Court upheld the 35 percent discount.