Choice of Entity

In Light of 2017

Tax Law Changes

(excerpted from
Structuring Ownership of Privately-Owned Businesses:
Tax and Estate Planning Implications)

Steven B. Gorin
Thompson Coburn LLP
One US Bank Plaza
505 N. 7th St.
St. Louis, MO 63101
sgorin@thompsoncoburn.com
phone 314-552-6151
http://www.thompsoncoburn.com/people/steve-gorin
http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions

THOMPSON COBURN LLP

This document may be cited as Gorin, [number and name of part as shown in the Table of Contents], "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications" (printed 10/31/2018), available by emailing the author at sgorin@thompsoncoburn.com. The author refers to this document not as a "treatise" or "book" but rather as his "materials," because the author views this as a mere compilation of preliminary ideas (albeit a large compilation) and not as a scholarly work. To receive quarterly a link to the most recent version, please complete http:\www.thompsoncoburn.com\forms\gorin-newsletter.

TABLE OF CONTENTS

Page

I. Introduction 1

II.A.1.e. Personal Holding Company Tax 2

II.A.2.f. Shareholders Eligible to Hold S corporation Stock 9

II.A.2.g. Qualified Subchapter S Subsidiary (QSub) 13

II.C.9. Whether an Arrangement (Including Tenancy-in-Common) Constitutes a Partnership 18

II.E. Recommended Structure for Entities 31

II.E.1. Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities 31

II.E.1.a. Taxes Imposed on C Corporations 33

II.E.1.b. Taxes Imposed on S corporations, Partnerships, and Sole Proprietorships 36

II.E.1.c. Code § 199A Pass-Through Deduction for Qualified Business Income 38

II.E.1.c.i. What Kind of Deduction; Maximum Impact of Deduction 44

II.E.1.c.i.(a). Summary of Impact of Deduction 44

II.E.1.c.i.(b). Other Effects of Code § 199A Deduction 46

II.E.1.c.ii. Types of Income and Activities Eligible or Ineligible for Deduction 46

II.E.1.c.ii.(a). Generally; List of Items Included in QBI 46

II.E.1.c.ii.(b). Trade or Business of Being an Employee (Excluded from QBI) 49

II.E.1.c.ii.(c). Items Excluded from Treatment as Qualified Business Income Under Code § 199A 53

II.E.1.c.iii. "Trade or Business" for Code § 199A 59

II.E.1.c.iii.(a). General Standards for "Trade or Business" for Code § 199A 59

II.E.1.c.iii.(b). Aggregating Activities for Code § 199A 60

II.E.1.c.iii.(c). "Trade or Business" in Other Areas of Tax Law 73

II.E.1.c.iv. Specified Service Trade or Business (SSTB) If Taxable Income Exceeds Certain Thresholds 75

II.E.1.c.iv.(a). Introduction to Specified Service Trade or Business (SSTB) 75

II.E.1.c.iv.(b). Health 82

II.E.1.c.iv.(c). Law 83

II.E.1.c.iv.(d). Accounting 84

II.E.1.c.iv.(e). Actuarial Science 84

II.E.1.c.iv.(f). Performing Arts 84

II.E.1.c.iv.(g). Consulting 85

II.E.1.c.iv.(h). Athletics 87

II.E.1.c.iv.(i). Financial Services 88

II.E.1.c.iv.(j). Brokerage Services 89

II.E.1.c.iv.(k). Investing and Investment Management 90

II.E.1.c.iv.(l). Trading 90

II.E.1.c.iv.(m). Dealing in Securities, Partnership Interests, or Commodities 91

II.E.1.c.iv.(n). Any Trade or Business Where the Principal Asset of Such Trade or Business Is the Reputation or Skill of One or More of Its Employees or Owners 92

II.E.1.c.iv.(o). SSTB Very Broad Anti-Abuse Rules 95

II.E.1.c.v. Calculation of Deduction Generally 97

II.E.1.c.v.(a). Taxable Income "Threshold Amount" 99

II.E.1.c.v.(b). Calculation When Taxable Income Does Not Exceed the Threshold Amount 103

II.E.1.c.v.(c). Calculation When Taxable Income Exceeds the Threshold Amount 104

II.E.1.c.vi. Wage Limitation If Taxable Income Is Above Certain Thresholds 112

II.E.1.c.vi.(a). W-2 Wages under Code § 199A 113

II.E.1.c.vi.(b). Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A 120

II.E.1.c.vii. Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction 132

II.E.1.c.viii. Income or Gain from or Sale of Property Used in the Business or Business Interest Itself 137

II.E.1.c.viii.(a). Passthrough Sale of Equipment It Is Using 137

II.E.1.c.viii.(b). Passthrough Sale of a Building It Is Using 138

II.E.1.c.viii.(c). Sale of an Interest in a Partnership Conducting a Trade or Business 138

II.E.1.c.viii.(d). Sale of a Stock in an S corporation Conducting a Trade or Business 139

II.E.1.c.ix. QBI and Effectively Connected Income 139

II.E.1.c.x. Bonus Depreciation and the Code § 199A Deduction 163

II.E.1.d. Partnerships Compared to S corporations for Code § 199A 163

II.E.1.e. Whether Real Estate Qualifies As a Trade or Business 164

II.E.1.e.i. General Rules Regarding Real Estate As a Trade or Business 164

II.E.1.e.ii. Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules 166

II.E.1.f. Trusts/Estates and the Code § 199A Deduction 171

II.E.1.f.i. Allocation under Former Code § 199 That Applies for Code § 199A 178

II.E.1.f.ii. Nongrantor Trusts Other Than ESBTs 184

II.E.1.f.ii.(a). How Qualified Business Income Flows to Beneficiaries 184

II.E.1.f.ii.(b). When to Shift Qualified Business Income (QBI) to Beneficiaries 185

II.E.1.f.ii.(c). Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs 185

II.E.1.f.iii. Electing Small Business Trusts (ESBTs) 186

II.E.1.f.iv. Grantor Trusts (Including QSSTs) 187

II.E.1.f.v. Interaction with Net Investment Income Tax 188

II.E.1.f.vi. Example Using Trusts to Split Income 188

II.E.1.f.vii. Ownership Restrictions 190

II.E.1.g. Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation 190

II.E.1.h. Effect of 2017 Tax Reform on Debt-Equity Structure 192

II.E.1.i. Conducting Businesses in Different Entities to Facilitate Using the Code § 199A Deduction 192

II.E.2. Comparing Exit Strategies from C Corporations and Pass-Through Entities 193

II.E.2.a. Transferring the Business 193

II.E.2.b. Converting from S corporation to C Corporation 194

II.E.2.c. Converting a C Corporation to an S corporation 195

II.E.3. Recommended Structure for Start-Ups 195

II.E.4. Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure 198

II.E.5. Recommended Long-Term Structure for Pass-Throughs – Description and Reasons 199

II.E.5.a. Strategic Income Tax Benefits of Recommended Structure 199

II.E.5.b. Self-Employment Tax and State Income Tax Implications of Recommended Structure 200

II.E.5.c. Operating the Recommended Structure 201

II.E.5.c.i. General Considerations 201

II.E.5.c.ii. Code § 199A Deduction under Recommended Structure 203

II.E.5.d. Net Investment Income Tax and Passive Loss Rules Under Recommended Structure ... 203

II.E.5.e. Estate Planning Aspects of Recommended Structure ... 204

II.E.5.e.i. Family Conflicts ... 204

II.E.5.e.ii. Estate Tax Deferral Using Recommended Structure ... 204

II.E.5.e.iii. Grantor Trust Planning ... 204

II.E.5.f. Recommended Structure with C Corporation ... 205

II.E.5.g. Other Aspects of Recommended Structure ... 205

II.E.6. Recommended Partnership Structure – Flowchart ... 206

II.E.7. Migrating into Partnership Structure ... 206

II.E.7.a. Overview of How to Migrate into Desired Structure ... 206

II.E.7.b. Flowcharts: Migrating LLC into Preferred Structure ... 208

II.E.7.b.i. Using Cash Contribution to Fund New S corporation ... 208

II.E.7.b.ii. Using LLC to Fund New S corporation ... 209

II.E.7.c. Flowcharts: Migrating Existing Corporation into Preferred Structure ... 209

II.E.7.c.i. Corporation Forms New LLC ... 209

II.E.7.c.i.(a). Direct Formation of LLC ... 209

II.E.7.c.i.(b). Use F Reorganization to Form LLC ... 210

II.E.7.c.ii. Moving New LLC into Preferred Structure ... 211

II.E.7.c.iii. Migrating Gradually Over Time ... 211

II.E.8. Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary ... 212

II.E.8.a. Description of Structure; Nontax Issues ... 212

II.E.8.b. Tax Issues ... 213

II.E.8.c. Migrating to LP with LLC Subsidiary Structure ... 214

II.E.9. Real Estate Drop Down into Preferred Limited Partnership ... 215

II.E.10. What if Self-Employment Tax Rules Change Unfavorably? 216

II.G.3.i. Business Deductions and Losses 216

II.G.3.i.i. Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit 216

II.G.3.i.i.(a). "Trade or Business" Under Code § 162 216

II.G.3.i.i.(b). Requirements for Deduction Under Code § 212 222

II.G.3.i.i.(c). Hobby Loss Benefits of Code § 183 224

II.G.3.i.i.(d). Whether Managing Investments Constitutes a Trade or Business 235

II.G.3.i.i.(e). Family Office As a Trade or Business 249

II.G.3.i.i.(f). Family Office – Securities Law Issues 251

II.G.3.i.ii. Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax 256

II.G.3.i.iii. Code § 172 Net Operating Loss Deduction 258

II.G.3.i.iv. Code § 267 Disallowance of Related-Party Deductions or Losses 258

II.G.4. Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation 261

II.G.4.a. Code 179 Expense 261

II.G.4.b. Bonus Depreciation 261

II.G.4.c. Cost Segregation Studies to Accelerate Depreciation 264

II.G.19. Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense 265

II.G.19.a. Limitations on Deducting Business Interest Expense 265

II.G.19.b. When Debt Is Recharacterized as Equity 271

II.I.8. Application of 3.8% Tax to Business Income 279

II.I.8.a. General Application of 3.8% Tax to Business Income 279

II.I.8.a.i. Passive Activity Recharacterization Rules 281

II.I.8.a.ii. Passive Activity Grouping Rules 282

II.I.8.a.iii. Qualifying Self-Charged Interest or Rent Is Not NII 283

II.I.8.a.iv. Determination of Trade or Business Status, Passive Activity Status, or Trading Status of Pass-Through Entities 284

II.I.8.a.v. Working Capital Is NII 285

II.I.8.a.v.(a). Policy of Working Capital as NII 285

II.I.8.a.v.(b). What Is Working Capital 286

II.I.8.a.vi. What is a "Trade or Business"? 288

II.I.8.a.vii. Former Passive Activities – NII Implications 289

II.I.8.b. 3.8% Tax Does Not Apply to Gain on Sale of Active Business Assets 290

II.I.8.c. Application of 3.8% Tax to Rental Income 291

II.I.8.c.i. If Not Self-Rental, Most Rental Income Is *Per Se* Passive Income and Therefore NII 291

II.I.8.c.ii. Real Estate Classified as Nonpassive for Real Estate Professionals 292

II.I.8.c.iii. Rental as a Trade or Business 293

II.I.8.d. Partnership Structuring in Light of the 3.8% Tax on Net Investment Income 299

II.I.8.d.i. Interest for Use of Capital Compared with Distributive Share 299

II.I.8.d.ii. Overview of Interaction between Code § 1411 and Code §§ 707(c) and 736 300

II.I.8.d.iii. Treatment of Code § 707(c) Guaranteed Payments under Code § 1411 300

II.I.8.d.iv. Treatment of Code § 736 Redemption Payments under Code § 1411 301

II.I.8.e. NII Components of Gain on the Sale of an Interest in a Partnership or S corporation 306

II.I.8.f. Summary of Business Activity Not Subject to 3.8% Tax 312

II.I.8.g. Structuring Businesses in Response to 3.8% Tax 314

II.I.9. Elections or Timing Strategies to Consider to Minimize the 3.8% Tax on NII 315

II.J. Fiduciary Income Taxation 315

II.J.1. Trust's Income Less Deductions and Exemptions Is Split Between Trust and Beneficiaries 317

II.J.2. Tactical Planning Shortly After Yearend to Save Income Tax for Year That Ended 317

II.J.3. Strategic Fiduciary Income Tax Planning 318

II.J.3.a. Who Is Best Taxed on Gross Income 319

II.J.3.b. Effect of Kiddie Tax on Rates 320

II.J.3.c. Who Is Benefits the Most from Losses 320

II.J.3.d. Who Benefits Most from Deductions 320

II.J.3.e. State and Local Income Tax 321

II.J.3.e.i. Residence Generally 321

II.J.3.e.ii. Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence 322

II.J.3.f. Consider Trust Purposes 323

II.J.3.g. Effect on Future Years 324

II.J.3.h. Drafting for Flexibility in Trust Income Taxation 324

II.J.3.i. Planning for Excess Losses 326

II.J.9. Separate Share Rule; Trust Divisions 327

II.J.9.a. Separate Share Rule 327

II.J.9.b. Trust Divisions 332

II.J.9.c. Multiple Trusts Created for Tax Avoidance 332

II.J.10. Consider Extending Returns for Year of Death and Shortly Thereafter 336

II.J.11. Trust Business Income Tax Nuances 336

II.J.11.a. Depreciation Advantages and Disadvantages 336

II.J.11.a.i. Code § 179 Disallowance for Estate or Nongrantor Trust 336

II.J.11.a.ii. Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses) 337

II.J.11.a.ii.(a). Separate Reporting of Depreciation Deductions Allocable to Beneficiary 337

II.J.11.a.ii.(b). Beneficiary's Ability to Deduct Depreciation That Generates Net Loss 339

II.J.11.a.ii.(c). Trust vs. Separately Recognized Business Entity Holding Depreciable Property 339

II.J.11.b. Code § 1244 Treatment Not Available for Trusts 340

II.J.12. Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act 341

II.J.13. Applying 3.8% Tax to Trusts Owning Businesses Other than S corporations If the Beneficiary is Active But the Trustee Is Not 345

II.J.14. Application of 3.8% NII Tax to ESBTs 346

II.J.15. QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items 346

II.J.15.a. QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) 346

II.J.15.b. QSSTs and State Income Tax Issues 348

II.J.16. Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets 349

II.J.17. Planning for Grantor and Nongrantor Trusts Holding Stock in S corporations in Light of the 3.8% Tax 351

II.J.18. Trust Mergers and Divisions; Decanting 352

II.K.2. Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business 353

II.K.2.a. Overview of Passive Loss Rules Applied to Trusts or Estates 353

II.K.2.b. Participation by an Estate or Nongrantor Trust 356

II.K.2.b.i. Participation by a Nongrantor Trust: Authority 356

II.K.2.b.ii. Participation by a Nongrantor Trust: Planning Issues 363

II.K.2.b.iii. Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity, But Be Wary If Multiple Grantors 367

II.K.2.b.iv. Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary; Interaction with Special Depreciation Rules 368

II.K.2.b.v. Electing Small Business Trusts (ESBTs) and the Passive Loss Rules 370

II.K.2.c. Participation When Grantor Trusts Are Involved; Effect of Toggling 370

II.K.2.d. Effect of Death of an Individual or Termination of Trust on Suspended Losses 370

II.K.3. NOL vs. Suspended Passive Loss - Being Passive Can Be Good 371

II.K.3.a. Why Being Passive Can Be Good 371

II.K.3.b. Maximizing Flexibility to Avoid NOLs and Use Losses in the Best Year 372

II.L.2.a.ii. Rental Exception to SE Tax 374

II.M.4.f. Issuing a Profits Interest to a Service Provider 378

II.M.4.f.i. Overview of Profits Interest; Contrast with Code § 409A 378

II.M.4.f.ii. Tax Effects of Profits Interests 380

II.M.4.f.ii.(a). Tax Effects of Issuing a Profits Interest 380

II.M.4.f.ii.(b). Certain Sales of Compensatory Partnership Interests Recharacterized from Long-Term to Short-Term Gains 384

II.M.4.f.iii. What Happens If a Nonvested Partnership Interest Does Not Qualify As a Profits Interest 389

II.M.4.f.iv. Alternative If a Prospective Partner Wants a Capital Interest Instead of a Profits Interest 390

II.P.3. Conversions 390

II.P.3.a. Need for New Tax ID 391

II.P.3.b. From Corporations to Partnerships and Sole Proprietorships 391

II.P.3.c. Conversion from C Corporation to S corporation 392

II.P.3.c.i. LIFO Recapture 392

II.P.3.c.ii. Built-in Gain Tax on Former C Corporations under Code § 1374 393

II.P.3.c.ii.(a). Explanation of Built-in Gain Tax on Former C Corporations under Code § 1374 393

II.P.3.c.ii.(b). Consider S Election Even If Plan to Sell Within 5 Years 396

II.P.3.c.iii. Excess Passive Investment Income 397

II.P.3.c.iv. Problem When S corporation with Earnings & Profits Invests in Municipal Bonds 401

II.P.3.c.v. Conversion from S corporation to C Corporation then Back to S corporation 402

II.P.3.d. Conversions from Partnerships and Sole Proprietorships to C Corporations or S corporations 403

II.P.3.d.i. Formless Conversion 403

II.P.3.d.ii. Transfer of Partnership Assets and Liabilities to a Newly Formed Corporation in Exchange for All of its Stock 404

II.P.3.e. Conversion from S corporation to C Corporation 407

II.P.3.f. Conversion from Qualified Subchapter S Subsidiary to Single Member LLC 409

II.P.3.g. Conversions from Partnership to Sole Proprietorships and Vice Versa 409

II.P.3.h. Rescissions, Including Rescinding Conversion of Entity 412

II.P.3.i. Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization 415

II.Q.7.a.vi. Redemptions and Accumulated Earnings Tax 420

II.Q.7.k. Exclusion of Gain on the Sale of Certain Stock in a C Corporation 422

II.Q.7.k.i. Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation 422

II.Q.7.k.ii. Limitation on Assets a Qualified Small Business May Hold 431

II.Q.7.k.iii. Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? 436

II.Q.7.l. Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244 439

II.Q.7.m. Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company ... 440

II.Q.8. Exiting From or Dividing a Partnership ... 440

II.Q.8.a. Partnership as a Master Entity ... 441

II.Q.8.a.i. Partnership Rules Allowing Basis Shifting ... 441

II.Q.8.a.ii. Caution When Using Master Entity If Liquidity Needed to Pay Estate Tax ... 443

II.Q.8.a.iii. Examples of Using Partnership to Shift Basis ... 443

II.Q.8.a.iii.(a). Applying Outside Basis to Very Low Inside Basis ... 443

II.Q.8.a.iii.(b). Basis Stripped from Distributed Property and Applied to Remaining Property ... 444

II.Q.8.a.iii.(c). Basis Stripped from New Property and Applied to Existing Property ... 444

II.Q.8.a.iii.(d). Basis Shift When Parent Owns Large Majority ... 445

II.Q.8.b. Partnership Redemption or Other Distribution ... 446

II.Q.8.b.i. Distribution of Property by a Partnership ... 446

II.Q.8.b.i.(a). Code § 731: General Rule for Distributions ... 446

II.Q.8.b.i.(b). Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them) ... 448

II.Q.8.b.i.(c). Disguised Sale from Partnership to Partner ... 451

II.Q.8.b.i.(d). Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property ... 452

II.Q.8.b.i.(e). Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value ... 462

II.Q.8.b.i.(f). Code § 751 – Hot Assets ... 467

II.Q.8.b.i.(g). Characteristics of Distributed Property ... 469

II.Q.8.b.ii. Partnership Redemption – Complete Withdrawal Using Code § 736 472

II.Q.8.b.ii.(a). Introduction to Code § 736 472

II.Q.8.b.ii.(b). Flexibility in Choosing between Code § 736(a) and (b) Payments 473

II.Q.8.b.ii.(c). Comparing Code § 736(a) with (b) Strategically 475

II.Q.8.b.ii.(d). Comparing Code § 736(b) to an Installment Sale 478

II.Q.8.b.ii.(e). Effect of Code § 736 Payments, Installment Sale Payments, or Deferred Compensation on Balance Sheet 485

II.Q.8.b.ii.(f). Planning for the 3.8% Tax on Net Investment Income and Passive Loss Rules When Using Code § 736 Payments 486

II.Q.8.b.ii.(g). Code § 736 Payments as Retirement Income – Possible FICA and State Income Tax Benefits 486

II.Q.8.b.ii.(h). Interaction of Death with Code § 736 Payments 487

II.Q.8.b.iii. Partnership Alternative to Seller-Financed Sale of Goodwill 487

II.Q.8.b.iii.(a). Non-Tax Financial Issues When Using a Preferred Partnership to Acquire Goodwill and Other Assets 490

II.Q.8.b.iii.(b). Tax Issues When Transferring Assets to New Entity 490

II.Q.8.c. Related Party Sales of Non-Capital Assets by or to Partnerships 491

II.Q.8.e.iii. Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S corporations 492

II.Q.8.e.iii.(a). Illustration of Inside Basis Issue 492

II.Q.8.e.iii.(b). Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss) 494

II.Q.8.e.iii.(c). When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000 500

II.Q.8.e.iii.(d). Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest 503

II.Q.8.e.iii.(e). Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election 515

II.Q.8.e.iii.(f). Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold 519

II.Q.8.e.iii.(g). Certain Changes in Inside Basis May Reduce Foreign Tax Credits 524

II.Q.8.e.iv. Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform) 525

II.Q.8.e.v. Partnership Mergers 529

II.Q.8.e.vi. Required Documentation to Avoid Withholding on Sale or Redemption of Partnership Interest 533

III.A.3.e. QSSTs and ESBTs 533

III.A.3.e.i. QSSTs 533

III.A.3.e.i.(a). QSSTs Generally 533

III.A.3.e.i.(b). QSST Issues When Beneficiary Dies 539

III.A.3.e.ii. ESBTs 541

III.A.3.e.ii.(a). Qualification as an ESBT 541

III.A.3.e.ii.(b). ESBT Income Taxation - Overview 546

III.A.3.e.ii.(c). When ESBT Income Taxation Might Help 548

III.A.3.e.iii. Comparing QSSTs to ESBTs 549

III.A.3.e.iv. Flexible Trust Design When Holding S corporation Stock 551

III.A.3.e.v. Converting a Multiple Beneficiary ESBT into One or More QSSTs 553

III.A.3.e.v.(a). Strategic Issues 553

III.A.3.e.v.(b). Implementation 554

III.A.3.e.v.(c). Timing Tax Deductions in Year of Conversion 555

III.A.3.e.vi. QSST as a Grantor Trust; Sales to QSSTs 555

III.A.3.e.vi.(a). Grantor Trust Issues Involved in a Sale of S Stock to a QSST 556

III.A.3.e.vi.(b). Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made) 558

III.A.3.e.vi.(c). Required Structure for a Sale to a QSST (Including Possible Pitfalls) 561

III.A.3.e.vi.(d). Using a QSST to Buy Stock When Using a "One-Lung" Marital Deduction Plan 564

III.A.3.e.vi.(e). Converting Existing Trust to a QSST to Obtain Beneficiary Grantor Trust Status 565

III.A.3.e.vi.(f). QSST to Convert Terminating Trust to GST-Exempt Life Trust 565

III.B.2.b. General Description of GRAT vs. Sale to Irrevocable Grantor Trust 566

III.B.7.b. Code § 2701 Overview 572

III.B.7.b.i. Code § 2701 Definitions 572

III.B.7.b.ii. Certain Exclusions from Code § 2701 577

III.B.7.b.iii. Capital Structure Transaction, If Each Individual Holds Substantially the Same Interest After the Transaction as That Individual Held Before the Transaction 578

III.B.7.b.iv. Divorce Planning to Avoid Code § 2701 579

III.B.7.c. Code § 2701 Interaction with Income Tax Planning 580

III.B.7.c.i. Profits Interest in a Partnership that Was a Straight-Up Partnership before the Transfer 580

III.B.7.c.i.(a). General Discussion of Implications of Profits Interest in a Partnership that Was a Straight-Up Partnership before the Transfer 580

III.B.7.c.i.(b). CCA 201442053 Discusses Profits Interest in a Partnership That Was a Straight-Up Partnership before the Transfer 583

III.B.7.c.ii. Profits Interest in a Partnership in Which Transferor and Applicable Family Members Initially Hold Only a Profits Interest 588

III.B.7.c.iii. Same Class Exception - Possible Application to Profits Interests and Other Situations 589

III.B.7.c.iv. Transfers When Owner Holds Profits Interest/Carried Interest and Other Interests 592

III.B.7.c.v. Income Tax Dynamics of Using Deferred Compensation Instead of Profits Interest 592

III.B.7.c.vi. Deferred Compensation 593

III.B.7.c.vii. Stock Options 594

III.B.7.c.viii. Creative Bonus Arrangements 595

III.B.7.c.ix. Debt vs. Equity 596

Choice of Entity

In Light of 2017

Tax Law Changes

by Steven B. Gorin*

I. Introduction

This document is excerpted from "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," over 1,700 pages in a fully searchable PDF that discusses how federal income, employment and transfer taxes and estate planning and trust administration considerations affect how one might structure a business and then transition the business through ownership changes, focusing on structural issues so that readers can plan the choice of entity or engage in estate planning with an eye towards eventual transfer of ownership in the business.

The author sends a link to the most recent version in his free electronic newsletter (roughly quarterly), called "Gorin's Business Succession Solutions." If you would like to receive this newsletter, please complete https://www.thompsoncoburn.com/forms/gorin-newsletter or email the author at sgorin@thompsoncoburn.com with "Gorin's Business Succession Solutions" in the subject line; the newsletter email list is opt-in only. Please include your complete contact information; to comply with the anti-spam laws, we must have a physical mailing address, even though delivery is electronic. Please also add ThompsonCoburnNews@tcinstitute.com to your "trusted" list so that your spam blocker will not block it. Send any inquiries to the author at sgorin@thompsoncoburn.com and not

---

* Steve Gorin is a partner in the Private Client practice group of Thompson Coburn LLP. He is a past chair of the Business Planning group of committees of the Real Property, Trust & Estate Law Section of the American Bar Association. Steve is a member of the Business Planning Committee of the American College of Trust and Estate Counsel. He is a past chair of the Business Law Section of the Bar Association of Metropolitan St. Louis. In addition to helping clients directly with their needs, Steve serves as a consultant to other attorneys in various areas of the country, primarily regarding the subject matter of these materials. For more details about the author, see http://www.thompsoncoburn.com/people/steve-gorin. He would welcome any questions or comments the reader might have regarding these materials; please email him at sgorin@thompsoncoburn.com. For those who wish to use part of these materials for presentations for professional organizations, Steve might prepare an excerpt that the presenter can use, with full attribution and without charge.

 This is not intended to be comprehensive; many portions only lightly touch the surface; and not all of the issues are updated at the same time (in fact, the author does not systematically refresh citations), so some parts may be less current than others. The author invites suggested changes, whether substantive or to point out typos (the author does not have a second set of eyes reviewing the author's work). The views expressed herein reflect the author's preliminary thoughts when initially written and are not necessarily those of Thompson Coburn LLP (or even of the author). Before using any information contained in these materials, a taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor. Tax advisors should research these issues independently rather than rely on these materials.

This document may be cited as Gorin, [number and name of part as shown in the Table of Contents], "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications" (printed 10/30/2018), available by emailing the author at sgorin@thompsoncoburn.com. The author refers to this document not as a "treatise" or "book" but rather as his "materials," because the author views this as a mere compilation of preliminary ideas (albeit a large compilation) and not as a scholarly work.

to ThompsonCoburnNews@tcinstitute.com, which is not the author's email address but rather is an address used to transmit newsletters.

You might also check out the author's blog at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions.

II.A.1.e. Personal Holding Company Tax

Code § 541 provides that any personal holding company is taxed on 20% of its undistributed personal holding company income.

Code § 541 is intended to require most C Corporations with excess investment income to pay dividends.[59] "Undistributed personal holding company income" is the excess of a personal holding company's adjusted taxable income[60] over dividends paid or deemed paid.[61] Dividends paid or deemed paid include dividends paid during or shortly after[62] the taxable year, consent

[59] "Dividend" means a taxable dividend paid from the corporation's current or accumulated earnings and profits. Code § 562(a). Preferred dividends do not count, except from a publicly offered regulated investment company or a publicly offered REIT. Code § 562(c)(1).

[60] Code § 545(b) adjusts taxable income for various federal income tax and similar taxes, adjusts the charitable contribution deduction, disallows certain dividend-received deductions, adjusts the deduction for net operating losses, deducts U.S. net after-tax capital gain, and limits depreciation to that allowed with respect to rental income.

[61] Code § 545(a).

[62] Code § 563 allows a corporation to elect to treat a dividend paid after the close of any taxable year and on or before the 15th day of the fourth month following the close of such taxable year to be considered as paid on the last day of that taxable year. However, the amount so elected cannot exceed either the corporation's undistributed personal holding company income for the taxable year, computed without regard to this rule, or 20% of the sum of the dividends paid during the taxable year, computed without regard to this rule.

dividends[63] for the taxable year, and dividends carried over from a prior year[64] for purposes of this test.[65]

Code § 542(a) provides that, unless excluded from this tax,[66] a corporation is a "personal holding company" if:

[63] A corporation and its shareholders may agree to deem dividends as paid on the last day of the corporation's taxable year, Code § 565(a), and contributed to the capital of the corporation by the shareholder on that last day. Code § 565(c). However, generally the deemed dividend must qualify under fn 59. Code § 565(b).

[64] Code § 564(b) determines the dividend carryover as follows:

(1) For each of the 2 preceding taxable years there shall be determined the taxable income computed with the adjustments provided in section 545 (whether or not the taxpayer was a personal holding company for either of such preceding taxable years), and there shall also be determined for each such year the deduction for dividends paid during such year as provided in section 561 (but determined without regard to the dividend carryover to such year).

(2) There shall be determined for each such taxable year whether there is an excess of such taxable income over such deduction for dividends paid or an excess of such deduction for dividends paid over such taxable income, and the amount of each such excess.

(3) If there is an excess of such deductions for dividends paid over such taxable income for the first preceding taxable year, such excess shall be allowed as a dividend carryover to the taxable year.

(4) If there is an excess of such deduction for dividends paid over such taxable income for the second preceding taxable year, such excess shall be reduced by the amount determined in paragraph (5), and the remainder of such excess shall be allowed as a dividend carryover to the taxable year.

(5) The amount of the reduction specified in paragraph (4) shall be the amount of the excess of the taxable income, if any, for the first preceding taxable year over such deduction for dividends paid, if any, for the first preceding taxable year.

[65] Code § 561.

[66] Code § 542(c) excludes the following:

(1) a corporation exempt from tax under subchapter F (sec. 501 and following);

(2) a bank as defined in section 581, or a domestic building and loan association within the meaning of section 7701(a)(19);

(3) a life insurance company;

(4) a surety company;

(5) a foreign corporation,

(6) a lending or finance company if-

    (A) 60 percent or more of its ordinary gross income (as defined in section 543(b)(1)) is derived directly from the active and regular conduct of a lending or finance business;

    (B) the personal holding company income for the taxable year (computed without regard to income described in subsection (d)(3) and income derived directly from the active and regular conduct of a lending or finance business, and computed by including as personal holding company income the entire amount of the gross income from rents, royalties, produced film rents, and compensation for use of corporate property by shareholders) is not more than 20 percent of the ordinary gross income;

    (C) the sum of the deductions which are directly allocable to the active and regular conduct of its lending or finance business equals or exceeds the sum of-

        (i) 15 percent of so much of the ordinary gross income derived therefrom as does not exceed $500,000, plus

        (ii) 5 percent of so much of the ordinary gross income derived therefrom as exceeds $500,000; and

(1) *Adjusted ordinary gross income requirement*. At least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year is personal holding company income (as defined in section 543(a)), and

(2) *Stock ownership requirement*. At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. For purposes of this paragraph, an organization described in section 401(a), 501(c)(17), or 509(a) or a portion of a trust permanently set aside or to be used exclusively for the purposes described in section 642(c) or a corresponding provision of a prior income tax law shall be considered an individual.

In calculating adjusted ordinary gross income, any business income is based on gross receipts, not net income.[67]

Code § 543(a) provides that "personal holding company income" means the portion of the adjusted ordinary gross income consisting of:

(1) *Dividends, etc.* Dividends, interest, royalties (other than mineral, oil, or gas royalties or copyright royalties), and annuities. This paragraph shall not apply to-

(A) interest constituting rent (as defined in subsection (b)(3)),

(B) interest on amounts set aside in a reserve fund under chapter 533 or 535 of title 46, United States Code,

---

(D) the loans to a person who is a shareholder in such company during the taxable year by or for whom 10 percent or more in value of its outstanding stock is owned directly or indirectly (including, in the case of an individual, stock owned by members of his family as defined in section 544(a)(2)), outstanding at any time during such year do not exceed $5,000 in principal amount;

(7) a small business investment company which is licensed by the Small Business Administration and operating under the Small Business Investment Act of 1958 (15 U.S.C. 661 and following) and which is actively engaged in the business of providing funds to small business concerns under that Act. This paragraph shall not apply if any shareholder of the small business investment company owns at any time during the taxable year directly or indirectly (including, in the case of an individual, ownership by the members of his family as defined in section 544(a)(2)) a 5 per centum or more proprietary interest in a small business concern to which funds are provided by the investment company or 5 per centum or more in value of the outstanding stock of such concern; and

(8) a corporation which is subject to the jurisdiction of the court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) unless a major purpose of instituting or continuing such case is the avoidance of the tax imposed by section 541.

Code § 542(d) further describes Code § 542(c)(6).

[67] Reg. § 1.542-2 begins:

> To meet the gross income requirement it is necessary that at least 80 percent of the total gross income of the corporation for the taxable year be personal holding company income as defined in section 543 and §§1.543-1 and 1.543-2. For the definition of "gross income" see section 61 and §§1.61-1 through 1.61-14. Under such provisions gross income is not necessarily synonymous with gross receipts.

The latter refers to the fact that basis, cost of goods sold, and similar items are subtracted.

(C) dividends received by a United States shareholder (as defined in section 951(b)) from a controlled foreign corporation (as defined in section 957(a)).

(D) active business computer software royalties (within the meaning of subsection (d)), and

(E) interest received by a broker or dealer (within the meaning of section 3(a)(4) or (5) of the Securities and Exchange Act of 1934) in connection with-

(i) any securities or money market instruments held as property described in section 1221(a)(1),

(ii) margin accounts, or

(iii) any financing for a customer secured by securities or money market instruments.

(2) *Rents*. The adjusted income from rents; except that such adjusted income shall not be included if-

(A) such adjusted income constitutes 50 percent or more of the adjusted ordinary gross income, and

(B) the sum of-

(i) the dividends paid during the taxable year (determined under section 562),

(ii) the dividends considered as paid on the last day of the taxable year under section 563(d) (as limited by the second sentence of section 563(b)), and

(iii) the consent dividends for the taxable year (determined under section 565),

equals or exceeds the amount, if any, by which the personal holding company income for the taxable year (computed without regard to this paragraph and paragraph (6), and computed by including as personal holding company income copyright royalties and the adjusted income from mineral, oil, and gas royalties) exceeds 10 percent of the ordinary gross income.

(3) *Mineral, oil, and gas royalties*. The adjusted income from mineral, oil, and gas royalties; except that such adjusted income shall not be included if-

(A) such adjusted income constitutes 50 percent or more of the adjusted ordinary gross income,

(B) the personal holding company income for the taxable year (computed without regard to this paragraph, and computed by including as personal holding company income copyright royalties and the adjusted income from rents) is not more than 10 percent of the ordinary gross income, and

(C) the sum of the deductions which are allowable under section 162 (relating to trade or business expenses) other than-

(i) deductions for compensation for personal services rendered by the shareholders, and

(ii) deductions which are specifically allowable under sections other than section 162,

equals or exceeds 15 percent of the adjusted ordinary gross income.

(4) *Copyright royalties*. Copyright royalties; except that copyright royalties shall not be included if-

(A) such royalties (exclusive of royalties received for the use of, or right to use, copyrights or interests in copyrights on works created in whole, or in part, by any shareholder) constitute 50 percent or more of the ordinary gross income,

(B) the personal holding company income for the taxable year computed-

(i) without regard to copyright royalties, other than royalties received for the use of, or right to use, copyrights or interests in copyrights in works created in whole, or in part, by any shareholder owning more than 10 percent of the total outstanding capital stock of the corporation,

(ii) without regard to dividends from any corporation in which the taxpayer owns at least 50 percent of all classes of stock entitled to vote and at least 50 percent of the total value of all classes of stock and which corporation meets the requirements of this subparagraph and subparagraphs (A) and (C), and

(iii) by including as personal holding company income the adjusted income from rents and the adjusted income from mineral, oil, and gas royalties,

is not more than 10 percent of the ordinary gross income, and

(C) the sum of the deductions which are properly allocable to such royalties and which are allowable under section 162, other than-

(i) deductions for compensation for personal services rendered by the shareholders,

(ii) deductions for royalties paid or accrued, and

(iii) deductions which are specifically allowable under sections other than section 162,

equals or exceeds 25 percent of the amount by which the ordinary gross income exceeds the sum of the royalties paid or accrued and the amounts allowable as deductions under section 167 (relating to depreciation) with respect to copyright royalties.

For purposes of this subsection, the term “copyright royalties” means compensation, however designated, for the use of, or the right to use, copyrights in works protected by copyright issued under title 17 of the United States Code and to which copyright protection is also extended by the laws of any country other than the United States of America by virtue of any international treaty, convention, or agreement, or interests in any such copyrighted works, and includes payments from any person for performing rights in any such copyrighted work and payments (other than produced film rents as defined in paragraph (5)(B)) received for the use of, or right to use, films. For purposes of this paragraph, the term "shareholder" shall include any person who owns stock within the meaning of section 544. This paragraph shall not apply to active business computer software royalties.

(5) *Produced film rents*.

(A) Produced film rents; except that such rents shall not be included if such rents constitute 50 percent or more of the ordinary gross income.

(B) For purposes of this section, the term "produced film rents" means payments received with respect to an interest in a film for the use of, or right to use, such film, but only to the extent that such interest was acquired before substantial completion of production of such film. In the case of a producer who actively participates in the production of the film, such term includes an interest in the proceeds or profits from the film, but only to the extent such interest is attributable to such active participation.

(6) *Use of corporate property by shareholder*.

(A) Amounts received as compensation (however designated and from whomever received) for the use of, or the right to use, tangible property of the corporation in any case where, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property (whether such right is obtained directly from the corporation or by means of a sublease or other arrangement).

(B) Subparagraph (A) shall apply only to a corporation which has personal holding company income in excess of 10 percent of its ordinary gross income.

(C) For purposes of the limitation in subparagraph (B), personal holding company income shall be computed-

(i) without regard to subparagraph (A) or paragraph (2),

(ii) by excluding amounts received as compensation for the use of (or right to use) intangible property (other than mineral, oil, or gas royalties or copyright royalties) if a substantial part of the tangible property used in connection with such intangible property is owned by the corporation and all such tangible and intangible property is used in the active conduct of a trade or business by an individual or individuals described in subparagraph (A), and

(iii) by including copyright royalties and adjusted income from mineral, oil, and gas royalties.

(7) *Personal service contracts*.

(A) Amounts received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

(B) amounts received from the sale or other disposition of such a contract.

This paragraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

(8) *Estates and trusts*. Amounts includible in computing the taxable income of the corporation under part I of subchapter J (sec. 641 and following, relating to estates, trusts, and beneficiaries).

Code § 543(b)(2) provides that ordinary gross income is adjusted as follows to determine "adjusted ordinary gross income":

(A) *Rents*. From the gross income from rents (as defined in the second sentence of paragraph (3) of this subsection) subtract the amount allowable as deductions for-

(i) exhaustion, wear and tear, obsolescence, and amortization of property other than tangible personal property which is not customarily retained by any one lessee for more than three years,

(ii) property taxes,

(iii) interest, and

(iv) rent,

to the extent allocable, under regulations prescribed by the Secretary, to such gross income from rents. The amount subtracted under this subparagraph shall not exceed such gross income from rents.

(B) *Mineral royalties, etc.* From the gross income from mineral, oil, and gas royalties described in paragraph (4), and from the gross income from working interests in an oil or gas well, subtract the amount allowable as deductions for—-

(i) exhaustion, wear and tear, obsolescence, amortization, and depletion,

(ii) property and severance taxes,

(iii) interest, and

(iv) rent,

to the extent allocable, under regulations prescribed by the Secretary, to such gross income from royalties or such gross income from working interests in oil or gas wells.

The amount subtracted under this subparagraph with respect to royalties shall not exceed the gross income from such royalties, and the amount subtracted under this subparagraph with respect to working interests shall not exceed the gross income from such working interests.

(C) *Interest*. There shall be excluded-

(i) interest received on a direct obligation of the United States held for sale to customers in the ordinary course of trade or business by a regular dealer who is making a primary market in such obligations, and

(ii) interest on a condemnation award, a judgment, and a tax refund.

(D) *Certain excluded rents*. From the gross income consisting of compensation described in subparagraph (D) of paragraph (3) subtract the amount allowable as deductions for the items described in clauses (i), (ii), (iii), and (iv) of subparagraph (A) to the extent allocable, under regulations prescribed by the Secretary, to such gross income. The amount subtracted under this subparagraph shall not exceed such gross income.

II.A.2.f. Shareholders Eligible to Hold S corporation Stock

To be eligible for an S election, a corporation must be a domestic corporation that is not an ineligible corporation and does not have:[134]

- more than 100 shareholders,
- a shareholder who is a person (other than an estate, an eligible trust,[135] or a qualified retirement plan[136] or charity[137]) who is not an individual,[138]
- a nonresident alien as a shareholder, and
- more than 1 class of stock.

As mentioned above, a person who does not hold formal legal title but has a community property interest in stock is counted as a shareholder whose consent is required.[139] Accordingly, consider making sure that the spouse of each shareholder, who lives or has lived in a community property state, is not and does not become a nonresident alien.

[134] Code § 1361(b)(1).
[135] Code § 1361(c)(2) describes eligible trusts, which are described in more detail in part III.A.3 Trusts Holding Stock in S corporations.
[136] Described in Code § 401(a) and exempt from taxation under Code § 501(a).
[137] Described in Code § 501(c)(3) and exempt from taxation under Code § 501(a).
[138] Although a corporation cannot hold stock in an S corporation, a parent S corporation may elect to treat its wholly owned subsidiary as a "qualified subchapter S subsidiary," which is treated as a disregarded entity. See part II.A.2.g Qualified Subchapter S Subsidiary.
[139] See part II.A.2.e.ii Procedure for Making the S Election; Verifying the S Election; Relief for Certain Defects in Making the Election, especially fns. 121-122.

However, an electing small business trust (ESBT)[140] may have a nonresident alien (NRA) as a permissible current distributee.[141] Thus, one may give or bequeath stock to NRA by making sure the bequest is to a trust that has an ESBT election in place. Make sure, however, that Code § 678 does not make the NRA a deemed owner. [142]

If an individual holds S corporation stock through a disregarded entity, the individual and not the disregarded entity is treated as the shareholder, whether the disregarded entity is a single member LLC,[143] is a partnership of disregarded entities all taxed to the same person (and therefore the partnership itself is disregarded),[144] or is an unincorporated entity owned by a married couple as community property that the couple elects to treat as disregarded.[145] Note, of course, that such a disregarded entity[146] or nominee[147] could easily be transformed into a

---

[140] See part III.A.3.e.ii ESBTs

[141] Code § 1361(c)(2)(B)(v) provides:

> In the case of a trust described in clause (v) of subparagraph (A), each potential current beneficiary of such trust shall be treated as a shareholder; except that, if for any period there is no potential current beneficiary of such trust, such trust shall be treated as the shareholder during such period. This clause shall not apply for purposes of subsection (b)(1)(C).

The first sentence states that each person who may receive a distribution for the current taxable year is counted as a shareholder, so that an ESBT cannot have any such beneficiaries whose stock ownership would make the S corporation ineligible. However, 2017 tax reform added the last sentence, stating the usual disqualification of an NRA does not apply if the NRA is merely a beneficiary of an ESBT.

[142] See part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

[143] Letter Rulings 9739014 and 200008015, which are implicitly reinforced by fn. 147.

[144] Letter Rulings 200008015 and 200513001 (the latter expressly mentioning that Rev. Rul. 2004-77 disregards a partnership of disregarded entities all taxed to the same person), which are implicitly reinforced by fn. 147. Also see fn. 293 in part II.B Limited Liability Company (LLC), discussing generally when an LLC with more than one member constitutes a disregarded entity.

[145] Letter Ruling 201610007. For disregarding such an entity, see Rev. Proc. 2002-69, which is described in fn. 311, found in part II.B Limited Liability Company (LLC). Rev. Proc. 2002-69 allows a married couple to disregard the entity by reporting its activity directly on their tax returns. In Letter Ruling 201610007, the couple filed partnership tax returns, which the Letter Ruling ruled was an inadvertent termination. The IRS approved the S election so long as the couple elected to disregard the entity as provided in Rev. Proc. 2002-69 for all open taxable years.

[146] Regarding a partnership of disregarded entities, Letter Ruling 201730002 granted inadvertent termination relief for the following:

> On Date 2, A, the sole shareholder of X, transferred A's entire interest in X to Y, a limited liability company wholly owned by A and treated as a disregarded entity for federal tax purposes. On Date 3, A transferred a n% interest in Y to Trust, a grantor trust that was treated (under subpart E of part I of subchapter J of chapter 1) as entirely owned by A. Trust was an eligible shareholder under § 1361(c)(2)(A)(i). On Date 4, A died, causing Trust to cease being a grantor trust. On Date 4, X's S corporation election terminated as Y, the sole owner of X, became a partnership for federal tax purposes, an ineligible shareholder. On Date 5, Y redeemed the shares of Estate (which were received by Estate at A's death), causing Y to be treated as a disregarded entity owned by Trust for federal tax purposes.

[147] Reg. § 1.1361-1(e)(1), added by T.D. 8600 (7/20/1995), includes:

> The person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation for purposes of this paragraph (e) and paragraphs (f) and (g) of this section. For example, a partnership may be a nominee of S corporation stock for a person who qualifies as a shareholder of an S corporation. However, if the partnership is the beneficial owner of the stock, then the partnership is the shareholder, and the corporation does not qualify as a small business corporation.

partnership, thereby becoming an ineligible shareholder; however, inadvertent termination relief may be available.[148] Bequeathing a partnership interest to the only other partner through one's will generally is not enough to prevent the partnership from being a separate entity, because the process of estate administration causes the estate itself to have a legal life.[149] Query whether a nonprobate transfer through a transfer on death statute[150] might be considered instantaneous, because any claims are asserted after the transfer to the beneficiary, not before. Having the partnership term end upon the death of the grantor of multiple grantor trusts that are the sole partners might prevent the stock from being considered owned by a partnership,[151] but I would

---

In light of the regulation expressly authorizing nominees, the Letter Rulings in fns. 143 and 144 ignoring disregarded entities seem doubly well-grounded (grounded in the check-the-box regulations and this regulation).

Note also that a partnership that has long ago wound up its operations might be an eligible shareholder. See fn. 151.

[148] Letter Ruling 200841007 granted relief as follows:

> A, an individual, owned X stock indirectly through Y, A's wholly-owned limited liability company, which was a disregarded entity for federal tax purposes. On D2 of Year 1, A transferred interests in Y to each of Trust 1, Trust 2, Trust 3, Trust 4, and Trust 5 (collectively, the Trusts), which are represented as having been wholly-owned grantor trusts under § 671 with respect to A. A died on D3 of Year 1 and Y became a partnership for federal tax purposes. A partnership is not an eligible S corporation shareholder and therefore, X's S corporation election terminated on D3 of Year 1. On D4 of Year 1, Y liquidated and distributed its X stock among the Trusts.
>
> … we conclude that X's S corporation election terminated on D3 of Year 1 and that the termination was inadvertent within the meaning of § 1362(f). We further hold that, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D3 to D4 of Year 1 and thereafter….

Letter Rulings 201709015, 200237011 and 200237014 also granted inadvertent termination relief for a partnership owning S corporation stock. In granting relief, Letter Ruling 201709015 treated the partners as the shareholders, allowing QSST and ESBT elections retroactive to when the partnership first obtained the stock.

Letter Rulings 8948015 (partnership and individuals transfer to empty shell), 8934020 (transfer to empty shell), 8926016 (transfer to empty shell), 9010042 (transfer to empty shell), and 9421022 (transfer to empty shell) ignored transitory ownership by a partnership of an S corporation as part of a series of immediately effective transactions. See also parts II.A.2.j.ii Disregarding Transitory Owners and II.P.3.d.i Formless Conversion, text accompanying fn. 3344 (formless conversion of a partnership to an S corporation the same as a Code § 351 followed by a liquidation of the partnership, and the transitory ownership of the S corporation by the partnership is disregarded).

[149] Rev. Rul. 62-116.

[150] See, *e.g.*, RSMo Chapter 461.

[151] *Guzowski v. Commissioner*, T.C. Memo. 1967-145, approved ownership of S corporation stock by a partnership that had terminated, but its termination had occurred long before the S election was made:

> In the final analysis, our decision turns on whether paper transfer of the shares from the Partnership to the individual Guzowskis was required. The Partnership discontinued manufacturing operations by February 28, 1953 and all other operations by June 30, 1953. Sometime after that date all of the assets were disposed of. The term of the Partnership expired on January 2, 1957, and there is not one scintilla of evidence that there was any intent or action on the part of the partners to extend the term. Long prior to September 2, 1958—the critical date for our purposes—the Partnership was in limbo. The only possible remaining vestige of partnership identity stems from the fact that a certificate for 100,000 shares of stock of the Corporation was registered in the name of the Partnership. Even assuming that this certificate had not been cancelled and new certificates had not been issued in the names of the individual partners—as to which there was considerable confusing and conflicting testimony—we are satisfied that the ownership of the stock had passed to the partners individually. Stock certificates and stock record books are only one indication of who the real shareholders are. *Bijou Park Properties*, 47 T.C. 207 (1966). Sections 761 and 7701

not recommend that in planning mode. Rather than hold S corporation stock in a partnership that is a disregarded entity and risk the need for an inadvertent termination ruling, consider whether the S corporation's business can be moved to a partnership;[152] such an arrangement can be done seamlessly via merger or conversion statutes through a reorganization under Code § 368(a)(1)(F),[153] and the IRS generally accepts using a partnership to avoid concerns over ineligible shareholders.[154]

If an S corporation that is a partner in a partnership gives its stock to an employee of the partnership as compensation, which presumably would be treated as contributing the stock to the partnership and the partnership then transferring the stock as compensation to the employee,[155] the partnership will not be treated as a momentary owner of the S corporation stock.[156]

In counting the number of shareholders, the following are treated as 1 shareholder:[157]

- a husband and wife (and their estates), and
- all members of a family (and their estates).

The term "members of a family" means a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant.[158]

> define "partnership" as an unincorporated organization "through or by means of which any business, financial operation, or venture is carried on." *Cf.* sec. 1.708-1, Income Tax Regs. The touchstone of a partnership is activity. *Cf. Seattle Renton Lumber Co. v. United States*, 135 F.2d 989 (C.A. 9, 1943); *Albert Bettens*, 19 B.T.A. 1166 (1930); *Royal Wet Wash Laundry, Inc.*, 14 B.T.A. 470 (1928). Mere common ownership of property is not to be equated with the existence of a partnership. *Cf. George Rothenberg*, 48 T.C. — (June 21, 1967); see 6 Mertens, *Law of Federal Income Taxation* (Zimet Revision), sec. 35.02.
>
> We have previously held that the absence of formal steps to change the identity of a stockholder is not critical in determining the applicability of Subchapter S. *Old Virginia Brick Co.*, 44 T.C. 724 (1965), *affd.* 367 F.2d 276 (C.A. 4, 1966). We hold that, under the circumstances of this case, the stock of the corporation was owned by the four Guzowskis in their individual capacities at all times from and after September 2, 1958 and that the Subchapter S election was valid.

This case preceded Reg. § 1.1361-1(e)(1), which allows a partnership to hold S corporation stock as a nominee; see fn. 147.

[152] As described in parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart, a partnership (whether LLC or limited partnership) generally has tax characteristics better than that of an S corporation.

[153] See part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure, especially part II.E.7.c.i.(b) Use F Reorganization to Form LLC. See also part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

[154] See part II.A.2.j.i Using a Partnership to Avoid S corporation Limitations on Identity or Number of Owners or to Permit Non-Pro Rata Equity Interests.

[155] Presumably such a transfer would be analogous to a shareholder's transfer of stock to an employee of the corporation described in part II.M.4.c.i When a Gift to an Employee Is Compensation and Not a Gift, fn. 3043.

[156] Letter Ruling 200009029.

[157] Code § 1361(c)(1)(A).

[158] Code § 1361(c)(1)(B)(i). Any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by the individual, and any eligible foster child of an individual (under Code § 152(f)(1)(C)), shall be treated as a child of such individual by blood. Code § 1361(c)(1)(C).

An individual is considered to be a common ancestor only if, on the applicable date, the individual is not more than six generations removed from the youngest generation of shareholders who otherwise would be members of the family.[159] "Applicable date" means the latest of the date the S election is made, the earliest date that a member of the family holds stock in the S corporation, or October 22, 2004.[160] The test is only applied as of the applicable date, and lineal descendants (and spouses) more than six generations removed from the common ancestor will be treated as members of the family even if they acquire stock in the corporation after that date.[161]

The members of a family are treated as one shareholder solely for purposes of counting shareholders.[162] Each member of the family who owns or is deemed to own stock must be an eligible shareholder.[163] Although a person may be a member of more than one family under these rules, each family (not all of whose members are also members of the other family) will be treated as one shareholder.[164]

In counting shareholders, the estate or grantor trust of a deceased member of the family will be considered to be a member of the family during the period in which the estate or trust (such trust during the two years the trust is eligible) holds stock in the S corporation, and the members of the family also include:[165]

- In the case of an ESBT, each potential current beneficiary who is a member of the family;
- In the case of a QSST, the income beneficiary who makes the QSST election, if that income beneficiary is a member of the family;
- In the case of a qualified voting trust, each beneficiary who is a member of the family;
- The deemed owner of a grantor trust if that deemed owner is a member of the family; and
- The owner of an entity disregarded as an entity separate from its owner under the check-the-box rules, if that owner is a member of the family.

II.A.2.g. Qualified Subchapter S Subsidiary (QSub)

An S corporation can own a wholly owned subsidiary, which the Code calls a "qualified subchapter S subsidiary"[166] and the regulations and this author refer to as a QSub.[167]

[159] Code § 1361(c)(1)(B)(ii). For purposes of the preceding sentence, a spouse (or former spouse) shall be treated as being of the same generation as the individual to whom such spouse is (or was) married.
[160] Code § 1361(c)(1)(B)(iii).
[161] Reg. § 1.1361-1(e)(3)(i).
[162] Reg. § 1.1361-1(e)(3)(i).
[163] Reg. § 1.1361-1(e)(3)(i).
[164] Reg. § 1.1361-1(e)(3)(i).
[165] Reg. § 1.1361-1(e)(3)(ii).
[166] Code § 1361(b)(3), especially Code § 1361(b)(3)(B).
[167] Reg. § 1.1361-2(a).

A QSub is any domestic corporation that is not an ineligible corporation,[168] is wholly owned by an S corporation, and that the parent elects to treat as a QSub.[169] The parent files Form 8869 no more than 12 months before or 2 months and 15 days after the election's effective date.[170] For relief for a late election, see part II.A.2.e.ii Procedure for Making the S Election; Verifying the S Election; Relief for Certain Defects in Making the Election, especially part II.A.2.e.iv Relief for Late QSub Elections.

A QSub is not treated as a separate corporation, and all of the QSub's assets, liabilities, and items of income, deduction, and credit are treated as assets, liabilities, and such items (as the case may be) of its parent;[171] this treatment applies for all purposes of the Code, except as provided in regulations.[172] Reg. § 1.1361-4(a)(1) states that this rule applies "for Federal tax purposes," except for certain provisions it references:

- If the parent or a QSub is a bank, then the special bank rules govern items of income, deduction, and credit at the bank entity level; however, after applying those rules, all of the QSub's assets, liabilities, and items of income, deduction, and credit, as determined in accordance with the special bank rules, are treated as the parent's.[173]

- A QSub is treated as a separate corporation for purposes of its Federal tax liabilities with respect to any taxable period for which the QSub was treated as a separate corporation, Federal tax liabilities of any other entity for which the QSub is liable, and refunds or credits of Federal tax.[174]

- A QSub is treated as a separate corporation for purposes of Federal employment taxes and withholding.[175]

---

[168] Referring to Code § 1362(b)(2), which provides that the following are ineligible to make an S election:
(A) a financial institution which uses the reserve method of accounting for bad debts described in section 585,
(B) an insurance company subject to tax under subchapter L,
(C) a corporation to which an election under section 936 applies, or
(D) a DISC or former DISC.

[169] Code § 1361(b)(3)(B); Reg. § 1.1361-2(a).

[170] Reg. § 1.1361-3(a)(4). If the parent is a newly formed holding company and the subsidiary is electing to be a QSub, see fn 3429 in part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

[171] CCA 201552026 asserts that a parent may not take a Code § 165(g)(3) worthless stock deduction with respect to its QSub's stock.

[172] Code § 1361(b)(3)(A).

[173] Reg. § 1.1361-4(a)(3), especially Reg. § 1.1361-4(a)(3)(ii), Example (2).

[174] Reg. § 1.1361-4(a)(6).

[175] Reg. § 1.1361-4(a)(7) provides:
(i) *In general*. A QSub is treated as a separate corporation for purposes of Subtitle C - Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code).
(ii) *Effective/applicability date*. This paragraph (a)(7) applies with respect to wages paid on or after January 1, 2009.

- A QSub is treated as a separate corporation for purposes of certain excise taxes,[176] none of which seem to have anything to do with estate, gift, or generation-skipping transfer taxes.[177]

- QSubs separately file certain information returns,[178] none of which seem to have anything to do with estate, gift, or generation-skipping transfer taxes.[179]

QSubs have some nice uses. First, suppose one would like to drop all of an S corporation's assets into a partnership, per part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons. The shareholders can contribute their stock to a new corporation and make a QSub election for the old S corporation, both as part of a tax-free reorganization,[180] then merge the QSub into a new disregarded LLC as a disregarded transaction, even if the new

---

[176] Reg. § 1.1361-4(a)(8) provides:

(i) *In general*. A QSub is treated as a separate corporation for purposes of—

(A) Federal tax liabilities imposed by Chapters 31, 32 (other than section 4181), 33, 34, 35, 36 (other than section 4461), 38, and 49 of the Internal Revenue Code, or any floor stocks tax imposed on articles subject to any of these taxes;

(B) Collection of tax imposed by Chapters 33 and 49 of the Internal Revenue Code;

(C) Registration under sections 4101, 4222, and 4412;

(D) Claims of a credit (other than a credit under section 34), refund, or payment related to a tax described in paragraph (a)(8)(i)(A) of this section or under section 6426 or 6427; and

(E) Assessment and collection of an assessable payment imposed by section 4980H and reporting required by section 6056.

(ii) *Effective/applicability date*.

(A) Except as provided in this paragraph (a)(8)(ii), paragraph (a)(8) of this section applies to liabilities imposed and actions first required or permitted in periods beginning on or after January 1, 2008.

(B) References to Chapter 49 in paragraph (a)(8) of this section apply to taxes imposed on amounts paid on or after July 1, 2012.

(C) Paragraph (a)(8)(i)(E) of this section applies for periods after December 31, 2014.

Reg. § 1.1361-4T(a)(8)(iii)(A) treated a QSub as a separate corporation for purposes of Chapter 49, the latter of which imposed a tax on indoor tanning services. Reg. § 1.1361-4T(a)(8)(iii)(C) provided that Reg. § 1.1361-4T(a)(8)(iii)(A) expired June 22, 2015.

[177] Estate, gift, or generation-skipping transfer taxes are imposed by Chapters 11, 12, and 13, respectively. Special valuation rules are in Chapter 14. Code §§ 6161, 6163, 6165 and 6166, relating to estate tax extensions, are in Chapter 62. Liens, including Code §§ 6324, 6324A, and 6324B (relating to estate and gift taxes, Code § 6166 deferral, and special use valuation) are in Chapter 64.

[178] Reg. § 1.1361-4(a)(9) provides:

(i) *In general*. Except to the extent provided by the Secretary or Commissioner in guidance (including forms or instructions), paragraph (a)(1) of this section shall not apply to part III of subchapter A of chapter 61, relating to information returns.

(ii) *Effective/applicability date*. This paragraph (a)(9) is effective on August 14, 2008.

[179] Part III of subchapter A of chapter 61 consists of Code §§ 6031-6060. Although Code §§ 6034, 6034A, and 6035 deal with information returns filed by trusts and estates, they are meaningless in a QSub context because a trust or estate would own the parent, not the QSub (given that a QSub must be wholly owned by a parent corporation). Estate and gift tax returns are required by Code §§ 6018 and 6019, respectively, which are in Part II, not Part III, of subchapter A of chapter 61. Generation-skipping transfer tax returns are required by Code § 2662, which is in Chapter 13.

[180] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization, especially fn. 3429, which includes the procedure when one combines such a reorganization with a QSub election. Consider whether the election to treat the old S corporation as a QSub should be made before merging into the LLC, out of concern that the surviving LLC is not taxed as a corporation and therefore can no longer make a QSub election on behalf of the old S corporation. See Letter Rulings 201501007 and 201724013.

LLC converts to a partnership immediately thereafter;[181] this transaction is diagrammed and explained in part II.E.7.c.i.(b) Use F Reorganization to Form LLC. A QSub might also allow a tiered structure to qualify for Code § 6166 estate tax deferral[182] when it might not have qualified or on more favorable terms than might otherwise have applied.[183] It might also be used to preserve the AAA of a corporation whose S election is revoked.[184] In the latter case, following the recommended reorganization the QSub election could be immediately terminated;[185] terminating it the same day as the day the QSub election is made prevents the 5-year waiting

---

[181] Reg. § 1.1361-5(b)(3), Example (2) clarifies that the merger into a wholly owned LLC has no federal income tax consequences, even if immediately thereafter the LLC is converted into a partnership, with the partnership tax rules governing the formation of such a partnership:

(i) X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. As part of a plan to sell a portion of Y, X causes Y to merge into T, a limited liability company wholly owned by X that is disregarded as an entity separate from its owner for Federal tax purposes. X then sells 21 percent of T to Z, an unrelated corporation, for cash. Following the sale, no entity classification election is made under § 301.7701-3(c) of this chapter to treat the limited liability company as an association for Federal tax purposes.

(ii) The merger of Y into T causes a termination of Y's QSub election. The new corporation Newco) that is formed as a result of the termination is immediately merged into T, an entity that is disregarded for Federal tax purposes. Because, at the end of the series of transactions, the assets continue to be held by X for Federal tax purposes, under step transaction principles, the formation of Newco and the transfer of assets pursuant to the merger of Newco into T are disregarded. The sale of 21 percent of T is treated as a sale of a 21 percent undivided interest in each of T's assets. Immediately thereafter, X and Z are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

(iii) Under section 1001, X recognizes gain or loss from the deemed sale of the 21 percent interest in each asset of the limited liability company to Z. Under section 721(a), no gain or loss is recognized by X and Z as a result of the deemed contribution of their respective interests in the assets to the partnership in exchange for ownership interests in the partnership.

[182] See part III.B.5.d.ii Code § 6166 Deferral, especially part III.B.5.d.ii.(b) Tiered Structures.

[183] See part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders, especially the text accompanying fns. 96-99.

[184] See part II.P.3.c.v Conversion from S corporation to C Corporation then Back to S corporation, especially fns. 3332-3334.

[185] Reg. § 1.1361-3(b), "Revocation of QSub election," provides in paragraphs (1) and (2):

(1) *Manner of revoking QSub election*. An S corporation may revoke a QSub election under section 1361 by filing a statement with the service center where the S corporation's most recent tax return was properly filed. The revocation statement must include the names, addresses, and taxpayer identification numbers of both the parent S corporation and the QSub, if any. The statement must be signed by a person authorized to sign the S corporation's return required to be filed under section 6037.

(2) *Effective date of revocation*. The revocation of a QSub election is effective on the date specified on the revocation statement or on the date the revocation statement is filed if no date is specified. The effective date specified on the revocation statement cannot be more than two months and 15 days prior to the date on which the revocation statement is filed and cannot be more than 12 months after the date on which the revocation statement is filed. If a revocation statement specifies an effective date more than two months and 15 days prior to the date on which the statement is filed, it will be effective two months and 15 days prior to the date it is filed. If a revocation statement specifies an effective date more than 12 months after the date on which the statement is filed, it will be effective 12 months after the date it is filed.

period for re-electing QSub status[186] from applying.[187] The revocation of the QSub election is treated as forming a new C corporation.[188]

If the parent later owns less than all of the stock of the subsidiary, the subsidiary becomes a C corporation.[189] Consider merging a QSub into a wholly owned LLC that is a disregarded entity,

---

[186] Reg. § 1.1361-5(c)(1). Code § 1361(b)(3)(D) provides:

> *Election after termination*. If a corporation's status as a qualified subchapter S subsidiary terminates, such corporation (and any successor corporation) shall not be eligible to make-
> (i) an election under subparagraph (B)(ii) to be treated as a qualified subchapter S subsidiary, or
> (ii) an election under section 1362(a) to be treated as an S corporation,
> before its 5th taxable year which begins after the 1st taxable year for which such termination was effective, unless the Secretary consents to such election.

[187] Reg. § 1.1361-3(b)(4) provides:

> *Revocation before QSub election effective*. For purposes of Section 1361(b)(3)(D) and § 1.1361-5(c) (five-year prohibition on re-election), a revocation effective on the first day the QSub election was to be effective will not be treated as a termination of a QSub election.

Eustice, Kuntz & Bogdanski, *Federal Income Taxation of S Corporations* (WG&L), ¶ 3.08[3][g][ii] Revocation, includes this example:

> X, an S corporation, files a proper qualified subchapter S subsidiary election for its wholly owned subsidiary, S, on January 1, 2016, effective on that date. On March 10 of the same year, while S is still an eligible qualified subchapter S subsidiary, X changes its mind and files a revocation of the election, effective January 1. Because the intended effective date is less than two months and fifteen days prior to the filing of the revocation statement, the revocation is effective, as stated, on January 1. Because this was also the first day on which the election was to be effective, S is not barred from being a qualified subchapter S subsidiary, or an S corporation, in the years 2016 to 2020.

RIA Checkpoint ¶ 254:182 Termination by Revocation includes an example making the same point. See Reg. § 1.1361-3(b)(2) in fn 185, supporting retroactive revocation in this manner.

[188] Reg. § 1.1361-5(b)(1)(i) provides:

> *In general*. If a QSub election terminates under paragraph (a) of this section, the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation. The tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. For purposes of determining the application of section 351 with respect to this transaction, instruments, obligations, or other arrangements that are not treated as stock of the QSub under § 1.1361-2(b) are disregarded in determining control for purposes of section 368(c) even if they are equity under general principles of tax law.

Reg. § 1.1361-5(b)(3), Example (5) provides:

> X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X subsequently revokes the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the revocation from its S corporation parent in a deemed exchange for Y stock. On a subsequent date, X sells 21 percent of the stock of Y to Z, an unrelated corporation, for cash. Assume that under general principles of tax law including the step transaction doctrine, the sale is not taken into account in determining whether X is in control of Y immediately after the deemed exchange of assets for stock. The deemed exchange by X of assets for Y stock and the deemed assumption by Y of its liabilities qualify under section 351 because, for purposes of that section, X is in control of Y within the meaning of section 368(c) immediately after the transfer.

[189] Reg. § 1.1361-5(a)(1)(iii) and Code § 1361(b)(3)(b)(i). Reg. § 1.1361-5(b)(3), Example (1) provides:

> X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X sells 21 percent of the Y stock to Z, an unrelated corporation, for cash, thereby terminating the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Y stock immediately before the termination from the

so that its pass-flow status is not lost if ownership of part of the entity is transferred or if potential changes in capital structure cause equity to be deemed to be issued (it was suggested to me that an underpriced warrant issued in a financing might cause problems), but beware state income taxation if a state in which the company is subject to income tax does not treat a QSub as a disregarded entity[190] and that a disregarded entity subsidiary might not have as strong an argument that Code § 6166 estate tax deferral applies.[191]

On the reverse side, if an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation in a generally tax-free transaction.[192]

II.C.9. Whether an Arrangement (Including Tenancy-in-Common) Constitutes a Partnership

Taxation as a partnership, although generally more flexible than corporate taxation, might be more unfavorable than taxation as co-owners who are not partners. For example, if co-owners have different goals regarding whether to reinvest sale proceeds or engage in a Code § 1031 like-kind exchange,[484] they might want to unwind anything that makes them considered partners.[485] Also,

---

> S corporation. The deemed exchange by X of assets for Y stock does not qualify under section 351 because X is not in control of Y within the meaning of section 368(c) immediately after the transfer as a result of the sale of stock to Z. Therefore, X must recognize gain, if any, on the assets transferred to Y in exchange for its stock. X's losses, if any, on the assets transferred are subject to the limitations of section 267.

[190] On the other hand, converting sooner rather than later might save higher state income tax on some later event, if the state does not recognize QSubs.

[191] See part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders, especially the text accompanying fns. 96-98.

[192] Reg. § 1.1361-4(a)(2)(i), which further provides that, subject to certain transition rules that apply to pre-2001 QSub elections, "the tax treatment of the liquidation or of a larger transaction that includes the liquidation will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine." Reg. § 1.1361-4(a)(2)(ii) illustrates this liquidation concept, including the Example (1) a liquidation that under Code §§ 332 and 337 is tax-free to the parent and subsidiary, respectively. For the latter, see part II.Q.7.a.vii Corporate Liquidation.

[484] See part II.G.15 Like-Kind Exchanges.

[485] For how to unwind a partnership in anticipation of a possible Code § 1031 exchange, see "Like-Kind Exchanges of Partnership Properties," *The Tax Adviser*, page 812, December 2008. Letter Ruling 9741017 drove this point home in the following situation:

> … each of the brothers, A and B, owns a one-half interest in Taxpayer, which itself owns ten rental real properties. A and B have responsibility for making major decisions regarding their properties. Management of the properties is performed by a property management corporation of which A and B are equal stockholders, but are no longer employees. A and B represent that they have never executed any partnership agreement regarding Taxpayer or considered themselves to be anything other than equal owners of the properties. For the five consecutive tax years 19x1 to 19x5, however, all net income and losses of Taxpayer relating to the properties have been reported on Form 1065, a Partnership Return.
>
> A and B represent that irreconcilable differences have developed between them regarding their ownership of the properties. Moreover, A and B are considering estate planning issues relating to the properties. To address those issues, A and B propose a like-kind exchange between themselves involving nine of the properties. After the exchange, six of the properties will be owned entirely by B, and three will be owned by A. The tenth property will continue to be owned by A and B as co-owners.

The ruling held:

the Code § 121 exclusion for gain on the sale of a residence does not apply when spouses hold their residence in a partnership.[486] On the other hand, partnership income tax reporting generally is easier than separately listing every item on each co-owner's income tax return.

Those holding properties as tenants-in-common[487] or a trust created by its beneficiaries[488] should consider whether they are deemed to have formed a partnership. Generally, as a matter of state law, "the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership."[489] Furthermore, the Uniform Partnership Act[490] provides:

> In determining whether a partnership is formed, the following rules apply:
>
> (1) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not by itself establish a partnership, even if the co-owners share profits made by the use of the property.
>
> (2) The sharing of gross returns does not by itself establish a partnership, even if the persons sharing them have a joint or common right or interest in property from which the returns are derived.
>
> (3) A person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received in payment:
>
> (A) of a debt by installments or otherwise;
>
> (B) for services as an independent contractor or of wages or other compensation to an employee;

> Without making a determination under Rev. Rul. 75-374 regarding A's and B's joint business activities relating to the properties, we note a crucial test under case law of whether the co- owners of property intended to create a partnership, as evidenced by their actions, notwithstanding the lack of characterization of their relationship. See *Estate of Levine*, 72 T.C. 780, 785 (1979). In this instance, we believe that Taxpayer's filing of partnership tax returns for several tax years indicates an intention to be taxed as a partnership. Accordingly, we conclude that A's and B's co-ownership of Taxpayer constitutes a partnership under section 761(a) and the regulations thereunder rather than a mere co-ownership.
>
> Since an exchange of partnership interests can not qualify for deferral under section 1031(a)(1) by reason of section 1031(a)(2)(D) we can not rule that the transaction qualifies for deferral as a like-kind exchange.

[486] *Farah v. Commissioner*, T.C. Memo. 2007-369, and Letter Ruling 200119014.

[487] For an excellent discussion of taxation of tenants-in-common, as well as when such an arrangement is taxed as a partnership, see Tucker and Langlieb, fn. 1299. In the real estate context, see also fn. 327.

[488] See parts II.D.1 Trust as a Business Entity and II.K.2.b.iii Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity.

[489] Section 202(a) of the Uniform Partnership Act ("UPA"), found at http://www.uniformlaws.org/Act.aspx?title=Partnership Act (1997) (Last Amended 2013) (general description of the UPA) or http://www.uniformlaws.org/Shared/Docs/Partnership/UPA%20_Final_2014_2015aug19.pdf (text of the UPA).

[490] UPA § 202(c). 805 ILCS 202 follows the quoted language, and 805 ILCS 1201 provides that 805 ILCS Act 206, the Uniform Partnership Act (1997), shall follow the uniform law.

(C) of rent;

(D) of an annuity or other retirement or health benefit to a beneficiary, representative, or designee of a deceased or retired partner;

(E) of interest or other charge on a loan, even if the amount of payment varies with the profits of the business, including a direct or indirect present or future ownership of the collateral, or rights to income, proceeds, or increase in value derived from the collateral; or

(F) for the sale of the goodwill of a business or other property by installments or otherwise.

Co-owners of real estate might form a partnership with respect to operations conducted on the real estate without the partnership applying to the ability to sell the real estate itself,[491] but equitable principles are likely to determine whether the court finds a partnership.[492]

---

[491] *Holton v. Guinn*, 76 F. 96 (W.D. Mo. 1896), held, "It might be conceded, for the purpose of this case, that a partnership existed between the parties in conducting a business on these lands, without affecting the legal status of the land or property, for the separate properties may be employed in partnership business." Although one of a few co-tenants might engage in conduct suggesting a partnership, that conduct must be authorized to find a partnership. Looking to the actions of all of the co-owners and finding a mere tenancy in common, *Hudson v. French*, 241 S.W. 443 (W.D. Mo. 1922), quoted *Holton*:

> "Where the conduct and acts of the parties in dealing with the estate may with reason be referred to the office of a tenant in common, the courts, in construing those acts, will prefer to attribute them to that relation."

Continuing this line of reasoning, *Thomas v. Lloyd*, 17 S.W.3d 177 (S.D. Mo. 2000), found a mere tenancy in common regarding real estate, analyzing the law as follows:

> In attempting to demonstrate that the parties intended for the real estate to be a partnership asset, Defendant points to the joint ownership of the farm and the fact that the parties operated the partnership cattle business on the farm as evidence that the two understood and intended for the farm to be a partnership asset. His reliance on those facts is misplaced, however. A joint purchase of real estate by two individuals does not, in and of itself, prove the land is a partnership asset. See *Hudson*, 241 S.W. at 446; 68 C.J.S. Partnership § 73, at 274–75 (1998). On the contrary, when land is conveyed to partnership members without any statement in the deed that the grantees hold the land as property of the firm, there is a presumption that title is in the individual grantees. 68 C.J.S. Partnership § 75, at 277 (1998). Moreover, "[e]vidence that the land is used by the firm is of itself insufficient to rebut the presumption." *Id.* The mere use of land by a partnership does little to show the land is owned by the partnership. 1 Bromberg and Ribstein on Partnership, § 3.02(b), at 3:7 (Release No. 7—1999–2 Supp.). Standing alone, evidence of partnership usage does not compel a finding that the land is a partnership asset. *Mischke v. Mischke*, 247 Neb. 752, 530 N.W.2d 235, 240 (1995); *In re Estate of Schreiber*, 227 N.W.2d 917, 925[9] (Wis. Sup. 1975). See *Shawneetown Feed and Seed Co. v. Ford*, 468 S.W.2d 54, 56 (Mo. App. 1971).

The result may be different if partnership funds were used to buy the property. *Engeman v. Engeman*, 123 S.W.3d 227 (W.D. Mo. 2003).

[492] *State Auto. and Cas. Underwriters v. Johnson*, 766 S.W.2d 113 (S.D. 1969), held that the building, furniture and fixtures destroyed by the fire constituted partnership property when a 50% tenant in common received insurance proceeds equal to 100% of the value of the property destroyed. Although the partnership agreement was terminated:

> We hold the trial court's findings that no final division had ever been made of the partnership property or partnership debts, that the partnership affairs were never wound up, and that the partnership had not been terminated at the time of the fire are supported by substantial evidence

6833577

Note some consequences to a tenancy in common being characterized as a partnership:

- Joint and several liability for all of the partnership's debts, obligations, and other liabilities, subject to various exceptions.[493]

- The right to withdraw at will,[494] even in contravention to any agreement of the parties,[495] either giving the owner the right to cash out for the greater of the liquidation value or the value based on a sale of the entire business as a going concern without the person[496] or causing the partnership to dissolve[497] and wind up its business.[498] The right to cash out might be especially troubling for the other owners. Also, federal case law[499] has established that an interest as a tenant in common is worth less (15%-20% tends to be a common valuation adjustment, but much higher adjustments may be appropriate when property is not easily partitioned) than a percentage of the property's value as a whole, this right to cash out might reduce that valuation adjustment. In the federal tax lien area, courts tend to view this valuation adjustment as ground for forcing the sale of the underlying property, because selling the tenant-in-common interest would prejudice the government's interest in collecting what is due.[500]

As a matter of federal tax law, regulations provide a fundamental definition:[501]

> *In general*. The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Further regulations provide:[502]

> *Certain joint undertakings give rise to entities for federal tax purposes*. A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the

---

and are not against the weight of the evidence, and that in making such findings the trial court neither erroneously declared nor erroneously applied the law.

[493] UPA § 306.
[494] UPA §§ 601(1), 602(a).
[495] UPA § 110(c)(9).
[496] UPA § 701.
[497] UPA § 801.
[498] UPA § 802.
[499] It has been suggested to me that "the New Jersey Division of Taxation has unilaterally proclaimed that they will not accept the assertion of a valuation discount for a 50% interest as a tenant in common of real property under any circumstances. In the past, I have routinely requested such a discount, citing federal case law, and I was never denied the discount. I had encountered difficulties with respect to valuation discounts for family limited partnerships and limited liability companies, even with a valuation report, but this is something new. Luckily, New Jersey is repealing the NJ Estate tax effective 1/1/2018, but we have to deal with them in the interim."
[500] See *U.S. v. Adent*, cited in fn. 6088, found in part III.B.5.d.iv.(i) Effect of Liens on Dealings with Third Parties.
[501] Reg. § 301.7701-1(a)(1).
[502] Reg. § 301.7701-1(a)(2). Code § 7701(a)(2) provides:
The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried

> participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

The controlling U.S. Supreme Court case held:[503]

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Presenting sufficient evidence to raise a genuine issue of material fact as to the parties' intent prevents the IRS from winning on summary judgment;[504] the IRS can't succeed merely by showing that the generation of tax losses was one of the purposes of a partnership's formation.[505]

> on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

[503] *Commissioner v. Culbertson*, 337 U.S. 733 (1949), clarifying *Commissioner v. Tower*, 327 U.S. 280 (1946).

[504] In denying summary judgment to the government, *Broadwood Investment Fund, LLC v. U.S.*, 116 A.F.T.R.2d 2015-5492 (9th Cir. 2015), held:

> In particular, Petitioners presented evidence that some of the investment materials projected that the partnerships could be profitable, and that the partners performed due diligence on the assets before acquiring them. Petitioners also presented evidence of efforts made to collect on the debts owned by the partnerships. And there is no dispute that the partnerships allocated distributions, profits, and losses to partners *pro rata*. The government also presented substantial evidence in support of its determination that the partnerships were shams, and we express no opinion on how this issue ultimately should be resolved on the merits. But the genuine factual dispute as to the partners' intent precludes summary judgment on the issue.

[505] *Peking Investment Fund LLC v. Commissioner*, Tax Court Docker No. 12772-09 Order 2/13/2018, regarding a distressed asset/debt ("DAD") transaction:

> Respondent has moved for partial summary adjudication in his favor that his FPAA properly disallowed a loss of $26,903,619 that PIF claimed for its taxable year ended December 31, 2001, as a result of its exchange of an interest in one portfolio of nonperforming loans (NPLs) for another. Specifically, PIF transferred an interest in a portfolio of NPLs originated by China Construction Bank (the CCB NPL portfolio) that it had received as a contribution from China Cinda Asset Management Corporation (Cinda). In exchange, PIF received interests in portfolios of NPLs originated by Korean Development Bank (the KDB NPL portfolios)….

The most commonly cited factors in federal tax case law, none of which is conclusive, are:[506]

- [t]he agreement of the parties and their conduct in executing its terms;
- the contributions, if any, which each party has made to the venture;

To determine whether respondent has submitted sufficient evidence to establish that, as a matter of law, PIF should be disregarded as a sham, we must first identify the relevant legal standard. The prior cases that have disregarded DAD partnerships as shams applied the Culbertson test. See *Southgate Master Fund, LLC v. United States*, 659 F.3d 466, 485 (5th Cir. 2011); *Kenna Trading, LLC v. Commissioner*, 143 T.C. 322, 351 (2014); *Superior Trading, LLC v. Commissioner*, 137 T.C. at 81; *Russian Recovery Fund Ltd. v. United States*, 122 Fed. Cl. At 615. And, as noted above, the parties before us appear to agree that *Culbertson* provides the governing test. Therefore, for purposes of the present motion, we will treat *Culbertson* test as the legal standard governing the recognition of a partnership for Federal income tax purposes. But see *AD Inv. 2000 Fund, LLC v. Commissioner*, T.C. Memo. 2015-223, at *25 (observing that Culbertson predated entity classification regulations adopted in 1997 that "may place the question of whether there is a tax-recognized entity ahead of the classification of the entity as a partnership or corporation for tax purposes"), vacated and superseded on reconsideration, T.C. Memo. 2016-226….

The mere fact that the generation of tax losses was one of the purposes of a partnership's formation would not justify disregarding the partnership as a sham under the Culbertson test. That test requires us to ask "whether, considering all the facts … the parties in good faith and acting with a business purpose intended to join together in the present conduct of … [a business] enterprise." *Commissioner v. Culbertson*, 337 U.S. at 742. Even if the generation of tax losses is the primary purpose for a partnership's formation, the partnership may also have as a secondary purpose the conduct of a business enterprise. To prevail in disregarding a DAD partnership as a sham under *Culbertson*, the Commissioner must establish that carrying out a business of collecting NPLs was so minimal a factor in the decision to form the partnership that it can be dismissed. In prior cases in which this Court and others have disregarded DAD partnerships as shams, the evidence showed that the partners ultimately had no real interest in collecting the NPLs. See, *e.g.*, *Superior Trading, LLC v. Commissioner*, 728 F.3d at 680 (noting that partnership's "purportedly active partner" made only "a few, feeble attempts" at collection and dismissing those efforts as "window dressing" because the partnership had not taken measures necessary under Brazilian law to pursue collection); *Southgate*, 659 F.3d at 485 (reasoning that partners' decision to abandon efforts to improve collection by servicer "manifests an unmistakable intent to forego the joint conduct of a profit-seeking venture"); *Kenna Trading, LLC v. Commissioner*, 143 T.C. at 353 (finding ambiguities in the record regarding the identity of the partners and their proportionate interests and observing that "[p]arties genuinely embarking on a joint business endeavor … would not accept such ambiguity"). But if the facts show an objective of profiting from collection, even though that objective may be outweighed by investors' objective of realizing the benefit of substantial tax losses, the partnership should not be disregarded as a sham under *Culbertson*.

… the parties' interest in or indifference to collections on PIF's NPL portfolio is a contested question of fact to be resolved at trial.

[506] *Luna v. Commissioner*, 42 T.C. 1067, 1077-78 (1964). Although this case dealt with an insurance agent, it has been cited in many other situations, including CCA 201323015 (joint venture between two corporations constituted a partnership because of their "sharing in the net profits and losses from the manufacture, development, and marketing of" [a particular undisclosed product]), *Holdner v. Commissioner*, T.C. Memo. 2010-175 (presumption of partners holding equal interests), *aff'd* 110 A.F.T.R.2d 2012-6324 (9th Cir. unpublished summary opinion), and *6611, Ltd., Ricardo Garcia, Tax Matters Partner, v. Commissioner*, T.C. Memo. 2013-49 (disregarding a partnership for purposes of applying IRS partnership audit procedures). In the context of whether an arrangement to provide services that awards equity-type incentives might constitute a partnership, see part III.B.7.c.viii Creative Bonus Arrangements.

- the parties' control over income and capital and the right of each to make withdrawals;[507]

- whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses,[508] or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income;

- whether business was conducted in the joint names of the parties;

- whether the parties filed Federal partnership returns or otherwise represented to [the IRS] or to persons with whom they dealt that they were joint venturers;

- whether separate books of account were maintained for the venture; and

- whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

Furthermore:[509]

> [T]he parties, to form a valid tax partnership, must have two separate intents: (1) the intent to act in good faith for some genuine business purpose and (2) the intent to be partners, demonstrated by an intent to share "the profits and losses." If the parties lack either intent, then no valid tax partnership has been formed. To determine whether the parties had these intents, a court must consider "all the relevant facts and circumstances," including (a) "the agreement," (b) "the conduct of the parties in execution of its provisions," (c) the parties' statements, (d) "the testimony of disinterested persons," (e) "the relationship of

---

[507] This factor is not, by itself, sufficient to prove the existence of a partnership. *Azimzadeh v. Commissioner*, T.C. Memo. 2013-169.

[508] Later cases held that, if a purported partner lacks any meaningful downside or upside potential, that person is not a partner. *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3rd Cir. 2012), *cert. den.* 2013 WL 249846 (5/28/2013); *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, 107 AFTR.2d 2011-1523 (4th Cir. 2011). On the other hand, a mere interest in future capital appreciation might suffice. See CCA 201326018, discussed in Banoff's and. Lipton's Shop Talk column, "General Partners Who Only Share in Capital Appreciation," *Journal of Taxation* (8/2013) (in-depth discussion of the issue of treating as a partner someone with no interest in the current year's operating profits) and their follow-up, "General Partners Who Only Share in Future Years' Profits: TEFRA and Beyond," *Journal of Tax*ation (5/2014).

In response to concern about how the *Historic Boardwalk* case, Rev. Proc. 2014-12 provides a safe harbor regarding the allocation of Code § 47 rehabilitation credits. Among other requirements, Section 4.02(1) of the Rev. Proc. requires the principal to have at least a 1% interest in each material item of partnership income, gain, loss, deduction, and credit at all times during the partnership's existence, and Section 4.02(2) requires to investor to have, at all times during the period it owns an interest in the partnership, a minimum interest in each material item of Partnership income, gain, loss, deduction, and credit equal to at least 5% of the investor's percentage interest in each such item for the taxable year for which the investor's percentage share of that item is the largest (as adjusted for sales, redemptions, or dilution of the investor's interest) and must participate in profits in a manner that is not limited to a preferred return that is in the nature of a payment for capital.

[509] *Chemtech Royalty Associates, L.P. v. U.S.*, 114 A.F.T.R.2d 2014-5940 (5th Cir 2014), quoting *Southgate Master Fund, L.L.C. ex rel. Montgomery Capital Advisors, LLC v. United States*, 659 F.3d 466, 488 (5th Cir. 2011).

the parties," (f) the parties' "respective abilities and capital contributions," (g) "the actual control of income and the purposes for which it is used," and (h) "any other facts throwing light on their true intent."

LAFA 20161101F asserted that in an investor in a coal production partnership was not entitled to the related credits because the capital contributions were based on future production and were nonrecourse and any chance of profit other than through tax credits was small.

The Tax Court has "consistently disregarded entities that attempt to generate artificial losses by exploiting the partnership tax rules."[510] When a partnership is disregarded for tax purposes, partnership income rules no longer apply, and one or more of the purported partners will be deemed to have engaged in the partnership's activities.[511]

If preferred payments are relatively fixed and certain, the following facts need to be considered:[512]

- whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both

- whether the preferred partner was a bona fide partner because the payments it expected to receive were essentially fixed and relatively secure[513]

---

[510] *New Millennium Trading, LLC v. Commissioner*, T.C. Memo. 2017-9, supporting this statement with: See *AD Inv. 2000 Fund, LLC v. Commissioner*, T.C. Memo. 2016-226; *436, Ltd. v. Commissioner*, T.C. Memo. 2015-28; *Markell Co. v. Commissioner*, T.C. Memo. 2014-86; *6611, Ltd. v. Commissioner*, T.C. Memo. 2013-49; *Palm Canyon X Invs., LLC v. Commissioner*, T.C. Memo. 2009-288; see also *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. 161 (2009) (disallowing the losses because the "transaction lacked economic substance"), *aff'd*, 408 F.App'x 908 (6th Cir. 2010); *Humboldt Shelby Holding Corp. v. Commissioner*, T.C. Memo. 2014-47 (similar), *aff'd* per summary order, 606 F.App'x 20 (2d Cir. 2015). Each scheme involved an entity (partnership or LLC) whose sole purpose was to provide its members with a high-basis membership interest to be disposed of at a loss; or, on its redemption, to put high-basis entity assets into the hands of the member, who would then dispose of them at a loss.

[511] *New Millennium Trading, LLC v. Commissioner*, T.C. Memo. 2017-9, supporting this statement with: See, *e.g.*, *6611, Ltd. v. Commissioner*, T.C. Memo. 2013-49. A disregarded partnership has no identity separate from its owners, and we treat is as an agent or nominee. See *Tigers Eye Trading v. Commissioner*, 138 T.C. at 94, 99. Pursuant to section 6233(a) and (b), TEFRA procedures still apply to the entity, its items, and persons holding an interest in the entity as long as the purported partnership filed a return, which NMT did for tax year 1999. See sec. 6233(b); sec. 301.6233-1987). Thus, we have jurisdiction to determine any items that would have been "partnership items", as defined in section 6231(a)(3), and section 301.6231(a)(3)-1, Proced. & Admin. Regs., had NMT been a valid partnership for tax purposes. See *Tigers Eye Trading v. Commissioner*, 138 T.C. at 97.

[512] *Principal Life Ins. Co. & Subs v. U.S.*, 120 Fed. Cl. 41 (Ct. Fed. Cl. 2/4/2015).

[513] The court also held:

> Even if a partnership exists, "consideration whether an interest has the prevailing character of debt or equity can be helpful in analyzing whether, for tax purposes, the interest should be deemed a bona fide equity participation in a partnership." [citations omitted] A party will not be considered a bona fide partner in a partnership if its interest is more akin to a debt-like interest, with little or no risk aside from credit risk, than to an equity participation, a share of ownership in which the party takes on true entrepreneurial risk in the partnership venture. [citations omitted] In the court's view, significant questions of fact remain as to how the interests in question should be treated in this regard, precluding a ruling on summary judgment….

- whether the existence of a preferred equity interest in a partnership, providing a relatively secure return, is sufficient to treat the holder of the interest as other than a partner

When one person contributes capital, another contributes management skill, and the person contributing management skill takes reduced compensation and a 20% share of the sale proceeds after the moneyed partner receives a nice preferred return, the person contributing management skill is a partner who can treat the receipt of 20% of the sale proceeds as capital gain.[514]

In light of uncertainty, generally co-owners may elect not to be treated as a partnership in either of two circumstances:[515]

(2) *Investing partnership*. Where the participants in the joint purchase, retention, sale, or exchange of investment property –

(i) Own the property as coowners,[516]

(ii) Reserve the right separately to take or dispose of their shares of any property acquired or retained, and

(iii) Do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, …. [or]

(3) *Operating agreements*. Where the participants in the joint production, extraction, or use of property—

(i) Own the property as coowners, either in fee or under lease or other form of contract granting exclusive operating rights, and

(ii) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and

(iii) Do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of

---

[514] *U.S. v. Stewart*, 116 A.F.T.R.2d 2015-5720 (S.D. Tex. 8/20/2015), relying on *Haley v. Commissioner*, 203 F.2d 815, 818 (5th Cir. 1953). *Stewart* did not cite *Luna* or any of the traditional cases defining what a partnership is.

[515] Reg. § 1.761-2(a)(2), (3). CCA 201323015 asserted that a joint venture between two corporations could not make this election. It was not an investment partnership under Reg. § 1.761-2(a)(2) for either one of two reasons:

- The product produced did not qualify as “investment property” (looking to the Code § 148(b)(2) definition of “investment property” the Reg. § 1.148-1(e) definition of “investment-type property”).
- It actively conducted the business of producing and selling the product.

The joint venture failed the requirements of Reg. § 1.761-2(a)(3) because the two corporations jointly sold the product.

[516] [my footnote – not found in the regulations that are quoted above:] The IRS has asserted that “coowners” means direct co-ownership and not ownership through a commonly owned LLC. FSA 200216005.

time in excess of the minimum needs of the industry, and in no event for more than 1 year....

This election-out of partnership treatment applies only for the purposes of the partnership income tax rules of subchapter K.[517]

A group of owners of undivided interests in rental real property[518] might seek a private letter ruling that their ownership does not rise to the level of being a partnership. To do so, they must satisfy the following conditions:[519]

> Each of the co-owners must hold title to the Property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.
>
> The number of co-owners must be limited to no more than 35 persons. For this purpose, "person" is defined as in § 7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.
>
> The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see section 6.06 of this revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the

---

[517] In *Methvin v. Commissioner*, T.C. Memo. 2015-81, *aff'd* 653 Fed. Appx. 616 (10th Cir. 6/24/2016), the Tax Court held:

> Petitioner also argues that in article 14 of the operating agreement the parties specifically elected to be excluded from the application of subchapter K and therefore cannot be considered a partnership. We have held that making this election "'does not operate to change the nature of the entity. A partnership remains a partnership; the exclusion simply prevents the application of subchapter K. The partnership remains intact and other sections of the Code are applicable as if no exclusion existed.'" *Cokes v. Commissioner*, 91 T.C. at 230-231 (quoting *Bryant v. Commissioner*, 46 T.C. 848, 864 (1966), *aff'd*, 399 F.2d 800 (5th Cir. 1968)). Accordingly, the parties' election under section 761(a) does not prevent us from finding that the operating agreements created a partnership.
>
> We conclude that the working interest owners and well operator created a pool or joint venture for operation of the wells. Accordingly, petitioner's income from the working interests was income from a partnership of which he was a member under the broad definition of "partnership" found in section 7701(a)(2). See *Cokes v. Commissioner*, 91 T.C. at 232; *Bentex Oil Corp. v. Commissioner*, 20 T.C. 565 (1953). Therefore, petitioner is liable for self-employment tax on the net income received from his working interests.

[518] For an excellent discussion of taxation of tenants-in-common, as well as when such an arrangement is taxed as a partnership, see Tucker and Langlieb, fn. 1299. In Letter Ruling 200826005, two individuals held a number of properties together, and their tenancy-in-common agreements, which included buy-sell provisions, were held not to constitute a partnership. As natural products of the land that are attached to the land, commercial plants, that were mature, had complex root systems, and were expected to produce a commercially harvestable crop, constituted real estate under Code § 865. Letter Ruling 201424017.

[519] Rev. Proc. 2002-22, Section 6, as modified by Rev. Proc. 2003-3, Section 1.02(8), which deleted Sections 6.03 and 6.06 of Rev. Proc. 2002-22.

vote of co-owners holding more than 50 percent of the undivided interests in the Property (see section 6.05 of this revenue procedure for conditions relating to voting).

The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the Property. A co-owner who has consented to an action in conformance with this section 6.05 may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner's undivided interest in the Property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the Property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the Property is equal to the co-owner's percentage interest in the Property multiplied by the fair market value of the Property as a whole. A co-owner may not acquire an option to sell the co-owner's undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75-374, 1975-2 C.B. 261. Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.

The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the Property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the Property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the Property, subject to the approval of the co-owners. (See section 6.05 of this revenue procedure for conditions relating to the approval of lease and debt modifications.) The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the Property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the Property. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). See section 856(d)(2)(A) and the regulations thereunder. Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements.

The lender with respect to any debt that encumbers the Property or with respect to any debt incurred to acquire an undivided interest in the Property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the Property.

Except as otherwise provided in this revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the Property.

A co-tenancy agreement satisfied these requirements, where the initial landlord owned 100% of the property through a disregarded LLC and had the right to sell fractional interests to the tenant (or the tenant's disregarded LLC) for fair market value, determined taking the initial appraised value and increasing it annually by a flat percentage that was a reasonable appreciation factor.[520]

See also part II.D.1 Trust as a Business Entity for whether pooling together ownership interests rises to the level of a business entity, when the owners used a trust to own real estate – especially

[520] Letter Ruling 201622008.

for guidelines on whether a lease arrangement might separate ownership of the real estate from the activity done on the property.

Spouses who own and operate a business as co-owners and who materially participate[521] may elect to treat the business as a disregarded entity (a "qualified joint venture")[522] if it is not in the name of a limited partnership, limited liability company or other state law entity.[523] If both spouses make that election, then "all items of income, gain, loss, deduction, and credit shall be divided between the spouses in accordance with their respective interests in the venture, and each spouse shall take into account such spouse's respective share of such items as if they were attributable to a trade or business conducted by such spouse as a sole proprietor.[524] Thus, each reports his or her portion of business income on a separate Schedule C or E.[525]

A purported partnership shall be treated as a lease of property if the arrangement is properly treated as a lease of property, taking into account all relevant factors.[526]

For additional ways that co-owners might escape partnership income tax treatment, see part II.D.4 Disregarding Multiple Owner Trust for Income Tax Purposes.

When an LLC that is taxed as a partnership signed a revenue sharing agreement with a person, held him out as an owner, and treated him as a partner in tax filings, the person was taxed as a

---

[521] Code § 761(f)(2)(B) cross-references Code § 469(h) but eliminates the application of Code § 469(h)(5), the latter of which would let each spouse count the other's participation. For more on Code § 469(h), see part II.K.1.a Counting Work as Participation in Business under the Passive Loss Rules.

[522] Code §761(f)(2), effective tax years beginning after December 31, 2006.

[523] If one goes to www.irs.gov, searches "qualified joint venture," and follows the hyperlink entitled "Election for Husband and Wife Unincorporated Businesses," then one can find (at https://www.irs.gov/businesses/small-businesses-self-employed/election-for-husband-and-wife-unincorporated-businesses when I last searched) the IRS' view that a state law entity owned by a married couple cannot qualify for treatment as a qualified joint venture. Similarly, an LLC owned by spouses does not qualify under special procedures for a favorable private letter ruling, which pre-date Code § 761(f) but remain in effect; see Section 6.01 of Rev. Proc. 2002-22 (which does, however, allow each spouse to have a single member LLC and have those LLCs own the properties as tenants in common). The IRS' view does not appear to be confirmed or refuted by the legislative history. *Argosy Technologies, LLC v. Commissioner*, T.C. Memo. 2018-35, subjected to penalties, for late filing of 2010 and 2011 returns, an LLC owned 100% by a married couple; the LLC protested, claiming it was a disregarded entity, but the court held that filing partnership returns admitted to partnership status and pointed out that there was no evidence of a Code § 761(f) election. The court did not reach the merits of whether a Code § 761(f) election could have been made.

[524] Code §761(f)(1), effective tax years beginning after December 31, 2006.

[525] Chief Counsel Advice 200816030 held that active rental that qualified as a Code § 761(f) trade or business did not generate self-employment income, reasoning that Code § 1402(17) is intended to allocate income one-half to each spouse rather than overriding various exceptions (including the rental exception) to self-employment tax. This CCA carries much more weight than most CCAs, as it was to the Asst. Division Counsel (Prefiling) (Small Business/Self-Employed) from the Branch Chief, Employment Tax Branch 1 (Exempt Organizations/Employment Tax/Government Entities) and recommended specific procedures for IRS Service Centers. See also "New Law Has Social Security Impact on Husband-Wife Partnerships," *Business Entities* (WG&L), Jan/Feb 2009.

[526] Code § 7701(e)(2).

partner even though he never signed the LLC's operating agreement and even though the K-1 the LLC issued to him reported only guaranteed payments and no profits interest.[527]

Transitory ownership in a partnership with almost no rights does not make a person a partner:[528]

> In the present case, Organization, as an assignee of Partner, was not a full-fledged partner of Partnership. Partner's assignment of Units to Organization entitled Organization to distributions made with respect to Units while Partner retained all other indicia of ownership of Units. Organization was only an assignee of Partner for one day before the Organization transferred it rights in Units to Corporation in exchange for Note. Partner determined the selling price of Units. Organization's momentary rights to distribution (which are totally controlled by Partner) are not sufficient to make Organization a partner in Partnership. Organization had no meaningful right to participate in Partnership's success or failure and as such, was not in substance a partner of Partnership.

II.E. Recommended Structure for Entities

II.E.1. Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities

Below is a comparison of annual federal and state income tax burdens when the owners are in the highest or in a modest tax bracket, based on calculations shown in Parts II.E.1.a Taxes Imposed on C Corporations and II.E.1.b Taxes Imposed on S corporations, Partnerships, and Sole Proprietorships. The assumptions made in putting together the chart can be criticized, but hopefully reviewing them helps one understand the post-2017 paradigm.

---

527 *Cahill v. Commissioner*, T.C. Memo. 2013-220. This case involved an insurance agent. The court pointed out:

> Petitioner entered into the memorandum of agreement and the revenue sharing agreement, both of which provided for the mechanism under which he would share in the profits of FC/CFC. Moreover, the memorandum of agreement and the revenue sharing agreement stated that FC/CFC would issue petitioner a Form 1099-MISC or a Schedule K-1 with respect to any money he received under either agreement. There is no indication in the record that petitioner objected to receiving a Schedule K-1 on the grounds that he was not a partner.

The court also pointed out that the parties held out the taxpayer as an owner and changed the LLC's name to include the taxpayer's.

528 CCA 201507018, which also invoked Reg. § 1.701-2 to disregard a transitory interest as a partner in a partnership:

> In this case, Partner purportedly transferred Units in Partnership with a low basis and a high fair market value to Organization, for which Partner took a charitable deduction based on the fair market value of Units on Partner's personal tax return. Subsequently, Partner arranged for Organization to sell those Units to Corp for the Note. As a result of this second purported transfer, Corp takes a deduction for interest payments on Note and a goodwill amortization deduction as a result of Partnership's § 743(b) adjustment. In this way, Partner and Partner affiliates take three deductions for one charitable contribution that never in substance occurred. Transaction significantly reduced Partner and Corp's tax liability. The purported transfer of Units to Organization was necessary to achieve that claimed result. Organization, an assignee of Partner with respect to Units, only momentarily had rights to distributions and no other rights to Units.

	Individual in Top Bracket	Individual in Modest Bracket
Distributing 100% of Corporate Net Income After Income Tax	47.3%	40.8%
Distributing 50% of Corporate Net Income After Income Tax	36.7%	33.4%
Distributing None of Corporate Net Income After Income Tax	26.0%	26.0%
S corporation, Partnership, or Sole Proprietorship (Pass-Through)	34.6%-45.8%	27.4%-46.2%

<u>Note, however, that distributing less than 100% of corporate net income after tax does not reflect the true tax cost, because additional tax will often be incurred when extracting the earnings later through a dividend or sale.</u> For a discussion of the extent to which that is true and how choice of entity affects exit strategies, see part II.E.2.a Transferring the Business.

Also consider that the excess of pass-through income tax rates over corporate rates is at an all-time high.

A partnership or S corporation that does business in many states incurs extra state compliance obligations, because states often require withholding on nonresident owners, require all owners to file in all of those states, or require both. Also note that individuals or trusts owning pass-through businesses will be able to deduct little or no of the state income tax on their business income, whereas C corporations are not subject to such limitations.[605]

For a start-up entity, consider that most businesses lose money initially, and some never get into the black. An LLC taxed as a sole proprietorship or partnership is a much better vehicle for deducting losses[606] than is an S corporation[607] or C corporation.[608] If one is enamored with corporate income taxation, one might start as an LLC and then contribute the LLC to a corporation when one becomes sufficiently profitable to save taxes.[609] The disadvantage of such an approach occurs when the owner is in a low tax bracket, so that losses provide little, if any, benefit; in that case, having the C corporation carry forward its losses to offset them against income that would

[605] See text accompanying fn 21 in part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment.
[606] See part II.G.3 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner, especially part II.G.3.c.ii Basis Limitations for Partners in a Partnership.
[607] See part II.G.3.c.i Basis Limitations for S corporation Owners Beyond Just Stock Basis.
[608] See parts II.G.3.b C Corporations: Losses Incurred by Business, Owner, or Employee and II.G.3.c.iii Comparing C Corporation Loss Limitations to Those for Partnership and S corporation Losses.
[609] Although one could just "check the box" by filing Form 8832 or 2553, as the case may be, contributing an interest in the LLC sets one up for an ideal entity structure and avoids possible (remote) self-employment tax issues. See parts II.E Recommended Structure for Entities and II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election, respectively. For entity conversion issues, see part II.P.3 Conversions.

otherwise have been taxed at a higher rate – and relying on Code § 1244 for ordinary loss treatment if the business is unsuccessful[610] – might be of greater benefit.

Incentive pay and deferred compensation can be more difficult in a corporate setting than in a partnership setting.[611] However, C corporations provide better fringe benefits.[612]

II.E.1.a. Taxes Imposed on C Corporations

For taxable years beginning after December 31, 2017, all C corporations pay tax at a flat 21% rate, unless some industry-specific exclusions, such as those for insurance companies, apply.[613] However, if a C corporation receives a dividend from another corporation, only part of that dividend is taxed,[614] reducing the effective tax rate to 10.5% for dividends from unrelated companies or zero or 7.35% for dividends from affiliates.

In addition to taxes on annual operations, consider:

---

[610] See parts II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244 and II.J.11.b Code § 1244 Treatment Not Available for Trusts.

[611] See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.

[612] See part II.P.2 C Corporation Advantage Regarding Fringe Benefits.

[613] Code § 11(a), (b). Code § 11(c) provides that corporate income tax does not apply to a corporation subject to a tax imposed by:

(1) section 594 (relating to mutual savings banks conducting life insurance business),
(2) subchapter L (sec. 801 and following, relating to insurance companies), or
(3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts).

Code § 11(d), "Foreign corporations," provides:

> In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882.

[614] See fns. 10-14 in part II.A.1.a C Corporations Generally.

- Dividends to shareholders, which are distributions out of a corporation's current or accumulated earnings and profits, are subject to regular tax at capital gain rates[615] (if qualified dividends)[616] and the 3.8% tax on net investment income.[617]

- A corporation that does not pay dividends may become subject to the 20% accumulated earnings tax. See part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax.

- A corporation that distributes property to its shareholders generally is subject to tax on the excess of value over basis (but cannot deduct a loss). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

Let's examine the effects of earning $100,000 taxable income inside the corporation and distributing various proportions of the net after-tax profits, assuming the taxpayer lives in a state that imposes moderate (5%) income tax on corporations and individuals. The individual in a top bracket is assumed taxed at a rate of 28.8%, consisting of 20% capital gain tax, 3.8% net

[615] Code §§ 1(h)(3), 1(h)(11)(A).

[616] Code § 1(h)(11)(B) provides the following parameters for "qualified dividend income":

(i) *In general*. The term "qualified dividend income" means dividends received during the taxable year from-
  (I) domestic corporations, and
  (II) qualified foreign corporations.

(ii) *Certain dividends excluded*. Such term shall not include-
  (I) any dividend from a corporation which for the taxable year of the corporation in which the distribution is made, or the preceding taxable year, is a corporation exempt from tax under section 501 or 521,
  (II) any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.), and
  (III) any dividend described in section 404(k).

(iii) *Coordination with section 246(c)*. Such term shall not include any dividend on any share of stock-
  (I) with respect to which the holding period requirements of section 246(c) are not met (determined by substituting in section 246(c) "60 days" for "45 days" each place it appears and by substituting "121-day period" for "91-day period"), or
  (II) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Elaborating on Code § 1(h)(11)(B)(i)(II), Code § 1(h)(11)(C) provides rules for qualified foreign corporations.

Code § 1(h)(11)(D) provides special rules:

(i) *Amounts taken into account as investment income*. Qualified dividend income shall not include any amount which the taxpayer takes into account as investment income under section 163(d)(4)(B). [My note: This relates to income against which investment interest may be deducted. See part II.G.19.a Limitations on Deducting Business Interest Expense, which mentions in passing investment interest expense.]

(ii) *Extraordinary dividends*. If a taxpayer to whom this section applies receives, with respect to any share of stock, qualified dividend income from 1 or more dividends which are extraordinary dividends (within the meaning of section 1059(c)), any loss on the sale or exchange of such share shall, to the extent of such dividends, be treated as long-term capital loss.

(iii) *Treatment of dividends from regulated investment companies and real estate investment trusts*. A dividend received from a regulated investment company or a real estate investment trust shall be subject to the limitations prescribed in sections 854 and 857.

[617] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

investment income tax, and 5% state income tax. The individual in a modest bracket is assumed taxed at a rate of 20%, consisting of 15% capital gain tax, no net investment income tax, and 5% state income tax.

Distributing 100% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Income Taxes at 28.8% or 20%	-21,312	-14,800
Net Cash to Owner	$52,688	$59,200

Note that the tax rates above seem somewhat high – 47.312% or 40.8%, depending on whether the shareholder is in a high or modest bracket. The corporation might try paying more compensation to avoid double taxation, but compensation income is taxed at ordinary income rates, and the employer's and employee's share of FICA combines to add tax equal to 2.5%-13.3%.[618] So, add that tax to the employee's federal, state, and local income tax rate and compare to the above. Consider, however, that a corporation cannot deduct more than reasonable compensation - see part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment – and in 2017 the IRS has instructed its examiners how to prevent taxpayers from contesting the issue in Tax Court.[619]

Distributing 50% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Distribution to Owner	$37,000	$37,000
Income Taxes at 28.8% or 20%	-10,656	-7,400
Net Cash to Owner	$26,344	$29,600
Corporate Cash Plus Shareholder Cash	$63,344	$66,600

[618] The tax hit is 2.9%-15.3%, as described in part II.E.1.b Taxes Imposed on S corporations, Partnerships, and Sole Proprietorships, text accompanying fn 621-623. However, the employer's deduction for half of this amount at an assumed 26% rate lowers the effective rate to 2.5%-13.3%.
[619] See fns. 87-89 in part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax.

Distributing None of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-26,000
Net Income after Income Tax	$74,000

Many years ago, Congress incentivized corporations to declare dividends, through the imposition of two taxes:

- Personal holding company tax. A personal holding company is taxed on 20% of its undistributed personal holding company income. See part II.A.1.e Personal Holding Company Tax.

- Accumulated earnings tax. Generally, a C corporation that accumulates funds could be subject to the 20% accumulated earnings tax on its excess undistributed accumulated earnings and profits. The corporation needs to articulate specific reasons why its needs to reinvest its earnings. For details, see part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax. This tax does not apply to personal holding companies (as used in the preceding bullet point). If the company not a personal holding company but is a mere holding or investment company, the tax kicks in if undistributed earnings exceed $125,000.[620]

Each of these taxes can be avoided by paying sufficient dividends. The corporation may manage these taxes by actual or deemed dividends; see the relevant tax for rules on the extent to which this is permitted and how to do it.

II.E.1.b. Taxes Imposed on S corporations, Partnerships, and Sole Proprietorships

Generally, S corporations and partnerships do not pay entity-level income tax; instead, their owners pay tax on their distributive share of the entity's income. However, some state or local governments do impose an entity-level tax, which may be in addition to imposing income tax on the owners' distributive share of the entity's income.

Tax reform in 2017 introduced a deduction of up to 20% of business earnings. See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

An owner of a partnership or sole proprietorship also generally pays tax self-employment ("SE") tax on income from a trade or business, subject to various exceptions; see part II.L Self-Employment Tax (FICA). SE tax is 15.3% OASDI and Medicare taxes until the taxpayer reaches the taxable wage base ($128,400 in 2018 and $132,900 in 2019),[621] then is 2.9% Medicare tax until it reaches 3.8%, when the supplemental Medicare tax (employee's portion) kicks in.[622] The

[620] See fn 4021 in part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax.
[621] See http://www.ssa.gov/OACT/COLA/cbb.html for the current amount.
[622] See fns 2781-2783 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.

employer's portion of SE tax, which is 7.65% up to the taxable wage base and 1.45% thereafter, is deductible in determining adjusted gross income (not as an itemized deduction).[623]

An owner of an S corporation or partnership may pay the 3.8% tax on net investment income ("NII"); see part II.I 3.8% Tax on Excess Net Investment Income (NII). SE income is excluded from NII.[624] The deduction for the employer's share of SE tax makes SE tax preferable to NII tax, except to the extent that the income would be below the taxable wage base.

To the extent that an owner's distributive share of a partnership's or S corporation's income is reinvested, the owner's basis in the partnership interest[625] or stock[626] increases. Generally, an owner can withdraw the earnings tax-free, merely reducing basis in the owner's partnership interest or stock. See parts II.Q.8.b.i Distribution of Property by a Partnership and II.Q.7.b Redemptions or Distributions Involving S corporations. However, an S corporation that distributes property triggers tax on the gain,[627] which gain is taxed at its shareholders' respective income tax rates and in many cases does not qualify for favorable capital gain rates.[628]

Let's examine the effects of earning $100,000 taxable income inside the entity, assuming the taxpayer lives in a state that imposes moderate (5%) income tax on corporations and individuals:

An individual in a top bracket might be taxed at a rate of 34.6%-45.8%, consisting of:

- 29.6%-37% ordinary income tax (depending on whether the Code § 199A 20% deduction is available)
- zero-3.8% net investment income tax (working in the business may avoid this tax, and exceptions to SE tax may apply as well), and
- 5% state income tax.

An individual in a modest bracket might be taxed at a rate of 27.4%-46.2%, consisting of:

---

[623] Code § 164(f), "Deduction for one-half of self-employment taxes," provides:

(1) *In general*. In the case of an individual, in addition to the taxes described in subsection (a), there shall be allowed as a deduction for the taxable year an amount equal to one-half of the taxes imposed by section 1401 (other than the taxes imposed by section 1401(b)(2)) for such taxable year.

(2) *Deduction treated as attributable to trade or business*. For purposes of this chapter, the deduction allowed by paragraph (1) shall be treated as attributable to a trade or business carried on by the taxpayer which does not consist of the performance of services by the taxpayer as an employee.

[624] As to SE income being excluded from NII, see fn 1874 in part II.I.5 What is Net Investment Income Generally.

[625] Code § 705.

[626] Code § 1367.

[627] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

[628] See parts II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

- 22.4%-28% ordinary income tax (depending on whether the Code § 199A 20% deduction is available, and the wage limitations[629] and restrictions on types of businesses do not apply to modest income taxpayers)

- zero-13.2% SE tax income tax (after considering the deduction for one-half of SE tax)

- 5% state income tax.

II.E.1.c. Code § 199A Pass-Through Deduction for Qualified Business Income

For taxpayers other than C corporations,[630] Code § 199A provides a deduction for taxable years beginning after December 31, 2017 but not beginning after December 31, 2025.[631] When applying Prop. Regs. §§ 1.199A-1 through 1.199A-6, a reference to an individual includes a reference to a trust (other than a grantor trust) or an estate to the extent that the Code § 199A deduction is determined by the trust or estate under the rules of Prop. Reg. § 1.199A-6.[632] The Proposed Regulations and preamble are found at https://www.federalregister.gov/documents/2018/08/16/2018-17276/qualified-business-income-deduction.

In the case of a partnership or S corporation, Code § 199A applies at the partner or shareholder level.[633] In the case of an S corporation, an allocable share is the shareholder's pro rata share of an item.[634] The deduction does not reduce one's basis in one's partnership interest or S corporation stock.[635]

Grantor trusts are of course disregarded and their activity attributed to their deemed owners, but estates and nongrantor trusts compute their distributive net income ("DNI") with considering the Code § 199A deduction. Then they allocate each Code § 199A item to the trust and the beneficiaries according to their respective shares of DNI. The trust uses its taxable income for its Code § 199A calculation, and each beneficiary uses his or her taxable income for his or her own Code § 199A calculation. See part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

The IRS is to "prescribe such regulations as are necessary to carry out the purposes of" Code § 199A, including regulations:[636]

(A) for requiring or restricting the allocation of items and wages under this section and such reporting requirements as the Secretary determines appropriate, and

(B) for the application of this section in the case of tiered entities.

---

[629] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[630] Code § 199A(a).
[631] Code § 199A(i).
[632] Prop. Reg. § 1.199A-1(a)(2)
[633] Code § 199A(f)(1)(A)(i).
[634] Code § 199A(f)(1)(A) (flush language).
[635] Prop. Reg. § 1.199A-1(e)(1) provides:

> *Effect of deduction*. In the case of a partnership or S corporation, section 199A is applied at the partner or shareholder level. The section 199A deduction has no effect on the adjusted basis of a partner's interest in the partnership, the adjusted basis of a shareholder's stock in an S corporation, or an S corporation's accumulated adjustments account.

[636] Code § 199A(f)(4).

The proposed regulations implementing subparagraph (A) follow the definitions below. Prop. Reg. § 1.199A-1(f), "Effective/applicability date," provides:

> (1) *General rule*. Except as provided in paragraph (f)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. However, taxpayers may rely on the rules of this section until the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.
>
> (2) *Exception for non-calendar year RPE*. For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

Reg. § 1.199A-1(f)(2) allows a fiscal year estate (including a qualified revocable trust electing taxation as such)[637] that distributes income to its beneficiaries to convert 2017 income into QBI. For example, suppose an S corporation issues a K-1 to an estate for calendar year 2017, and the estate elects a calendar year ending September 30, 2018. That K-1 is reported on the estate's return for a taxable year that begins before January 1, 2018 and ends after December 31, 2017, meaning that the K-1 will pass through QBI, W-2 wages and UBIA to the extent that the estate is an RPE.[638] The estate is an RPE only to the extent QBI is allocated to beneficiaries on K-1s issued to them.[639] The government is not disturbed by this conversion of 2017 income to QBI.[640] However, the RPE conducting the qualified trade or business may be – it might not have been expecting to compute QBI, W-2 wages and UBIA for 2017! Nevertheless, I believe that they are required to report this information, because S corporations[641] and partnerships[642] must separately report any items that affect an owner's tax return differently than the entity's overall taxable income.

---

[637] See part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate.

[638] See part II.E.1.f Trusts/Estates and the Code § 199A Deduction, text accompanying fn 819.

[639] See part II.E.1.f.ii.(a) How Qualified Business Income Flows to Beneficiaries.

[640] The preamble to Prop. Reg. § 1.199A-6(d), REG-107892-18 (8/16/2018), explains:

> Section 199A applies to taxable years beginning after December 31, 2017. However, there is no statutory requirement under section 199A that a qualified item arise after December 31, 2017.

[641] See fns 834-836 in part II.E.1.f.iii Electing Small Business Trusts (ESBTs).

[642] Using language similar to regulations referred to in fn 642, Reg. § 1.702-1(a)(8)(ii) provides:

> Each partner must also take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately.

Instructions for Form 1065 (2017), pages 34-35 provide much detail on how partnerships report items relating to Code § 199, which Code § 199A replaced.

The rules described in the various subparts of this part II.E.1.c apply to pass-throughs, but similar rules apply to any "specified agricultural or horticultural cooperative."[643]

Prop. Reg. § 1.199A-1(b) provides the following definitions for Code § 199A and Prop. Regs. §§ 1.199A-1 through 1.199A-6:

(1) Aggregated trade or business means two or more trades or businesses that have been aggregated pursuant to § 1.199A-4.

(2) Applicable percentage means, with respect to any taxable year,100 percent reduced (not below zero) by the percentage equal to the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return).

(3) Phase-in range means a range of taxable income, the lower limit of which is the threshold amount, and the upper limit of which is the threshold amount plus $50,000 (or $100,000 in the case of a joint return).

(4) Qualified business income (QBI) means the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business as determined under the rules of § 1.199A-3(b).

(5) QBI component means the amount determined under paragraph (d)(2) of this section.

(6) Qualified PTP income is defined in § 1.199A-3(c)(3).

(7) Qualified REIT dividends are defined in § 1.199A-3(c)(2).

(8) Reduction amount means, with respect to any taxable year, the excess amount multiplied by the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return). For purposes of this paragraph (b)(8), the excess amount is 20 percent of QBI over the greater of 50 percent of W-2 wages or the sum of 25 percent of W-2 wages plus 2.5 percent of the UBIA of qualified property.

(9) Relevant passthrough entity (RPE) means a partnership (other than a PTP) or an S corporation that is owned, directly or indirectly by at least one individual, estate, or trust. A trust or estate is treated as an RPE to the extent it passes through QBI,

---

[643] Code § 199A(g) describes qualified entities and the related deduction. The Senate report said (note that the Conference Committee reduced the deduction from 23% to 20% and pushed up the effective date by one year):

> For taxable years beginning after December 31, 2018 but not after December 31, 2025, a deduction is allowed to any specified agricultural or horticultural cooperative equal to the lesser of 23 percent of the cooperative's taxable income for the taxable year or 50 percent of the W-2 wages paid by the cooperative with respect to its trade or business. A specified agricultural or horticultural cooperative is an organization to which subchapter T applies that is engaged in (a) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, (b) the marketing of agricultural or horticultural products that its patrons have so manufactured, produced, grown, or extracted, or (c) the provision of supplies, equipment, or services to farmers or organizations described in the foregoing.

W-2 wages, UBIA of qualified property, qualified REIT dividends, or qualified PTP income.

(10) Specified service trade or business (SSTB) means a specified service trade or business as defined in § 1.199A-5(b).

(11) Threshold amount means, for any taxable year beginning before 2019, $157,500 (or $315,000 in the case of a taxpayer filing a joint return). In the case of any taxable year beginning after 2018, the threshold amount is the dollar amount in the preceding sentence increased by an amount equal to such dollar amount, multiplied by the cost-of-living adjustment determined under section 1(f)(3) of the Code for the calendar year in which the taxable year begins, determined by substituting "calendar year 2017] for "calendar year 2016] in section 1(f)(3)(A)(ii). The amount of any increase under the preceding sentence is rounded as provided in section 1(f)(7) of the Code.

(12) Total QBI amount means the net total QBI from all trades or businesses (including the individual's share of QBI from trades or business conducted by RPEs).

(13) Trade or business means a section 162 trade or business other than the trade or business of performing services as an employee. In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented or licensed to a trade or business which is commonly controlled under § 1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under § 1.199A-4(b)(1)).

(14) Unadjusted basis immediately after acquisition of qualified property (UBIA of qualified property) is defined in § 1.199A-2(c).

(15) W-2 wages means a trade or business's W-2 wages properly allocable to QBI as defined in § 1.199A-2(b).

Various items described in part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds are to be allocated pursuant to fn 636 above. Accordingly, Prop. Reg. § 1.199A-2(a) provides:[644]

(1) *In general*. This section provides guidance on calculating a trade or business's W-2 wages properly allocable to QBI (W-2 wages) and the trade or business's unadjusted basis immediately after acquisition of all qualified property (UBIA of qualified property). The provisions of this section apply solely for purposes of Section 199A of the Internal Revenue Code (Code).

(2) *W-2 wages*. Paragraph (b) of this section provides guidance on the determination of W-2 wages. The determination of W-2 wages must be made for each trade or business by the individual or RPE that directly conducts the trade or business before applying the aggregation rules of § 1.199A-4. In the case of W-2 wages paid by an

[644] See parts II.E.1.c.vi.(a) W-2 Wages under Code § 199A and II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A.

RPE, the RPE must determine and report W-2 wages for each trade or business conducted by the RPE. W-2 wages are presumed to be zero if not determined and reported for each trade or business.

(3) *UBIA of qualified property*. Paragraph (c) of this section provides guidance on the determination of the UBIA of qualified property. The determination of the UBIA of qualified property must be made for each trade or business by the individual or RPE that directly conducts the trade or business before applying the aggregation rules of § 1.199A-4. In the case of qualified property held by an RPE, each partner's or shareholder's share of the UBIA of qualified property is an amount which bears the same proportion to the total UBIA of qualified property as the partner's or shareholder's share of tax depreciation bears to the RPE's total tax depreciation with respect to the property for the year. In the case of qualified property held by a partnership which does not produce tax depreciation during the year (for example, property that has been held for less than 10 years but whose recovery period has ended), each partner's share of the UBIA of qualified property is based on how gain would be allocated to the partners pursuant to sections 704(b) and 704(c) if the qualified property were sold in a hypothetical transaction for cash equal to the fair market value of the qualified property. In the case of qualified property held by an S corporation which does not produce tax depreciation during the year, each shareholder's share of the UBIA of qualified property is a share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder over the total shares of the S corporation. The UBIA of qualified property is presumed to be zero if not determined and reported for each trade or business.

Prop. Reg. § 1.199A-2(b) and (c) are described in part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds. For now, let's delve into how those items get reported to the ultimate individual or trust. Note that the sentence describing S corporation UBIA is simplistic compared to part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S corporation.

Prop. Reg. § 1.199A-6(b) describes computational and reporting rules for a relevant passthrough entity (RPE). It provides:

(1) *In general*. An RPE must determine and report information attributable to any trades or businesses it is engaged in necessary for its owners to determine their Section 199A deduction.

(2) *Computational rules*. Using the following four rules, an RPE must determine the items necessary for individuals who own interests in the RPE to calculate their Section 199A deduction under § 1.199A-1(c) or (d):

(i) First, the RPE must determine if it is engaged in one or more trades or businesses. The RPE must also determine whether any of its trades or businesses is an SSTB under the rules of § 1.199A-5.

(ii) Second, the RPE must apply the rules in § 1.199A-3 to determine the QBI for each trade or business engaged in directly.

(iii) Third, the RPE must apply the rules in § 1.199A-2 to determine the W-2 wages and UBIA of qualified property for each trade or business engaged in directly.

(iv) Fourth, the RPE must determine whether it has any qualified REIT dividends as defined in § 1.199A-3(c)(1) earned directly or through another RPE. The RPE must also determine the net amount of qualified PTP income as defined in § 1.199A-3(c)(2) earned directly or indirectly through investments in PTPs.

(3) *Reporting rules for RPEs*—

(i) *Trade or business directly engaged in*. An RPE must separately identify and report on the Schedule K-1 issued to its owners for any trade or business engaged in directly by the RPE--

(A) Each owner's allocable share of QBI, W-2 wages, and UBIA of qualified property attributable to each such trade or business, and

(B) Whether any of the trades or businesses described in paragraph (b)(3)(i)(A) of this section is an SSTB.

(ii) *Other items*. An RPE must also report on an attachment to the Schedule K-1, any QBI, W-2 wages, UBIA of qualified property, or SSTB determinations, reported to it by any RPE in which the RPE owns a direct or indirect interest. The RPE must also report each owner's allocated share of any qualified REIT dividends or qualified PTP income or loss received by the RPE (including through another RPE).

(iii) *Failure to report information*. If an RPE fails to separately identify or report on the Schedule K-1 (or any attachments thereto) issued to an owner any items described in paragraph (b)(3)(i) of this section, the owner's share (and the share of any upper-tier indirect owner) of positive QBI, W-2 wages, and UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero.

Paragraph (3)(i), (ii) above is consistent with reporting requirements for partnerships in Code § 702(a)(7) and Reg. § 1.702-1(a)(8)(iii) and for S corporations in Code § 1366(a)(1)(A).

This RPE paradigm means that each RPE is treated as a stand-alone taxpayer for purposes of evaluating the nature of the business. This has negative consequences for real estate owners[645] and for those conducting tiered partnerships.[646]

The preamble, REG-107892-18 (8/16/2018), comments in part VI.A., "Computational steps for RPEs and PTPs," starts with a description of RPE reporting requirements:

> Although RPEs cannot take the Section 199A deduction at the RPE level, each RPE must determine and report the information necessary for its direct and indirect owners to determine their own Section 199A deduction. Proposed § 1.199A-6(b) follows the rules applicable to individuals with taxable income above the threshold amount set forth in § 1.199A-1(d) in directing RPEs to determine what amounts and information to report to their owners and the IRS, including QBI, W-2 wages, the UBIA of qualified property for each trade or business directly engaged in, and whether any of its trades or businesses

[645] See fn 647.
[646] See part II.E.5.c.ii Code § 199A Deduction under Recommended Structure.

are SSTBs. RPEs must also determine and report qualified REIT dividends and qualified PTP income received directly by the RPE. Proposed § 1.199A-6(b)(3) then requires each RPE to report this information on or with the Schedules K-1 issued to the owners. RPEs must report this information regardless of whether a taxpayer is below the threshold. The Treasury Department and the IRS request comments whether it is administrable to provide a special rule that if none of the owners of the RPE have taxable income above the threshold amount, the RPE does not need to determine and report W-2 wages, UBIA of qualified property, or whether the trade or business is an SSTB. Although such a rule would relieve an RPE of an unnecessary burden, the RPE would need to have knowledge of the ultimate owner's taxable income.

Part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A describes when taxpayers may combine QBI, W-2 wages, and UBIA from multiple businesses. It does not, however, change the fundamental concept that whether an activity rises to the level of a trade or business is tested only for the RPE and is not tested across RPEs:

- For example, if a triple-net lease does not qualify for special relief due to common ownership and would not rise to the level of a trade or business,[647] one cannot consider the fact the owners have 100 different RPEs with triple-net leases, which together add up to one big trade or business. Instead, the owners would need to have one master partnership with multiple single-member LLCs that are disregarded for income tax purposes. Presumably owners could have special allocations to adjust for any economic distortions of holding the various properties in one master partnership.

- Suppose the activities are conducted within one or more S corporations (which is unusual for real estate but not other activities). An S corporation could use as a subsidiary disregarded entity either an LLC or another corporation. For the latter, see part II.A.2.g Qualified Subchapter S Subsidiary (QSub). As part II.A.2.g discusses, unless there is a good state income tax or other reason, I tend to prefer single member LLC subsidiaries over QSubs.

II.E.1.c.i. What Kind of Deduction; Maximum Impact of Deduction

II.E.1.c.i.(a). Summary of Impact of Deduction

The deduction is not allowed in computing adjusted gross income[648] but also is not an itemized deduction,[649] so it is in its own category of deduction.

The deduction applies for income tax but not for net investment income tax[650] or self-employment tax[651] purposes.[652]

---

[647] Part II.E.1.e.i General Rules Regarding Real Estate As a Trade or Business, text accompanying fns 795-782.
[648] Code § 62(a).
[649] Code § 63(d)(3).
[650] Net investment income tax, described in part II.I 3.8% Tax on Excess Net Investment Income (NII), is provided by Code § 1411, which is Chapter 2A.
[651] Self-employment tax, described in part II.L Self-Employment Tax (FICA), is provided by Code §§ 1401-1403, which is Chapter 2.
[652] Code § 199A(f)(3) provides:

When calculating alternative minimum taxable income under Code § 55, qualified business income is determined without regard to any adjustments under Code §§ 56-59.[653]

Although wage income is not qualified business income,[654] in computing withholding allowances and employee may take into account the estimated deduction under Code § 199A.[655]

With a top regular income tax bracket of 37%, the deduction's maximum relief is the equivalent of a 7.4% (20% of 37%) rate reduction, reducing the effective regular income tax rate to 29.6% (37% minus 7.4%).

However, the rate reduction may be thought of as being somewhere between zero and 7.4%, for the following reasons:

- Each trade or business the entity runs needs to be separately subjected to the limitations described below.

- Some income does not qualify for the deduction at all, although generally business activities qualify if the taxpayer's taxable income is below certain thresholds. See parts II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction and II.E.1.c.v.(a) Taxable Income "Threshold.

- An activity that does qualify may have its deduction limited if it has insufficient wages and not enough investment to make up for insufficient wages, although this limitation does not apply if the taxpayer's taxable income is below certain thresholds. See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds regarding those particular items and part II.E.1.c.v Calculation of Deduction Generally showing how they affect the deduction.

- Deducting a net operating loss may in some situations cause the taxpayer to lose part or all of the benefit of the Code § 199A deduction.[656]

> DEDUCTION LIMITED TO INCOME TAXES.—The deduction under subsection (a) shall only be allowed for purposes of this chapter.

Chapter 1 of Subtitle A of the Code includes Code §§ 1-1400U-3.

Prop. Reg. § 1.199A-1(e)(2), "Self-employment tax and net investment income tax," provides:

> The deduction under section 199A does not reduce net earnings from self-employment under section 1402 or net investment income under section 1411.

653 Code § 199A(f)(2). Chapter 1 of Subtitle A of the Code includes Code §§ 1-1400U-3.

Prop. Reg. § 1.199A-1(e)(4), "Coordination with alternative minimum tax," provides:

> For purposes of determining alternative minimum taxable income under section 55, the deduction allowed under section 199A(a) for a taxable year is equal in amount to the deduction allowed under section 199A(a) in determining taxable income for that taxable year (that is, without regard to any adjustments under sections 56 through 59).

654 See parts II.E.1.c.ii.(b) Trade or Business of Being an Employee (Excluded from QBI) and II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

655 Code § 3402(m)(1).

656 See part II.E.1.c.i.(b) Other Effects of Code § 199A Deduction, fn. 657.

II.E.1.c.i.(b). Other Effects of Code § 199A Deduction

When determining how much Code § 172 net operating loss is applied, the Code § 199A deduction is disallowed.[657]

Claiming the Code § 199A deduction makes the taxpayer more susceptible to the penalty for understatement of income tax.[658]

The Code § 199A deduction does not reduce income when computing the percentages of income used in calculating the individual income tax charitable deduction.[659]

It does not reduce taxable income in computing the taxable income limitation for percentage depletion under Code § 613(a) or 613A(d)(1).

The Code § 199A deduction also has some interaction with the dividends-received deduction that I have not yet tried to analyze,[660] which is unexpected in that the dividends-received deduction applies only to corporations; presumably this applies to a specified agricultural or horticultural cooperative.[661]

II.E.1.c.ii. Types of Income and Activities Eligible or Ineligible for Deduction

II.E.1.c.ii.(a). Generally; List of Items Included in QBI

QBI means "the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer;"[662] see part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A. It does not include any "qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income."[663] (Note that the Code § 199A separately takes into account qualified cooperative dividends in addition to QBI.)

---

[657] Code § 172(d)(8). See part II.G.3.i.iii Code § 172 Net Operating Loss Deduction.

[658] Prop. Reg. § 1.199A-1(e)(5), "Imposition of accuracy-related penalty on underpayments," provides:

> For rules related to the imposition of the accuracy-related penalty on underpayments for taxpayers who claim the deduction allowed under section 199A, see section 6662(d)(1)(C).

Code § 6662(d)(1)(C) provides:

> (C) *Special Rule For Taxpayers Claiming Section 199A Deduction*. In the case of any taxpayer who claims the deduction allowed under section 199A for the taxable year, subparagraph (A) shall be applied by substituting "5 percent" for "10 percent."

[659] Code § 170(b)(2)(D)(vi).

[660] Code § 246(b)(1).

[661] See fn 643.

[662] Code § 199A(c)(1).

[663] Code § 199A(c)(1). Code § 199A(e)(3) provides:

> QUALIFIED REIT DIVIDEND.—The term "qualified REIT dividend" means any dividend from a real estate investment trust received during the taxable year which—
>
> (A) is not a capital gain dividend, as defined in section 857(b)(3), and
>
> (B) is not qualified dividend income, as defined in section 1(h)(11).

Code § 199A(e)(4) provides:

> QUALIFIED PUBLICLY TRADED PARTNERSHIP INCOME. The term "qualified publicly traded partnership income" means, with respect to any qualified trade or business of a taxpayer, the sum of—

In the case of a partnership or S corporation, each partner or shareholder takes into account such person's allocable share of each qualified item of income, gain, deduction, and loss.[664] In the case of an S corporation, an allocable share is the shareholder's pro rata share of an item.[665]

To be a qualified item of "income, gain, deduction, and loss," the item must be a U.S.-source item[666] and "included or allowed in determining taxable income for the taxable year."[667] Prop. Reg. § 1.199A-3(b)(2)(i) provides:

> *In general*. The term qualified items of income, gain, deduction, and loss means items of gross income, gain, deduction, and loss to the extent such items are—
>
> (A) Effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "trade or business (within the meaning of Section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears), and
>
> (B) Included or allowed in determining taxable income for the taxable year.

See part II.E.1.c.ix QBI and Effectively Connected Income.

Prop. Reg. § 1.199A-3(b)(1) provides:

> *In general*. For purposes of this section, the term qualified business income (QBI) means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business of the taxpayer as described in paragraph (b)(2) of this section, provided the other requirements of this section and Section 199A are

---

> (A) the net amount of such taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (as defined in subsection (c)(3) and determined after the application of subsection (c)(4)) from a publicly traded partnership (as defined in section 7704(a)) which is not treated as a corporation under section 7704(c), plus
>
> (B) any gain recognized by such taxpayer upon disposition of its interest in such partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset under section 751(a).

[664] Code § 199A(f)(1)(A)(ii).

[665] Code § 199A(f)(1)(A) (flush language).

[666] Code § 199A(c)(3)(A)(i) requires the item to be:

> effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting 'qualified trade or business (within the meaning of section 199A)' for 'nonresident alien individual or a foreign corporation' or for 'a foreign corporation' each place it appears)"

I think this really just means that the individual seeking the Code § 199A deduction needs to be tested, because a literal plugging in of this language makes no sense:

> In the case of a qualified trade or business (within the meaning of section 199A) engaged in trade or business within the United States during the taxable year, the rules set forth in paragraphs (2), (3), (4), (6), (7), and (8) shall apply in determining the income, gain, or loss which shall be treated as effectively connected with the conduct of a trade or business within the United States.

However, Code § 199A(f)(1)(C)(i) provides:

> *In General*. In the case of any taxpayer with qualified business income from sources within the commonwealth of Puerto Rico, if all such income is taxable under section 1 for such taxable year, then for purposes of determining the qualified business income of such taxpayer for such taxable year, the term "United States" shall include the Commonwealth of Puerto Rico.

[667] Code § 199A(c)(3)(A)(ii).

satisfied (including, for example, the exclusion of income not effectively connected with a United States trade or business).

(i) *Section 751 gain*. With respect to a partnership, if section 751(a) or (b) applies, then gain or loss attributable to assets of the partnership giving rise to ordinary income under section 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and is taken into account for purposes of computing QBI.

(ii) *Guaranteed payments for the use of capital*. Income attributable to a guaranteed payment for the use of capital is not considered to be attributable to a trade or business, and thus is not taken into account for purposes of computing QBI; however, the partnership's deduction associated with the guaranteed payment will be taken into account for purposes of computing QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

(iii) *Section 481 adjustments*. Section 481 adjustments (whether positive or negative) are taken into account for purposes of computing QBI to the extent that the requirements of this section and Section 199A are otherwise satisfied, but only if the adjustment arises in taxable years ending after December 31, 2017.

(iv) *Previously disallowed losses*. Generally, previously disallowed losses or deductions (including under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year are taken into account for purposes of computing QBI. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (including under sections 465, 469, 704(d), and 1366(d)), are not taken into account in a later taxable year for purposes of computing QBI.

(v) *Net operating losses*. Generally, a deduction under section 172 for a net operating loss is not considered with respect to a trade or business and therefore, is not taken into account in computing QBI. However, to the extent that the net operating loss is disallowed under section 461(l), the net operating loss is taken into account for purposes of computing QBI.

Comments submitted October 12, 2018 by the American Bar Association's Section on Taxation asserted that Prop. Reg. § 1.199A-3(b)(1)(ii) above incorrectly takes the position that guaranteed payments for the use of capital (GPUC) are per se not QBI.[668] However, if the government

[668] After making several arguments, the comments said (footnotes omitted):

> A plain reading of the statute would indicate Congress's intent to include GPUCs as QBI. There is no provision in section 199A that excludes a guaranteed payment (either for services or for the use of capital) from being a Qualified Item. Although guaranteed payments for services can be Qualified Items, they are specifically excluded from QBI under section 199A(c)(4)(B). Notably, there is no exclusion of GPUCs from QBI. This suggests that a GPUC may be QBI because a guaranteed payment may be a Qualified Item, but a guaranteed payment may not be included in QBI if it is paid with respect to services rendered by the partner to the partnership's trade or business. In fact, if all guaranteed payments failed to be Qualified Items, then section 199A(c)(4)(B) would be superfluous because QBI only includes Qualified Items. The statutory silence with respect to GPUCs could suggest that Congress had no intention to exclude GPUCs from QBI because Congress clearly contemplated guaranteed payments under

changes that rule, note that, to the extent that GPUC is viewed as the equivalent of an interest payment,[669] that characterization may disallow part or all of the GPUC.[670]

Various items of investment income, including short- or long-term capital gains and losses, are not qualified items. Code § 199A(c)(3)(B), which is reproduced in full in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

"Qualified trade or business" means any trade or business other than:[671]

> (A) a specified service trade or business,[672] or
>
> (B) the trade or business of performing services as an employee.[673]

II.E.1.c.ii.(b). Trade or Business of Being an Employee (Excluded from QBI)

Code § 199A(d)(1)(B) excludes from a "qualified trade or business" the trade or business of performing services as an employee.

Prop. Reg. § 1.199A-5(a)(3), "Trade or business of performing services as an employee," provides:

> The trade or business of performing services as an employee is not a trade or business for purposes of section 199A and the regulations thereunder. Therefore, no items of income, gain, loss, or deduction from the trade or business of performing services as an employee constitute QBI within the meaning of section 199A and § 1.199A-3. No taxpayer may claim a section 199A deduction for wage income, regardless of the amount of taxable income.

The preamble, REG-107892-18 (8/16/2018), provides in part V.B.:

> section 707(c) and chose only to exclude from QBI those guaranteed payments that are made for services rendered with respect to the trade or business.
>
> On balance, there are strong arguments that a GPUC is treated as a partner's distributive share, and therefore as the payee partner's allocable share of the partnership's Qualified Items, for purposes of section 199A. We believe treating a GPUC as a Qualified Item to the extent of a partnership's Qualified Items most furthers the intent of section 199A. Therefore, we recommend that final guidance allow GPUCs under section 707(c) to be a Qualified Item and included in QBI to the extent of the partnership's Qualified Items, determined without regard to the GPUC expense. If the Final Regulations follow the Proposed Regulations and preclude GPUCs from being included in QBI, then we recommend that the Final Regulations also exclude from QBI any expense related to guaranteed payments for the use of capital. Otherwise, the existence of a GPUC arrangement would reduce (inappropriately, in our view) the section 199A benefit afforded with respect to the QBI of a partnership.

[669] See part II.I.8.d.iii Treatment of Code § 707(c) Guaranteed Payments under Code § 1411.

[670] See part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

[671] Code § 199A(d)(1).

[672] See part II.E.1.c.iv Specified Service Trade or Business.

[673] See part II.E.1.c.ii.(b) Trade or Business of Being an Employee.

B. Trade or Business of Performing Services as an Employee

Under section 199(d)(1)(B), the trade or business of performing services as an employee is not a qualified trade or business. Unlike an SSTB, there is no threshold amount that applies to the trade or business of performing services as an employee. Thus, wage or compensation income earned by any employee is not eligible for the Section 199A deduction no matter the amount.

1. Definition

An individual is an employee for Federal employment tax purposes if he or she has the status of an employee under the usual common law and statutory rules applicable in determining the employer-employee relationship. Guides for determining employment status are found in §§ 31.3121(d)-1, 31.3306 (i)-1, and 31.3401(c)-1. As stated in the regulations, generally, the common law relationship of employer and employee exists when the person for whom the services are performed has the right to direct and control the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the direction and control of the employer not only as to what shall be done but how it shall be done. In this connection it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he or she has the right to do so.

In addition, the regulations and section 3401(c) state, generally, that an officer of a corporation (including an S corporation) is an employee of the corporation. However, an officer of a corporation who does not perform any services or performs only minor services in his or her capacity as officer and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is not considered to be an employee of the corporation. Whether an officer's services are minor is a question of fact that depends on the nature of the services, the frequency and duration of their performance, and the actual and potential importance or necessity of the services in relation to the conduct of the corporation's business. See Rev. Rul. 74-390.

To provide clarity, proposed § 1.199A-5(d) provides a general rule that income from the trade or business of performing services as an employee refers to all wages (within the meaning of section 3401(a)) and other income earned in a capacity as an employee, including payments described in § 1.6041-2(a)(1) (other than payments to individuals described in section 3121(d)(3)) and § 1.6041-2(b)(1). If an individual derives income in the course of a trade or business that is not described in section 3401(a), § 1.6041-2(a)(1) (other than payments to individuals described in section 3121(d)(3)), or § 1.6041-2(b)(1), that individual is not considered to be in the trade or business of performing services as an employee with regard to such income.

2. Presumption for Former Employees

Section 199A provides that the trade or business of providing services as an employee is not eligible for the Section 199A deduction. Therefore, taxpayers and practitioners noted that it may be beneficial for employees to treat themselves as independent contractors or as having an equity interest in a partnership or S corporation in order to benefit from the deduction under Section 199A.

Section 530(b) of the Revenue Act of 1978 (Pub. L. 95-600), as amended by section 9(d)(2) of Public Law 96-167, section 1(a) of Public Law 96-541, and section 269(c) of Public Law 97-248, provides a prohibition against regulations and rulings on employment status for purposes of employment taxes. Specifically, section 530(b) provides that no regulation or revenue ruling shall be published before the effective date of any law clarifying the employment status of individuals for purposes of the employment taxes by the Treasury Department (including the IRS) with respect to the employment status of any individual for purposes of the employment taxes. Section 530(c) of the Revenue Act of 1978 provides that, for purposes of section 530, the term 'employment tax' means any tax imposed by subtitle C of the Internal Revenue Code of 1954, and the term 'employment status' means the status of an individual, under the usual common law rules applicable in determining the employer-employee relationship as an employee or as an independent contractor (or other individual who is not an employee). These longstanding rules of section 530 of the Revenue Act of 1978 limit the ability of the IRS to impose employment tax liability on employers for misclassifying employees as independent contractors but do not preclude challenging a worker's status for purposes of Section 199A, an income tax provision under subtitle A of the Code.

Therefore, proposed § 1.199A-5(d)(3) provides that for purposes of Section 199A, if an employer improperly treats an employee as an independent contractor or other non-employee, the improperly classified employee is in the trade or business of performing services as an employee notwithstanding the employer's improper classification. This issue is particularly important in the case of individuals who cease being treated as employees of an employer, but subsequently provide substantially the same services to the employer (or a related entity) but claim to do so in a capacity other than as an employee. However, it would not be appropriate to provide that someone who formerly was an employee of an employer is now 'less likely' to be respected as an independent contractor. Such a rule would not treat similarly-situated taxpayers similarly: two individuals who have a similar relationship with a company and each claim to be treated as independent contractors would be treated differently depending on any prior employment history with the company. Therefore, proposed § 1.199A-5(d)(3) does not provide any new or different standards to be properly classified as an independent contractor or owner of a business. Instead, proposed § 1.199A-5(d)(3) contains a presumption that applies in certain situations to ensure that individuals properly substantiate their status.

Specifically, proposed § 1.199A-5(d)(3) provides that, solely for purposes of Section 199A(d)(1)(B) and the regulations thereunder, an individual who was treated as an employee for Federal employment tax purposes by the person to whom he or she provided services, and who is subsequently treated as other than an employee by such person with regard to the provision of substantially the same services directly or indirectly to the person (or a related person), is presumed to be in the trade or business of performing services as an employee with regard to such services. This presumption may be rebutted only upon a showing by the individual that, under Federal tax rules, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than as an employee. This presumption applies regardless of whether the individual provides services directly or indirectly through an entity or entities. This presumption is solely for purposes of Section 199A and does not otherwise change the employment tax classification of the individual. Section 199A is in subtitle A of the Code, and this rule does not apply for purposes of any other subtitle, including subtitle C. Accordingly, this rule does not implicate section 530(b) of the Revenue Act of 1978. Proposed § 1.199A-5(d)(3)(ii) contains three examples illustrating this rule.

Prop. Reg. § 1.199A-5(d), "Trade or business of performing services as an employee," provides:

(1) *In general*. The trade or business of performing services as an employee is not a trade or business for purposes of section 199A and the regulations thereunder. Therefore, no items of income, gain, loss, and deduction from the trade or business of performing services as an employee constitute QBI within the meaning of section 199A and § 1.199A-3. Except as provided in paragraph (d)(3) of this section, income from the trade or business of performing services as an employee refers to all wages (within the meaning of section 3401(a)) and other income earned in a capacity as an employee, including payments described in § 1.6041-2(a)(1) (other than payments to individuals described in section 3121(d)(3)) and § 1.6041-2(b)(1).

(2) *Employer's Federal employment tax classification of employee immaterial*. For purposes of determining whether wages are earned in a capacity as an employee as provided in paragraph (d)(1) of this section, the treatment of an employee by an employer as anything other than an employee for Federal employment tax purposes is immaterial. Thus, if a worker should be properly classified as an employee, it is of no consequence that the employee is treated as a non-employee by the employer for Federal employment tax purposes.

(3) *Presumption that former employees are still employees*.

(i) *Presumption*. Solely for purposes of section 199A(d)(1)(B) and paragraph (d)(1) of this section, an individual that was properly treated as an employee for Federal employment tax purposes by the person to which he or she provided services and who is subsequently treated as other than an employee by such person with regard to the provision of substantially the same services directly or indirectly to the person (or a related person), is presumed to be in the trade or business of performing services as an employee with regard to such services. This presumption may be rebutted upon a showing by the individual that, under Federal tax law, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than as an employee. This presumption applies regardless of whether the individual provides services directly or indirectly through an entity or entities.

(ii) *Examples*. The following examples illustrate the provision of paragraph (b)(3)(i) of this section. Unless otherwise provided, the individual in each example has taxable income in excess of the threshold amount.

Example (1). A is employed by PRS, a partnership, as a fulltime employee and is treated as such for Federal employment tax purposes. A quits his job for PRS and enters into a contract with PRS under which A provides substantially the same services that A previously provided to PRS in A's capacity as an employee. Because A was treated as an employee for services he provided to PRS, and now is no longer treated as an employee with regard to such services, A is presumed (solely for purposes of section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with regard to his services performed for PRS. Unless the presumption is rebutted with a showing that, under Federal tax law, regulations, and principles (including the common-law employee classification rules), A is not an employee, any amounts paid by PRS to A with respect to such services will not be QBI for purposes of section 199A. The presumption would apply even if, instead of contracting directly with PRS, A formed a disregarded entity, or an S corporation, and the disregarded entity or the S corporation entered into the contract with PRS.

Example (2). C is an attorney employed as an associate in a law firm (Law Firm 1) and was treated as such for Federal employment tax purposes. C and the other associates in Law Firm 1 have taxable income below the threshold amount. Law Firm 1 terminates its employment relationship with C and its other associates. C and the other former associates form a new partnership, Law Firm 2, which contracts to perform legal services for Law Firm 1. Therefore, in form, C is now a partner in Law Firm 2 which earns income from providing legal services to Law Firm 1. C continues to provide substantially the same legal services to Law Firm 1 and its clients. Because C was previously treated as an employee for services she provided to Law Firm 1, and now is no longer treated as an employee with regard to such services, C is presumed (solely for purposes of section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with respect to the services C provides to Law Firm 1 indirectly through Law Firm 2. Unless the presumption is rebutted with a showing that, under Federal tax law, regulations, and principles (including common-law employee classification rules), C's distributive share of Law Firm 2 income (including any guaranteed payments) will not be QBI for purposes of section 199A. The results in this example would not change if, instead of contracting with Law Firm 1, Law Firm 2 was instead admitted as a partner in Law Firm 1.

Example (3). E is an engineer employed as a senior project engineer in an engineering firm, Engineering Firm. Engineering Firm is a partnership and structured such that after 10 years, senior project engineers are considered for partner if certain career milestones are met. After 10 years, E meets those career milestones and is admitted as a partner in Engineering Firm. As a partner in Engineering Firm, E shares in the net profits of Engineering Firm, and also otherwise satisfies the requirements under Federal tax law, regulations, and principles (including common-law employee classification rules) to be respected as a partner. E is presumed (solely for purposes of section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with respect to the services E provides to Engineering Firm. However, E is able to rebut the presumption by showing that E became a partner in Engineering Firm as a career milestone, shares in the overall net profits in Engineering Firm, and otherwise satisfies the requirements under Federal tax law, regulations, and principles (including common-law employee classification rules) to be respected as a partner.

II.E.1.c.ii.(c). Items Excluded from Treatment as Qualified Business Income Under Code § 199A

Various items of investment income, including short- or long-term capital gains and losses, are not qualified items. Code § 199A(c)(3)(B) lists those nonqualified items, originally providing:

Exceptions. The following investment items shall not be taken into account as a qualified item of income, gain, deduction, or loss:

(i) Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss.

(ii) Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G).[674]

(iii) Any interest income other than interest income which is properly allocable to a trade or business.

(iv) Any item of gain or loss described in subparagraph (C) or (D) of section 954(c)(1) (applied by substituting "qualified trade or business" for "controlled foreign corporation").

(v) Any item of income, gain, deduction, or loss taken into account under section 954(c)(1)(F) (determined without regard to clause (ii) thereof and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7)).[675]

(vi) Any amount received from an annuity which is not received in connection with the trade or business.

---

[674] [My footnote – not from the statute:] Code § 954(c)(1)(G) refers to "payments in lieu of dividends which are made pursuant to an agreement to which" Code § 1058 applies. Code § 1058(b) requires an agreement to:

(1) provide for the return to the transferor of securities identical to the securities transferred;
(2) require that payments shall be made to the transferor of amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor;
(3) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred; and
(4) meet such other requirements as the Secretary may by regulation prescribe.

[675] [My footnote – not from the statute:] Code § 954(c)(1)(F)(i) provides that foreign personal holding company income" includes the portion of the gross income which consists of "net income from notional principal contracts." Code § 1221(a)(7) provides that "capital asset" does not include:

> any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe)…

Code § 1221(b)(2)(a) provides that "hedging transaction" is "any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily:"

(i) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer,
(ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or
(iii) to manage such other risks as the Secretary may prescribe in regulations.

(vii) Any item of deduction or loss properly allocable to an amount described in any of the preceding clauses.

The Senate report said that the statute excludes “specified investment-related income” such as “any item taken into account in determining net long-term capital gain or net long-term capital loss:”[676]

However, the Consolidated Appropriations Act, 2018 amended Code § 199A(c)(3)(B) to delete “investment,” clarifying that an item does not have to be derived from an “investment” to be excluded from QBI.

Code § 199A(c)(4) provides that QBI does not include:

(A) reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,

(B) any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and

(C) to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.

The Senate report made it apparent that subparagraph (A) was aimed at reasonable compensation paid by an S corporation. Thus, the reasonable compensation exception means that wages paid to an owner-employee of an S corporation are not themselves QBI. See also part II.E.1.c.ii.(b) Trade or Business of Being an Employee (Excluded from QBI). However, those wages would increase the QBI-related deduction to the extent that the wage limitation is a concern.[677]

The preamble, REG-107892-18 (8/16/2018), provides:

---

[676] The Senate report said:

> *Treatment of investment income*
>
> Qualified items do not include specified investment-related income, deductions, or loss. Specifically, qualified items of income, gain, deduction and loss do not include (1) any item taken into account in determining net long-term capital gain or net long-term capital loss, (2) dividends, income equivalent to a dividend, or payments in lieu of dividends, (3) interest income other than that which is properly allocable to a trade or business, (4) the excess of gain over loss from commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business, (5) the excess of foreign currency gains over foreign currency losses from section 988 transactions, other than transactions directly related to the business needs of the business activity, (6) net income from notional principal contracts, other than clearly identified hedging transactions that are treated as ordinary (*i.e.*, not treated as capital assets), and (7) any amount received from an annuity that is not used in the trade or business of the business activity. Qualified items under this provision do not include any item of deduction or loss properly allocable to such income.

[677] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds, the impact of which may be reduced or eliminated under part II.E.1.c.v.(a) Taxable Income “Threshold.

vii. Exclusion from QBI for certain items

a. Treatment of section 1231 gains and losses

Section 199A(c)(3)(B)(i) provides that QBI does not include any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss. The Treasury Department and the IRS have received comments requesting guidance on the extent to which gains and losses subject to section 1231 may be taken into account in calculating QBI. Section 1231 provides rules under which gains and losses from certain involuntary conversions and the sale of certain property used in a trade or business are either treated as long-term capital gains or long-term capital losses, or not treated as gains and losses from sales or exchanges of capital assets.

Section 199A(c)(3)(B)(i) excludes capital gains or losses, regardless of whether those items arise from the sale or exchange of a capital asset. The legislative history of Section 199A provides that QBI does not include any item taken into account in determining net long-term capital gain or net long-term capital loss. Conference Report page 30. Accordingly, proposed § 1.199A-3(b)(2)(ii)(A) clarifies that, to the extent gain or loss is treated as capital gain or loss, it is not included in QBI. Specifically, if gain or loss is treated as capital gain or loss under section 1231, it is not QBI. Conversely, if section 1231 provides that gains or losses are not treated as gains and losses from sales or exchanges of capital assets, Section 199A(c)(3)(B)(i) does not apply and thus, the gains or losses must be included in QBI (provided all other requirements are met).

b. Interest Income.

Section 199A(c)(4)(C) provides that QBI does not include any interest income other than interest income that is properly allocable to a trade or business. The Treasury Department and the IRS believe that interest income received on working capital, reserves, and similar accounts is not properly allocable to a trade or business, and therefore should not be included in QBI, because such interest income, although held by a trade or business, is simply income from assets held for investment. Accordingly, proposed § 1.199A-3(b)(2)(ii)(C) provides that interest income received on working capital, reserves, and similar accounts is not properly allocable to a trade or business. In contrast, interest income received on accounts or notes receivable for services or goods provided by the trade or business is not income from assets held for investment, but income received on assets acquired in the ordinary course of trade or business.

c. Reasonable compensation

Section 199A(c)(4)(A) provides that QBI does not include "reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business." Similarly, guaranteed payments for services under section 707(c) are excluded from QBI. The phrase "reasonable compensation" is a well-known standard in the context of S corporations. Under Rev. Rul. 74-44, 1974-1 C.B. 287, S corporations must pay shareholder-employees "reasonable compensation for services performed" prior to making "dividend" distributions with respect to shareholder-employees' stock in the S corporation under section 1368. See also *David E. Watson, P.C. v. United States*, 668 F.3d 1008, 1017 (8th Cir. 2012). The legislative history of Section 199A confirms that the reasonable compensation rule was intended to apply to S corporations.

The Treasury Department and the IRS have received requests for guidance on whether the phrase "reasonable compensation" within the meaning of Section 199A extends beyond the context of S corporations for purposes of Section 199A. The Treasury Department and the IRS believe "reasonable compensation" is best read as limited to the context from which it derives: compensation of S corporation shareholders-employees. If reasonable compensation were to apply outside of the context of S corporations, a partnership could be required to apply the concept of reasonable compensation to its partners, regardless of whether amounts paid to partners were guaranteed. Such a result would violate the principle set forth in Rev. Rul. 69-184, 1969-1 CB 256, that a partner of a partnership cannot be an employee of that partnership. There is no indication that Congress intended to change this long-standing Federal income tax principle. Accordingly, proposed § 1.199A-3(b)(2)(ii)(H) provides that QBI does not include reasonable compensation paid by an S corporation but does not extend this rule to partnerships. Because the trade or business of performing services as an employee is not a qualified trade or business under Section 199A(d)(1)(B), wage income received by an employee is never QBI. The rule for reasonable compensation is merely a clarification that, even if an S corporation fails to pay a reasonable wage to its shareholder-employees, the shareholder-employees are nonetheless prevented from including an amount equal to reasonable compensation in QBI.

d. Guaranteed payments

Section 199A(c)(4)(B) provides that QBI does not include any guaranteed payment described in section 707(c) paid by a partnership to a partner for services rendered with respect to the trade or business. Proposed § 1.199A-3(b)(2)(ii)(I) restates this statutory rule and clarifies that the partnership's deduction for such guaranteed payment is an item of QBI if it is properly allocable to the partnership's trade or business and is otherwise deductible for Federal income tax purposes. It may be unclear whether a guaranteed payment to an upper-tier partnership for services performed for a lower-tier partnership is QBI for the individual partners of the upper-tier partnership if the upper-tier partnership does not itself make a guaranteed payment to its partners. Section 199A(c)(4)(B) does not limit the term "partner" to an individual. Consequently, for purposes of the guaranteed payment rule, a partner may be an RPE. Accordingly, proposed § 1.199A-3(b)(2)(ii)(I) clarifies that QBI does not include any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. Therefore, for the purposes of this rule, a guaranteed payment paid by a lower-tier partnership to an upper-tier partnership retains its character as a guaranteed payment and is not included in QBI of a partner of the upper-tier partnership regardless of whether it is guaranteed to the ultimate recipient.

e. Section 707(a) payments

Section 199A(c)(4)(C) provides that QBI does not include, to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business. Section 707(a) addresses arrangements in which a partner engages with the partnership other than in its capacity as a partner. Within the context of Section 199A, payments under section 707(a) for services are similar to, and therefore, should be treated similarly as, guaranteed payments, reasonable compensation, and wages, none of which is includable in QBI. In addition, consistent with the tiered partnership rule for guaranteed payments described previously, to the extent an upper-tier RPE receives a section 707(a) payment, that income should not constitute QBI to the partners of the upper-tier entity. Accordingly, proposed § 1.199A-3(b)(2)(ii)(J) provides that QBI does not include any payment described in section 707(a) to a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. The Treasury Department and the IRS request comments on whether there are situations in which it is appropriate to include section 707(a) payments in QBI.

Prop. Reg. § 1.199A-3(b)(2)(ii), "Items not taken into account," provides:

Notwithstanding paragraph (b)(2)(i) of this section and in accordance with Section 199A(c)(3)(B), the following items are not taken into account as a qualified item of income, gain, deduction, or loss:

(A) Any item of short-term capital gain, short-term capital loss, long-term capital gain, long-term capital loss, including any item treated as one of such items, such as gains or losses under section 1231 which are treated as capital gains or losses.

(B) Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G). Any amount described in section 1385(a)(1) is not treated as described in this clause.

(C) Any interest income other than interest income which is properly allocable to a trade or business. For purposes of Section 199A and this section, interest income attributable to an investment of working capital, reserves, or similar accounts is not properly allocable to a trade or business.

(D) Any item of gain or loss described in section 954(c)(1)(C) (transactions in commodities) or section 954(c)(1)(D) (excess foreign currency gains) applied in each case by substituting "trade or business" for "controlled foreign corporation."

(E) Any item of income, gain, deduction, or loss taken into account under section 954(c)(1)(F) (income from notional principal contracts) determined without regard to section 954(c)(1)(F)(ii) and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7).

(F) Any amount received from an annuity which is not received in connection with the trade or business.

(G) Any qualified REIT dividends as defined in paragraph (c)(2) of this section or qualified PTP income as defined in paragraph (c)(3) of this section.

(H) Reasonable compensation received by a shareholder from an S corporation. However, the S corporation's deduction for such reasonable compensation will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

(I) Any guaranteed payment described in section 707(c) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. However, the partnership's deduction for such guaranteed payment will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

(J) Any payment described in section 707(a) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. However, the partnership's deduction for such payment will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

My best guess is that the exclusion of Code § 707(a) and (c) payments from QBI was intended to prevent the service provider from attributing the partnership's QBI to any Code § 707(a) or (c) payment. If the service provider is in the trade or business of providing those services, the Code § 707(a) or (c) payment may be QBI as to that trade or business. Presumably, holding a small partnership interest in a service recipient should not disqualify a person in the trade or business of supplying such services to many businesses. For example, a company manages many properties for their owners. Management fees would be QBI. However, if the company becomes a partner in a landlord partnership, then the management fees would be payments under Code § 707(a) if an independent contractor relationship or under Code § 707(c) is provided as a partner. To me, becoming a partner should disqualify the management fees from being QBI as relates to the landlord's trade or business status but should not disqualify them as to the management company's own status. Unfortunately, Prop. Reg. § 1.199A-3(b)(2)(ii)(I) provides no relief from the Code § 707(a) or (c) disallowance.

Instead of making Code § 707(c) guaranteed payments to service partners, consider granting them a preferred profits interest. See part II.M.4.f Issuing a Profits Interest to a Service Provider. Consider whether doing so would, from a financial viewpoint, be relatively safe or relative risky for the service partners.

For details on the references Code § 707(a) and (c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

II.E.1.c.iii. "Trade or Business" for Code § 199A

How do we delineate what is a "trade or business" to which we apply these rules?

Part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A allows taxpayers to count as part of a trade or business activities that might not otherwise qualify under part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A.

II.E.1.c.iii.(a). General Standards for "Trade or Business" for Code § 199A

Prop. Reg. § 1.199A-1(b)(13) provides:[678]

> Trade or business means a section 162 trade or business other than the trade or business of performing services as an employee. In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented or licensed to a trade or business which is commonly controlled under § 1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under § 1.199A-4(b)(1)).

[678] The second sentence is referred to in Prop. Reg. § 1.199A-4(d), Examples (8) and (9), reproduced in full in the text before and after fn 696 in part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A.

Part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A explains Prop. Reg. § 1.199A-4.

The preamble to Prop. Reg. § 1.199A-1, REG-107892-18 (8/16/2018), explains the general definition:

> Proposed § 1.199A-1(b) also defines trade or business for purposes of Section 199A and proposed §§ 1.199A-1 through 1.199A-6. Neither the statutory text of Section 199A nor the legislative history provides a definition of trade or business for purposes of Section 199A. Multiple commenters stated that section 162 is the most appropriate definition for purposes of Section 199A. Although the term trade or business is defined in more than one provision of the Code, the Department of the Treasury (Treasury Department) and the IRS agree with commenters that for purposes of Section 199A, section 162(a) provides the most appropriate definition of a trade or business. This is based on the fact that the definition of trade or business under section 162 is derived from a large body of existing case law and administrative guidance interpreting the meaning of trade or business in the context of a broad range of industries. Thus, the definition of a trade or business under section 162 provides for administrable rules that are appropriate for the purposes of Section 199A and which taxpayers have experience applying and therefore defining trade or business as a section 162 trade or business will reduce compliance costs, burden, and administrative complexity.
>
> The proposed regulations extend the definition of trade or business for purposes of Section 199A beyond section 162 in one circumstance. Solely for purposes of Section 199A, the rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing and the other trade or business are commonly controlled under proposed § 1.199A-4(b)(1)(i). It is not uncommon that for legal or other non-tax reasons taxpayers may segregate rental property from operating businesses. This rule allows taxpayers to aggregate their trades or businesses with the associated rental or intangible property under proposed § 1.199A-4 if all of the requirements of proposed § 1.199A-4 are met. In addition, this rule may prevent taxpayers from improperly allocating losses or deductions away from trades or businesses that generate income that is eligible for a Section 199A deduction.

II.E.1.c.iii.(b). Aggregating Activities for Code § 199A

This part II.E.1.c.ii.(b) describes optional aggregation that allows taxpayers to combine wages and UBIA from separate (but related in some manner) businesses. However, each RPE separately determines whether its activity qualifies as a trade or business. Owners might want to combine their RPEs into a master partnership in which each LLC is a disregarded entity. See the discussion at the end of the introductory portion of part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.[679]

Although these rules are optional, parts II.E.1.c.v.(c) Calculation When Taxable Income Exceeds the Threshold Amount and II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction show how aggregation is beneficial in most cases. Whether or not a

[679] See text accompanying fn 647, which also mentions the possibility of using QSubs when the master RPE is an S corporation.

taxpayers aggregates, real estate rented to a commonly controlled business also receives relief; see part II.E.1.e.i General Rules Regarding Real Estate As a Trade or Business.[680]

In contrast to optional aggregation under this part II.E.1.c.ii.(b), part II.E.1.c.iv.(o) SSTB Very Broad Anti-Abuse Rules shows how businesses closely tied to a specified service trade or business (SSTB) may lose part or all of their QBI solely because of that connection.

The preamble to Prop. Reg. § 1.199A-4, REG-107892-18 (8/16/2018), explains optional aggregation:

> **IV. Proposed § 1.199A-4: Aggregation Rules**
>
> **A. Overview**
>
> The proposed regulations incorporate the rules under section 162 for determining whether a trade or business exists for purposes of Section 199A. A taxpayer can have more than one trade or business for purposes of section 162. See § 1.446-1(d)(1). However, in most cases, a trade or business cannot be conducted through more than one entity.
>
> The Treasury Department and the IRS have received comments requesting that the regulations provide that taxpayers be permitted to group or "aggregate" trades or businesses under Section 199A using the grouping rules described in § 1.469-4 (grouping rules). Section 1.469-4 sets forth the rules for grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of section 469. Section 469 uses the term "activities" in determining the application of the limitation rules under section 469. In contrast, Section 199A applies to trades or businesses. By focusing on activity, the grouping rules may be both under and over inclusive in determining what activities give rise to a trade or business for Section 199A purposes.
>
> Additionally, section 469 is a loss limitation rule used to prevent taxpayers from sheltering passive losses with nonpassive income. The Section 199A deduction is not based on the level of a taxpayer's involvement in the trade or business (that is, both active and passive owners of a trade or business may be entitled to a Section 199A deduction if they otherwise satisfy the requirements of Section 199A and these proposed regulations). Complicating matters further, a taxpayer's section 469 groupings may include specified service trades or businesses, requiring separate rules to segregate the two categories of trades or businesses to calculate the Section 199A deduction.
>
> Therefore, the grouping rules under section 469 are not appropriate for determining a trade or business for Section 199A purposes. Accordingly, the Treasury Department and the IRS are not adopting the section 469 grouping rules as the means by which taxpayers can aggregate trades or businesses for purposes of applying Section 199A.
>
> Although it is not appropriate to apply the grouping rules under section 469 to Section 199A, the Treasury Department and the IRS agree with practitioners that some amount of aggregation should be permitted. It is not uncommon for what are commonly thought of as single trades or businesses to be operated across multiple entities. Trades or businesses may be structured this way for various legal, economic, or other non-tax

[680] Especially the text accompanying fns 795-797.

reasons. The fact that businesses are operated across entities raises the question of whether, in defining trade or business for purposes of Section 199A, section 162 trades or businesses should be permitted or required to be aggregated or disaggregated, and if so, whether such aggregation or disaggregation should occur at the entity level or the individual level. Allowing taxpayers to aggregate trades or businesses offers taxpayers a means of combining their trades or businesses for purposes of applying the W-2 wage and UBIA of qualified property limitations and potentially maximizing the deduction under Section 199A. If such aggregation is not permitted, taxpayers could be forced to incur costs to restructure solely for tax purposes. In addition, business and non-tax law requirements may not permit many taxpayers to restructure their operations. Therefore, proposed § 1.199A-4 permits the aggregation of separate trades or businesses, provided certain requirements are satisfied.

The Treasury Department and the IRS are aware that many commenters were concerned with having multiple regimes for grouping (that is, under sections 199A, 1411, and 469). Accordingly, comments are requested on the aggregation method described in proposed § 1.199A-4, including whether this would be an appropriate grouping method for purposes of sections 469 and 1411, in addition to Section 199A.

B. Aggregation rules

Under proposed § 1.199A-4, aggregation is permitted but is not required. However, an individual may aggregate trades or businesses only if the individual can demonstrate that the requirements in proposed § 1.199A-4(b)(1) are satisfied. First, consistent with other provisions in the proposed regulations, each trade or business must itself be a trade or business as defined in § 1.199A-1(b)(13).

Second, the same person, or group of persons, must directly or indirectly, own a majority interest in each of the businesses to be aggregated for the majority of the taxable year in which the items attributable to each trade or business are included in income. All of the items attributable to the trades or businesses must be reported on returns with the same taxable year (not including short years). Proposed § 1.199A-4(b)(3) provides rules allowing for family attribution. Because the proposed rules look to a group of persons, non-majority owners may benefit from the common ownership and are permitted to aggregate. The Treasury Department and the IRS considered certain reporting requirements in which the majority owner or group of owners would be required to provide information about all of the other pass-through entities in which they held a majority interest. Due to the complexity and potential burden on taxpayers of such an approach, proposed § 1.199A-4 does not provide such a reporting requirement. The Treasury Department and the IRS request comments on whether a reporting or other information sharing requirement should be required.

Third, none of the aggregated trades or businesses can be an SSTB. Proposed § 1.199A-5 addresses SSTBs and trades or businesses with SSTB income.

Fourth, individuals and trusts must establish that the trades or businesses meet at least two of three factors, which demonstrate that the businesses are in fact part of a larger, integrated trade or business. These factors include: (1) the businesses provide products and services that are the same (for example, a restaurant and a food truck) or they provide products and services that are customarily provided together (for example, a gas station and a car wash); (2) the businesses share facilities or share significant centralized business elements (for example, common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); or (3) the businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (for example, supply chain interdependencies).

C. Individuals

An individual is permitted to aggregate trades or businesses operated directly and trades or businesses operated through RPEs. Individual owners of the same RPEs are not required to aggregate in the same manner.

An individual directly engaged in a trade or business must compute QBI, W-2 wages, and UBIA of qualified property for each trade or business before applying the aggregation rules. If an individual has aggregated two or more trades or businesses, then the combined QBI, W-2 wages, and UBIA of qualified property for all aggregated trades or businesses is used for purposes of applying the W-2 wage and UBIA of qualified property limitations described in proposed § 1.199A-1(d)(2)(iv).

D. RPEs

RPEs must compute QBI, W-2 wages, and UBIA of qualified property for each trade or business. An RPE must provide its owners with information regarding QBI, W-2 wages, and UBIA of qualified property attributable to its trades or businesses.

The Treasury Department and the IRS considered permitting aggregation by an RPE in a tiered structure. The Treasury Department and the IRS considered several approaches to tiered structures, including permitting only the operating entity to aggregate the trades or businesses or permitting each tier to add to the aggregated trade or business from a lower-tier, provided that the combined aggregated trade or business otherwise satisfied the requirements of proposed § 1.199A-4(b)(1) had the businesses all been owned by the lower-tier entity. The Treasury Department and the IRS are concerned that the reporting requirements needed for either of these rules would be overly complex for both taxpayers and the IRS to administer. In addition, because the Section 199A deduction is in all cases taken at the individual level, it should not be detrimental, and in fact may provide flexibility to taxpayers, to provide for aggregation at only one level. The Treasury Department and the IRS request comments on the proposed approach to tiered structures and the reporting necessary to allow an individual to demonstrate to which trades or businesses his or her QBI, W-2 wages, and UBIA of qualified property are attributable for purposes of calculating his or her Section 199A deduction.

E. Reporting and consistency

Proposed § 1.199A-4(c)(1) requires that once multiple trades or businesses are aggregated into a single aggregated trade or business, individuals must consistently report the aggregated group in subsequent tax years. Proposed § 1.199A-4(c)(1) provides rules for situations in which the aggregation rules are no longer met as well as rules for when a newly created or acquired trade or business can be added to an existing aggregated group.

Proposed § 1.199A-4(c)(2)(i) provides reporting and disclosure requirements for individuals that choose to aggregate, including identifying information about each trade or

> business that constitutes a part of the aggregated trade or business. Proposed § 1.199A-4(c)(2)(ii) allows the Commissioner to disaggregate trades or businesses if an individual fails to make the required aggregation disclosure. The Treasury Department and the IRS request comments as to whether it is administrable to create a standard under which trades or businesses will be disaggregated by the Commissioner and what that standard might be.

Prop. Reg. § 1.199A-4(a), "Scope and purpose, provides:[681]

> An individual or Relevant Passthrough Entity (RPE) may be engaged in more than one trade or business. Except as provided in this section, each trade or business is a separate trade or business for purposes of applying the limitations described in § 1.199A-1(d)(2)(iv). This section sets forth rules to allow individuals to aggregate trades or businesses, treating the aggregate as a single trade or business for purposes of applying the limitations described in § 1.199A-1(d)(2)(iv). Trades or businesses may be aggregated only to the extent provided in this section, but aggregation by taxpayers is not required.

Prop. Reg. § 1.199A-4 applies to taxable years ending after the date the Treasury decision adopting it as a final regulation is published in the Federal Register, but taxpayers may rely on it until the date the Treasury decision adopting it as final regulations is published in the Federal Register.[682]

Prop. Reg. § 1.199A-4(b)(1), "General rule," provides that, except as provided in Prop. Reg. § 1.199A-4(b)(3) (family attribution), trades or businesses may be aggregated only if an individual can demonstrate that-

> (i) The same person or group of persons, directly or indirectly, owns 50 percent or more of each trade or business to be aggregated, meaning in the case of such trades or businesses owned by an S corporation, 50 percent or more of the issued and outstanding shares of the corporation, or, in the case of such trades or businesses owned by a partnership, 50 percent or more of the capital or profits in the partnership;
>
> (ii) The ownership described in paragraph (b)(1)(i) of this section exists for a majority of the taxable year in which the items attributable to each trade or business to be aggregated are included in income;
>
> (iii) All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years;
>
> (iv) None of the trades or businesses to be aggregated is a specified service trade or business (SSTB) as defined in § 1.199A-5; and

---

[681] The reference to Prop. Reg. § 1.199A-1(d)(2)(iv) is to part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds, with Prop. Reg. § 1.199A-1(d)(2)(iv)(A) reproduced in fn 726 in that part.

[682] Prop. Reg. § 1.199A-4(e)(1), which is expressly subject to Prop. Reg. § 1.199A-4(e)(2), "Exception for non-calendar year RPE," which provides:

> For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

(v) The trades or businesses to be aggregated satisfy at least two of the following factors (based on all of the facts and circumstances):

(A) The trades or businesses provide products and services that are the same or customarily offered together.

(B) The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.

(C) The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

These aggregation rules are very different than the passive loss rules under parts II.K.1.b Grouping Activities, II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity, and II.K.1.e.iii.(b) Aggregating Real Estate Activities for a Real Estate Professional.

[Below are references to Examples in Prop. Reg. § 1.199A-4(d). Each Example is bookmarked so that users of the full set of materials can click on it and go to the Example.]

As to the Prop. Reg. § 1.199A-4(b)(1)(i) ownership requirement:

- It allows partnerships and S corporations to be aggregated (which is often important for real estate, which often is held by a partnership that leases it to an S corporation).[683] Prop. Reg. § 1.199A-4(d), Example (3) provides, "W owns more than 50% of the stock of S1 and more than 50% of the capital and profits of PRS thereby satisfying paragraph (b)(1)(i) of this section." Example (8) concludes, "G owns more than 50% of the stock of S1 and more than 50% of the capital and profits in LLC1 and LLC2 thus satisfying paragraph (b)(1)(i) of this section."

- Example (5), allowing a 10% owner to aggregate when another person owned more than 50%, implements the statement from the preamble above, "Because the proposed rules look to a group of persons, non-majority owners may benefit from the common ownership and are permitted to aggregate." So does Example (10), allowing 5% and 10% owners to aggregate.

- Example (9) shows that family attribution under Reg. § 1.199A-4(b)(3) can allow an owner to satisfy Prop. Reg. § 1.199A-4(b)(1)(i).[684]

Only passthrough activity can be aggregated. Prop. Reg. § 1.199A-4(d), Example (11).

[683] In part II.E.1.e.i General Rules Regarding Real Estate As a Trade or Business, fn 795 refers back to these Examples. That part demonstrates that real estate might not qualify as a trade or business and mentions that leasing it to a business under common control under Prop. Reg. § 1.199A-4(b)(1)(i) can allow the rental to be eligible for the Code § 199A deduction.
[684] Reg. § 1.199A-4(b)(3) is reproduced in the text accompanying fn 687.

Regarding the Prop. Reg. § 1.199A-4(b)(1)(v)(B) requirement that "the trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources":

- Prop. Reg. § 1.199A-4(d), Example (1) states that subparagraph (B) was satisfied when two businesses, a catering business and a restaurant, "share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting."[685]

- In Example (3), the 75% owner of two businesses manages the businesses, but the Example states that does not satisfy subparagraph (B).

- In Example (4), "A team of executives oversees the operations of all four of the businesses and controls the policy decisions involving the business as a whole. Human resources and accounting are centralized for the four businesses." The analysis concludes that subparagraph (B) is satisfied "because the businesses share accounting and human resource functions." The analysis implicitly seems to suggest that having a team of executives overseeing operations and controlling policy decisions adds little or no weight to analyzing how subparagraph (B) operates but rather places great weight on common accounting and human resource functions.

- In Example (6), two businesses share "centralized purchasing functions to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business." The Example analysis concludes that subparagraph (B) is satisfied "because of their centralized purchasing and accounting offices."

- Example (7) has the same facts as Example (6), but the businesses "do not have centralized purchasing or accounting functions." Its analysis concludes that taking away these centralized functions prevents subparagraph (B) from being satisfied.

- In Example (8), sharing "common advertising and management" appears to satisfy subparagraph (B) because they are viewed as sharing "significant centralized business elements."

- In Example (10), a 5% owner of various restaurants, G, "is the executive chef of all of the restaurants and as such he creates the menus and orders the food supplies." The Example's analysis concludes, "paragraph (b)(1)(v)(B) of this section is satisfied as G is the executive chef of all of the restaurants and the businesses share a centralized function for ordering food and supplies."

---

685 Facts included the following, with A being the common sole owner:

> The catering business and the restaurant share centralized purchasing to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. A maintains a website and print advertising materials that reference both the catering business and the restaurant. A uses the restaurant kitchen to prepare food for the catering business. The catering business employs its own staff and owns equipment and trucks that are not used or associated with the restaurant.

- Example (14) states that subparagraph (B) is satisfied when the businesses "have a centralized human resources department, payroll, and accounting department."

For what is an SSTB violating the Prop. Reg. § 1.199A-4(b)(1)(iv) prohibition against aggregating SSTBs,[686] see part II.E.1.c.iv Specified Service Trade or Business.

Reg. § 1.199A-4(b)(3), "Family attribution," provides that, for purposes of determining ownership under Reg. § 1.199A-4(b)(1)(i),[687] an individual is considered as owning the interest in each trade or business owned, directly or indirectly, by or for-

> (i) The individual's spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and
>
> (ii) The individual's children, grandchildren, and parents.

If an individual aggregates multiple trades or businesses under Prop. Reg. § 1.199A-4(b)(1), the individual must combine the QBI, W-2 wages, and UBIA of qualified property for all aggregated trades or businesses for purposes of applying the W-2 wage and unadjusted basis immediately after acquisition (UBIA) of qualified property limitations described in Prop. Reg. § 1.199A-1(d)(2)(iv).[688] Otherwise, however, an individual may aggregate trades or businesses operated directly and the individual's share of QBI, W-2 wages, and UBIA of qualified property from trades or businesses operated through RPEs.[689] Multiple owners of an RPE need not aggregate in the same manner.[690] For those trades or businesses directly operated by the individual, the individual computes QBI, W-2 wages, and UBIA of qualified property for each trade or business before applying the Prop. Reg. § 1.199A-4 aggregation rules.[691]

Prop. Reg. § 1.199A-4(c)(1) provides consistency rules:

> Once an individual chooses to aggregate two or more trades or businesses, the individual must consistently report the aggregated trades or businesses in all subsequent taxable years. However, an individual may add a newly created or newly acquired (including through non-recognition transfers) trade or business to an existing aggregated trade or business if the requirements of paragraph (b)(1) of this section are satisfied. In a subsequent year, if there is a change in facts and circumstances such that an individual's prior aggregation of trades or businesses no longer qualifies for aggregation under the rules of this section, then the trades or businesses will no longer be aggregated within the meaning of this section, and the individual must reapply the rules in paragraph (b)(1) of this section to determine a new permissible aggregation (if any).

---

[686] Prop. Reg. § 1.199A-4(d), Example (10) implicitly assumes that restaurants owned in part and run to a large degree by an executive chef are not SSTBs.
[687] For an example of this interaction see the text accompanying fn 684, referring to Prop. Reg. § 1.199A-4(d), Example (9).
[688] Reg. § 1.199A-4(b)(2).
[689] Reg. § 1.199A-4(b)(2).
[690] Reg. § 1.199A-4(b)(2).
[691] Reg. § 1.199A-4(b)(2).

For each taxable year, individuals (including trusts)[692] must attach a statement to their returns identifying each trade or business aggregated under Reg. § 1.199A-4(b)(1).[693] If an individual fails to attach the required statement, the IRS may disaggregate the individual's trades or businesses.[694]

Prop. Reg. § 1.199A-4(d) provides the examples listed in the rest of this part II.E.1.c.iii.(b), all of which include particular assumptions.[695]

Prop. Reg. § 1.199A-4(d), Example (1) provides:

(i) *Facts*. A wholly owns and operates a catering business and a restaurant through separate disregarded entities. The catering business and the restaurant share centralized purchasing to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. A maintains a website and print advertising materials that reference both the catering business and the restaurant. A uses the restaurant kitchen to prepare food for the catering business. The catering business employs its own staff and owns equipment and trucks that are not used or associated with the restaurant.

(ii) *Analysis*. Because the restaurant and catering business are held in disregarded entities, A will be treated as operating each of these businesses directly and thereby satisfies paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, A satisfies the following factors: (1) paragraph (b)(1)(v)(A) is met as both businesses offer prepared food to customers; and (2) paragraph (b)(1)(v)(B) of this section is met because the two businesses share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting. Having satisfied paragraph (b)(1)(i)-(v) of this section, A may treat the catering business and the restaurant as a single trade or business for purposes of applying § 199A-1(d).

---

692 Reg. § 1.199A-1(a)(2), "Usage of term individual," provides:

For purposes of applying the rules of §§ 1.199A-1 through 1.199A-6, a reference to an individual includes a reference to a trust (other than a grantor trust) or an estate to the extent that the section 199A deduction is determined by the trust or estate under the rules of § 1.199A-6.

693 Prop. Reg. § 1.199A-4(c)(2)(i), "Required annual disclosure," requires the statement to contain:

(A) A description of each trade or business;
(B) The name and EIN of each entity in which a trade or business is operated;
(C) Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year; and
(D) Such other information as the Commissioner may require in forms, instructions, or other published guidance.

694 Prop. Reg. § 1.199A-4(c)(2)(ii).

695 Prop. Reg. § 1.199A-4(d) provides:

The following examples illustrate the principles of this section. For purposes of these examples, assume the taxpayer is a United States citizen, all individuals and RPEs use a calendar taxable year, there are no ownership changes during the taxable year, all trades or businesses satisfy the requirements under section 162, all tax items are effectively connected to a trade or business within the United States within the meaning of section 864(c), and none of the trades or businesses is an SSTB within the meaning of § 1.199A-5. Except as otherwise specified, a single letter denotes an individual taxpayer.

Prop. Reg. § 1.199A-4(d), Example (2) provides:

(i) *Facts*. Assume the same facts as in Example 1, but the catering and restaurant businesses are owned in separate partnerships and A, B, C, and D each own a 25% interest in the capital and profits of each of the two partnerships. A, B, C, and D are unrelated.

(ii) *Analysis*. Because under paragraph (b)(1)(i) of this section A, B, C, and D together own more than 50% of the capital and profits in each of the two partnerships, they may each treat the catering business and the restaurant as a single trade or business for purposes of applying § 1.199A-1(d).

Prop. Reg. § 1.199A-4(d), Example (3) provides:

(i) *Facts*. W owns a 75% interest in S1, an S corporation, and a 75% interest in the capital and profits of PRS, a partnership. S1 manufactures clothing and PRS is a retail pet food store. W manages S1 and PRS.

(ii) *Analysis*. W owns more than 50% of the stock of S1 and more than 50% of the capital and profits of PRS thereby satisfying paragraph (b)(1)(i) of this section. Although W manages both S1 and PRS, W is not able to satisfy the requirements of paragraph (b)(1)(v) of this section as the two businesses do not provide goods or services that are the same or customarily offered together; there are no significant centralized business elements; and no facts indicate that the businesses are operated in coordination with, or reliance upon, one another. W must treat S1 and PRS as separate trades or businesses for purposes of applying § 1.199A-1(d).

Prop. Reg. § 1.199A-4(d), Example (4) provides:

(i) *Facts*. E owns a 60% interest in the capital and profits of each of four partnerships (PRS1, PRS2, PRS3, and PRS4). Each partnership operates a hardware store. A team of executives oversees the operations of all four of the businesses and controls the policy decisions involving the business as a whole. Human resources and accounting are centralized for the four businesses. E reports PRS1, PRS3, and PRS4 as an aggregated trade or business under paragraph (b)(1) of this section and reports PRS2 as a separate trade or business. Only PRS2 generates a net taxable loss.

(ii) *Analysis*. E owns more than 50% of the capital and profits of each partnership thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the following factors are satisfied: (1) paragraph (b)(1)(v)(A) of this section because each partnership operates a hardware store; and (2) paragraph (b)(1)(v)(B) of this section because the businesses share accounting and human resource functions. E's decision to aggregate only PRS1, PRS3, and PRS4 into a single trade or business for purposes of applying § 1.199A-1(d) is permissible. The loss from PRS2 will be netted against the aggregate profits of PRS1, PRS3 and PRS4 pursuant to § 1.199A-1(d)(2)(iii).

Prop. Reg. § 1.199A-4(d), Example (5) provides:

(i) *Facts*. Assume the same facts as Example 4, and that F owns a 10% interest in the capital and profits of PRS1, PRS2, PRS3, and PRS4.

(ii) *Analysis*. Because under paragraph (b)(1)(i) of this section E owns more than 50% of the capital and profits in the four partnerships, F may aggregate PRS 1, PRS2, PRS3, and PRS4 as a single trade or business for purposes of applying § 1.199A-1(d), provided that F can demonstrate that the ownership test is met by E.

Prop. Reg. § 1.199A-4(d), Example (6) provides:

(i) *Facts*. D owns 75% of the stock of S1, S2, and S3, each of which is an S corporation. Each S corporation operates a grocery store in a separate state. S1 and S2 share centralized purchasing functions to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. S3 is operated independently from the other businesses.

(ii) *Analysis*. D owns more than 50% of the stock of each S corporation thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the grocery stores satisfy paragraph (b)(1)(v)(A) of this section because they are in the same trade or business. Only S1 and S2 satisfy paragraph (b)(1)(v)(B) of this section because of their centralized purchasing and accounting offices. D is only able to show that the requirements of paragraph (b)(1)(v)(B) of this section are satisfied for S1 and S2; therefore, D only may aggregate S1 and S2 into a single trade or business for purposes of § 1.199A-1(d). D must report S3 as a separate trade or business for purposes of applying § 1.199A-1(d).

Prop. Reg. § 1.199A-4(d), Example (7) provides:

(i) *Facts*. Assume the same facts as Example 6 except each store is independently operated and S1 and S2 do not have centralized purchasing or accounting functions.

(ii) *Analysis*. Although the stores provide the same products and services within the meaning of paragraph (b)(1)(v)(A) of this section, D cannot show that another factor under paragraph (b)(1)(v) of this section is present. Therefore, D must report S1, S2, and S3 as separate trades or businesses for purposes of applying § 1.199A-1(d).

Prop. Reg. § 1.199A-4(d), Example (8) provides:

(i) *Facts*. G owns 80% of the stock in S1, an S corporation and 80% of the capital and profits in LLC1 and LLC2, each of which is a partnership for Federal tax purposes. LLC1 manufactures and supplies all of the widgets sold by LLC2. LLC2 operates a retail store that sells LLC1's widgets. S1 owns the real property leased to LLC1 and LLC2 for use by the factory and retail store. The entities share common advertising and management.

(ii) *Analysis*. G owns more than 50% of the stock of S1 and more than 50% of the capital and profits in LLC1 and LLC2 thus satisfying paragraph (b)(1)(i) of this section. LLC1, LLC2, and S1 share significant centralized business elements and are operated in coordination with, or in reliance upon, one or more of the businesses in the aggregated group. G can treat the business operations of LLC1 and LLC2 as a single trade or business for purposes of applying § 1.199A-1(d). S1 is eligible to be included in the aggregated group because it leases property to a trade or business within the aggregated trade or business as described in § 1.199A-1(b)(13) and meets the requirements of paragraph (b)(1) of this section.

Example (8) above and Example (9) below refer to Prop. Reg. § 1.199A-1(b)(13), which provides in part:[696]

> … rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented or licensed to a trade or business which is commonly controlled under § 1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under § 1.199A-4(b)(1)).

Prop. Reg. § 1.199A-4(d), Example (9) provides:

(i) *Facts*. Same facts as Example 8, except G owns 80% of the stock in S1 and 20% of the capital and profits in each of LLC1 and LLC2. B, G's son, owns a majority interest in LLC2, and M, G's mother, owns a majority interest in LLC1. B does not own an interest in S1 or LLC1, and M does not own an interest in S1 or LLC2.

(ii) *Analysis*. Under the rules in paragraph (b)(3) of this section, B and M's interest in LLC2 and LLC1, respectively, are attributable to G and G is treated as owning a majority interest in LLC2 and LLC; G thus satisfies paragraph (b)(1)(i) of this section. G may aggregate his interests in LLC1, LLC2, and S1 as a single trade or business for purposes of applying § 1.199A-1(d). Under paragraph (b)(3) of this section, S1 is eligible to be included in the aggregated group because it leases property to a trade or business within the aggregated trade or business as described in § 1.199A-1(b)(13) and meets the requirements of paragraph (b)(1) of this section.

Prop. Reg. § 1.199A-4(d), Example (10) provides:

(i) *Facts*. F owns a 75% interest and G owns a 5% interest in the capital and profits of five partnerships (PRS1-PRS5). H owns a 10% interest in the capital and profits of PRS1 and PRS2. Each partnership operates a restaurant and each restaurant separately constitutes a trade or business for purposes of section 162. G is the executive chef of all of the restaurants and as such he creates the menus and orders the food supplies.

(ii) *Analysis*. F owns more than 50% of capital and profits in the partnerships thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the restaurants satisfy paragraph (b)(1)(v)(A) of this section because they are in the same trade or business, and paragraph (b)(1)(v)(B) of this section is satisfied as G is the executive chef of all of the restaurants and the businesses share a centralized function for ordering food and supplies. F can show the requirements under paragraph (b)(1) of this section are satisfied as to all of the restaurants. Because F owns a majority interest in each of the partnerships, G can demonstrate that paragraph (b)(1)(i) of this section is satisfied G can also aggregate all five restaurants into a single trade or business for purposes of applying § 1.199A-1(d). H, however,

[696] Reg. § 1.199A-1(b)(13) is reproduced in full in fn 678 in part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A.

only owns an interest in PRS1 and PRS2. Like G, H satisfies Paragraph (b)(1)(i) of this section because F owns a majority interest. H can, therefore, aggregate PRS1 and PRS2 into a single trade or business for purposes of applying § 1.199A-1(d).

Prop. Reg. § 1.199A-4(d), Example (11) provides:

(i) *Facts*. H, J, K, and L own interests in PRS1 and PRS2, each a partnership, and S1 and S2, each an S corporation. H, J, K and L also own interests in C, an entity taxable as a C corporation. H owns 30%, J owns 20%, K owns 5%, L owns 45% of each of the five entities. All of the entities satisfy 2 of the 3 factors under paragraph (b)(1)(v) of this section. For purposes of Section 199A the taxpayers report the following aggregated trades or businesses: H aggregates PRS1 and S1 together and aggregates PRS2 and S2 together; J aggregates PRS1, S1 and S2 together and reports PRS2 separately; K aggregates PRS1 and PRS2 together and aggregates S1 and S2 together; and L aggregates S1, S2, and PRS2 together and reports PRS1 separately. C cannot be aggregated.

(ii) *Analysis*. Under paragraph (b)(1)(i) of this section, because H, J, and K together own a majority interest in PRS1, PRS2, S1, and S2, H, J, K, and L are permitted to aggregate under paragraph (b)(1). Further, the aggregations reported by the taxpayers are permitted, but not required for each of H, J, K, and L. C's income is not eligible for the Section 199A deduction and it cannot be aggregated for purposes of applying § 1.199A-1(d).

Prop. Reg. § 1.199A-4(d), Example (12) provides:

(i) *Facts*. L owns 60% of the profits and capital interests in PRS1, a partnership, a business that sells non-food items to grocery stores. L also owns 55% of the profits and capital interests in PRS2, a partnership, which owns and operates a distribution trucking business. The predominant portion of PRS2's business is transporting goods for PRS1.

(ii) *Analysis*. L is able to meet (b)(1)(i) as the majority owner of PRS1 and PRS2. Under paragraph (b)(1)(v) of this section, L is only able to show the operations of PRS1 and PRS2 are operated in reliance of one another under paragraph (b)(1)(v)(C) of this section. For purposes of applying § 1.199A-1(d), L must treat PRS1 and PRS2 as separate trades or businesses.

Example (12)'s point is that satisfying only one of the three factors in Prop. Reg. § 1.199A-4(b)(1)(v) is not enough.

Prop. Reg. § 1.199A-4(d), Example (13) provides:

(i) *Facts*. C owns a majority interest in a sailboat racing team and also owns an interest in PRS1 which operates a marina. PRS1 is a trade or business under section 162, but the sailboat racing team is not a trade or business within the meaning of section 162.

(ii) *Analysis*. C has only one trade or business for purposes of Section 199A and, therefore, cannot aggregate the interest in the racing team with PRS1 under paragraph (b)(1) of this section.

Contrast Example (13) with Examples (8) and (9) above, which referred to Reg. § 1.199A-1(b)(13), which allows rental activity that does not rise to the level of trade or business to be treated as a trade or business.[697] The sailboat racing team is not a trade or business in the facts of Example (13), and Example (13) implicitly assume it is not tangible or intangible property rented or licensed to the marina.

Prop. Reg. § 1.199A-4(d), Example (14) provides:

(i) *Facts*. Trust wholly owns LLC1, LLC2, and LLC3. LLC1 operates a trucking company that delivers lumber and other supplies sold by LLC2. LLC2 operates a lumber yard and supplies LLC3 with building materials. LLC3 operates a construction business. LLC1, LLC2, and LLC3 have a centralized human resources department, payroll, and accounting department.

(ii) *Analysis*. Because Trust owns 100% of the interests in LLC1, LLC2, and LLC3, Trust satisfies paragraph (b)(1)(i) of this section. Trust can also show that it satisfies paragraph (b)(1)(v)(B) of this section as the trades or businesses have a centralized human resources department, payroll, and accounting department. Trust also can show is meets paragraph (b)(1)(v)(C) of this section as the trades or businesses are operated in coordination, or reliance upon, one or more in the aggregated group. Trust can aggregate LLC1, LLC2, and LLC3 for purposes of applying § 1.199A-1(d).

II.E.1.c.iii.(c). "Trade or Business" in Other Areas of Tax Law

Neither the statute nor the legislative history explain what is a "trade or business." Here are some resources that may help, to the extent that regulations do not provide guidance:

- Part II.G.3.i.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit would be the most important source.

- What is a "trade or business" is important regarding particular issues for the Code § 1411 3.8% tax on net investment income ("NII"), which is tied to the Code § 469 passive activity loss ("PAL") rules. When reviewing the resources below, keep in mind that (a) being passive tends to be bad for taxpayers in the context of the NII and PAL rules but is irrelevant for Code § 199A, and (b) real estate has special rules regarding its character as passive, which again is irrelevant for Code § 199A:

  - The government received and responded to comments on what is a "trade or business" when working on regulations for the net investment income. See:

    - Part II.I.8.a General Application of 3.8% Tax to Business Income, fns 1918-1927, and

    - Part II.I.8.c.iii Rental as a Trade or Business, fns 1981-1991.

  - In the PAL rules:

    - What is a trade or business has received some attention in the real estate professional exception, but most of that tends to be whether the trade or business qualifies as a real estate trade or business. Although I don't view those as particularly instructive as

[697] See text accompanying fn 696.

to what is a trade or business, here is the discussion so you can see for yourself: Part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity.

  - Part II.K.1.f Royalty as a Trade or Business may have some application.

  - Because what is a "trade or business" is so driven by facts and circumstances and one needs to delineate among separate trades or businesses in applying Code § 199A, one wonders whether the government might provide some guidance. The PAL rules provide guidance that one might speculate the government might consider adopting, rather than creating a whole new set of rules. The PAL rules allow taxpayers to group activities, with a general grouping rule and a rule specific to real estate professionals. See parts II.K.1.b Grouping Activities and II.K.1.e.iii.(b) Aggregating Real Estate Activities for a Real Estate Professional. The net investment income tax rules were required to refer to the PAL rules, so they also adopted those grouping rules, but allowed taxpayers to regroup when first subject to the NII tax. See part II.I.8.a.ii Passive Activity Grouping Rules.

- Self-employment tax is imposed only on activity that is a trade or business. See:

  - Part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax, fns 2795-2798.

  - Part II.L.2.a.ii Rental Exception to SE Tax and II.L.2.a.iii Whether Gain from Sale of Property is Subject to SE Tax, keeping in mind that the rental exception excludes certain trades or businesses for self-employment tax purposes. Part II.L.2.a.ii also discusses that generally equipment rental is a trade or business, in contrast to real estate, which needs more activity to rise to the level of a trade or business.

- A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.[698]

The last bullet point, focusing of accounting methods, might be a paradigm if the government does not base the separation of businesses on passive loss rules. Reg. § 1.446-1(d), "Taxpayer engaged in more than one business," provides:

> (1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

[698] Code § 446(d). Thus, a single member LLC that is a disregarded entity may use a different accounting method than its parent if the single member LLC engages in a separate trade or business; see CCA 201430013 (see fn 294 in part II.B Limited Liability Company (LLC)).

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

II.E.1.c.iv. Specified Service Trade or Business (SSTB) If Taxable Income Exceeds Certain Thresholds

II.E.1.c.iv.(a). Introduction to Specified Service Trade or Business (SSTB)

Prop. Reg. § 1.199A-5(a)(2), "Effect of being an SSTB," provides:

> If a trade or business is an SSTB, no QBI, W-2 wages, or UBIA of qualified property from the SSTB may be taken into account by any individual whose taxable income exceeds the phase-in range as defined in § 1.199A-1(b)(3), even if the item is derived from an activity that is not itself a specified service activity. If a trade or business conducted by a relevant passthrough entity (RPE) is an SSTB, this limitation applies to any direct or indirect individual owners of the business, regardless of whether the owner is passive or participated in any specified service activity. However, the SSTB limitation does not apply to individuals with taxable income below the threshold amount as defined in § 1.199A-1(b)(11). A phase-in rule, provided in § 1.199A-1(d)(2), applies to individuals with taxable income within the phase-in range, allowing them to take into account a certain "applicable percentage" of QBI, W-2 wages, and UBIA of qualified property from an SSTB. A direct or indirect owner of a trade or business engaged in the performance of a specified service is engaged in the performance of the specified service for purposes of section 199A and this section, regardless of whether the owner is passive or participated in the specified service activity.

A "specified service trade or business" is any trade or business other than (A) certain businesses listed in Code § 1202(e)(3)(A) that do not qualify for the Code § 1202 exclusion from capital gain on the sale of C corporation stock, or (B) which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in Code § 475(c)(2)), partnership interests, or commodities (as defined in Code § 475(e)(2)).[699]

Code § 1202(e)(3)(A), which is discussed in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation, fns. 4326-4327, lists as a "specified service trade or business" (SSTB) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. However, Code § 199A(d)(2)(A) specifically excludes engineering and architecture from this blacklist, so

[699] Code § 199A(d)(2).

that those professions <u>do</u> qualify for QBI treatment. Also, Code § 199A(d)(2)(A) specifically looks to the work of not only employees but also owners.

This blacklisting of a specified service trade or business is relaxed or does not apply if taxable income is below certain thresholds.[700] See part II.E.1.c.v.(a) Taxable Income "Threshold.

Getting into details:

Prop. Reg. § 1.199A-5(e) provides the effective date of the Prop. Reg. § 1.199A-5 (described below), regarding SSTBs and the trade or business of being an employee:

(1) *General rule*. Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. However, taxpayers may rely on the rules of this section until the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.

(2) *Exceptions*.

(i) *Anti-abuse rules*. The provisions of paragraphs (c)(2), (c)(3), and (d)(3) of this section apply to taxable years ending after December 22, 2017.

(ii) *Non-calendar year RPE*. For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

The preamble, REG-107892-18 (8/16/2018), provides:

V. Proposed § 1.199A-5: Specified Service Trade or Business and the Trade or Business of Performing Services as an Employee

Section 199A(c)(1) provides that only items attributable to a qualified trade or business are taken into account in determining the Section 199A deduction for QBI. Section 199A(d)(1) provides that a "qualified trade or business" means any trade or business other than (A) an SSTB, or (B) the trade or business of performing services as an employee.

A. SSTB

This part V.A. explains the provisions under proposed § 1.199A-5 relating to SSTBs. First, the effect of classification as an SSTB is discussed. Second, the exceptions for taxpayers below the threshold amount and a de minimis exception are described. Third, guidance is provided on the meaning of the activities listed in the definition of SSTB. Fourth, the rules for determining whether a trade or business is treated as part of an SSTB are

[700] Code § 199A(d)(3).

described. Finally, rules regarding classification as an employee for purposes of Section 199A are discussed.

1. Effect of being an SSTB

a. General Rule

Consistent with Section 199A, proposed § 1.199A-5(a)(2) provides that, unless an exception applies, if a trade or business is an SSTB, none of its items are to be taken into account for purposes of determining a taxpayer's QBI. In the case of an SSTB conducted by an entity, such as a partnership or an S corporation, if it is determined that the trade or business is an SSTB, none of the income from that trade or business flowing to an owner of the entity is QBI, regardless of whether the owner participates in the specified service activity. Therefore, a direct or indirect owner of a trade or business engaged in an SSTB is treated as engaged in the SSTB for purposes of Section 199A regardless of whether the owner is passive or participated in the SSTB. Similarly, none of the W-2 wages or UBIA of qualified property will be taken into account for purposes of Section 199A. For example, because the field of athletics is an SSTB, if a partnership owns a professional sports team, the partners' distributive shares of income from the partnership's athletics trade or business is not QBI, regardless of whether the partners participate in the partnership's trade or business. Proposed § 1.199A-5 contains further examples illustrating the operation of this rule.

b. Exceptions to the General Rule

Under Section 199A(d)(3), individuals with taxable income below the threshold amount are not subject to a restriction with respect to SSTBs. Therefore, if an individual or trust has taxable income below the threshold amount, the individual or trust is eligible to receive the deduction under Section 199A notwithstanding that a trade or business is an SSTB. As described in part I.C of this Explanation of Provisions, the exclusion of QBI, W-2 wages, and UBIA of qualified property from the computation of the Section 199A deduction is subject to a phase-in for individuals with taxable income within the phase-in range. The application of this phase-in is determined at the individual, trust, or estate level, which may not be where the trade or business is operated. Therefore, if a partnership or an S corporation operates an SSTB, the application of the threshold does not depend on the partnership or S corporation's taxable income but rather, the taxable income of the individual partner or shareholder claiming the Section 199A deduction. For example, if the partnership's taxable income is less than the threshold amount, but each of the partnership's individual partners have income that exceeds the threshold amount plus $50,000 ($100,000 in the case of a joint return) then none of the partners may claim a Section 199A deduction with respect to any income from the partnership's SSTB.

An RPE conducting an SSTB may not know whether the taxable income of any of its equity owners is below the threshold amount. However, the RPE is best positioned to make the determination as to whether its trade or business is an SSTB. Therefore, reporting rules under proposed § 1.199A-6(b)(3)(B) requires each RPE to determine whether it conducts an SSTB and disclose that information to its partners, shareholders, or owners. With respect to each trade or business, once it is determined that a trade or business is an SSTB, it remains an SSTB and cannot be aggregated with other trades or business. In the case of a trade or business conducted by an individual, such as a sole proprietorship, disregarded entity, or grantor trust, the determination of whether the business is an SSTB is made by the individual.

Section 199A defines an SSTB to include any trade or business that "involves the performance of services in" a specified service activity. Although the statute, read literally, does not suggest that a certain quantum of specified service activity is necessary to find an SSTB, the Treasury Department and the IRS believe that requiring all taxpayers to evaluate and quantify any amount of specified service activity would create administrative complexity and undue burdens for both taxpayers and the IRS. Therefore, analogous to the regulations under section 448, it is appropriate to provide a de minimis rule, under which a trade or business will not be considered to be an SSTB merely because it provides a small amount of services in a specified service activity.

Therefore, analogous to the regulations under section 448, it is appropriate to provide a de minimis rule, under which a trade or business will not be considered to be an SSTB merely because it provides a small amount of services in a specified service activity.

Accordingly, proposed § 1.199A-5(c)(1) provides that a trade or business (determined before the application of the aggregation rules in proposed § 1.199A-4) is not an SSTB if the trade or business has gross receipts of $25 million or less (in a taxable year) and less than 10 percent of the gross receipts of the trade or business is attributable to the performance of services in an SSTB. For trades or business with gross receipts greater than $25 million (in a taxable year), a trade or business is not an SSTB if less than 5 percent of the gross receipts of the trade or business are attributable to the performance of services in an SSTB.

2. Definition of Specified Service Trade or Business

The definition of an SSTB set forth in Section 199A incorporates, with modifications, the text of section 1202(e)(3)(A). The text of section 1202(e)(3)(A) substantially tracks the definition of 'qualified personal service corporation' under section 448. Therefore, consistent with ordinary rules of statutory construction, the guidance in proposed § 1.199A-5(b) is informed by existing interpretations and guidance under both sections 1202 and 448 when relevant. However, existing guidance under those sections is sparse and the scope and purpose of those sections and Section 199A are different. The Treasury Department and the IRS also note that, unlike sections 1202(e)(3)(A) and 448, the purpose of Section 199A is to provide a deduction based on the character of the taxpayer's trade or business. Distinct guidance for Section 199A is warranted. Therefore, the guidance in proposed § 1.199A-5(b) applies only to Section 199A, not sections 1202 and 448.

a. Guidance on the Meaning of the Listed Activities

Section 199A(d)(2)(A) provides that an SSTB is any trade or business described in section 1202(e)(3)(A) (applied without regard to the words "engineering [and] architecture") or that would be so described if the term "employees or owners" were substituted for "employees" therein. Section 199A(d)(2)(B) provides that an SSTB is any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

> Section 1202 provides an exclusion from gross income for some or all of the gain on the sale of certain qualified small business stock. Section 1202 generally requires that, for stock to be qualified small business stock, the corporation must be engaged in a qualified trade or business. Section 1202(e)(3) provides that, for purposes of section 1201(e), the term 'qualified trade or business' means any trade or business other than any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees; any banking, insurance, financing, leasing, investing, or similar business; any farming business (including the business of raising or harvesting trees); any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and; any business of operating a hotel, motel, restaurant, or similar business.
>
> Thus, after application of the modifications described in Section 199A(d)(2)(A), the definition of an SSTB for purposes of Section 199A is (1) any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, and (2) any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).
>
> The Treasury Department and the IRS have received comments requesting guidance on the meaning and scope of the various trades or businesses described in the preceding paragraph. The Treasury Department and the IRS agree with commenters that guidance with respect to these trades or businesses is necessary for several reasons. Most importantly, Section 199A is a new Code provision intended to benefit a wide range of businesses, and taxpayers need certainty in determining whether their trade or business generates income that is eligible for the Section 199A deduction. As previously discussed, given the differing scope, objectives, and, in some respects, language of sections 199A, 448, and 1202, the guidance under sections 1202(e)(3)(A) and 448(d)(2) is not an appropriate substitute for clear and distinct guidance governing what constitutes an SSTB under Section 199A. In particular, some SSTBs are listed in section 1202(e)(3)(A), but not listed in section 448(d)(2), such as athletics, financial services, brokerage services, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. In addition, some activities are mentioned only in 199A, such as investment management, trading, and dealing. As described in the remainder of this part V.A.2., proposed § 1.199A-5(b) provides guidance on the definition of an SSTB based on the plain meaning of the statute, past interpretations of substantially similar language in other Code provisions, and other indicia of legislative intent.

The preamble then provides an overview of parts II.E.1.c.iv.(b) Health, II.E.1.c.iv.(c) Law, II.E.1.c.iv.(d) Accounting, II.E.1.c.iv.(e) Actuarial Science, II.E.1.c.iv.(f) Performing Arts, II.E.1.c.iv.(g) Consulting, II.E.1.c.iv.(h) Athletics, II.E.1.c.iv.(i) Financial Services, II.E.1.c.iv.(j) Brokerage Services, and II.E.1.c.iv.(n) Any Trade or Business Where the Principal Asset of Such Trade or Business Is the Reputation or Skill of One or More of Its Employees or Owners:

i. SSTBs Listed in Section 199A(d)(2)(A)

The definition of an SSTB under Section 199A is substantially similar to the list of service trades or businesses provided in section 448(d)(2)(A) and § 1.448-1T(e)(4)(i), as the legislative history notes. See Joint Explanatory Statement of the Committee of Conference, footnotes 44-46. Section 448 prohibits certain taxpayers from computing taxable income under the cash receipts and disbursements method of accounting. Under section 448, qualified personal service corporations generally are not subject to the prohibition from using the cash method. Section 448(d)(2) defines the term qualified personal service corporation to include certain employee-owned corporations, substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. The regulations under section 448(d)(2), found in § 1.448-1T(e)(4)(i), provide additional guidance on several of the terms, including health, performing arts, and consulting. In addition, there have been several court opinions, technical advice memoranda, and private letter rulings interpreting the various fields listed in section 448(d)(2) and § 1.448-1T(e)(4)(i).

In general, the guidance under section 448(d)(2) emphasizes the direct provision of services by the employees of a trade or business, rather than the application of capital. Commenters have suggested that the regulations under section 448 serve as a reasonable starting point for defining an SSTB for purposes of Section 199A. However, commenters also noted that the objectives and included categories of trades or businesses within section 448 and Section 199A are different. Consistent with ordinary rules of statutory construction and the legislative history of Section 199A, proposed § 1.199A-5(b) draws upon the existing guidance under section 448(d)(2) when appropriate for purposes of Section 199A. Proposed § 1.199A-5(b) generally follows the guidance issued under section 448(d)(2) with some modifications. In certain instances, the principles of section 448(d)(2) provide useful analogies in defining the particular fields listed in section 1202(e)(3)(A) (as modified by Section 199A(d)(2)(A)) for purposes of Section 199A.

In addition, section 1202(e)(3)(A) also includes 'any trade or business where the principal asset of such trade or business is the reputation of skill of 1 or more of its employees.' Section 199A(d)(2)(A) modifies this clause by adding the words 'or owners' to the end, to read as follows: 'any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners.' The meaning of this clause is best determined by examining the language of section 1202(e)(3) (A) in light of the purpose of Section 199A.

Case law under section 448 provides that whether a service is performed in a qualifying field under section 448(d)(2) is to be decided by examining all relevant indicia and is not controlled by state licensing laws. *See Rainbow Tax Serv., Inc. v. Commissioner*, 128 T.C. 42 (2007); *Kraatz & Craig Surveying Inc., v. Commissioner*, 134 T.C. 167 (2010). This approach also is appropriate for Section 199A purposes.

Additionally, states can widely vary in what they require in terms of licensure or certification. The Treasury Department and the IRS believe that the Federal tax law should not treat similarly situated taxpayers differently based on a particular state's decision that for consumer protection purposes or otherwise a particular business type requires a license or certification. Thus, proposed § 1.199A-5(b) does not adopt a bright-line licensing rule for purposes of determining whether a trade or business is within a certain field for purposes of Section 199A.

The preamble then provides an overview of parts II.E.1.c.iv.(k) Investing and Investment Management, II.E.1.c.iv.(l) Trading, and II.E.1.c.iv.(m) Dealing in Securities, Partnership Interests, or Commodities:

ii. SSTBs Described in 199A(d)(2)(B)

As mentioned previously, Section 199A(d)(2)(B) provides that an SSTB also includes any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)). This rule does not appear in section 1202(e)(3)(A) or section 448(d)(2).

Section 475(c)(2) provides a detailed list of interests treated as securities, including stock in a corporation; ownership interests in widely held or publicly traded partnerships or trusts; notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in any of the foregoing securities or any currency, including any option, forward contract, short position, or any similar financial instruments; and certain hedges with respect to any such securities. Section 475(e)(2) provides a similarly detailed list of property treated as a commodity, including any commodity which is actively traded (within the meaning of section 1092(d)(1)) or any notional principal contract with respect to any such commodity, evidences of an interest in, or derivative financial instruments in any of the foregoing commodities, and certain hedges with respect to any such commodities.

The preamble then provides some anti-abuse rules, which are in part II.E.1.c.iv.(o).

Implementing the above, Prop. Reg. § 1.199A-5(b), "Definition of specified service trade or business," provides:

Except as provided in paragraph (c)(1) of this section, the term specified service trade or business (SSTB) means any of the following:

(1) *Listed SSTBs*. Any trade or business involving the performance of services in one or more of the following fields:

(i) Health as described in paragraph (b)(2)(ii) of this section;

(ii) Law as described in paragraph (b)(2)(iii) of this section;

(iii) Accounting as described in paragraph (b)(2)(iv) of this section;

(iv) Actuarial science as described in paragraph (b)(2)(v) of this section;

(v) Performing arts as described in paragraph (b)(2)(vi) of this section;

(vi) Consulting as described in paragraph (b)(2)(vii) of this section;

(vii) Athletics as described in paragraph (b)(2)(viii) of this section;

(viii) Financial services as described in paragraph (b)(2)(ix) of this section;

(ix) Brokerage services as described in paragraph (b)(2)(x) of this section;

(x) Investing and investment management as described in paragraph (b)(2)(xi) of this section;

(xi) Trading as described in paragraph (b)(2)(xii) of this section;

(xii) Dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)) as described in paragraph (b)(2)(xiii) of this section; or

(xiii) Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners as defined in paragraph (b)(2)(xiv) of this section.

(2) *Additional rules for applying section 199A(d)(2) and paragraph (b) of this section*.

(i) *In general*. This paragraph (b)(2) provides additional rules for determining whether a business is an SSTB within the meaning of section 199A(d)(2) and paragraph (b) of this section only. The rules of this paragraph (b)(2) may not be taken into account for purposes of applying any provision of law or regulation other than section 199A and the regulations thereunder except to the extent such provision expressly refers to section 199A(d) or this section.

Prop. Reg. § 1.199A-5(b)(3), "Examples," provides caveats to its examples that are reproduced below in various parts of this part II.E.1.c.iv:

> The following examples illustrate the rules in paragraphs (a) and (b) of this section. The examples do not address all types of services that may or may not qualify as specified services. Unless otherwise provided, the individual in each example has taxable income in excess of the threshold amount.

II.E.1.c.iv.(b). Health

Footnote 44 of the Senate report commented about the services in the field of health:

> A similar list of service trades or business is provided in section 448(d)(2)(A) and Treas. Reg. sec. 1.448-1T(e)(4)(i). For purposes of section 448, Treasury regulations provide that the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers. See Treas. Reg. sec. 1.448-1T(e)(4)(ii).

The preamble, REG-107892-18 (8/16/2018), describes "Health":

> Proposed § 1.199A-5(b)(2)(ii) is informed by the definition of 'health' under section 448 and provides that the term 'performance of services in the field of health' means the provision of medical services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide medical services directly to a patient. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.

Prop. Reg. § 1.199A-5(b)(2)(ii), "Meaning of services performed in the field of health," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(i) of this section only, the performance of services in the field of health means the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists and other similar healthcare professionals performing services in their capacity as such who provide medical services directly to a patient (service recipient). The performance of services in the field of health does not include the provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or the research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.

II.E.1.c.iv.(c). Law

The preamble, REG-107892-18 (8/16/2018), describes "Law":

> Proposed § 1.199A-5(b)(2)(iii) is based on the ordinary meaning of 'services in the field of law' and provides that the term 'performance of services in the field of law' means the provision of services by lawyers, paralegals, legal arbitrators, mediators, and similar professionals in their capacity as such. The performance of services in the field of law does not include the provision of services that do not require skills unique to the field of law, for example, the provision of services in the field of law does not include the provision of services by printers, delivery services, or stenography services.

Prop. Reg. § 1.199A-5(b)(2)(iii), "Meaning of services performed in the field of law," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(ii) of this section only, the performance of services in the field of law means the performance of services by individuals such as lawyers, paralegals, legal arbitrators, mediators, and similar professionals performing services in their capacity as such. The performance of services in the field of law does not include the provision of services that do not require skills unique to the field of law, for example, the provision of services in the field of law does not include the provision of services by printers, delivery services, or stenography services.

II.E.1.c.iv.(d). Accounting

The preamble, REG-107892-18 (8/16/2018), describes "Accounting":

> Proposed § 1.199A-5(b)(2)(iv) is based on the ordinary meaning of 'accounting' and provides that the term 'performance of services in the field of accounting' means the provision of services by accountants, enrolled agents, return preparers, financial auditors, and similar professionals in their capacity as such. Provision of services in the field of accounting is not limited to services requiring state licensure as a certified public accountant (CPA). The aim of proposed § 1.199A-5(b)(2)(iv) is to capture the common understanding of accounting, which includes tax return and bookkeeping services, even though the provision of such services may not require the same education, training, or mastery of accounting principles as a CPA. The field of accounting does not include payment processing and billing analysis.

Prop. Reg. § 1.199A-5(b)(2)(iv), "Meaning of services performed in the field of accounting," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(iii) of this section only, the performance of services in the field of accounting means the provision of services by individuals such as accountants, enrolled agents, return preparers, financial auditors, and similar professionals performing services in their capacity as such.

II.E.1.c.iv.(e). Actuarial Science

The preamble, REG-107892-18 (8/16/2018), describes "Actuarial Science":

> Proposed § 1.199A-5(b)(2)(v) is based on the ordinary meaning 'actuarial science' and provides that the term 'performance of services in the field of actuarial science' means the provision of services by actuaries and similar professionals in their capacity as such. Accordingly, the field of actuarial science does not include the provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.

Prop. Reg. § 1.199A-5(b)(2)(v), "Meaning of services performed in the field of actuarial science," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(iv) of this section only, the performance of services in the field of actuarial science means the provision of services by individuals such as actuaries and similar professionals performing services in their capacity as such.

II.E.1.c.iv.(f). Performing Arts

Footnote 45 of the Senate report commented about the services in the field of performing arts:

> For purposes of the similar list of services in section 448, Treasury regulations provide that the performance of services in the field of the performing arts means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists

> (*e.g.*, persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts). Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate the performance of such artists to members of the public (*e.g.*, employees of a radio station that broadcasts the performances of musicians and singers). See Treas. Reg. sec. 1.448-1T(e)(4)(iii).

The preamble, REG-107892-18 (8/16/2018), describes "Performing Arts":

> Proposed § 1.199A-5(b)(2)(vi) is informed by the definition of 'performing arts' under section 448 and provides that the term 'performance of services in the field of the performing arts' means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such. The performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.

Prop. Reg. § 1.199A-5(b)(2)(vi), "Meaning of services performed in the field of performing arts," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(v) of this section only, the performance of services in the field of the performing arts means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such. The performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (1) provides:

> A, a singer, records a song. A is paid a mechanical royalty when the song is licensed or streamed. A is also paid a performance royalty when the recorded song is played publicly. A is engaged in the performance of services in an SSTB in the field of performing arts within the meaning of paragraphs (b)(1)(v) and (b)(2)(vi) of this section. The royalties that A receives for the song are not eligible for a deduction under section 199A.

II.E.1.c.iv.(g). Consulting

Footnote 46 of the Senate report commented about the services in the field of consulting:

> For purposes of the similar list of services in section 448, Treasury regulations provide that the performance of services in the field of consulting means the provision of advice and counsel. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or brokerage

> services, or economically similar services. For purposes of the preceding sentence, the determination of whether a person's services are sales or brokerage services, or economically similar services, shall be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided (*e.g.*, whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect). See Treas. Reg. sec. 1.448-1T(e)(4)(iv).

The preamble, REG-107892-18 (8/16/2018), describes "Consulting":

> Proposed § 1.199A-5(b)(2)(vii) is informed by the definition of 'consulting' under section 448 and provides that the term 'performance of services in the field of consulting' means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. The performance of services in the field of consulting does not include the performance of services other than advice and counsel. This determination is made based on all the facts and circumstances of a person's business.
>
> Additionally, the Treasury Department and the IRS are aware of the concern noted by commenters that in certain kinds of sales transactions it is common for businesses to provide consulting services in connection with the purchase of goods by customers. For example, a company that sells computers may provide customers with consulting services relating to the setup, operation, and repair of the computers, or a contractor who remodels homes may provide consulting prior to remodeling a kitchen. As described previously in this Explanation of Provisions, proposed § 1.199A-5(c) provides a de minimis rule, under which a trade or business is not an SSTB if less than 10 percent of the gross receipts (5 percent if the gross receipts are greater than $25 million) of the trade or business are attributable to the performance of services in a specified service activity. However, this de minimis rule may not provide sufficient relief for certain trades or business that provide ancillary consulting services. The Treasury Department and the IRS believe that if a trade or business involves the selling or manufacturing of goods, and such trade or business provides ancillary consulting services that are not separately purchased or billed, then such trades or businesses are not in a trade or business in the field of consulting. Accordingly, proposed § 1.199A-5(b)(2)(vii) provides that the field of consulting does not include consulting that is embedded in, or ancillary to, the sale of goods if there is no separate payment for the consulting services.

Prop. Reg. § 1.199A-5(b)(2)(vii), "Meaning of services performed in the field of consulting," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(vi) of this section only, the performance of services in the field of consulting means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. The performance of services in the field of consulting does not include the performance of

services other than advice and counsel, such as sales or economically similar services or the provision of training and educational courses. For purposes of the preceding sentence, the determination of whether a person's services are sales or economically similar services will be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided. Performance of services in the field of consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (3) provides:

> C is in the business of providing services that assist unrelated entities in making their personnel structures more efficient. C studies its client's organization and structure and compares it to peers in its industry. C then makes recommendations and provides advice to its client regarding possible changes in the client's personnel structure, including the use of temporary workers. C is engaged in the performance of services in an SSTB in the field of consulting within the meaning of paragraphs (b)(1)(vi) and (b)(2)(vii) of this section.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (4) provides:

> D is in the business of licensing software to customers. D discusses and evaluates the customer's software needs with the customer. The taxpayer advises the customer on the particular software products it licenses. D is paid a flat price for the software license. After the customer licenses the software, D helps to implement the software. D is engaged in the trade or business of licensing software and not engaged in an SSTB in the field of consulting within the meaning of paragraphs (b)(1)(vi) and (b)(2)(vii) of this section.

II.E.1.c.iv.(h). Athletics

The preamble, REG-107892-18 (8/16/2018), describes “Athletics”:

> The field of athletics is not listed in section 448(d)(2), and there is little guidance on its meaning as used in section 1202(e)(3)(A). However, commenters noted, and the Treasury Department and the IRS agree, that among the services specified in Section 199A(d)(2)(A) the field of athletics is most similar to the field of performing arts. Accordingly, proposed § 1.199A-5(b)(2) (viii) provides that the term ‘performance of services in the field of athletics’ means the performances of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing. The performance of services in the field of athletics does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Similarly, the performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

Prop. Reg. § 1.199A-5(b)(2)(viii), “Meaning of services performed in the field of athletics,” provides:

For purposes of section 199A(d)(2) and paragraph (b)(1)(vii) of this section only, the performance of services in the field of athletics means the performance of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing. The performance of services in the field of athletics does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Similarly, the performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (2) provides:

B is a partner in Partnership, which solely owns and operates a professional sports team. Partnership employs athletes and sells tickets to the public to attend games in which the sports team competes. Therefore, Partnership is engaged in the performance of services in an SSTB in the field of athletics within the meaning of paragraphs (b)(1)(vii) and (b)(2)(viii) of this section. B is a passive owner in Partnership and B does not provide any services with respect to Partnership or the sports team. However, because Partnership is engaged in an SSTB in the field of athletics, B's distributive share of the income, gain, loss, and deduction with respect to Partnership is not eligible for a deduction under section 199A.

II.E.1.c.iv.(i). Financial Services

The preamble, REG-107892-18 (8/16/2018), describes "Financial Services":

Commenters requested guidance as to whether financial services includes banking. These commenters noted that section 1202(e)(3)(A) includes the term financial services, but that banking in separately listed in section 1202(e)(3)(B) which suggests that banking is not included as part of financial services in section 1202(e)(3)(A). The Treasury Department and the IRS agree with such commenters that this suggests that financial services should be more narrowly interpreted here. Therefore, proposed § 1.199A-5(b)(2)(ix) limits the definition of financial services to services typically performed by financial advisors and investment bankers and provides that the field of financial services includes the provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 or similar cases), and raising financial capital by underwriting, or acting as the client's agent in the issuance of securities, and similar services. This includes services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals, but does not include taking deposits or making loans.

Prop. Reg. § 1.199A-5(b)(2)(ix), "Meaning of services performed in the field of financial services," provides:

For purposes of section 199A(d)(2) and paragraph (b)(1)(viii) of this section only, the performance of services in the field of financial services means the provision of financial services to clients including managing wealth, advising clients with respect to finances,

> developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 or similar cases), and raising financial capital by underwriting, or acting as a client's agent in the issuance of securities and similar services. This includes services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals performing services in their capacity as such.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (5) provides:

> E is in the business of providing services to assist clients with their finances. E will study a particular client's financial situation, including, the client's present income, savings and investments, and anticipated future economic and financial needs. Based on this study, E will then assist the client in making decisions and plans regarding the client's financial activities. Such financial planning includes the design of a personal budget to assist the client in monitoring the client's financial situation, the adoption of investment strategies tailored to the client's needs, and other similar services. E is engaged in the performance of services in an SSTB in the field of financial services within the meaning of paragraphs (b)(1)(viii) and (b)(2)(ix) of this section.

II.E.1.c.iv.(j). Brokerage Services

The preamble, REG-107892-18 (8/16/2018), describes "Brokerage Services":

> Proposed § 1.199A-5(b)(2)(x) uses the ordinary meaning of 'brokerage services' and provides that the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. This includes services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

Prop. Reg. § 1.199A-5(b)(2)(x), "Meaning of services performed in the field of brokerage services," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(ix) of this section only, the performance of services in the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. This includes services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (6) provides:

> F is in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks. Customers place orders with F to trade securities or commodities based on the taxpayer's recommendations. F's compensation for its services typically is based on completion of the trade orders. F is engaged in an SSTB in the field of brokerage services within the meaning of paragraphs (b)(1)(ix) and (b)(2)(x) of this section.

II.E.1.c.iv.(k). Investing and Investment Management

The preamble, REG-107892-18 (8/16/2018), describes "Investing and Investment Management":

> Proposed § 1.199A-5(b)(2)(xi) uses the ordinary meaning of 'investing and investment management' and provides that any trade or business that involves the 'performance of services that consist of investing and investment management' means a trade or business that earns fees for investment, asset management services, or investment management services including providing advice with respect to buying and selling investments. The performance of services that consist of investing and investment management would include a trade or business that receives either a commission, a flat fee, or an investment management fee calculated as a percentage of assets under management. The performance of services of investing and investment management does not include directly managing real property.

Prop. Reg. § 1.199A-5(b)(2)(xi), "Meaning of the provision of services in investing and investment management," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(x) of this section only, the performance of services that consist of investing and investment management refers to a trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments. The performance of services of investing and investment management does not include directly managing real property.

II.E.1.c.iv.(l). Trading

The preamble, REG-107892-18 (8/16/2018), describes "Trading":

> Proposed § 1.199A-5(b)(2)(xii) provides that any trade or business involving the 'performance of services that consist of trading' means a trade or business of trading in securities, commodities, or partnership interests. Whether a person is a trader is determined taking into account the relevant facts and circumstances. Factors that have been considered relevant to determining whether a person is a trader include the source and type of profit generally sought from engaging in the activity regardless of whether the activity is being provided on behalf of customers or for a taxpayer's own account. See *Endicott v. Commissioner*, T.C. Memo. 2013-199; *Nelson v. Commissioner*, T.C. Memo. 2013-259, *King v. Commissioner*, 89 T.C. 445 (1987). A person that is a trader under these principles will be treated as performing the services of trading for purposes of Section 199A(d)(2)(B).

Prop. Reg. § 1.199A-5(b)(2)(xii), "Meaning of the provision of services in trading," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(xi) of this section only, the performance of services that consist of trading means a trade or business of trading in securities (as defined in section 475(c)(2)), commodities (as defined in section 475(e)(2)), or partnership interests. Whether a person is a trader in securities, commodities, or partnership interests is determined by taking into account all relevant facts and circumstances, including the source and type of profit that is associated with engaging in the activity regardless of whether that person trades for the person's own account, for the account of others, or any combination thereof. A taxpayer, such as a manufacturer or a

farmer, who engages in hedging transactions as part of their trade or business of manufacturing or farming is not considered to be engaged in the trade or business of trading commodities.

II.E.1.c.iv.(m). Dealing in Securities, Partnership Interests, or Commodities

The preamble, REG-107892-18 (8/16/2018), describes "Dealing in Securities, Partnership Interests, and Commodities":

> For purposes of proposed § 1.199A-5(b)(2)(xiii), the 'performance of services that consist of dealing in securities (as defined in section 475(c)(2))' means regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. For purposes of the preceding sentence, a taxpayer that regularly originates loans in the ordinary course of a trade or business of making loans but engages in no more than negligible sales of the loans is not dealing in securities for purposes of Section 199A(d)(2). See § 1.475(c)-1(c)(2) and (4) for the definition of negligible sales.
>
> For purposes of proposed § 1.199A-5(b)(2)(xiii), 'the performance of services that consist of dealing in partnership interests' means regularly purchasing partnership interests from and selling partnership interests to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in partnership interests with customers in the ordinary course of a trade or business.
>
> For purposes of proposed § 1.199A-5(b)(2)(xiii), 'the performance of services that consist of dealing in commodities (as defined in section 475(e)(2))' means regularly purchasing commodities from and selling commodities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in commodities with customers in the ordinary course of a trade or business.

Prop. Reg. § 1.199A-5(b)(2)(xiii), "Meaning of the provision of services in dealing," provides:

> (A) *Dealing in securities*. For purposes of section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, the performance of services that consist of dealing in securities (as defined in section 475(c)(2)) means regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. For purposes of the preceding sentence, however, a taxpayer that regularly originates loans in the ordinary course of a trade or business of making loans but engages in no more than negligible sales of the loans is not dealing in securities for purposes of section 199A(d)(2) and this section. See § 1.475(c)-1(c)(2) and (4) for the definition of negligible sales.
>
> (B) *Dealing in commodities*. For purposes of section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, the performance of services that consist of dealing in commodities (as defined in section 475(e)(2)) means regularly purchasing commodities from and selling commodities to customers in the ordinary course of a trade or business or

regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in commodities with customers in the ordinary course of a trade or business.

(C) *Dealing in partnership interests*. For purposes of section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, the performance of services that consist of dealing in partnership interests means regularly purchasing partnership interests from and selling partnership interests to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in partnership interests with customers in the ordinary course of a trade or business.

II.E.1.c.iv.(n). Any Trade or Business Where the Principal Asset of Such Trade or Business Is the Reputation or Skill of One or More of Its Employees or Owners

The preamble, REG-107892-18 (8/16/2018), describes "Any Trade or Business Where the Principal Asset of Such Trade or Business Is the Reputation or Skill of 1 or More of Its Employees or Owners":

> Guidance on the meaning of the 'reputation or skill' clause in section 1202(e)(3)(A) is limited to dicta in one case. In *John P. Owen v. Commissioner*, T.C. Memo. 2012-21, the Tax Court examined whether Mr. Owen, whose business was insurance, was entitled to benefits under section 1202 with respect to the sale of his interest in a corporation conducting such business. Under the facts described in the case, the corporation had extensive training programs and sales structures, but primarily relied on the services of independent contractors (including Mr. Owen) in conducting its business. Although the Tax Court acknowledged that the business' success was due to Mr. Owen's efforts, it found that the principal asset of the company in question was the training program and sales structure of the business rather than Mr. Owen's services.
>
> The Treasury Department and the IRS received several comments regarding the meaning of the 'reputation or skill' clause. Commenters described potential methods to give maximum effect to the literal language of the reputation or skill clause by describing ways to (1) determine the extent to which the reputation or skill of employees or owners constitutes an asset of the business under Federal tax accounting principles, and (2) measure whether such an asset is in fact the principal asset of the business.
>
> One commenter suggested using an activity-based standard under which no service-based businesses would qualify for the Section 199A deduction. An SSTB definition this broad would not comport with the statute and would deny a Section 199A deduction to businesses that the statute does not appear to exclude. If the 'reputation or skill' clause was intended to exclude all service businesses from Section 199A, there would have been no reason to enumerate specific types of businesses in Section 199A(d)(2); that language would be pure surplusage. A broad service-based test would also fail to provide a clear classification of businesses that combine services with sales of products, such as plumbing and HVAC services, if those businesses sell goods or equipment in the course of providing services. Therefore, the Treasury Department and the IRS do not believe it is consistent with the text, structure, or purpose of Section 199A to exclude all service businesses above the threshold amount from qualifying for the Section 199A deduction.

Another commenter described a balance sheet test that would compare the value of assets other than goodwill and workforce in place to the value of such goodwill and workforce in place. The commenter acknowledged that such a test could also be broader than Congress intended. In addition, the commenter noted that such a test could easily lead to strange and unintuitive results, and may be difficult to apply in the case of small businesses that do not maintain audited financial statements and would both be ripe for abuse, and could potentially result in many legal disputes between taxpayers and the IRS.

Finally, one commenter described a standard based on whether the trade or business involves the provision of highly-skilled services. The commenter argued that the primary benefit of a standard like this is that it would harmonize the meaning of the reputation or skill phrase with the trades or businesses listed in section 1202(e)(3)(A), each of which involve the provision of services by professionals who either received a substantial amount of training (for example, doctors, nurses, lawyers, and accountants), or who have otherwise achieved a high degree of skill in a given field (for example, professional athletes or performing artists).

Congress enacted Section 199A to provide a deduction from taxable income to trades or businesses conducted by sole proprietorships and passthrough entities that do not benefit from the income tax rate reduction afforded to C corporations under the TCJA. The Treasury Department and the IRS are concerned that a broad definition of the 'reputation or skill' phrase that relied on a balance sheet test or numerical ratios would have several consequences inconsistent with the intent of Section 199A. Testing businesses based on metrics, some of them subjective, that change over time could result in inappropriate year-over-year tax consequences and lead to distorted decision-making. As the commenters noted, such mechanical tests pose administrative difficulties and fail to provide taxpayers with needed certainty regarding the tax law necessary for conducting their business affairs. Most significantly, such mechanical rules might prevent trades or businesses that Congress intended to be eligible for the Section 199A deduction from claiming the Section 199A deduction.

In sum, the Treasury Department and the IRS believe that the 'reputation or skill' clause as used in Section 199A was intended to describe a narrow set of trades or businesses, not otherwise covered by the enumerated specified services, in which income is received based directly on the skill and/or reputation of employees or owners. Additionally, the Treasury Department and the IRS believe that 'reputation or skill' must be interpreted in a manner that is both objective and administrable. Thus, proposed § 1.199A-5(b)(2)(xiv) limits the meaning of the 'reputation or skill' clause to fact patterns in which the individual or RPE is engaged in the trade or business of: (1) receiving income for endorsing products or services, including an individual's distributive share of income or distributions from an RPE for which the individual provides endorsement services; (2) licensing or receiving income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity, including an individual's distributive share of income or distributions from an RPE to which an individual contributes the rights to use the individual's image; or (3) receiving appearance fees or income (including fees or income to reality performers performing as themselves on television, social media, or other forums, radio, television, and other media hosts, and video game players). Proposed § 1.199A-5(b)(4) contains two examples illustrating the application of this definition. The Treasury Department and the IRS request comments on this rule, the clarity of definitions for the statutorily enumerated trades or businesses that are SSTBs under Section 199A(d)(2)(A), and the accompanying examples.

Prop. Reg. § 1.199A-5(b)(2)(xiv), "Meaning of trade or business where the principal asset of such trade or business is the reputation or skill of one or more employees or owners," provides:

> For purposes of section 199A(d)(2) and paragraph (b)(1)(xiii) of this section only, the term any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners means any trade or business that consists of any of the following (or any combination thereof):
>
> (A) A trade or business in which a person receives fees, compensation, or other income for endorsing products or services,
>
> (B) A trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity,
>
> (C) Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format.
>
> (D) For purposes of paragraph (b)(2)(xiv)(A) through (C) of this section, the term fees, compensation, or other income includes the receipt of a partnership interest and the corresponding distributive share of income, deduction, gain or loss from the partnership, or the receipt of stock of an S corporation and the corresponding income, deduction, gain or loss from the S corporation stock.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (7) provides:

> G owns 100% of Corp, an S corporation, which operates a bicycle sales and repair business. Corp has 8 employees, including G. Half of Corp's net income is generated from sales of new and used bicycles and related goods, such as helmets, and bicycle-related equipment. The other half of Corp's net income is generated from bicycle repair services performed by G and Corp's other employees. Corp's assets consist of inventory, fixtures, bicycle repair equipment, and a leasehold on its retail location. Several of the employees and G have worked in the bicycle business for many years, and have acquired substantial skill and reputation in the field. Customers often consult with the employees on the best bicycle for purchase. G is in the business of sales and repairs of bicycles and is not engaged in an SSTB within the meaning of paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (8) provides:

> H is a well-known chef and the sole owner of multiple restaurants each of which is owned in a disregarded entity. Due to H's skill and reputation as a chef, H receives an endorsement fee of $500,000 for the use of H's name on a line of cooking utensils and cookware. H is in the trade or business of being a chef and owning restaurants and such trade or business is not an SSTB. However, H is also in the trade or business of receiving endorsement income. H's trade or business consisting of the receipt of the endorsement fee for H's skill and/or reputation is an SSTB within the meaning of paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

Prop. Reg. § 1.199A-5(b)(3) [click on citation for caveats], Example (9) provides:

> J is a well-known actor. J entered into a partnership with Shoe Company, in which J contributed her likeness and the use of her name to the partnership in exchange for a 50% interest in the capital and profits of the partnership and a guaranteed payment. J's trade or business consisting of the receipt of the partnership interest and the corresponding distributive share with respect to the partnership interest for J's likeness and the use of her name is an SSTB within the meaning of paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

II.E.1.c.iv.(o). SSTB Very Broad Anti-Abuse Rules

The preamble, REG-107892-18 (8/16/2018), "Defining What is Included in an SSTB," provides:

> The Treasury Department and the IRS are aware that some taxpayers have contemplated a strategy to separate out parts of what otherwise would be an integrated SSTB, such as the administrative functions, in an attempt to qualify those separated parts for the Section 199A deduction. Such a strategy is inconsistent with the purpose of Section 199A. Therefore, in accordance with Section 199A(f)(4), in order to carry out the purposes of Section 199A, proposed § 1.199A-5(c)(2) provides that an SSTB includes any trade or business with 50 percent or more common ownership (directly or indirectly) that provides 80 percent or more of its property or services to an SSTB. Additionally, if a trade or business has 50 percent or more common ownership with an SSTB, to the extent that the trade or business provides property or services to the commonly-owned SSTB, the portion of the property or services provided to the SSTB will be treated as an SSTB (meaning the income will be treated as income from an SSTB). For example, A, a dentist, owns a dental practice and also owns an office building. A rents half the building to the dental practice and half the building to unrelated persons. Under proposed § 1.199A-5(c)(2), the renting of half of the building to the dental practice will be treated as an SSTB.
>
> Additionally, proposed § 1.199A-5 provides a rule that if a trade or business (that would not otherwise be treated as an SSTB) has 50 percent or more common ownership with an SSTB and shared expenses, including wages or overhead expenses with the SSTB, it is treated as incidental to an SSTB and, therefore, as an SSTB, if the trade or business represents no more than five percent of gross receipts of the combined business.

Prop. Reg. § 1.199A-5(c), "Special rules," provides:

> (1) *De minimis rule*.
>
> > (i) *Gross receipts of $25 million or less*. For a trade or business with gross receipts of $25 million dollars or less for the taxable year, a trade or business is not an SSTB if less than 10 percent of the gross receipts of the trade or business are attributable to the performance of services in a field described in paragraph (b) of this section. For purposes of determining whether this 10 percent test is satisfied, the performance of any activity incident to the actual performance of services in the field is considered the performance of services in that field.
> >
> > (ii) *Gross receipts of greater than $25 million*. For a trade or business with gross receipts of greater than $25 million for the taxable year, the rules of

paragraph (c)(1)(i) of this section are applied by substituting "5 percent" for "10 percent" each place it appears.

(2) *Services or property provided to an SSTB*.

(i) *In general*. An SSTB includes any trade or business that provides 80 percent or more of its property or services to an SSTB if there is 50 percent or more common ownership of the trades or businesses.

(ii) *Less than substantially all of property or services provided*. If a trade or business provides less than 80 percent of its property or services to an SSTB within the meaning of this section and there is 50 percent or more common ownership of the trades or businesses, that portion of the trade or business of providing property or services to the 50 percent or more commonly-owned SSTB is treated as a part of the SSTB.

(iii) *50 percent or more common ownership*. For purposes of paragraphs (c)(2)(i) and (ii) of this section, 50 percent or more common ownership includes direct or indirect ownership by related parties within the meaning of sections 267(b) or 707(b).

(iv) *Example*. Law Firm is a partnership that provides legal services to clients, owns its own office building and employs its own administrative staff. Law Firm divides into three partnerships. Partnership 1 performs legal services to clients. Partnership 2 owns the office building and rents the entire building to Partnership 1. Partnership 3 employs the administrative staff and through a contract with Partnership 1 provides administrative services to Partnership 1 in exchange for fees. All three of the partnerships are owned by the same people (the original owners of Law Firm). Because there is 50% or more common ownership of each of the three partnerships, Partnership 2 provides substantially all of its property to Partnership 1, and Partnership 3 provides substantially all of its services to Partnership 1, Partnerships 1, 2, and 3 will be treated as one SSTB under paragraph (a)(6) of this section.

(3) *Incidental to specified service trade or business*.

(i) *In general*. If a trade or business (that would not otherwise be treated as an SSTB) has 50 percent or more common ownership with an SSTB, including related parties (within the meaning of sections 267(b) or 707(b)), and has shared expenses with the SSTB, including shared wage or overhead expenses, then such trade or business is treated as incidental to and, therefore, part of the SSTB within the meaning of this section if the gross receipts of the trade or business represents no more than 5 percent of the total combined gross receipts of the trade or business and the SSTB in a taxable year.

(ii) *Example*. A, a dermatologist, provides medical services to patients on a regular basis through Dermatology LLC, a disregarded entity owned by A. In addition to providing medical services, Dermatology LLC also sells skin care products to A's patients. The same employees and office space are used for the medical services and sale of skin care products. The gross receipts with respect to the skin care product sales do not exceed 5% of the gross receipts of Dermatology LLC.

> Accordingly, the sale of the skin care products is treated as incidental to A's SSTB of performing services in the field of health (within the meaning of paragraph (b)(1)(i) and (b)(2)(ii) of this section) and is treated under paragraph (c)(3) of this section as part of such SSTB.

Code § 267(b) is reproduced in part II.G.3.i.iv Code § 267 Disallowance of Related-Party Deductions or Losses. For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

II.E.1.c.v. Calculation of Deduction Generally

Taxpayers other than C corporations may deduct a portion of qualified business income ("QBI") and qualified cooperative dividends ("QCDs"). Code § 199A(a) provides:

> *In general*. In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year an amount equal to the sum of—
>
> (1) the lesser of -
>
> (A) the combined qualified business income amount of the taxpayer, or
>
> (B) an amount equal to 20 percent of the excess (if any) of-
>
> (i) the taxable income of the taxpayer for the taxable year, over
>
> (ii) the sum of any net capital gain (as defined in section 1(h)), plus the aggregate amount of the qualified cooperative dividends, of the taxpayer for the taxable year, plus
>
> (2) the lesser of -
>
> (A) 20 percent of the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year, or
>
> (B) taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.
>
> The amount determined under the preceding sentence shall not exceed the taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

The deduction for QCDs[701] is not a focus of this document,[702] nor do Prop. Reg. §§ 1.199A-1 through 1.199A-6 address it.[703] Note the limitation related to net capital gain.[704] This limitation seems designed to keep the capital gain rate as the floor for a taxpayer's rate and not let the QBI/QCD deduction reduce that rate. Capital gains cannot be QBI.[705] In understanding how this limitation works, note that the QBI/QCD deduction is not a deduction in arriving at gross income, is not a deduction in arriving at adjusted gross income, and is not an itemized deduction.[706] When one calculates income tax, one calculates it on taxable income with and without net capital gain.[707] Thus, this limit on the QBI deduction is applied after all business and nonbusiness income and deductions are calculated to determine taxable income. Therefore, if capital gain can be QBI, the

---

[701] Code § 199A(e)(4) provides:

> *Qualified Cooperative Dividend*. The term "qualified cooperative dividend" means any patronage dividend (as defined in section 1388(a)), any per-unit retain allocation (as defined in section 1388(f)), and any qualified written notice of allocation (as defined in section 1388(c)), or any similar amount received from an organization described in subparagraph (B)(ii), which—
>
> (A) is includible in gross income, and
>
> (B) is received from—
>
> (i) an organization or corporation described in section 501(c)(12) or 1381(a), or
>
> (ii) an organization which is governed under this title by the rules applicable to cooperatives under this title before the enactment of subchapter T.

[702] The Senate report explained (footnotes omitted) (remember that the Conference Committee reduced the deduction from 23% to 20%):

> A deduction is allowed under the provision for 23 percent of the taxpayer's aggregate amount of qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income for the taxable year. Qualified REIT dividends do not include any portion of a dividend received from a REIT that is a capital gain dividend or a qualified dividend. A qualified cooperative dividend means a patronage dividend, per-unit retain allocation, qualified written notice of allocation, or any similar amount, provided it is includible in gross income and is received from either (1) a tax-exempt benevolent life insurance association, mutual ditch or irrigation company, cooperative telephone company, like cooperative organization, or a taxable or tax-exempt cooperative that is described in section 1381(a), or (2) a taxable cooperative governed by tax rules applicable to cooperatives before the enactment of subchapter T of the Code in 1962. Qualified publicly traded partnership income means (with respect to any qualified trade or business of the taxpayer), the sum of the (a) the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (that are effectively connected with a U.S. trade or business and are included or allowed in determining taxable income for the taxable year and do not constitute excepted enumerated investment-type income, and not including the taxpayer's reasonable compensation, guaranteed payments for services, or (to the extent provided in regulations) section 707(a) payments for services) from a publicly traded partnership not treated as a corporation, and (b) gain recognized by the taxpayer on disposition of its interest in the partnership that is treated as ordinary income (for example, by reason of section 751).

[703] Reg. § 1.199A-1(a)(1) concludes with:

> This section and §§1.199A-2 through 1.199A-6 do not apply for purposes of calculating the deduction in section 199A(g) for specified agricultural and horticultural cooperatives.

[704] Although Code § 199A(a)(1)(B)(ii) refers to Code § 1(h) to define "net capital gain," Code § 1(h) does not define the term. "Net capital gain" means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year. Code § 1222(11), which applies for purposes of subtitle A (Code §§ 1-1563).

[705] See Prop. Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

[706] See fns 648-649 in part II.E.1.c.i.(a) Summary of Impact of Deduction.

[707] Code § 1(h).

related deduction can be applied against any business or nonbusiness income that is not net capital gain.

The QBI-based deduction is the lesser of the taxpayer's combined QBI amount or 20% of the excess (if any) of (i) the taxpayer's taxable income over (ii) the sum of the taxpayer's net capital gain and aggregate QCDs.[708]

The combined QBI amount is (A) the sum of certain QBI-related amounts for each qualified trade or business the taxpayer carries on, plus (B) "20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year."[709] By "qualified" I mean not a specified service trade or business (SSTB)[710] unless taxable income is below certain thresholds.[711]

All of the analysis in this part II.E.1.c.v Calculation of Deduction Generally needs to be viewed in light of part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

Parts II.E.1.c.v.(b) and II.E.1.c.v.(c) below provide details on this part II.E.1.c.v and refer to the threshold amount, which is described in part II.E.1.c.v.(a) Taxable Income "Threshold

II.E.1.c.v.(a). Taxable Income "Threshold Amount"

The wage limitation[712] and the disqualification of SSTBs[713] are eased up or do not apply if the taxpayer's taxable income, computed without regard to the Code § 199A deduction,[714] is below the "threshold amount." The "threshold amount" is $315,000 for a joint return and $157,500 for any other return.[715] The "threshold amount" will be indexed for inflation in a manner similar to indexing the income tax brackets.[716] Prop. Reg. § 1.199A-1(b)(11) provides:

> Threshold amount means, for any taxable year beginning before 2019, $157,500 (or $315,000 in the case of a taxpayer filing a joint return). In the case of any taxable year beginning after 2018, the threshold amount is the dollar amount in the preceding sentence increased by an amount equal to such dollar amount, multiplied by the cost-of-living adjustment determined under section 1(f)(3) of the Code for the calendar

---

[708] Code § 199A(a)(1).
[709] Code § 199A(b)(1). Fn 663 defines "qualified REIT dividend" and "qualified publicly traded partnership income."
[710] See part II.E.1.c.iv Specified Service Trade or Business (SSTB).
[711] For the latter, see part II.E.1.c.v.(a) Taxable Income "Threshold.
[712] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[713] See text accompanying fns. 699-700 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.
[714] Code § 199A(e)(1).
[715] Code § 199A(e)(2)(A).
[716] Code § 199A(e)(2)(B) provides:

> INFLATION ADJUSTMENT.—In the case of any taxable year beginning after 2018, the dollar amount in subparagraph (A) shall be increased by an amount equal to—
> (i) such dollar amount, multiplied by
> (ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting "calendar year 2017" for "calendar year 2016" in subparagraph (A)(ii) thereof.
>
> The amount of any increase under the preceding sentence shall be rounded as provided in section 1(f)(7).

year in which the taxable year begins, determined by substituting "calendar year 2017" for "calendar year 2016" in section 1(f)(3)(A)(ii). The amount of any increase under the preceding sentence is rounded as provided in section 1(f)(7) of the Code.

The preamble to Prop. Reg. § 1.199A-2, REG-107892-18 (8/16/2018), explains:

B. Computation of the Section 199A Deduction for Individuals With Taxable Income Below the Threshold Amount

1. Basic Computational Rules

An individual with income attributable to one or more domestic trades or businesses, other than as a result of owning stock of a C corporation or engaging in the trade or business of being an employee, and with taxable income (before computing the Section 199A deduction) at or below the threshold amount, is entitled to a Section 199A deduction equal to the lesser of (i) 20 percent of the QBI (generally defined as the net amount of qualified items of income, gain, deduction, and loss with respect to a qualified trade or business of the taxpayer) from the individual's trades or businesses plus 20 percent of the individual's combined qualified REIT dividends and qualified PTP income or (ii) 20 percent of the excess (if any) of the individual's taxable income over the individual's net capital gain. Proposed § 1.199A-1(c) contains guidance on calculating the amount of the deduction in these circumstances. If an individual's combined QBI is negative or combined qualified REIT dividends and PTP income is less than zero, proposed § 1.199A-1(c)(2) provides rules for the carryover of the losses.

2. Carryover Loss Rules for Negative Total QBI Amounts

If an individual has multiple trades or businesses, the individual must calculate the QBI from each trade or business and then net the amounts. Section 199A(c)(2) provides that, for purposes of Section 199A, if the net QBI with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount shall be treated as a loss from a qualified trade or business in the succeeding taxable year. Proposed § 1.199A-1(c)(2)(i) repeats this rule and provides that the Section 199A carryover rules do not affect the deductibility of the losses for purposes of other provisions of the Code.

3. Carryover Loss Rules if Combined Qualified REIT Dividends and Qualified PTP Income is Less Than Zero

One commenter stated it was not clear whether, if a taxpayer has an overall loss from combined qualified REIT dividends and qualified PTP income (because a loss from a PTP exceeds REIT dividends and PTP income), the negative amount should be netted against any net positive QBI (regardless of source), or whether the negative amount should be segregated and subject to its own loss carryforward rule distinct from but analogous to the QBI loss carryforward rule. Section 199A contemplates that qualified REIT dividends and qualified PTP income are computed and taken into account separately from QBI and should not affect QBI. If overall losses attributable to qualified REIT dividends and qualified PTP income were netted against QBI, these losses would affect QBI. Therefore, a separate loss carryforward rule is needed to segregate an overall loss attributable to qualified REIT dividends and qualified PTP income from QBI. Additionally, commenters have expressed concern that losses in excess of income could create a negative Section 199A deduction, a result incompatible with the statute. Accordingly, proposed

§ 1.199A-1(c)(2)(ii) provides that if an individual has an overall loss after qualified REIT dividends and qualified PTP income are combined, the portion of the individual's Section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. In addition, the overall loss does not affect the amount of the taxpayer's QBI. Instead, such overall loss is carried forward and must be used to offset combined qualified REIT dividends and qualified PTP income in the succeeding taxable year or years for purposes of Section 199A.

Prop. Reg. § 1.199A-1(c), "Computation of the § 199A deduction for individuals with taxable income not exceeding threshold amount," provides:

(1) *In general*. The Section 199A deduction is determined for individuals with taxable income for the taxable year that does not exceed the threshold amount by adding 20 percent of the total QBI amount (including QBI attributable to an SSTB) and 20 percent of the combined amount of qualified REIT dividends and qualified PTP income (including the individual's share of qualified REIT dividends, and qualified PTP income from RPEs). That sum is then compared to 20 percent of the amount by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's Section 199A deduction.

(2) *Carryover rules*.

(i) *Negative total QBI amount*. If the total QBI amount is less than zero, the portion of the individual's Section 199A deduction related to QBI is zero for the taxable year. The negative total QBI amount is treated as negative QBI from a separate trade or business in the succeeding taxable year of the individual for purposes of Section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

(ii) *Negative combined qualified REIT dividends/qualified PTP income*. If the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of the individual's Section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends and qualified PTP income in the succeeding taxable year of the individual for purposes of Section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

Prop. Reg. § 1.199A-1(c)(3), "Examples," provides:

The following examples illustrate the provisions of this paragraph (c). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(1) of this section and all of tax items are effectively connected to a trade or business within the United States within the meaning of section 864(c). Total taxable income does not include the Section 199A deduction.

Prop. Reg. § 1.199A-1(c)(3), Example (1), provides:

> A, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business generated $100,000 in net taxable income from operations in 2018. A has no capital gains or losses. After allowable deductions not relating to the business, A's total taxable income for 2018 is $81,000. The business's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. A's Section 199A deduction for 2018 is equal to $16,200, the lesser of 20% of A's QBI from the business ($100,000 x 20% = $20,000) and 20% of A's total taxable income for the taxable year ($81,000 x 20% = $16,200).

Prop. Reg. § 1.199A-1(c)(3), Example (2), provides:

> Assume the same facts as in Example 1 of this paragraph (c)(3), except that A also has $7,000 in net capital gain for 2018 and that, after allowable deductions not relating to the business, A's taxable income for 2018 is $74,000. A's taxable income minus net capital gain is $67,000 ($74,000 - $7,000). A's Section 199A deduction is equal to $13,400, the lesser of 20% of A's QBI from the business ($100,000 x 20% = $20,000) and 20% of A's total taxable income minus net capital gain for the taxable year ($67,000 x 20% = $13,400).

Prop. Reg. § 1.199A-1(c)(3), Example (3), provides:

> B and C are married and file a joint individual income tax return. B earned $500,000 in wages as an employee of an unrelated company in 2018. C owns 100% of the shares of X, an S corporation that provides landscaping services. X generated $100,000 in net income from operations in 2018. X paid C $150,000 in wages in 2018. B and C have no capital gains or losses. After allowable deductions not related to X, B and C's total taxable income for 2018 is $270,000. B's and C's wages are not considered to be income from a trade or business for purposes of the Section 199A deduction. Because X is an S corporation, its QBI is determined at the S corporation level. X's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. The wages paid by X to C are considered to be a qualified item of deduction for purposes of determining X's QBI. The Section 199A deduction with respect to X's QBI is then determined by C, X's sole shareholder, and is claimed on the joint return filed by B and C. B and C's Section 199A deduction is equal to $20,000, the lesser of 20% of C's QBI from the business ($100,000 x 20% = $20,000) and 20% of B and C's total taxable income for the taxable year ($270,000 x 20% = $54,000).

Prop. Reg. § 1.199A-1(c)(3), Example (4), provides:

> Assume the same facts as in Example 3 of this paragraph (c)(3) except that B also earns $1,000 in qualified REIT dividends and $500 in qualified PTP income in 2018, increasing taxable income to $271,500. B and C's Section 199A deduction is equal to $20,300, the lesser of (i) 20% of C's QBI from the business ($100,000 x 20% = $20,000) plus 20% of B's combined qualified REIT dividends and qualified PTP income ($1,500 x 20% = $300) and (ii) 20% of B and C's total taxable for the taxable year ($271,500 x 20% = $54,300).

II.E.1.c.v.(b). Calculation When Taxable Income Does Not Exceed the Threshold Amount

Prop. Reg. § 1.199A-1(c)(1) combines the above, as well as the benefits of taxable income not exceeding the threshold amount:[717]

> *In general*. The section 199A deduction is determined for individuals with taxable income for the taxable year that does not exceed the threshold amount by adding 20 percent of the total QBI amount (including QBI attributable to an SSTB) and 20 percent of the combined amount of qualified REIT dividends and qualified PTP income (including the individual's share of qualified REIT dividends, and qualified PTP income from RPEs). That sum is then compared to 20 percent of the amount by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's section 199A deduction.

Prop. Reg. § 1.199A-1(b)(12) provides:

> Total QBI amount means the net total QBI from all trades or businesses (including the individual's share of QBI from trades or business conducted by RPEs).

Prop. Reg. § 1.199A-1(c)(3), "Examples," provides:

> The following examples illustrate the provisions of this paragraph (c). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(1) of this section and all of tax items are effectively connected to a trade or business within the United States within the meaning of section 864(c). Total taxable income does not include the section 199A deduction.

Prop. Reg. § 1.199A-1(c)(3), Example (1) provides:

> A, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business generated $100,000 in net taxable income from operations in 2018. A has no capital gains or losses. After allowable deductions not relating to the business, A's total taxable income for 2018 is $81,000. The business's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. A's section 199A deduction for 2018 is equal to $16,200, the lesser of 20% of A's QBI from the business ($100,000 x 20% = $20,000) and 20% of A's total taxable income for the taxable year ($81,000 x 20% = $16,200).

Prop. Reg. § 1.199A-1(c)(3), Example (2) provides:

> Assume the same facts as in Example 1 of this paragraph (c)(3), except that A also has $7,000 in net capital gain for 2018 and that, after allowable deductions not relating to the business, A's taxable income for 2018 is $74,000. A's taxable income minus net capital gain is $67,000 ($74,000 - $7,000). A's section 199A deduction is equal to $13,400, the lesser of 20% of A's QBI from the business ($100,000 x 20% = $20,000) and 20% of A's

[717] For the latter, see part II.E.1.c.v.(a) Taxable Income "Threshold.

> total taxable income minus net capital gain for the taxable year ($67,000 x 20% = $13,400).

The difference between the facts in the two examples is that A's total taxable income minus net capital gain in Example (2) was only $67,000, which is $14,000 less than $81,000 in Example (1). Because in each example the total QBI amount exceeded total taxable income minus net capital gain, the change in total taxable income minus net capital gain is the sole difference accounting for the difference in the deduction. Multiplying this $14,000 difference by 20% equals $2,800, which equals the difference between the $16,200 deduction in Example (1) and the $13,400 deduction in Example (2).

Prop. Reg. § 1.199A-1(c)(3), Example (3) provides:

> B and C are married and file a joint individual income tax return. B earned $500,000 in wages as an employee of an unrelated company in 2018. C owns 100% of the shares of X, an S corporation that provides landscaping services. X generated $100,000 in net income from operations in 2018. X paid C $150,000 in wages in 2018. B and C have no capital gains or losses. After allowable deductions not related to X, B and C's total taxable income for 2018 is $270,000. B's and C's wages are not considered to be income from a trade or business for purposes of the section 199A deduction. Because X is an S corporation, its QBI is determined at the S corporation level. X's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. The wages paid by X to C are considered to be a qualified item of deduction for purposes of determining X's QBI. The section 199A deduction with respect to X's QBI is then determined by C, X's sole shareholder, and is claimed on the joint return filed by B and C. B and C's section 199A deduction is equal to $20,000, the lesser of 20% of C's QBI from the business ($100,000 x 20% = $20,000) and 20% of B and C's total taxable income for the taxable year ($270,000 x 20% = $54,000).

Example (3) points out that, even though B and C have income that is significantly higher than the $315,000 threshold amount, their $270,000 taxable income is below that. For B's and C's wages not being QBI, see part II.E.1.c.ii.(b) Trade or Business of Being an Employee.

Prop. Reg. § 1.199A-1(c)(3), Example (4) provides:

> Assume the same facts as in Example 3 of this paragraph (c)(3) except that B also earns $1,000 in qualified REIT dividends and $500 in qualified PTP income in 2018, increasing taxable income to $271,500. B and C's section 199A deduction is equal to $20,300, the lesser of (i) 20% of C's QBI from the business ($100,000 x 20% = $20,000) plus 20% of B's combined qualified REIT dividends and qualified PTP income ($1,500 x 20% = $300) and (ii) 20% of B and C's total taxable for the taxable year ($271,500 x 20% = $54,300).

II.E.1.c.v.(c). Calculation When Taxable Income Exceeds the Threshold Amount

Parts II.E.1.c.iv Specified Service Trade or Business (SSTB) and II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds apply when not fully protected by part II.E.1.c.v.(a) Taxable Income "Threshold Amount".

If the wage limitation reduces the QBI-related amount (20% of QBI income)[718] with respect to any qualified trade or business, and the taxpayer's taxable income does not exceed the threshold amount by $100,000 for a joint return or $50,000 for other returns, then the reduction is pro-rated.[719] The reduction is multiplied by the excess over the threshold divided by $100,000 or $50,000, as applicable.[720] Thus, the phase-out of the benefit of modest taxable income occurs initially from $315,000-$415,000 for married filing jointly and $157,500-$207,500 for all others.

If an SSTB is excluded from being QBI, the taxpayer having taxable income below the threshold removes the exclusion, so that the trade or business qualifies for the deduction.[721] If the taxpayer's taxable exceeds the threshold, the deduction is phased out using a $100,000 or $50,000 calculation similar to that described above:[722]

> only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W-2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such specified service trade or business shall be taken into account in computing the qualified business income, W-2 wages, and the unadjusted basis immediately after acquisition of qualified property of the taxpayer for the taxable year for purposes of applying this section.

The "applicable percentage" is 100% minus the ratio of the excess taxable income to the $100,000 or $50,000 threshold.[723]

---

[718] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[719] Code § 199A(b)(3)(B)(i), "Phase-in of limit for certain taxpayers," provides:

> *In general*. If-
> (I) the taxable income of a taxpayer for any taxable year exceeds the threshold amount, but does not exceed the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), and
> (II) the amount determined under paragraph (2)(B) (determined without regard to this subparagraph) with respect to any qualified trade or business carried on by the taxpayer is less than the amount determined under paragraph (2)(A) with respect such trade or business,
>
> then paragraph (2) shall be applied with respect to such trade or business without regard to subparagraph (B) thereof and by reducing the amount determined under subparagraph (A) thereof by the amount determined under clause (ii).

[720] Code § 199A(b)(3)(B)(ii) and (iii) provide:

> (ii) *Amount of reduction*. The amount determined under this subparagraph is the amount which bears the same ratio to the excess amount as-
> (I) the amount by which the taxpayer's taxable income for the taxable year exceeds the threshold amount, bears to
> (II) $50,000 ($100,000 in the case of a joint return).
>
> (iii) *Excess amount*. For purposes of clause (ii), the excess amount is the excess of-
> (I) the amount determined under paragraph (2)(A) (determined without regard to this paragraph), over
> (II) the amount determined under paragraph (2)(B) (determined without regard to this paragraph).

[721] Code § 199(d)(3)(A)(i) provides, "any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A)," so one needs to go to Code § 199(d)(1)(A).

[722] Code § 199A(d)(3)(A)(ii).

[723] Code § 199A(d)(3)(B) provides:

Applying these concepts, Prop. Reg. § 1.199A-1(b) includes the following definitions:

(2) Applicable percentage means, with respect to any taxable year,100 percent reduced (not below zero) by the percentage equal to the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return).

(3) Phase-in range means a range of taxable income, the lower limit of which is the threshold amount, and the upper limit of which is the threshold amount plus $50,000 (or $100,000 in the case of a joint return).

(8) Reduction amount means, with respect to any taxable year, the excess amount multiplied by the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return). For purposes of this paragraph (b)(8), the excess amount is 20 percent of QBI over the greater of 50 percent of W-2 wages or the sum of 25 percent of W-2 wages plus 2.5 percent of the UBIA of qualified property.

Prop. Reg. § 1.199A-1(d)(1) explains:

> *In general*. The section 199A deduction is determined for individuals with taxable income for the taxable year that exceeds the threshold amount by adding the QBI component and 20 percent of the combined amount of qualified REIT dividends and qualified PTP income (including the individual's share of qualified REIT dividends and qualified PTP income from RPEs). That sum is then compared to 20 percent of the amount by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's section 199A deduction.

Note the reference to "the QBI component" for individuals with taxable income above the threshold amount, contrasted with Prop. Reg. § 1.199A-1(c)(1) referring to "20 percent of the total QBI amount" for individuals with taxable income below the threshold amount. Prop. Reg. § 1.199A-1(d)(2), "QBI component," provides:

> An individual with taxable income for the taxable year that exceeds the threshold amount determines the QBI component using the following computational rules, which are to be applied in the order they appear.
>
> (i) *SSTB exclusion*. If the individual's taxable income is within the phase-in range, then only the applicable percentage of QBI, W-2 wages, and UBIA of qualified property for each SSTB is taken into account for purposes of determining the individual's section 199A deduction. If the individual's taxable income exceeds the phase-in range, then none of the individual's share of QBI, W-2 wages, or UBIA of qualified property attributable to an SSTB may be taken into account for purposes of determining the individual's section 199A deduction.

Applicable percentage. For purposes of subparagraph (A), the term "applicable percentage" means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio of-

(i) the taxable income of the taxpayer for the taxable year in excess of the threshold amount, bears to

(ii) $50,000 ($100,000 in the case of a joint return).

(ii) *Aggregated trade or business*. If an individual chooses to aggregate trades or businesses under the rules of § 1.199A-4, the individual must combine the QBI, W-2 wages, and UBIA of qualified property of each trade or business within an aggregated trade or business prior to applying the W-2 wages and UBIA of qualified property limitations described in paragraph (d)(2)(iv) of this section.

Prop. Reg. § 1.199A-1(d)(2)(iv), "QBI component calculation," provides:

(A) *General rule*. Except as provided in paragraph (d)(iv)(B) of this section, the QBI component is the sum of the amounts determined under this paragraph (d)(2)(iv)(A) for each trade or business. For each trade or business (including trades or businesses operated through RPEs) the individual must determine the lesser of—

(1) 20 percent of the QBI for that trade or business; or

(2) The greater of—

(i) 50 percent of W-2 wages with respect to that trade or business, or

(ii) the sum of 25 percent of W-2 wages with respect to that trade or business plus 2.5 percent of the UBIA of qualified property with respect to that trade or business.

(B) *Taxpayers with taxable income within phase-in range*. If the individual's taxable income is within the phase-in range and the amount determined under paragraph (d)(2)(iv)(A)(2) of this section for a trade or business is less than the amount determined under paragraph (d)(2)(iv)(A)(1) of this section for that trade or business, the amount determined under paragraph (d)(2)(iv)(A) of this section for such trade or business is modified. Instead of the amount determined under paragraph (d)(2)(iv)(A)(2) of this section, the QBI component for the trade or business is the amount determined under paragraph (d)(2)(iv)(A)(1) of this section reduced by the reduction amount as defined in paragraph (b)(8) of this section. This reduction amount does not apply if the amount determined in paragraph (d)(2)(iv)(A)(2) of this section is greater than the amount determined under paragraph (d)(2)(iv)(A)(1) of this section (in which circumstance the QBI component for the trade or business will be the unreduced amount determined in paragraph (d)(2)(iv)(A)(1) of this section).

Prop. Reg. § 1.199A-1(d)(3), "Negative combined qualified REIT dividends/qualified PTP income," is discussed in part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

Prop. Reg. § 1.199A-1(d)(4), "Examples," provides:

The following examples illustrate the provisions of this paragraph (d). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(13) of this section, none of the trades or businesses are SSTBs as defined in paragraph (b)(10) of this section and §1.199A-5(b); and all of the tax items associated with the trades or businesses are effectively connected to a trade or business within the United States within the meaning of section 864(c). Also assume that the taxpayers report no capital gains or losses or other tax items not specified in the examples. Total taxable income does not include the section 199A deduction.

Prop. Reg. § 1.199A-1(d)(4), Example (1) provides:

> D, an unmarried individual, owns several parcels of land that D manages and which are leased to several suburban airports for parking lots. The business generated $1,000,000 of QBI in 2018. The business paid no wages and the property was not qualified property because it was not depreciable. After allowable deductions unrelated to the business, D's total taxable income for 2018 is $980,000. Because D's taxable income exceeds the applicable threshold amount, D's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. D's section 199A deduction is limited to zero because the business paid no wages and held no qualified property.

This example illustrates part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds. Note the assumption, however, that leasing several parcels of land to several suburban airports for parking lots constitutes QBI, which is helpful given uncertainty as to whether real estate rental qualifies as a trade or business.[724]

Prop. Reg. § 1.199A-1(d)(4), Example (2) provides:

> Assume the same facts as in Example 1 of this paragraph (d)(4), except that D developed the land parcels in 2019, expending a total of $10,000,000 to build parking structures on each of the parcels, all of which is depreciable. During 2020, D leased the parking structures and the land to the suburban airports. D reports $4,000,000 of QBI for 2020. After allowable deductions unrelated to the business, D's total taxable income for 2020 is $3,980,000. Because D's taxable income is above the threshold amount, the QBI component of D's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. Because the business has no W-2 wages, the QBI component of D's section 199A deduction will be limited to the lesser of 20% of the business's QBI or 2.5% of its UBIA of qualified property. Twenty percent of the $4,000,000 of QBI is $800,000. Two and one-half percent of the $10,000,000 UBIA of qualified property is $250,000. The QBI component of D's section 199A deduction is thus limited to $250,000. D's section 199A deduction is equal to the lesser of (i) 20% of the QBI from the business as limited ($250,000) or (ii) 20% of D's taxable income ($3,980,000 x 20% = $796,000). Therefore, D's section 199A deduction for 2020 is $250,000.

See part II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A.

Prop. Reg. § 1.199A-1(d)(4), Example (3) provides:

> E, an unmarried individual, is a 30% owner of LLC, which is classified as a partnership for Federal income tax purposes. In 2018, the LLC has a single trade or business and reported QBI of $3,000,000. The LLC paid total W-2 wages of $1,000,000, and its total UBIA of qualified property is $100,000. E is allocated 30% of all items of the partnership. For the 2018 taxable year, E reports $900,000 of QBI from the LLC. After allowable deductions unrelated to LLC, E's taxable income is $880,000. Because E's taxable income is above the threshold amount, the QBI component of E's section 199A deduction

[724] See part II.E.1.e Whether Real Estate Qualifies As a Trade or Business.

will be limited to the lesser of (i) 20% of E's share of LLC's QBI or (ii) the greater of the W-2 wage or UBIA of qualified property limitations. Twenty percent of E's share of QBI of $900,000 is $180,000. The W-2 wage limitation equals 50% of E's share of the LLC's wages ($300,000) or $150,000. The UBIA of qualified property limitation equals $75,750, the sum of (i) 25% of E's share of LLC's wages ($300,000) or $75,000 plus (ii) 2.5% of E's share of UBIA of qualified property ($30,000) or $750. The greater of the limitation amounts ($150,000 and $75,750) is $150,000. The QBI component of E's section 199A deduction is thus limited to $150,000, the lesser of (i) 20% of QBI ($180,000) and (ii) the greater of the limitations amounts ($150,000). E's section 199A deduction is equal to the lesser of (i) 20% of the QBI from the business as limited ($150,000) or (ii) 20% of E's taxable income ($880,000 x 20% = $176,000). Therefore, E's section 199A deduction is $150,000 for 2018.

Prop. Reg. § 1.199A-1(d)(4), Example (4) provides:

> F, an unmarried individual, owns a 50% interest in Z, an S corporation for Federal income tax purposes that conducts a single trade or business. In 2018, Z reported QBI of $6,000,000. Z paid total W-2 wages of $2,000,000, and its total UBIA of qualified property is $200,000. For the 2018 taxable year, F reports $3,000,000 of QBI from Z. F is not an employee of Z and receives no wages or reasonable compensation from Z. After allowable deductions unrelated to Z and a deductible qualified net loss from a PTP of ($10,000), F's taxable income is $1,880,000. Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction will be limited to the lesser of (i) 20% of F's share of Z's QBI or (ii) the greater of the W-2 wage and UBIA of qualified property limitations. Twenty percent of F's share of QBI of $3,000,000 is $600,000. The W-2 wage limitation equals 50% of F's share of Z's W-2 wages ($1,000,000) or $500,000. The UBIA of qualified property limitation equals $252,500, the sum of (i) 25% of F's share of Z's W-2 wages ($1,000,000) or $250,000 plus (ii) 2.5% of E's share of UBIA of qualified property ($100,000) or $2,500. The greater of the limitation amounts ($500,000 and $252,500) is $500,000. The QBI component of F's section 199A deduction is thus limited to $500,000, the lesser of (i) 20% of QBI ($600,000) and (ii) the greater of the limitations amounts ($500,000). F reported a qualified loss from a PTP and has no qualified REIT dividend. F does not net the ($10,000) loss against QBI. Instead, the portion of F's section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for 2018. F's section 199A deduction is equal to the lesser of (i) 20% of the QBI from the business as limited ($500,000) or (ii) 20% of F's taxable income over net capital gain ($1,880,000 x 20% = $376,000). Therefore, F's section 199A deduction is $376,000 for 2018. F must also carry forward the $(10,000) qualified loss from a PTP to be netted against F's qualified REIT dividends and qualified PTP income in the succeeding taxable year.

Prop. Reg. § 1.199A-1(d)(4), Example (5), "Phase-in range," provides:

> (i) B and C are married and file a joint individual income tax return. B is a shareholder in M, an entity taxed as an S corporation for Federal income tax purposes that conducts a single trade or business. M holds no qualified property. B's share of the M's QBI is $300,000 in 2018. B's share of the W-2 wages from M in 2018 is $40,000. C earns wage income from employment by an unrelated company. After allowable deductions unrelated to M, B and C's taxable income for 2018 is $375,000. B and C are within the phase-in range because their taxable income exceeds the applicable threshold amount, $315,000, but does not exceed the threshold amount plus

$100,000, or $415,000. Consequently, the QBI component of B and C's section 199A deduction may be limited by the W-2 wage and UBIA of qualified property limitations but the limitations will be phased in.

(ii) The UBIA of qualified property limitation amount is zero because M does not hold qualified property. B and C must apply the W-2 wage limitation by first determining 20% of B's share of M's QBI. Twenty percent of B's share of M's QBI of $300,000 is $60,000. Next, B and C must determine 50% of B's share of M's W-2 wages. Fifty percent of B's share of M's W-2 wages of $40,000 is $20,000. Because 50% of B's share of M's W-2 wages ($20,000) is less than 20% of B's share of M's QBI ($60,000), B and C must determine the QBI component of their section 199A deduction by reducing 20% of B's share of M's QBI by the reduction amount.

(iii) B and C are 60% through the phase-in range (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000). B and C must determine the excess amount, which is the excess of 20% of B's share of M's QBI, or $60,000, over 50% of B's share of M's W-2 wages, or $20,000. Thus, the excess amount is $40,000. The reduction amount is equal to 60% of the excess amount, or $24,000. Thus, the QBI component of B and C's section 199A deduction is equal to $36,000, 20% of B's $300,000 share M's QBI (that is, $60,000), reduced by $24,000. B and C's section 199A deduction is equal to the lesser of (i) 20% of the QBI from the business as limited ($36,000) or (ii) 20% of B and C's taxable income ($375,000 x 20% = $75,000). Therefore, B and C's section 199A deduction is $36,000 for 2018.

Prop. Reg. § 1.199A-1(d)(4), Example (6) explains how the phase-in works when the business is am SSTB and has insufficient wages (or wages and UBIA):

(i) Assume the same facts as in Example 5 to paragraph (d)(4), except that M was engaged in an SSTB. Because B and C are within the phase-in range, B must reduce the QBI and W-2 wages allocable to B from M to the applicable percentage of those items. B and C's applicable percentage is 100% reduced by the percentage equal to the ratio that their taxable income for the taxable year ($375,000) exceeds their threshold amount ($315,000), or $60,000, bears to $100,000. Their applicable percentage is 40%. The applicable percentage of B's QBI is ($300,000 x 40% =) $120,000, and the applicable percentage of B's share of W-2 wages is ($40,000 x 40% =) $16,000. These reduced numbers must then be used to determine how B's section 199A deduction is limited.

(ii) B and C must apply the W-2 wage limitation by first determining 20% of B's share of M's QBI as limited by paragraph (i) of this example. Twenty percent of B's share of M's QBI of $120,000 is $24,000. Next, B and C must determine 50% of B's share of M's W-2 wages. Fifty percent of B's share of M's W-2 wages of $16,000 is $8,000. Because 50% of B's share of M's W-2 wages ($8,000) is less than 20% of B's share of M's QBI ($24,000), B and C must determine the QBI component of their section 199A deduction by reducing 20% of B's share of M's QBI by the reduction amount.

(iii) B and C are 60% through the phase-in range (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000). B and C must determine the excess amount, which is the excess of 20% of B's share of M's QBI, as adjusted in paragraph (i) of this example or $24,000, over 50% of B's share of M's W-

2 wages, as adjusted in paragraph (i) of this example, or $8,000. Thus, the excess amount is $16,000. The reduction amount is equal to 60% of the excess amount or $9,600. Thus, the QBI component of B and C's section 199A deduction is equal to $14,400, 20% of B's share M's QBI of $24,000, reduced by $9,600. B and C's section 199A deduction is equal to the lesser of (i) 20% of the QBI from the business as limited ($14,400) or 20% of B's and C's taxable income ($375,000 x 20% = $75,000). Therefore, B and C's section 199A deduction is $14,400 for 2018.

The $14,400 deduction in Example (6) is 40% of the $36,000 deduction in Example (5). That 40% result from Example (6) applying the SSTB limitation, and being 60% through the phase-in range leaves 40% of the benefit of the threshold remaining.

Prop. Reg. § 1.199A-1(d)(4), Example (7) provides:

(i) F, an unmarried individual, owns as a sole proprietor 100 percent of three trades or businesses, Business X, Business Y, and Business Z. None of the businesses hold qualified property. F does not aggregate the trades or businesses under § 1.199A-4. For taxable year 2018, Business X generates $1 million of QBI and pays $500,000 of W-2 wages with respect to the business. Business Y also generates $1 million of QBI but pays no wages. Business Z generates $2,000 of QBI and pays $500,000 of W-2 wages with respect to the business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $2,722,000.

(ii) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W-2 wage limitation must be calculated. Because QBI from each business is positive, F applies the limitation by determining the lesser of 20% of QBI and 50% of W-2 wages for each business. For Business X, the lesser of 20% of QBI ($1,000,000 x 20 percent = $200,000) and 50% of Business X's W-2 wages ($500,000 x 50% = $250,000) is $200,000. Business Y pays no W-2 wages. The lesser of 20% of Business Y's QBI ($1,000,000 x 20% = $200,000) and 50% of its W-2 wages (zero) is zero. For Business Z, the lesser of 20% of QBI ($2,000 x 20% = $400) and 50% of W-2 wages ($500,000 x 50% = $250,000) is $400.

(iii) Next, F must then combine the amounts determined in paragraph (ii) of this example and compare that sum to 20% of F's taxable income. The lesser of these two amounts equals F's section 199A deduction. The total of the combined amounts in paragraph (ii) is $200,400 ($200,000 + 0 + 400). Twenty percent of F's taxable income is $544,400 ($2,722,000 x 20%). Thus, F's section 199A deduction for 2018 is $200,400.

Note that $100,000 Business X's wages were wasted, in that Business X needed only $400,000 of wages to support a $200,000 deduction. Similarly, all but $800 ($4,000 deduction divided by 50%) of Business Z's $500,000 of wages were wasted. Thus, $599,200 of wages are wasted ($100,000 + $500,000 minus $800).

Prop. Reg. § 1.199A-1(d)(4), Example (8) provides:

(i) Assume the same facts as in Example 7 of this paragraph (d)(4), except that F aggregates Business X, Business Y, and Business Z under the rules of § 1.199A-4.

(ii) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. Because the businesses are aggregated, these limitations are applied on an aggregated basis. None of the businesses holds qualified property, therefore only the W-2 wage limitation must be calculated. F applies the limitation by determining the lesser of 20% of the QBI from the aggregated businesses, which is $400,400 ($2,002,000 x 20%) and 50% of W-2 wages from the aggregated businesses, which is $500,000 ($1,000,000 x 50%). F's section 199A deduction is equal to the lesser of $400,400 and 20% of F's taxable income ($2,722,000 x 20% = $544,400). Thus, F's section 199A deduction for 2018 is $400,400.

Example (8) shows the benefit of irrevocably electing to aggregate, as described in part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A. Although Example (8) has more wages than necessary to support the $400,400 deduction, aggregation enabled F to use most of wages that were wasted in Example (7).

Prop. Reg. § 1.199A-1(d)(4), Examples (9) through (12) are reproduced in part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

II.E.1.c.vi. Wage Limitation If Taxable Income Is Above Certain Thresholds

After considering part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A,[725] the wage limitation is the greater of:[726]

(i) 50 percent of the W-2 wages with respect to the qualified trade or business, or

(ii) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

For details on the wage limitation, see parts II.E.1.c.vi.(a) W-2 Wages under Code § 199A and II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property

---

[725] Within that part, fn 681 cross-references fn 726 of this part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[726] Code § 199A(b)(2)(B). Prop. Reg. § 1.199A-1(d)(2)(iv)(A) provides:

General rule. Except as provided in subparagraph (d)(iv)(B) of this section, the QBI component is the sum of the amounts determined under this paragraph (d)(2)(iv)(A) for each trade or business. For each trade or business (including trades or businesses operated through RPEs) the individual must determine the lesser of—

(1) 20 percent of the QBI for that trade or business; or

(2) The greater of—

(i) 50 percent of W-2 wages with respect to that trade or business, or

(ii) the sum of 25 percent of W-2 wages with respect to that trade or business plus 2.5 percent of the UBIA of qualified property with respect to that trade or business.

under Code § 199A, which generally are effectuated under Prop. Reg § 1.199A-2. Prop. Reg § 1.199A-2(d), "Effective/applicability date," provides:

> (1) *General rule*. Except as provided in paragraph (d)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. However, taxpayers may rely on the rules of this section until the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.
>
> (2) *Exceptions*.
>
> (i) *Anti-abuse rules*. The provisions of paragraph (c)(1)(iv) of this section apply to taxable years ending after December 22, 2017.
>
> (ii) *Non-calendar year RPE*. For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

The wage limitation is relaxed or does not apply if taxable income is below certain thresholds.[727] See part II.E.1.c.v.(a) Taxable Income "Threshold.

II.E.1.c.vi.(a). W-2 Wages under Code § 199A

The preamble to Prop. Reg. § 1.199A-2, REG-107892-18 (8/16/2018), explains:

> **II. Proposed § 1.199A-2: Determination of W-2 Wages and the UBIA of Qualified Property**
>
> As described in part I.C. of this Explanation of Provisions, if an individual's taxable income exceeds the threshold amount, Section 199A(b)(2)(B) imposes a limit on the Section 199A deduction based on the greater of either (i) the W-2 wages paid, or (ii) the W-2 wages paid and UBIA of qualified property attributable to a trade or business. This part of this Explanation of Provisions describes the rules in proposed § 1.199A-2 regarding the determination of W-2 wages and UBIA of qualified property.
>
> **A. W-2 wages attributable to a trade or business**
>
> The W-2 wage rules of proposed § 1.199A-2 generally follow the rules under former section 199. Section 199, which was repealed by the TCJA, provided for a deduction with respect to certain domestic production activities and contained a W-2 wage limitation similar to the one in Section 199A. The legislative text of the W-2 wage limitation in Section 199A is modeled on the text of former section 199, and both taxpayers and the IRS have developed experience in applying those W-2 wage rules for over a decade. The regulations under former section 199 provided rules to determine W-2 wages, which provide a useful starting point in developing the W-2 wage rules under Section 199A,

[727] Code § 199A(b)(3).

including rules on the definition of W-2 wages, wages paid by persons other than the common-law employer, and methods for calculating W-2 wages.

The Treasury Department and the IRS have received comments concerning whether amounts paid to workers who receive Forms W-2 from third party payors (such as professional employer organizations, certified professional employer organizations, or agents under section 3504) that pay these wages to workers on behalf of their clients and report wages on Forms W-2, with the third party payor as the employer listed in Box c of the Forms W-2, may be included in the W-2 wages of the clients of third party payors. In order for wages reported on a Form W-2 to be included in the determination of W-2 wages of a taxpayer, the Form W-2 must be for employment by the taxpayer. The regulations under former section 199, specifically § 1.199-2(a)(2), addressed this issue, providing that, since employees of the taxpayer are defined in the regulations as including only common law employees of the taxpayer and officers of a corporate taxpayer, taxpayers may take into account wages reported on Forms W-2 issued by other parties provided that the wages reported on the Forms W-2 were paid to employees of the taxpayer for employment by the taxpayer.

Proposed § 1.199A-2(b)(2)(ii) provides a rule for wages paid by a person other than the common law employer that is substantially similar to the rule in § 1.199-2(a)(2). Specifically, the proposed regulations provide that, in determining W-2 wages, a person may take into account any W-2 wages paid by another person and reported by the other person on Forms W-2 with the other person as the employer listed in Box c of the Forms W-2, provided that the W-2 wages were paid to common law employees or officers of the person for employment by the person. In such cases, the person paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that person. Persons that pay and report W-2 wages on behalf of or with respect to others can include certified professional employer organizations under section 7705, statutory employers under section 3401(d)(1), and agents under section 3504. Under this rule, persons who otherwise qualify for the deduction under Section 199A are not limited in applying the deduction merely because they use a third party payor to pay and report wages to their employees. However, with respect to individuals who taxpayers assert are their common law employees for purposes of Section 199A, taxpayers are reminded of their duty to file returns and apply the tax law on a consistent basis.

Unlike former section 199, the W-2 wage limitation in Section 199A applies separately for each trade or business. Accordingly, proposed § 1.199A-2 provides that, in the case of W-2 wages that are allocable to more than one trade or business, the portion of the W-2 wages allocable to each trade or business is determined to be in the same proportion to total W-2 wages as the deductions associated with those wages are allocated among the particular trades or businesses. Section 199A(b)(4) also requires that to be taken into account, W-2 wages must be properly allocable to QBI. W-2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI.

Additionally, proposed § 1.199A-2(b)(4) restates the rule of Section 199A(f)(1)(A)(iii), which provides that, in the case of a trade or business conducted by an RPE, a partner's or shareholder's allocable share of wages must be determined in the same manner as the partner's allocable share or a shareholder's pro rata share of wage expenses.

> Consistent with Section 199A(b)(5) and the legislative history of the TCJA, which direct the Secretary to provide rules for applying the W-2 wage limitation in cases in which the taxpayer acquires, or disposes of, a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business during the year, proposed § 1.199A-2 (b)(2)(iv)(B) provides rules that apply in the case of an acquisition or disposition of a trade or business. See Joint Explanatory Statement of the Committee of Conference, 38. Specifically, proposed § 1.199A-2(b)(2)(iv)(B)(1) provides that, in the case of an acquisition or disposition of a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business that causes more than one individual or entity to be an employer of the employees of the acquired or disposed of trade or business during the calendar year, the W-2 wages of the individual or entity for the calendar year of the acquisition or disposition are allocated between each individual or entity based on the period during which the employees of the acquired or disposed of trade or business were employed by the individual or entity, regardless of which permissible method is used for reporting predecessor and successor wages on Form W-2. For this purpose, the period of employment is determined consistently with the principles for determining whether an individual is an employee described in proposed § 1.199A-2(b).
>
> A notice of proposed revenue procedure, Notice 2018-64, 2018-35 IRB ____, which provides three methods for calculating W-2 wages is being issued concurrently with this notice of proposed rulemaking. The three methods in the notice are substantially similar to the methods provided in Rev. Proc. 2006-47, 2006-2 C.B. 869, for purposes of calculating "paragraph (e)(1) wages" (that is, wages described in § 1.199-2(e)(1) issued under former section 199). The first method (the unmodified Box method) allows for a simplified calculation while the second and third methods (the modified Box 1 method and the tracking wages method) provide for greater accuracy.

For a taxpayer using W-2 wages in calculating the QBI deduction, see Prop. Reg. § 1.199A-2(a)(2), reproduced in the text accompanying fn 644 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

Prop. Reg. § 1.199A-2(b)(1) provides an overview of the rules for W-2 wages:

> *In general*. Section 199A(b)(2)(B) provides limitations on the Section 199A deduction based on the W-2 wages paid with respect each trade or business. Section 199A(b)(4)(B) provides that W-2 wages do not include any amount which is not properly allocable to QBI for purposes of Section 199A(c)(1). This section provides a three step process for determining the W-2 wages paid with respect to a trade or business that are properly allocable to QBI. First, each individual or RPE must determine its total W-2 wages paid for the taxable year under the rules in paragraph (b)(2) of this section. Second, each individual or RPE must allocate its W-2 wages between or among one or more trades or businesses under the rules in paragraph (b)(3) of this section. Third, each individual or RPE must determine the amount of such wages with respect to each trade or business that are allocable to the QBI of the trade or business under the rules in paragraph (b)(4) of this section.

"W-2 wages" means, with respect to any person for any taxable year of such person, the W-2 wages paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year:[728]

- In the case of a partnership or S corporation, each partner or shareholder is treated "as having W-2 wages and unadjusted basis immediately after acquisition of qualified property for the taxable year in an amount equal to such person's allocable share of the W-2 wages and the unadjusted basis immediately after acquisition of qualified property of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary)."[729] A partner's or shareholder's allocable share of W-2 wages is determined in the same manner as the partner's or shareholder's allocable share of wage expenses.[730] A partner's or shareholder's allocable share of the unadjusted basis immediately after acquisition of qualified property is determined in the same manner as the partner's or shareholder's allocable share of depreciation.[731] In the case of an S corporation, an allocable share is the shareholder's pro rata share of an item.[732]

- For trusts and estates, rules similar to those that applied to the former Code § 199 deduction for domestic production activities apply.[733] See part II.E.1.f Trusts/Estates and the Code § 199A Deduction, which is summarized in part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

W-2 wages generally are wages subject to withholding and include elective deferral, such as Code § 401(k) and similar plans.[734] The wages must be "properly allocable to" QBI.[735] The wages must be "properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return."[736]

Prop. Reg. § 1.199A-2(b)(2), "Definition of W-2 wages," elaborates on the above, starting with:

> (i) *In general*. Section 199A(b)(4)(A) provides that the term W-2 wages means with respect to any person for any taxable year of such person, the amounts described in

[728] Code § 199A(b)(4)(A).
[729] Code § 199A(f)(1)(A)(iii).
[730] Code § 199A(f)(1)(A) (flush language).
[731] Code § 199A(f)(1)(A) (flush language).
[732] Code § 199A(f)(1)(A) (flush language).
[733] Code § 199A(f)(1)(B) provides:

> *Application to Trusts and Estates*. Rules similar to the rules under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W-2 wages shall apply to the apportionment of W-2 wages and the apportionment of unadjusted basis immediately after acquisition of qualified property under this section.

[734] Code § 199A(b)(4)(A) provides:

> *In General*. The term "W-2 wages" means, with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year.

If a taxpayer has qualified business income from sources within the commonwealth of Puerto Rico and all that income is taxable under Code § 1 for the taxable year, then Code § 199A(f)(1)(C)(ii) provides that:

> the determination of W-2 wages of such taxpayer with respect to any qualified trade or business conducted in Puerto Rico shall be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services in Puerto Rico.

[735] Code § 199A(b)(4)(B).
[736] Code § 199A(b)(4)(C).

section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Thus, the term W-2 wages includes the total amount of wages as defined in section 3401(a) plus the total amount of elective deferrals (within the meaning of section 402(g)(3)), the compensation deferred under section 457, and the amount of designated Roth contributions (as defined in section 402A). For this purpose, except as provided in paragraphs (b)(2)(iv)(C)(2) and (b)(2)(iv)(D) of this section, the Forms W-2, "Wage and Tax Statement," or any subsequent form or document used in determining the amount of W-2 wages are those issued for the calendar year ending during the individual's or RPE's taxable year for wages paid to employees (or former employees) of the individual or RPE for employment by the individual or RPE. For purposes of this section, employees of the individual or RPE are limited to employees of the individual or RPE as defined in section 3121(d)(1) and (2). (For purposes of Section 199A, this includes officers of an S corporation and employees of an individual or RPE under common law.)

(ii) *Wages paid by a person other than a common law employer*. In determining W-2 wages, an individual or RPE may take into account any W-2 wages paid by another person and reported by the other person on Forms W-2 with the other person as the employer listed in Box c of the Forms W-2, provided that the W-2 wages were paid to common law employees or officers of the individual or RPE for employment by the individual or RPE. In such cases, the person paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that person. For purposes of this subparagraph, persons that pay and report W-2 wages on behalf of or with respect to others can include certified professional employer organizations under section 7705, statutory employers under section 3401(d)(1), and agents under section 3504.

(iii) *Requirement that wages must be reported on return filed with the Social Security Administration (SSA)*.

(A) *In general*. Pursuant to Section 199A(b)(4)(C), the term W-2 wages does not include any amount that is not properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return. Under § 31.6051-2 of this chapter, each Form W-2 and the transmittal Form W-3, "Transmittal of Wage and Tax Statements," together constitute an information return to be filed with SSA. Similarly, each Form W-2c, "Corrected Wage and Tax Statement," and the transmittal Form W-3 or W-3c, "Transmittal of Corrected Wage and Tax Statements," together constitute an information return to be filed with SSA. In determining whether any amount has been properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return, each Form W-2 together with its accompanying Form W-3 will be considered a separate information return and each Form W-2c together with its accompanying Form W-3 or Form W-3c will be considered a separate information return. Section 6071(c) provides that Forms W-2 and W-3 must be filed on or before January 31 of the year following the calendar year to which such returns relate (but see the special rule in § 31.6071(a)-1T(a)(3)(1) of this chapter for monthly returns filed under § 31.6011(a)-5(a) of this chapter). Corrected Forms W-2 are required to be filed with SSA on or before January 31 of the year following the year in which the correction is made.

(B) *Corrected return filed to correct a return that was filed within 60 days of the due date*. If a corrected information return (Return B) is filed with SSA on or before the 60th day after the due date (including extensions) of Return B to correct an information return (Return A) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return A) and paragraph (b)(2)(iii)(C) of this section does not apply, then the wage information on Return B must be included in determining W-2 wages. If a corrected information return (Return D) is filed with SSA later than the 60th day after the due date (including extensions) of Return D to correct an information return (Return C) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return C), and if Return D reports an increase (or increases) in wages included in determining W-2 wages from the wage amounts reported on Return C, then such increase (or increases) on Return D will be disregarded in determining W-2 wages (and only the wage amounts on Return C may be included in determining W-2 wages). If Return D reports a decrease (or decreases) in wages included in determining W-2 wages from the amounts reported on Return C, then, in determining W-2 wages, the wages reported on Return C must be reduced by the decrease (or decreases) reflected on Return D.

(C) *Corrected return filed to correct a return that was filed later than 60 days after the due date*. If an information return (Return F) is filed to correct an information return (Return E) that was not filed with SSA on or before the 60th day after the due date (including extensions) of Return E, then Return F (and any subsequent information returns filed with respect to Return E) will not be considered filed on or before the 60th day after the due date (including extensions) of Return F (or the subsequent corrected information return). Thus, if a Form W-2c (or corrected Form W-2) is filed to correct a Form W-2 that was not filed with SSA on or before the 60th day after the due date (including extensions) of the information return including the Form W-2 (or to correct a Form W-2c relating to an information return including a Form W-2 that had not been filed with SSA on or before the 60th day after the due date (including extensions) of the information return including the Form W-2), then the information return including this Form W-2c (or corrected Form W-2) will not be considered to have been filed with SSA on or before the 60th day after the due date (including extensions) for this information return including the Form W-2c (or corrected Form W-2), regardless of when the information return including the Form W-2c (or corrected Form W-2) is filed.

The IRS must explain how the QBI rules apply "in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the taxable year."[737]

Prop. Reg. § 1.199A-2(b)(2), "Methods for calculating W-2 wages," implements the above:

(A) *In general*. The Secretary may provide for methods to be used in calculating W-2 wages, including W-2 wages for short taxable years by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter).

(B) *Acquisition or disposition of a trade or business*.

[737] Code § 199A(b)(5).

(1) In general. In the case of an acquisition or disposition of a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business that causes more than one individual or entity to be an employer of the employees of the acquired or disposed of trade or business during the calendar year, the W-2 wages of the individual or entity for the calendar year of the acquisition or disposition are allocated between each individual or entity based on the period during which the employees of the acquired or disposed of trade or business were employed by the individual or entity, regardless of which permissible method is used for reporting predecessor and successor wages on Form W-2, "Wage and Tax Statement." For this purpose, the period of employment is determined consistently with the principles for determining whether an individual is an employee described in § 1.199A-2(b).

(2) Acquisition or disposition. For purposes of this paragraph (b)(2)(iv)(B), the term acquisition or disposition includes an incorporation, a formation, a liquidation, a reorganization, or a purchase or sale of assets.

(C) *Application in the case of a person with a short taxable year*.

(1) In general. In the case of an individual or RPE with a short taxable year, subject to the rules of paragraph (b)(2) of this section, the W-2 wages of the individual or RPE for the short taxable year include only those wages paid during the short taxable year to employees of the individuals or RPE, only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the individual or RPE and only compensation actually deferred under section 457 during the short taxable year with respect to employees of the individual or RPE.

(2) Short taxable year that does not include December 31. If an individual or RPE has a short taxable year that does not contain a calendar year ending during such short taxable year, wages paid to employees for employment by such individual or RPE during the short taxable year are treated as W-2 wages for such short taxable year for purposes of paragraph (b) of this section (if the wages would otherwise meet the requirements to be W-2 wages under this section but for the requirement that a calendar year must end during the short taxable year).

(D) *Remuneration paid for services performed in the Commonwealth of Puerto Rico*. In the case of an individual or RPE that conducts a trade or business in the Commonwealth of Puerto Rico, the determination of W-2 wages of such individual or RPE will be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services performed in the Commonwealth of Puerto Rico. The individual or RPE must maintain sufficient documentation (for example, Forms 499R-2/W-2PR) to substantiate the amount of remuneration paid for services performed in the Commonwealth of Puerto Rico that is used in determining the W-2 wages of such individual or RPE with respect to any trade or business conducted in the Commonwealth of Puerto Rico.

Prop. Reg. § 1.199A-2(b)(3), "Allocation of wages to trades or businesses," provides:

After calculating total W-2 wages for a taxable year, each individual or RPE that directly conducts more than one trade or business must allocate those wages among its various trades or businesses. W-2 wages must be allocated to the trade or business that generated those wages. In the case of W-2 wages that are allocable to more than one trade or business, the portion of the W-2 wages allocable to each trade or business is determined in the same manner as the expenses associated with those wages are allocated among the trades or businesses under § 1.199A-3(b)(5).

Prop. Reg. § 1.199A-2(b)(4), "Allocation of wages to QBI," completes the allocation process:

> Once W-2 wages for each trade or business have been determined, each individual or RPE must identify the amount of W-2 wages properly allocable to QBI for each trade or business. W-2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI under § 1.199A-3. In the case of an RPE, the wage expense must be allocated and reported to the partners or shareholders of the RPE as required by the Code, including subchapters K and S. The RPE must also identify and report the associated W-2 wages to its partners or shareholders.

Prop. Reg. § 1.199A-2(b)(5), "Non-duplication rule," provides:

> Amounts that are treated as W-2 wages for a taxable year under any method cannot be treated as W-2 wages of any other taxable year. Also, an amount cannot be treated as W-2 wages by more than one trade or business.

II.E.1.c.vi.(b). Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A

As discussed above, part of the wage limitation test is an alternative calculation relating to qualified property.[738] For a taxpayer using Unadjusted Basis Immediately after Acquisition (UBIA) of qualified property in calculating the QBI deduction, see Prop. Reg. § 1.199A-2(a)(3), reproduced in the text accompanying fn 644 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

The preamble to Prop. Reg. § 1.199A-2, REG-107892-18 (8/16/2018), explains:

> **B. The UBIA of qualified property**
>
> Section 199A(b)(2)(B)(ii) provides an alternative deduction limitation based on 25 percent of W-2 Wages with respect to the qualified trade or business and 2.5 percent of the UBIA of qualified property. Proposed § 1.199A-2 restates the statutory definitions under the qualified property rules, and provides additional guidance.
>
> **1. General definition of UBIA of qualified property**
>
> Proposed § 1.199A-2(c)(1) restates the definition of qualified property in Section 199A(b)(6)(A), which provides that "qualified property" means tangible property of a character subject to depreciation that is held by, and available for use in, a trade or business at the close of the taxable year, and which is used in the production of QBI, and for which the depreciable period has not ended before the close of the taxable year. Proposed § 1.199A-2(c)(2) also restates the definition of depreciable period in Section 199A(b)(6)(B), which provides that "depreciable" period means the period

[738] Code § 199A(b)(2)(B)(ii).

beginning on the date the property is first placed in service by the taxpayer and ending on the later of (a) the date 10 years after that date, or (b) the last day of the last full year in the applicable recovery period that would apply to the property under section 168(c), regardless of the application of section 168(g).

Because the applicable recovery period under section 168(c) of the property is not changed by any additional first-year depreciation deduction allowable under section 168, proposed § 1.199A-2(c)(2)(ii) also clarifies that the additional first-year depreciation deduction allowable under section 168 (for example, under section 168(k) or section 168(m)) does not affect the applicable recovery period under section 168(c).

Proposed § 1.199A-2(c)(3) provides a definition of UBIA. The Treasury Department and the IRS believe that existing general principles used to define "unadjusted basis" in § 1.263(a)-3(h)(5) provide a reasonable basis for an administrable rule that is appropriate for the purposes of Section 199A and that their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them. In addition, the Treasury Department and the IRS believe that "immediately after acquisition" means as of the date the property is placed in service because Section 199A provides that "qualified property" must be used in the production of QBI. In order to be used in the production of QBI, the qualified property necessarily must be placed in service. Determining UBIA as of the date the property is placed in service ensures consistency between purchased and produced qualified property, and reduces compliance costs, burden, and administrative complexity because taxpayers are already required to determine that amount. Accordingly, proposed § 1.199A-2 provides that the term "UBIA" means the basis as determined under section 1012 or other applicable sections of chapter 1, including subchapter O (relating to gain or loss on dispositions of property), subchapter C (relating to corporate distributions and adjustments), subchapter K (relating to partners and partnerships), and subchapter P (relating to capital gains and losses). UBIA is determined without regard to any adjustments described in section 1016(a)(2) or (3), any adjustments for tax credits claimed by the taxpayer (for example, under section 50(c)), or any adjustments for any portion of the basis for which the taxpayer has elected to treat as an expense (for example, under sections 179, 179B, or 179C). Therefore, for purchased or produced qualified property, UBIA generally will be its cost under section 1012 as of the date the property is placed in service. For qualified property contributed to a partnership in a section 721 transaction and immediately placed in service, UBIA generally will be its basis under section 723. For qualified property contributed to an S corporation in a section 351 transaction and immediately placed in service, UBIA generally will be its basis under section 362. Further, for property inherited from a decedent and immediately placed in service by the heir, the UBIA generally will be its fair market value at the time of the decedent's death under section 1014. However, proposed § 1.199A-2(c)(3) provides that UBIA does reflect the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business.

2. Partnership special basis adjustments

After the enactment of the TCJA, the Treasury Department and the IRS received comments requesting guidance as to whether partnership special basis adjustments under sections 734(b) or 743(b) constitute qualified property for purposes of Section 199A. Treating partnership special basis adjustments as qualified property could result in inappropriate duplication of UBIA of qualified property (if, for example, the fair market value of the property has not increased and its depreciable period has not ended).

Accordingly, proposed § 1.199A-2(c)(1)(iii) provides that partnership special basis adjustments are not treated as separate qualified property.

3. Property transferred with a principal purpose of increasing Section 199A deduction

Qualified property includes depreciable property used during the taxable year in the production of QBI and held by, and available for use in, the trade or business at the close of the taxable year. However, it would be inconsistent with the purposes of Section 199A to permit trades or businesses to transfer or acquire property at the end of the year merely to manipulate the UBIA of qualified property attributable to the trade or business. Therefore, pursuant to the authority granted to the Secretary under Section 199A(f)(4), proposed § 1.199A-2(c)(1)(iv) provides that property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the Section 199A deduction.

4. Like-kind exchanges and involuntary conversions

Section 199A does not provide rules to determine UBIA for qualified property in the case of an exchange of property under section 1031 (like-kind exchange) or involuntary conversion under section 1033. However, Section 199A(h)(2) specifically instructs the Secretary to do so. The Treasury Department and the IRS believe that existing general principles used for like-kind exchanges and involuntary conversions under § 1.168(i)-(6) provide a useful analogy for administrable rules that are appropriate for the purposes of Section 199A and that their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them. Accordingly, proposed § 1.199A-2 (c)(2)(iii) generally follows the rules of § 1.168(i)-6 to provide that qualified property that is acquired in a like-kind exchange, as defined in § 1.168(i)-6(b)(11), or in an involuntary conversion, as defined in § 1.168(i)-6(b)(12), is treated as replacement Modified Accelerated Cost Recovery System (MACRS) property as defined in § 1.168(i)-6(b)(1) whose depreciable period generally is determined as of the date the relinquished property was first placed in service. Accordingly, subject to one exception, proposed § 1.199A-2(c)(2)(iii) provides that, for purposes of determining the depreciable period, the date the exchanged basis in the replacement qualified property is first placed in service by the trade or business is the date on which the relinquished property was first placed in service by the individual or RPE and the date the excess basis in the replacement qualified property is first placed in service by the individual or RPE is the date on which the replacement qualified property was first placed in service by the individual or RPE. As a result, the depreciable period under Section 199A for the exchanged basis of the replacement qualified property will end before the depreciable period for the excess basis of the replacement qualified property ends.

The exception is that proposed § 1.199A-2(c)(2)(iii)(C) provides that, for purposes of determining the depreciable period, if the individual or RPE makes an election under § 1.168(i)-6(i)(1) (the election not to apply § 1.168(i)-6)), the date the exchanged basis and excess basis in the replacement qualified property are first placed in service by the trade or business is the date on which the replacement qualified property is first placed in service by the individual or RPE, with UBIA determined as of that date. In this case, the depreciable periods under Section 199A for the exchanged basis and the excess basis of the replacement qualified property will end on the same date.

Thus, unless the exception applies, qualified property acquired in a like-kind exchange or involuntary conversion will have two separate placed in service dates under the proposed regulations: for purposes of determining the UBIA of the property, the relevant placed in service date will be the date the acquired property is actually placed in service; for purposes of determining the depreciable period of the property, the relevant placed in service date generally will be the date the relinquished property was first placed in service. The proposed regulations contain an example illustrating these rules.

5. Other nonrecognition transactions

The Treasury Department and the IRS have received comments requesting guidance on the application of the qualified property rules to nonrecognition transfers involving transferred basis property within the meaning of section 7701(a)(43) (transferred basis transactions). For example, taxpayers and practitioners requested guidance on how to determine the depreciable period of the property if a partnership conducts a trade or business and qualified property is contributed to that trade or business in a nonrecognition transfer under section 721(a). Also of relevance in the context of non-recognition transfers, Section 199A(h)(1) grants the Secretary anti-abuse authority to apply rules similar to the rules under section 179(d)(2) (which can restrict the expensing of certain assets in transferred basis transactions) to prevent the manipulation of the depreciable period of qualified property using transactions between related parties.

The Treasury Department and the IRS believe that existing general principles used for transferred basis transactions under § 168(i)(7) provide a useful analogy for administrable rules that are appropriate for the purposes of Section 199A and that their use will reduce compliance costs, burden, and administrative complexity because taxpayers have experience applying them. Accordingly, proposed § 1.199A-2(c)(2)(iv) provides that, for purposes of determining the depreciable period, if an individual or RPE (the transferee) acquires qualified property in a transaction described in section 168(i)(7)(B), the transferee determines the date on which the qualified property was first placed in service using a two-step approach. First, for the portion of the transferee's UBIA of the qualified property that does not exceed the transferor's UBIA of such property, the date such portion was first placed in service by the transferee is the date on which the transferor first placed the qualified property in service. Second, for the portion of the transferee's UBIA of the qualified property that exceeds the transferor's UBIA of such property, if any, such portion is treated as separate qualified property that the transferee first placed in service on the date of the transfer. Thus, qualified property acquired in these non-recognition transactions will have two separate placed in service dates under the proposed regulations: for purposes of determining the UBIA of the property, the relevant placed in service date will be the date the acquired property is placed in service by the transferee (for instance, the date the partnership places in service property received in a section 721 transaction); for purposes of determining the depreciable period of the property, the relevant placed in service date generally will be the date the transferor first placed the property in service (for instance, the date the partner placed the property in service in his or her sole proprietorship). The proposed regulations contain an example illustrating these rules.

The Treasury Department and the IRS request comments concerning appropriate methods for accounting for non-recognition transactions, including rules to prevent the manipulation of the depreciable period of qualified property using transactions between related parties.

6. Redetermination of UBIA and subsequent improvements to qualified property

The Treasury Department and the IRS have received comments requesting guidance on the treatment of subsequent improvements to qualified property. Subsequent improvements to qualified property are generally treated as a separate item of property under section 168(i)(6). The Treasury Department and the IRS do not believe a different approach is necessary for purposes of Section 199A. Accordingly, proposed § 1.199A-2(c)(1)(ii) provides that, in the case of any addition to, or improvement of, qualified property that is already placed in service by the taxpayer, such addition or improvement is treated as separate qualified property that the taxpayer first placed in service on the date such addition or improvement is placed in service by the taxpayer for purposes of determining the depreciable period of the qualified property. For example, if a taxpayer acquired and placed in service a machine on March 26, 2018, and then incurs additional capital expenditures to improve the machine in May 2020, and places such improvements in service on May 27, 2020, the taxpayer has two qualified properties: the machine acquired and placed in service on March 26, 2018, and the improvements to the machine incurred in May 2020 and placed in service on May 27, 2020.

7. Allocation of UBIA of qualified property by RPEs

In the case of a trade or business conducted by an RPE, Section 199A(f) provides that a partner's or shareholder's allocable share of the UBIA of qualified property is determined in the same manner as the partner's allocable share or shareholder's pro rata share of depreciation. Proposed § 1.199A-2(a)(3) provides that, in the case of qualified property held by an RPE, each partner's or shareholder's share of the UBIA of qualified property is an amount that bears the same proportion to the total UBIA of qualified property as the partner's or shareholder's share of tax depreciation bears to the entity's total tax depreciation attributable to the property for the year. In the case of qualified property of a partnership that does not produce tax depreciation during the year (for example, property that has been held for less than 10 years but whose recovery period has ended), each partner's share of the UBIA of qualified property is based on how gain would be allocated to the partners pursuant to sections 704(b) and 704(c) if the qualified property were sold in a hypothetical transaction for cash equal to the fair market value of the qualified property. In the case of qualified property of an S corporation that does not produce tax depreciation during the year, each shareholder's share of the UBIA of the qualified property is a share of the UBIA proportionate to the ratio of shares in the S corporation held by the shareholder over the total shares of the S corporation.

Getting into the Code and Proposed Regulations themselves:

"Qualified property" means, with respect to any QBI for a taxable year, tangible property of a character subject to the allowance for depreciation under Code § 167:[739]

[739] Code § 199A(b)(6)(A).

(i) which is held by, and available for use in, the qualified trade or business at the close of the taxable year,

(ii) which is used at any point during the taxable year in the production of qualified business income, and

(iii) the depreciable period for which has not ended before the close of the taxable year.

After almost mirroring this statutory definition,[740] Prop. Reg. § 1.199A-2(c)(1) continues:

(ii) *Improvements to qualified property*. In the case of any addition to, or improvement of, qualified property that has already been placed in service by the individual or RPE, such addition or improvement is treated as separate qualified property first placed in service on the date such addition or improvement is placed in service for purposes of paragraph (c)(2) of this section.

(iii) *Adjustments under sections 734(b) and 743(b)*. Basis adjustments under sections 734(b) and 743(b) are not treated as qualified property.

(iv) *Property acquired at end of year*. Property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the Section 199A deduction.

Clause (iii) does not surprise me. Although certain positive basis adjustments under Code § 743(b) on the transfer of a partnership interest or under Code § 734(b) on a partnership's distribution of property are treated as the purchase of new property for purposes of Code § 168 depreciation deductions, they apply only for the purpose of Code § 168 and do not appear to affect the unadjusted basis used in this calculation.[741] From a practical viewpoint, if the policy goal of Code § 199A is to encourage new investment in business assets, allowing a basis step-up on death would not have achieved that result. On the other hand, when a person invests by buying a partnership interest, the buyer is essentially buying a share of the partnership's assets; shouldn't that be treated as an investment?

On the other hand, the preamble above provides, "for property inherited from a decedent and immediately placed in service by the heir, the UBIA generally will be its fair market value at the time of the decedent's death under section 1014." Presumably, the heir's business is considered a new business, because for tax purposes the decedent was the business, that business died with the decedent, and the heir is now the business. After discussing the "depreciable period," we will revisit this issue.[742]

---

[740] Prop. Reg. § 1.199A-2(c)(1)(i) almost mirrors the above definition, except:

- It refers to Code § 167(a) instead of Code § 167.
- It provides that the taxable year is the individual's or RPE's taxable year.

[741] See fns 4757-4758 in part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest and fn 4826 in part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election.

[742] See fn 752.

Note that the test for qualified property refers to "unadjusted basis," so it does not take into account depreciation deductions or any other basis reductions, such as bonus depreciation deductions.[743] Also note that land is not "qualified property" except to the extent of depreciable land improvements.

Prop. Reg. § 1.199A-2(c)(3), "Unadjusted basis immediately after acquisition," provides:

> The term unadjusted basis immediately after acquisition (UBIA) means the basis on the placed in service date of the property as determined under section 1012 or other applicable sections of Chapter 1, including subchapters O (relating to gain or loss on dispositions of property), C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). UBIA is determined without regard to any adjustments described in section 1016(a)(2) or (3), to any adjustments for tax credits claimed by the individual or RPE (for example, under section 50(c)), or to any adjustments for any portion of the basis for which the individual or RPE has elected to treat as an expense (for example, under sections 179, 179B, or 179C). However, UBIA does reflect the reduction in basis for the percentage of the individual's or RPE's use of property for the taxable year other than in the trade or business.

Code § 1016(a)(2), (3) is the basis adjustment for accumulated depreciation.

The "depreciable period" means the period beginning on the date the taxpayer first placed the property in service and ending on the later of the tenth anniversary of being placed in service or the last day of the last full year in the applicable recovery period under Code § 168 (the current depreciation rules).[744] The IRS must:[745]

> (1) apply rules similar to the rules under section 179(d)(2) in order to prevent the manipulation of the depreciable period of qualified property using transactions between related parties, and
>
> (2) prescribe rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.

Prop. Reg. § 1.199A-2(c)(2), "Depreciable period," provides:

> (i) *In general*. The term depreciable period means, with respect to qualified property of a trade or business, the period beginning on the date the property was first placed in service by the individual or RPE and ending on the later of—
>
> (A) The date that is 10 years after such date, or
>
> (B) The last day of the last full year in the applicable recovery period that would apply to the property under section 168(c), regardless of any application of section 168(g).

[743] See part II.G.4 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation. Code § 179 expense is not available to nongrantor trusts.
[744] Code § 199A(b)(6)(B), which also provides that Code § 168(g), under which an extended depreciable life is required or permitted to be elected, does not apply in determining the property's depreciable life.
[745] Code § 199A(h).

(ii) *Additional first-year depreciation under section 168*. The additional first-year depreciation deduction allowable under section 168 (for example, under section 168(k) or (m)) does not affect the applicable recovery period under this paragraph for the qualified property.

(iii) *Qualified property acquired in transactions subject to section 1031 or section 1033*. For purposes of paragraph (c)(2)(i) of this section, qualified property that is acquired in a like-kind exchange, as defined in § 1.168(i)-6(b)(11), or in an involuntary conversion, as defined in § 1.168(i)-6(b)(12), is treated as replacement MACRS property as defined in § 1.168(i)-6(b)(1). For purposes of paragraph (c)(2)(i) of this section, the date on which the replacement MACRS property was first placed in service by the individual or RPE is determined as follows—

(A) Except as provided in paragraph (c)(2)(iii)(C) of this section, the date the exchanged basis, as defined in § 1.168(i)-6(b)(7), in the replacement MACRS property was first placed in service by the trade or business is the date on which the relinquished property was first placed in service by the individual or RPE; and

(B) Except as provided in paragraph (c)(2)(iii)(C) of this section, the date the excess basis, as defined in § 1.168(i)-6(b)(8), in the replacement MACRS property was first placed in service by the individual or RPE is the date on which the replacement MACRS property was first placed in service by the individual or RPE; or

(C) If the individual or RPE makes an election under § 1.168(i)-6(i)(1) (the election not to apply § 1.168(i)-6)), the date the exchanged basis and excess basis in the replacement MACRS property was first placed in service by the trade or business is the date on which the replacement MACRS property was first placed in service by the individual or RPE.

(iv) *Qualified property acquired in transactions subject to section 168(i)(7)*. If an individual or RPE acquires qualified property in a transaction described in section 168(i)(7)(B) (pertaining to treatment of transferees in certain nonrecognition transactions), the individual or RPE must determine the date on which the qualified property was first placed in service for purposes of paragraph (c)(2)(i) of this section as follows—

(A) For the portion of the transferee's unadjusted basis in the qualified property that does not exceed the transferor's unadjusted basis in such property, the date such portion was first placed in service by the transferee is the date on which the transferor first placed the qualified property in service; and

(B) For the portion of the transferee's unadjusted basis in the qualified property that exceeds the transferor's unadjusted basis in such property, such portion is treated as separate qualified property that the transferee first placed in service on the date of the transfer.

Code § 168(i)(7)(B) refers to Code §§ 332 (parent corporation not recognizing gain on liquidation of a subsidiary), 351 (no gain or loss on contribution of property to a controlled corporation in exchange for stock in that corporation),[746] 721 (no gain or loss on contribution of property to a

[746] See part § II.M.2 Buying into or Forming a Corporation.

partnership in exchange for a partnership interest),[747] and 731 (no gain or loss on distribution of property from a partnership).[748]

Prop. Reg. § 1.199A-2(c)(4), Example (1), provides:

> (i) On January 5, 2012, A purchases for $1 million and places in service Real Property X in A's trade or business. A's trade or business is not an SSTB. A's basis in Real Property X under section 1012 is $1 million. Real Property X is qualified property within the meaning of Section 199A(b)(6). As of December 31, 2018, A's basis in Real Property X, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $821,550.
>
> (ii) For purposes of Section 199A(b)(2)(B)(ii) and this section, A's UBIA of Real Property X is its $1 million cost basis under section 1012, regardless of any later depreciation deductions under section 168(a) and resulting basis adjustments under section 1016(a)(2).

Prop. Reg. § 1.199A-2(c)(4), Example (2), provides:

> The facts are the same as in Example 1 of this paragraph (c)(4), except that on January 15, 2019, A enters into a like-kind exchange under section 1031 in which A exchanges Real Property X for Real Property Y. Real Property Y has a value of $1 million. No cash or other property is involved in the exchange. As of January 15, 2019, A's basis in Real Property X, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $820,482. A's UBIA in Real Property Y is $820,482 as determined under section 1031(d) (A's adjusted basis in Real Property X carried over to Real Property Y). Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Property X was first placed in service by A.

Prop. Reg. § 1.199A-2(c)(4), Example (3), provides:

> (i) C operates a trade or business that is not an SSTB as a sole proprietorship. On January 5, 2011, C purchases for $10,000 and places in service Machinery Y in C's trade or business. C's basis in Machinery Y under section 1012 is $10,000. Machinery Y is qualified property within the meaning of Section 199A(b)(6). Assume that Machinery Y's recovery period under section 168(c) is 10 years, and C depreciates Machinery Y under the general depreciation system by using the straight-line depreciation method, a 10-year recovery period, and the half-year convention. As of December 31, 2018, C's basis in Machinery Y, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $2,500. On January 1, 2019, C incorporates the sole proprietorship and elects to treat the newly formed entity as an S corporation for Federal income tax purposes. C contributes Machinery Y and all other assets of the trade or business to the S corporation in a non-recognition transaction under section 351. The S corporation immediately places all the assets in service.

[747] See part II.M.3 Buying into or Forming a Partnership.
[748] See part II.Q.8.b.i Distribution of Property by a Partnership.

(ii) For purposes of Section 199A(b)(2)(B)(ii) and this section, C's UBIA of Machinery Y from 2011 through 2018 is its $10,000 cost basis under section 1012, regardless of any later depreciation deductions under section 168(a) and resulting basis adjustments under section 1016(a)(2). Pursuant to paragraph (c)(3) of this section, S corporation's UBIA of Machinery Y is determined under the applicable rules of subchapter C as of date the S corporation places it in service. Therefore, the S corporation's UBIA of Machinery Y is $2,500, the basis of the property under section 362 at the time the S corporation places the property in service. Pursuant to paragraph (c)(2)(iv)(A) of this section, for purposes of determining the depreciable period of Machinery Y, the S corporation's placed in service date will be the date C originally placed the property in service in 2011. Therefore, Machinery Y may be qualified property of the S corporation (assuming it continues to be used in the business) for 2019 and 2020 and will not be qualified property of the S corporation after 2020, because its depreciable period will have expired.

Example (3) shows a strategic mistake that a business owner can make when reorganizing. By incorporating C's business, C reduced Machinery Y's UBIA from $10,000 to only $2,500. (In addition to reducing UBIA under these rules, contributions of appreciated property may generate surprising allocations of UBIA; see fn 757.) C should have retained Machinery Y outside of the S corporation and leased it to the S corporation. C would have been able to aggregate C's rental income and deductions with the S corporation's QBI, even if the rental activity did not rise to the level of a trade or business.[749] Even if aggregation were not possible, equipment rental generally is considered to be a trade or business with even minimal activity,[750] whereas real estate requires some substantial level of activity.[751]

With all of this in mind, let's revisit the contrast between the lack of Code § 754 basis attributes for Code § 199A and the fresh start given when an individual (presumably including a disregarded entity) owns property.[752] Should each partner should consider whether he or she should have his or her own single member LLC own and lease property to the business? Consider equipment rental:

- As mentioned above,[753] equipment rental generally is considered to be a trade or business with even minimal activity, whereas real estate requires some substantial level of activity.

- Suppose equipment rental income is 20% of UBIA. That would generate a tentative QBI deduction of 4% (20% of 20%) of UBIA. That tentative deduction may be limited by the wage & UBIA limitation of 2.5% of UBIA. So the Code § 199A deduction may be less than it otherwise would be if the equipment rental cannot get aggregated with the main business and use the wage base.

- This strategy would backfire if the owner dies only a few years after the equipment purchase. Generally, used equipment is worth only a fraction of its original purchase price, so the UBIA would be significantly decreased. On the other hand, if the owner dies toward the end of the

[749] See Example (8) and Example (9) in part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A, referring to Reg. § 1.199A-1(b)(13) (special rule deeming rental as a trade or business when it otherwise would not be), which is reproduced in full in fn 678 in part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A.
[750] See part II.L.2.a.ii Rental Exception to SE Tax, fns 2817-2821.
[751] See part II.E.1.e Whether Real Estate Qualifies As a Trade or Business.
[752] For this contrast, see text preceding and accompanying fn 742.
[753] See fns 750-751.

depreciable period (the greater of 10 years or the property's class life, then restarting the depreciable period would be helpful. Note, however, that restarting the depreciable period would not be helpful under current law, because Code § 199A is scheduled to last less than 10 years; on the other hand, equipment near the end of the depreciable period may benefit from a depreciable period restart.

Now let's use a similar analysis for real estate:

- Real estate requires some substantial level of activity to constitute a trade or business,[754] unless it is under common control with a tenant that engages in a trade or business.[755]

- Gross rental income tends to be about 8% of the property's value, although in 2017 I heard of long-term leases with high quality tenants being 4% or lower. Depreciation over approximately 40 years means 2.5% per year. On the high end of the spectrum, that means profit of no more than 5.5% per year (8.0% minus 2.5%), which would generate a tentative QBI deduction of 1.1% (20% of 5.5%) of UBIA. Thus, that tentative deduction would not be limited by the wage & UBIA limitation of 2.5% of UBIA. However, if the property's value increased and the rent increased with it, the wage & UBIA limitation would kick in. At that point, consider whether to shift employees from the operating business to the landlord, if the rental is not aggregated with the operating business.

- The strategy would well if the property's value increased before the owner's death or the property needed a depreciable period restart. However, given that Code § 199A is scheduled to sunset in a period that is much shorter than real estate's class life, a restart would help only for real estate bought decades ago that is nearing the end of its class life or if Code § 199A is permanently extended.

If going for this new UBIA and new depreciation period in a disregarded entity LLC is helpful, consider distributing separate properties from the current partnership/LLC to separate disregarded entity LLCs:

- Distributions from a partnership to partners generally is tax-free, unless the distributed property was contributed by a partner other than the recipient partner. Be sure to consider all of the issues described in part II.Q.8.b Partnership Redemption or Other Distribution.

- Distributing a fractional interest to separate LLCs is unlikely to work. As described in part II.C.9 Whether an Arrangement (Including Tenancy-in-Common) Constitutes a Partnership, co-owners operating a trade or business generally will be treated as partners for federal income tax purposes and under state law. The main way to avoid partnership treatment is if the property is fully leased with triple-net-leases involving almost no work by the landlord; see part II.D.4.a Investment Trusts. If real estate is not a trade or business, it can qualify as QBI only by being under common control with the tenant.[756]

---

[754] See part II.E.1.e.i General Rules Regarding Real Estate As a Trade or Business.

[755] Prop. Reg. § 1.199A-4(b)(1)(i) is reproduced in full in part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A and illustrated by various Examples accompanying fn 683, including those demonstrating that a pass-through entity that owns a business can be in a different type of pass-through entity (S corporation compared to partnership) than the type that owns the real estate.

[756] See fn 795 in part II.E.1.e.i General Rules Regarding Real Estate As a Trade or Business.

As mentioned in the preamble above, Prop. Reg. § 1.199A-2(a)(3), reproduced in the text accompanying fn 644 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income, determines the allocation of UBIA to various owners, which includes:

> In the case of qualified property held by an RPE, each partner's … share of the UBIA of qualified property is an amount which bears the same proportion to the total UBIA of qualified property as the partner's … share of tax depreciation bears to the RPE's total tax depreciation with respect to the property for the year. In the case of qualified property held by a partnership which does not produce tax depreciation during the year (for example, property that has been held for less than 10 years but whose recovery period has ended), each partner's share of the UBIA of qualified property is based on how gain would be allocated to the partners pursuant to sections 704(b) and 704(c) if the qualified property were sold in a hypothetical transaction for cash equal to the fair market value of the qualified property.

In its Ocetober 12, 2018 comments regarding Prop. Reg. § 1.199A-2(a)(3), the American Bar Association's Section on Taxation stated:

> We recommend that the Final Regulations provide that a partnership allocate the UBIA of its Qualified Property to its partners in the same manner as the allocation of section 704(b) depreciation with respect to the Qualified Property. If Qualified Property does not produce section 704(b) depreciation, then the UBIA with respect to that Qualified Property should be allocated in the same manner as either (i) the allocation of section 704(b) depreciation with respect to other Qualified Property, or (ii) the allocation of "bottom line" section 704(b) income or loss, as described in Regulation section 1.704-1(a)(1)(vii).

Its recommendation is based on the idea that book depreciation is based on economics, whereas the Proposed Regulation allocations, which the comments refer to as the "Tax Items Approach," require much more detailed calculations and take into account the effect of prior depreciation deductions, which the concept of UBIA is supposed to ignore.[757] That recommendation persuades me, but we'll see whether it persuades the government.

---

[757] The comments said (footnotes omitted):

> The Tax Items Approach would require a separate calculation for each piece of Qualified Property. Section 704(c), which affects the allocation of tax depreciation in situations where there is a difference between section 704(b) basis and tax basis, generally is applied property-by-property. Therefore, the manner in which tax depreciation is allocated can vary for each piece of Qualified Property held by a partnership. In addition, these calculations could be even more complicated if the traditional method with curative allocations or the remedial method is used. If UBIA of Qualified Property is allocated based on section 704(b) depreciation instead of tax depreciation, then section 704(c) would not be taken into account, meaning that the allocation of Qualified Property would not necessarily need to be done separately for each piece of Qualified Property. The gain on the Hypothetical Transaction would also need be allocated separately for each piece of Qualified Property to properly account for section 704(c). This burdensome property-by-property calculation could be avoided by allowing taxpayers to refer to either (i) the allocation of section 704(b) depreciation of other Qualified Property, or (ii) the allocation of "bottom line" section 704(b) income or loss items under Regulation section 1.704-1(a)(1)(vii), when allocating the UBIA of Qualified Property that does not produce depreciation.
>
> The Tax Items Approach could also produce results that are unintended from a policy perspective. Often times, section 704(c) results in the contributing partner being allocated little or none of the tax depreciation with respect to contributed property. Therefore, little or none of the UBIA of

II.E.1.c.vii. Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction

If the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, that amount is treated as a loss from a qualified trade or business in the succeeding taxable year.[758] The Senate's report states (note that the Conference Committee reduced the deduction from 23% to 20%):

> If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward as a loss from a qualified trade or business in the next taxable year. Similar to a qualified trade or business that has a qualified business loss for the current taxable year, any deduction allowed in a subsequent year is reduced (but not below zero) by 23 percent of any carryover qualified business loss. For example, Taxpayer has qualified business income of $20,000 from qualified business A and a qualified business loss of $50,000 from qualified business B in Year 1. Taxpayer is not permitted a deduction for Year 1 and has a carryover qualified business loss of $30,000 to Year 2. In Year 2, Taxpayer has qualified business income of $20,000 from qualified business A and qualified business income of $50,000 from qualified business B. To determine the deduction for Year 2, Taxpayer reduces the 23 percent deductible amount determined for the qualified business income of $70,000 from qualified businesses A and B by 23 percent of the $30,000 carryover qualified business loss.

For individuals with taxable income for the taxable year that does not exceed the threshold amount, Prop. Reg. § 1.199A-1(c)(2), "Carryover rules," provides:

> (i) *Negative total QBI amount*. If the total QBI amount is less than zero, the portion of the individual's section 199A deduction related to QBI is zero for the taxable year. The negative total QBI amount is treated as negative QBI from a separate trade or business in the succeeding taxable year of the individual for purposes of section 199A and this

---

Qualified Property that is contributed to a partnership with a built-in gain would be allocated to the contributing partner. The fact that the contributing partner receives little to no tax depreciation with respect to contributed property is especially problematic considering that the impact of section 704(c) allocations will generally result in the contributing partners receiving a disproportionately large share of the partnership's income. If the contributing partner is allocated a disproportionately large share of the partnership's QBI and is allocated a disproportionately small share of the partnership's UBIA of Qualified Property, then the section 199A deduction available to the contributing partner may be limited even though the non-contributing partners have abundant UBIA of Qualified Property.

We considered whether the fact that a contributing partner may have contributed property with little to no basis is a good policy reason to allocate such partner a disproportionately small share of UBIA of Qualified Property. Because the rules under section 704(c) generally operate to ensure that a contributing partner is recognizing its built-in gain or loss over the life of contributed property, we do not believe limiting a contributing partner's ability to take a section 199A deduction is appropriate. Thus, any policy concerns with allocating UBIA of Qualified Property based on section 704(b) items versus tax items seem unwarranted, especially given the administrative burden resulting from the Tax Items Approach. Accordingly, it would seem more appropriate for partners to share in the UBIA of Qualified Property in the same manner that they share in the economic depreciation of such Qualified Property. For these reasons, we recommend that a partnership's UBIA of Qualified Property be allocated based on section 704(b) items, instead of applying the Tax Items Approach adopted in the Proposed Regulations.

[758] Code § 199A(c)(2).

section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

(ii) *Negative combined qualified REIT dividends/qualified PTP income*. If the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of the individual's section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends and qualified PTP income in the succeeding taxable year of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

Thus, losses from QBI are computed completely separately from losses from qualified PTP income that exceed qualified REIT dividends.

For individuals with taxable income for the taxable year that exceeds the threshold amount, Prop. Reg. § 1.199A-1(d)(2)(iii), "Netting and Carryover," provides:

(A) *Netting*. If an individual's QBI from at least one trade or business is less than zero, the individual must offset the QBI attributable to each trade or business that produced net positive QBI with the QBI from each trade or business that produced net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses with positive QBI. The adjusted QBI is then used in paragraph (d)(2)(iv) of this section. The W-2 wages and UBIA of qualified property from the trades or businesses which produced net negative QBI are not taken into account for purposes of this paragraph (d) and are not carried over to the subsequent year.

(B) *Carryover of negative total QBI amount*. If an individual's QBI from all trades or businesses combined is less than zero, the QBI component is zero for the taxable year. This negative amount is treated as negative QBI from a separate trade or business in the succeeding taxable year of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code. The W-2 wages and UBIA of qualified property from the trades or businesses which produced net negative QBI are not taken into account for purposes of this paragraph (d) and are not carried over to the subsequent year.

Let's see how some examples apply these rules. Prop. Reg. § 1.199A-1(d)(4), Example (7), part (i) provides the facts on which the examples below are based:

> F, an unmarried individual, owns as a sole proprietor 100 percent of three trades or businesses, Business X, Business Y, and Business Z. None of the businesses hold qualified property. F does not aggregate the trades or businesses under § 1.199A-4. For taxable year 2018, Business X generates $1 million of QBI and pays $500,000 of W-2 wages with respect to the business. Business Y also generates $1 million of QBI but pays no wages. Business Z generates $2,000 of QBI and pays $500,000 of W-2 wages with respect to the business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $2,722,000.

Prop. Reg. § 1.199A-1(d)(4), Example (9) provides:

(i) Assume the same facts as in Example 7 of this paragraph (d)(4), except that for taxable year 2018, Business Z generates a loss that results in ($600,000) of negative QBI and pays $500,000 of W-2 wages. After allowable deductions unrelated to the businesses, F's taxable income is $2,120,000. Because Business Z had negative QBI, F must offset the positive QBI from Business X and Business Y with the negative QBI from Business Z in proportion to the relative amounts of positive QBI from Business X and Business Y. Because Business X and Business Y produced the same amount of positive QBI, the negative QBI from Business Z is apportioned equally among Business X and Business Y. Therefore, the adjusted QBI for each of Business X and Business Y is $700,000 ($1 million plus 50% of the negative QBI of $600,000). The adjusted QBI in Business Z is $0, because its negative QBI has been fully apportioned to Business X and Business Y.

(ii) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W-2 wage limitation must be calculated. For Business X, the lesser of 20% of QBI ($700,000 x 20% = $140,000) and 50% of W-2 wages ($500,000 x 50% = $250,000) is $140,000. Business Y pays no W-2 wages. The lesser of 20% of Business Y's QBI ($700,000 x 20% = $140,000) and 50% of its W-2 wages (zero) is zero.

(iii) F must combine the amounts determined in paragraph (ii) of this example and compare the sum to 20% of taxable income. F's section 199A deduction equals the lesser of these two amounts. The combined amount from paragraph (ii) of this example is $140,000 ($140,000 + $0) and 20% of F's taxable income is $424,000 ($2,120,000 x 20%). Thus, F's section 199A deduction for 2018 is $140,000. There is no carryover of any loss into the following taxable year for purposes of section 199A.

Business Z’s wages are totally wasted from a Code § 199A view, because it has a loss and the wages cannot support a deduction. That’s not much of a different result that Example (7), where Business Z has nominal income. Note also the way that the losses were apportioned from Business Z to Businesses X and Y according to their respective shares of QBI.

Prop. Reg. § 1.199A-1(d)(4), Example (10) provides:

(i) Assume the same facts as in Example 9 of this paragraph (d)(4), except that F aggregates Business X, Business Y, and Business Z under the rules of §1.199A-4.

(ii) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. Because the businesses are aggregated, these limitations are applied on an aggregated basis. None of the businesses holds qualified property, therefore only the W-2 wage limitation must be calculated. F applies the limitation by determining the lesser of 20% of the QBI from the aggregated businesses ($1,400,000 x 20% = $280,000) and 50% of W-2 wages from the aggregated businesses ($1,000,000 x 50% = $500,000), or $280,000. F's section 199A deduction is equal to the lesser of $280,000 and 20% of F's taxable income ($2,120,000 x 20% = $424,000). Thus, F's section 199A deduction for 2018 is $280,000. There is no carryover of any loss into the following taxable year for purposes of section 199A.

Example (10) shows the benefit of irrevocably electing to aggregate, as described in part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A. Although Example (10) has more wages than necessary to support the $280,000 deduction, aggregation enabled F to use most of wages that were wasted in Example (9).

Prop. Reg. § 1.199A-1(d)(4), Example (11) provides:

(i) Assume the same facts as in Example 7 of this paragraph (d)(4), except that Business Z generates a loss that results in ($2,150,000) of negative QBI and pays $500,000 of W-2 wages with respect to the business in 2018. Thus, F has a negative combined QBI of ($150,000) when the QBI from all of the businesses are added together ($1 million plus $1 million minus the loss of ($2,150,000)). Because F has a negative combined QBI for 2018, F has no section 199A deduction with respect to any trade or business for 2018. Instead, the negative combined QBI of ($150,000) carries forward and will be treated as negative QBI from a separate trade or business for purposes of computing the section 199A deduction in the next taxable year. None of the W-2 wages carry forward. However, for income tax purposes, the $150,000 loss may offset F's $750,000 of wage income (assuming the loss is otherwise allowable under the Code).

(ii) In taxable year 2019, Business X generates $200,000 of net QBI and pays $100,000 of W-2 wages with respect to the business. Business Y generates $150,000 of net QBI but pays no wages. Business Z generates a loss that results in ($120,000) of negative QBI and pays $500 of W-2 wages with respect to the business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $960,000. Pursuant to paragraph (d)(2)(iii)(B) of this section, the ($150,000) of negative QBI from 2018 is treated as arising in 2019 from a separate trade or business. Thus, F has overall net QBI of $80,000 when all trades or businesses are taken together ($200,000 plus $150,000 minus $120,000 minus the carryover loss of $150,000). Because Business Z had negative QBI and F also has a negative QBI carryover amount, F must offset the positive QBI from Business X and Business Y with the negative QBI from Business Z and the carryover amount in proportion to the relative amounts of positive QBI from Business X and Business Y. Because Business X produced 57.14% of the total QBI from Business X and Business Y, 57.14% of the negative QBI from Business Z and the negative QBI carryforward must be apportioned to Business X, and the remaining 42.86% allocated to Business Y. Therefore, the adjusted QBI in Business X is $45,722 ($200,000 minus 57.14% of the loss from Business Z ($68,568), minus 57.14% of the carryover loss ($85,710)). The adjusted QBI in Business Y is $34,278 ($150,000, minus 42.86% of the loss from Business Z ($51,432) minus one third of the carryover loss ($64,290)). The adjusted QBI in Business Z is $0, because its negative QBI has been apportioned to Business X and Business Y.

(iii) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W-2 wage limitation must be calculated. For Business X, 20% of QBI is $9,144 ($45,722 x 20%) and 50% of W-2 wages is $50,000 ($100,000 x 50%), so the lesser amount is $9,144. Business Y pays no W-2 wages. Twenty percent of Business Y's QBI is $6,856 ($34,278 x 20%) and 50% of its W-2 wages (zero) is zero, so the lesser amount is zero.

(iv) F must then compare the combined amounts determined in paragraph (iii) of this example to 20% of F's taxable income. The section 199A deduction equals the lesser of these amounts. F's combined amount from paragraph (iii) of this example is $9,144 ($9,144 plus zero) and 20% of F's taxable income is $192,000 ($960,000 x 20%) Thus, F's section 199A deduction for 2019 is $9,144. There is no carryover of any negative QBI into the following taxable year for purposes of section 199A.

Note again how losses were apportioned from Business Z to Businesses X and Y according to their respective shares of QBI – this time not only for the current loss but also the carryover loss. Also note that some wages from Business X and all wages from Business Z were wasted, with Business Y not receiving any benefit from them. However, at least Business Y was able to absorb some of the losses from Business Z and the carryover losses, so the Business X was not hit with all of them and was therefore able to use its wages.

Prop. Reg. § 1.199A-1(d)(4), Example (12) provides:

(i) Assume the same facts as in Example 11 of this paragraph (d)(4), except that F aggregates Business X, Business Y, and Business Z under the rules of § 1.199A-4. For 2018, F's QBI from the aggregated trade or business is ($150,000). Because F has a combined negative QBI for 2018, F has no section 199A deduction with respect to any trade or business for 2018. Instead, the negative combined QBI of ($150,000) carries forward and will be treated as negative QBI from a separate trade or business for purposes of computing the section 199A deduction in the next taxable year. However, for income tax purposes, the $150,000 loss may offset taxpayer's $750,000 of wage income (assuming the loss is otherwise allowable under the Code)

(ii) In taxable year 2019, F will have QBI of $230,000 and W-2 wages of $100,500 from the aggregated trade or business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $960,000. F must treat the negative QBI carryover loss ($150,000) from 2018 as a loss from a separate trade or business for purposes of section 199A. This loss will offset the positive QBI from the aggregated trade or business, resulting in an adjusted QBI of $80,000 ($230,000 - $150,000).

(iii) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W-2 wage limitation must be calculated. For the aggregated trade or business, the lesser of 20% of QBI ($80,000 x 20% = $16,000) and 50% of W-2 wages ($100,500 x 50% = $50,250) is $16,000. F's section 199A deduction equals the lesser of these amounts ($16,000) and 20% of F's taxable income ($960,000 x 20% = $192,000). Thus, F's section 199A deduction for 2019 is $16,000. There is no carryover of any negative QBI into the following taxable year for purposes of section 199A.

Once again, aggregation has increased the deduction by allowing the wages of all of the qualified businesses to be counted.

A business that is projected to lose money might consider deferring wages to the next year if the wage limitation is a significant limitation in determining its owners' Code § 199A deduction. Of course, deferring that deduction also increases the owners' current taxable income, so any such planning should consider its context in the owners' overall tax planning.

Prop. Reg. § 1.199A-3(b)(1)(iv), "Previously disallowed losses," provides:

> Generally, previously disallowed losses or deductions (including under sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year are taken into account for purposes of computing QBI. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (including under sections 465, 469, 704(d), and 1366(d)), are not taken into account in a later taxable year for purposes of computing QBI.

This does not authorize the wage and UBIA attributes to be carried over as well. However, for other reasons, being passive may be beneficial; see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. On the other hand, being passive is unfavorable if it generates the 3.8% tax on net investment income; see part II.I.8.a General Application of 3.8% Tax to Business Income.

II.E.1.c.viii. Income or Gain from or Sale of Property Used in the Business or Business Interest Itself

This part II.E.1.c.viii discusses specific applications:

- Part II.E.1.c.viii.(a) Passthrough Sale of Equipment It Is Using
- Part II.E.1.c.viii.(b) Passthrough Sale of a Building It Is Using.
- Part II.E.1.c.viii.(c) Sale of an Interest in a Partnership Conducting a Trade or Business.
- Part II.E.1.c.viii.(d) Sale of a Stock in an S corporation Conducting a Trade or Business.

II.E.1.c.viii.(a). Passthrough Sale of Equipment It Is Using

Qualified business income ("QBI") means "the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer."[759] Thus, gain from the sale of equipment can be QBI only if it is with respect to a qualified trade or business.

Long-term capital gain is not QBI; see Prop. Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A. However, Part II.E.1.c.ii.(c) includes an excerpt from the preamble (Treatment of section 1231 gains and losses) that gain taxed as ordinary income is QBI.

[759] Code § 199A(c)(1), first cited in fn 662 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

II.E.1.c.viii.(b). Passthrough Sale of a Building It Is Using

Qualified business income ("QBI") means "the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer."[760] Thus, gain from the sale of a building can be QBI only if it is with respect to a qualified trade or business.

Strangely enough, property used in a business is not a capital asset. When real estate that is depreciated using straight-line depreciation (which generally applies to real estate acquired after 1986 and some acquired before 1986), Code § 1231 taxes gain of real estate held more than one year as long-term capital gain and losses as ordinary losses. Capital gain that recaptures straight-line depreciation is subject to capital gain tax higher that regular capital gain tax rates. However, if and to the extent that the taxpayer previously deducted ordinary losses under Code § 1231, the gain is taxed as ordinary income. See part II.G.5.a Code § 1231 Property, which also covers the sale of goodwill.

If and to the extent that a cost segregation study causes components to be subject to accelerated depreciation or if accelerated depreciation was used for the building, see the analysis in part II.E.1.c.viii.(a) Passthrough Sale of Equipment It Is Using.

Also, if a passthrough sells depreciable property to a related party, generally any gain is taxed as ordinary income. See parts II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill) and II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships. That, too would use the analysis in part II.E.1.c.viii.(a) Passthrough Sale of Equipment It Is Using.

To the extent that the sale of a building is taxed as long-term capital gain, it is not QBI. See Prop. Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A. However, Part II.E.1.c.ii.(c) includes an excerpt from the preamble (Treatment of section 1231 gains and losses) that gain taxed as ordinary income is QBI.

II.E.1.c.viii.(c). Sale of an Interest in a Partnership Conducting a Trade or Business

Qualified business income ("QBI") means "the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer."[761] Thus, gain from the sale of a partnership interest can be QBI only if it is with respect to a qualified trade or business.

The sale of a partnership interest may be taxed as capital gain, as provided in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, or as gain from the sale of an asset that is not a capital asset (ordinary income), under part II.Q.8.b.i.(f) Code § 751 – Hot Assets. Capital gain from the sale of a partnership interest is not QBI. See Prop. Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

---

760 Code § 199A(c)(1), first cited in fn 662 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

761 Code § 199A(c)(1), first cited in fn 662 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

However, Code § 751 ordinary income qualifies. See Prop. Reg. § 1.199A-3(b)(1)(i), reproduced in part II.E.1.c.ii.(a) Generally; List of Items Included in QBI.

II.E.1.c.viii.(d). Sale of a Stock in an S corporation Conducting a Trade or Business

Because the sale of S corporation stock is taxed as capital gain, it is not QBI. See Prop. Reg. § 1.199A-3(b)(2)(ii)(A), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.

However, the sale of S corporation stock is often treated as a sale of the underlying assets, with the gain increasing the stock's basis, followed by a deemed liquidation of the corporation, shifting the gain on sale of stock to a gain on sale of assets. See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold. Such a sale tends to trigger ordinary income on the deemed sale of the assets, to the extent of depreciation recapture on personal property and any other property not depreciable as real estate. For additional ordinary income concerns if the buyer is a related party, see part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property. Part II.E.1.c.ii.(c) includes an excerpt from the preamble (Treatment of section 1231 gains and losses) that gain taxed as ordinary income is QBI. Thus, the Code § 199A deduction would ameliorate tax on actual or deemed asset sales.

II.E.1.c.ix. QBI and Effectively Connected Income

Items of QBI are "of income, gain, deduction, and loss" included or allowed in determining taxable income for the taxable year to the extent such items are:[762]

> effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "qualified trade or business (within the meaning of Section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears)….

The preamble, REG-107892-18 (8/16/2018), provides:

> **vi. Requirement that an item be effectively connected with a U.S. trade or business**
>
> Section 199A applies to all noncorporate taxpayers, whether such taxpayers are domestic or foreign. Accordingly, Section 199A applies to both U.S. citizens and resident aliens as well as nonresident aliens that have QBI. As noted previously in this Explanation of Provisions, QBI includes items of income, gain, deduction, and loss to the extent such items are (i) included or allowed in determining taxable income for the taxable year and (ii) effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "qualified trade or

[762] Code § 199A(c)(3)(A)(i), cited in fn 666 in part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction. Literally plugging Code § 199A(c)(3)(A)(i) into Code § 864(c) would make Code § 864(c)(1) read as follows:

> In the case of a qualified trade or business (within the meaning of section 199A) engaged in trade or business within the United States during the taxable year, the rules set forth in paragraphs (2), (3), (4), (6), (7), and (8) shall apply in determining the income, gain, or loss which shall be treated as effectively connected with the conduct of a trade or business within the United States.

business (within the meaning of Section 199A)” for “nonresident alien individual or a foreign corporation” or for “a foreign corporation” each place it appears).

a. Summary of rules for generally determining whether income is effectively connected with a United States trade or business

Section 864(c) provides rules that nonresident alien individuals and foreign corporations use to determine which items of income, gain, or loss are effectively connected with a United States trade or business. Section 873(a) permits nonresident aliens to deduct expenses only if and to the extent that they are connected with, or properly allocable and apportioned to, income effectively connected with a United States trade or business.

Thus, for example, a U.S. partner of a partnership that operates a trade or business in both the United States and in a foreign country would only include the items of income, gain, deductions, and loss that would be effectively connected with a United States trade or business. Similarly, a shareholder of an S corporation that is engaged in a trade or business in both the United States and in a foreign country would only take into account the items of income, gain, deduction, and loss that would be effectively connected to the portion of the business conducted by the S corporation in the United States, determined by applying the principles of section 864(c).

In general, whether a nonresident alien is engaged in a trade or business within the United States, as opposed to a trade or business conducted solely outside the United States, is based upon the all the facts and circumstances, as developed through case law and other published guidance. Pursuant to section 875(1), a nonresident alien is considered engaged in a trade or business within the United States if the partnership of which such individual is a member is so engaged.

Section 864(b) provides that the term “trade or business within the United States” includes (but is not limited to) the performance of personal services within the United States at any time during the taxable year, but excludes the performance of services described in section 864(b)(1) and (2). Section 864(b)(1) covers a limited set of nonresident aliens who perform services in the United States on behalf of foreign persons not otherwise engaged in a U.S. trade or business, or on behalf of U.S. persons through a foreign office, if the nonresident aliens are present in the United States less than 90 days during the taxable year and their compensation does not exceed $3,000. Section 864(b)(2) generally treats foreign persons, including partnerships, who are trading in stocks, securities, and in commodities for their own account or through a broker or other independent agent as not engaged in a United States trade or business.

b. Application to Section 199A

Although the cross reference in Section 199A(c)(3)(A)(i) to section 864 is limited to paragraph (c) of that section, no income derived from excluded services under section 864(b)(1) or (2) could ever be effectively connected income in the hands of a nonresident alien. Accordingly, Section 199A incorporates the specific rules regarding the scope of the term “trade or business in the United States” in determining QBI. As such, if a trade or business is not engaged in a U.S. trade or business by reason of section 864(b), items of income, gain, deduction, or loss from that trade or business will not be included in QBI because such items would not be effectively connected with the conduct of a U.S. trade or business.

If a trade or business is determined to be conducted in the United States, section 864(c)(3) generally treats all income of a nonresident alien from sources within the United States as effectively connected with the conduct of a U.S. trade or business. However, any income from sources within the United States described in section 871(a)(1) or (h) and any gain or loss from the sale of capital assets are only effectively connected if the income meets requirements of section 864(c)(2) and the regulations thereunder. Under section 864(c)(4), income from sources without the United States is generally not treated as effectively connected with the conduct of a U.S. trade or business unless an exception under section 864(c)(4)(B) applies. Thus, a trade or business's foreign source income, gain, or loss, (and any deductions effectively connected with such foreign source income, gain, or loss) would generally not be included in QBI, unless the income meets an exception in section 864(c)(4)(B). Whether income is U.S. or foreign sourced is determined under sections 861, 862, 863, and 865, and the regulations thereunder.

This rule does not mean that any item that is effectively connected with the conduct of a trade or business with the United States is therefore QBI. As discussed previously, the item must also be "with respect to" a trade or business. Certain provisions of the Code allow items to be treated as effectively connected, even though they are not with respect to a trade or business. For example, section 871(d) allows a nonresident alien individual to elect to treat income from real property in the United States that would not otherwise be treated as effectively connected with the conduct of a trade or business within the United Sates as effectively connected. However, for purposes of Section 199A, if items are not attributable to a trade or business under 162, such items do not constitute QBI.

Similarly, the fact that a deduction is allowed for purposes of computing effectively connected taxable income does not necessarily mean that it is taken into account for purposes of Section 199A. For example, for purposes of computing effectively connected taxable income, section 873(b) allows certain deductions, including for theft losses of property located within the United States and charitable contributions allowed under section 170, to be taken into account regardless of whether they are connected with income that is effectively connected with the conduct of a trade or business within the United States. However, for purposes of Section 199A, these items would not be taken into account because Section 199A only permits a deduction for income that is both attributable to a trade or business and that is also effectively connected income.

Prop. Reg. § 1.199A-3(b)(2)(i) provides:

In general. The term qualified items of income, gain, deduction, and loss means items of gross income, gain, deduction, and loss to the extent such items are—

(A) Effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "trade or business (within the meaning of Section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears), and

(B) Included or allowed in determining taxable income for the taxable year.

Code § 864(c) taxes nonresident alien individuals on income and sets forth rules that "apply in determining the income, gain, or loss which shall be treated as effectively connected with the conduct of a trade or business within the United States."[763]

Note re: various citations below to regulations under Code § 864(c): various tax research services warn that the Treasury has not yet amended them to reflect changes made by laws since 1984, and they include this warning even for regulations promulgated many years after 1984. I have not taken the time to look how accurate these warnings are; however, it has been suggested to me that the regulations are good law. Furthermore, ruling or determination letters will not ordinarily be issued:[764]

> Section 864. - Definitions and Special Rules. - Whether a taxpayer is engaged in a trade or business within the United States, and whether income is effectively connected with the conduct of a trade or business within the United States; whether an instrument is a security as defined in § 1.864-2(c)(2); whether a taxpayer effects transactions in the United States in stocks or securities under § 1.864-2(c)(2); whether an instrument or item is a commodity as defined in § 1.864-2(d)(3); and for purposes of § 1.864-2(d)(1) and (2), whether a commodity is of a kind customarily dealt in on an organized commodity exchange, and whether a transaction is of a kind customarily consummated at such place.

Code § 864(c)(2) provides that, in determining whether certain "fixed or determinable income" - or:[765]

> whether gain or loss from sources within the United States from the sale or exchange of capital assets, is effectively connected with the conduct of a trade or business within the United States, the factors taken into account shall include whether-
>
> (A) the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business, or
>
> (B) the activities of such trade or business were a material factor in the realization of the income, gain, or loss.
>
> In determining whether an asset is used in or held for use in the conduct of such trade or business or whether the activities of such trade or business were a material factor in

[763] Code § 864(c)(1)(A).

[764] Rev. Proc. 2018-7, Section 4.01(4).

[765] Reg. § 1.864-4(a), "In general," provides:

> This section applies only to a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year beginning after December 31, 1966, and to the income, gain, or loss of such person form sources within the United States. If the income, gain, or loss of such person for the taxable year from sources within the United States consists of (1) gain or loss from the sale or exchange of capital assets or (2) fixed or determinable annual or periodical gains, profits, and income or certain other gains described in section 871(a)(1) or 881(a), certain factors must be taken into account, as prescribed by section 864(c)(2) and paragraph (c) of this section, in order to determine whether the income, gain, or loss is effectively connected for the taxable year with the conduct of a trade or business in the United States by that person. All other income, gain, or loss of such person for the taxable year from sources within the United States shall be treated as effectively connected for the taxable year with conduct of a trade or business in the United States by that person, as prescribed by section 864(c)(3) and paragraph (b) of this section.

> realizing an item of income, gain, or loss, due regard shall be given to whether or not such asset or such income, gain, or loss was accounted for through such trade or business.

The fixed or determinable income to which Code § 864(c)(2) refers is "income from sources within the United States of the types described in section 871(a)(1), section 871(h), section 881(a), or section 881(c)." Code § 871(a)(1), "Income other than capital gains," provides that, except as provided in Code § 871(h) (relating to "portfolio interest"), a 30% tax is imposed on

> the amount received from sources within the United States by a nonresident alien individual as—
>
> (A) interest (other than original issue discount as defined in section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income,
>
> (B) gains described in subsection (b) or (c) of section 631,
>
> (C) in the case of—
>
> (i) a sale or exchange of an original issue discount obligation, the amount of the original issue discount accruing while such obligation was held by the nonresident alien individual (to the extent such discount was not theretofore taken into account under clause (ii)), and
>
> (ii) a payment on an original issue discount obligation, an amount equal to the original issue discount accruing while such obligation was held by the nonresident alien individual (except that such original issue discount shall be taken into account under this clause only to the extent such discount was not theretofore taken into account under this clause and only to the extent that the tax thereon does not exceed the payment less the tax imposed by subparagraph (A) thereon), and
>
> (D) gains from the sale or exchange after October 4, 1966, of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property, or of any interest in any such property, to the extent such gains are from payments which are contingent on the productivity, use, or disposition of the property or interest sold or exchanged,
>
> but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

Code § 881, which applies to foreign corporations, is similar to Code § 871, which applies to nonresident aliens, regarding the above items.

Code § 871(a)(1)(A) is further described in part II.E.1.e.ii Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules.[766]

---

[766] Absent any guidance under the ECI rules, see part II.E.1.e.i General Rules Regarding Real Estate As a Trade or Business.

In determining whether fixed or determinable income and capital gains for the taxable year from sources within the United States is effectively connected for the taxable year with the conduct of a trade or business in the United States:[767]

> the principal tests to be applied are (a) the asset-use test, that is, whether the income, gain, or loss is derived from assets used in, or held for use in, the conduct of the trade or business in the United States, and (b) the business-activities test, that is, whether the activities of the trade or business conducted in the United States were a material factor in the realization of the income, gain, or loss.

The asset-use test ordinarily applies in:[768]

> making a determination with respect to income, gain, or loss of a passive type where the trade or business activities as such do not give rise directly to the realization of the income, gain, or loss. However, even in the case of such income, gain, or loss, any activities of the trade or business which materially contribute to the realization of such income, gain, or loss shall also be taken into account as a factor in determining whether the income, gain, or loss is effectively connected with the conduct of a trade or business in the United States. The asset-use test is of primary significance where, for example, interest income is derived from sources within the United States by a nonresident alien individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the United States.

Ordinarily, an asset is treated as used in, or held for use in, the conduct of a trade or business in the United States if the asset is:[769]

> (a) Held for the principal purpose of promoting the present conduct of the trade or business in the United States; or
>
> (b) Acquired and held in the ordinary course of the trade or business conducted in the United States, as, for example, in the case of an account or note receivable arising from that trade or business; or
>
> (c) Otherwise held in a direct relationship to the trade or business conducted in the United States, as determined under paragraph (c)(2)(iv) of this section.

---

767 Reg. § 1.864-4(c)(1)(i). Reg. § 1.864-4(c)(1)(ii) provides:

> *Special rule relating to interest on certain deposits*. For purposes of determining under section 861(a)(1)(A) (relating to interest on deposits with banks, savings and loan associations, and insurance companies paid or credited before Jan. 1, 1976) whether the interest described therein is effectively connected for the taxable year with the conduct of a trade or business in the United States, such interest shall be treated as income from sources within the United States for purposes of applying this paragraph and § 1.864-5. If by reason of the application of this paragraph such interest is determined to be income which is not effectively connected for the taxable year with the conduct of a trade or business in the United States, it shall then be treated as interest from sources without the United States which is not subject to the application of § 1.864-5.

768 Reg. § 1.864-4(c)(2)(i), which concludes:

> See also subparagraph (5) of this paragraph for rules applicable to taxpayers conducting a banking, financing, or similar business in the United States.

769 Reg. § 1.864-4(c)(2)(ii).

Generally, "stock of a corporation (whether domestic or foreign) shall not be treated as an asset used in, or held for use in, the conduct of a trade or business in the United States."[770] However, the preceding sentence "shall not apply to stock of a corporation (whether domestic or foreign) held by a foreign insurance company unless the foreign insurance company owns 10 percent or more of the total voting power or value of all classes of stock of such corporation."[771]

Reg. § 1.864-4(c)(2)(iv), "Direct relationship between holding of asset and trade or business," provides:

> (a) *In general*. In determining whether an asset is held in a direct relationship to the trade or business conducted in the United States, principal consideration shall be given to whether the asset is needed in that trade or business. An asset shall be considered needed in a trade or business, for this purpose, only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset shall be considered as needed in the trade or business conducted in the United States if, for example, the asset is held to meet the operating expenses of that trade or business. Conversely, an asset shall be considered as not needed in the trade or business conducted in the United States if, for example, the asset is held for the purpose of providing for (1) future diversification into a new trade or business, (2) expansion of trade or business activities conducted outside of the United States, (3) future plant replacement, or (4) future business contingencies.
>
> (b) *Presumption of direct relationship*. Generally, an asset will be treated as held in a direct relationship to the trade or business if (1) the asset was acquired with funds generated by that trade or business, (2) the income from the asset is retained or reinvested in that trade or business, and (3) personnel who are present in the United States and actively involved in the conduct of that trade or business exercise significant management and control over the investment of such asset.

The following examples illustrate Reg. § 1.864-4(c)(2)(iv):[772]

> *Example (1)*. M, a foreign corporation which uses the calendar year as the taxable year, is engaged in industrial manufacturing in a foreign country. M maintains a branch in the United States which acts as importer and distributor of the merchandise it manufactures abroad; by reason of these branch activities, M is engaged in business in the United States during 1968. The branch in the United States is required to hold a large current cash balance for business purposes, but the amount of the cash balance so required varies because of the fluctuating seasonal nature of the branch's business. During 1968 at a time when large cash balances are not required the branch invests the surplus amount in U.S. Treasury bills. Since these Treasury bills are held to meet the present needs of the business conducted in the United States they are held in a direct relationship to that business, and the interest for 1968 on these bills is effectively connected for that year with the conduct of the business in the United States by M.

---

[770] Reg. § 1.864-4(c)(2)(iii)(a).

[771] Reg. § 1.864-4(c)(2)(iii)(b), which further provides:

> For purposes of this section, section 318(a) shall be applied in determining ownership, except that in applying section 318(a)(2)(C), the phrase "10 percent" is used instead of the phrase "50 percent."

[772] Reg. § 1.864-4(c)(2)(v).

Example (2). Foreign corporation M, which uses the calendar year as the taxable year, has a branch office in the United States where it sells to customers located in the United States various products which are manufactured by that corporation in a foreign country. By reason of this activity M is engaged in business in the United States during 1997. The U.S. branch establishes in 1997 a fund to which are periodically credited various amounts which are derived from the business carried on at such branch. The amounts in this fund are invested in various securities issued by domestic corporations by the managing officers of the U.S. branch, who have the responsibility for maintaining proper investment diversification and investment of the fund. During 1997, the branch office derives from sources within the United States interest on these securities, and gains and losses resulting from the sale or exchange of such securities. Since the securities were acquired with amounts generated by the business conducted in the United States, the interest is retained in that business, and the portfolio is managed by personnel actively involved in the conduct of that business, the securities are presumed under paragraph (c)(2)(iv)(b) of this section to be held in a direct relationship to that business. However, M is able to rebut this presumption by demonstrating that the fund was established to carry out a program of future expansion and not to meet the present needs of the business conducted in the United States. Consequently, the income, gains, and losses from the securities for 1997 are not effectively connected for that year with the conduct of a trade or business in the United States by M.

The business-activities test ordinarily applies:[773]

in making a determination with respect to income, gain, or loss which, even though generally of the passive type, arises directly from the active conduct of the taxpayer's trade or business in the United States. The business-activities test is of primary significance, for example, where (a) dividends or interest are derived by a dealer in stocks or securities, (b) gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business by an investment company, (c) royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, or (d) service fees are derived in the active conduct of a servicing business. In applying the business-activities test, activities relating to the management of investment portfolios shall not be treated as activities of the trade or business conducted in the United States unless the maintenance of the investments constitutes the principal activity of that trade or business.

The following examples illustrate the business-activities test:[774]

Example (1). Foreign corporation S is a foreign investment company organized for the purpose of investing in stocks and securities. S is not a personal holding company or a corporation which would be a personal holding company but for section 542(c)(7) or 543(b)(1)(C). Its investment portfolios consist of common stocks issued by both foreign and domestic corporations and a substantial amount of high grade bonds. The business activity of S consists of the management of its portfolios for the purpose of investing, reinvesting, or trading in stocks and securities. During the taxable year 1968, S has its principal office in the United States within the meaning of paragraph (c)(2)(iii) of § 1.864-

[773] Reg. § 1.864-4(c)(3)(i), which concludes:

See also subparagraph (5) of this paragraph for rules applicable to taxpayers conducting a banking, financing, or similar business in the United States.

[774] Reg. § 1.864-4(c)(3)(ii).

2, and, by reason of its trading in the United States in stocks and securities, is engaged in business in the United States. The dividends and interest derived by S during 1968 from sources within the United States, and the gains and losses from sources within the United States for such year from the sale of stocks and securities from its investment portfolios, are effectively connected for 1968 with the conduct of the business in the United States by that corporation, since its activities in connection with the management of its investment portfolios are activities of that business and such activities are a material factor in the realization of such income, gains, or losses.

> *Example (2)*. N, a foreign corporation which uses the calendar year as the taxable year, has a branch in the United States which acts as an importer and distributor of merchandise; by reason of the activities of that branch, N is engaged in business in the United States during 1968. N also carries on a business in which it licenses patents to unrelated persons in the United States for use in the United States. The businesses of the licensees in which these patents are used have no direct relationship to the business carried on in N's branch in the United States, although the merchandise marketed by the branch is similar in type to that manufactured under the patents. The negotiations and other activities leading up to the consummation of these licenses are conducted by employees of N who are not connected with the U.S. branch of that corporation, and the U.S. branch does not otherwise participate in arranging for the licenses. Royalties received by N during 1968 from these licenses are not effectively connected for that year with the conduct of its business in the United States because the activities of that business are not a material factor in the realization of such income.

In applying the asset-use test or the business-activities test described above:[775]

> due regard shall be given to whether or not the asset, or the income, gain, or loss is accounted for through the trade or business conducted in the United States, that is, whether or not the asset, or the income, gain or loss, is carried on books of account separately kept for that trade or business, but this accounting test shall not by itself be controlling. In applying this subparagraph, consideration shall be given to whether the accounting treatment of an item reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted condition or practices in that trade or business and whether there is a consistent accounting treatment of that item from year to year by the taxpayer.

Regarding income related to an individual's personal services:[776]

> (i) *Income, gain, or loss from assets*. Income or gains from sources within the United States described in section 871(a)(1) and derived from an asset, and gain or loss from sources within the United States from the sale of exchange of capital assets, realized by a nonresident alien individual engaged in a trade or business in the United States during the taxable year solely by reason of his performing personal services in the United States shall not be treated as income, gain, or loss which is effectively connected for the taxable year with the conduct of a trade or business in the United States, unless there is a direct economic relationship between his holding of the asset

[775] Reg. § 1.864-4(c)(4).
[776] Reg. § 1.864-4(c)(6).

from which the income, gain, or loss results and his trade or business or performing the personal services.

(ii) *Wages, salaries, and pensions*. Wages, salaries, fees, compensations, emoluments, or other remunerations, including bonuses, received by a nonresident alien individual for performing personal services in the United States which, under paragraph (a) of § 1.864-2, constitute engaging in a trade or business in the United States, and pensions and retirement pay attributable to such personal services, constitute income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual if he is engaged in a trade or business in the United States at some time during the taxable year in which such income is received.

Other than fixed or determinable income and capital gains, all income, gain, or loss "from sources within the United States" is "treated as effectively connected with the conduct of a trade or business within the United States."[777] For example:[778]

Example (1). M, a foreign corporation which uses the calendar year as the taxable year, is engaged in the business of manufacturing machine tools in a foreign country. It establishes a branch office in the United States during 1968 which solicits orders from customers in the United States for the machine tools manufactured by that corporation. All negotiations with respect to such sales are carried on in the United States. By reason of its activity in the United States M is engaged in business in the United States during 1968. The income or loss from sources within the United States from such sales during 1968 is treated as effectively connected for that year with the conduct of a business in the United States by M. Occasionally, during 1968 the customers in the United States write directly to the home office of M, and the home office makes sales directly to such customers without routing the transactions through it branch office in the United States. The income or loss from sources within the United States for 1968 from these occasional direct sales by the home office is also treated as effectively connected for that year with the conduct of a business in the United States by M.

Example (2). The facts are the same as in example (1) except that during 1967 M was also engaged in the business of purchasing and selling office machines and that it used the installment method of accounting for the sales made in this separate business. During 1967 M was engaged in business in the United States by reason of the sales activities it carried on in the United States for the purpose of selling therein a number of the office machines which it had purchased. Although M discontinued this business activity in the United States in December of 1967, it received in 1968 some installment

---

[777] Code § 864(c)(3). Reg. § 1.864-4(b), "Income other than fixed or determinable income and capital gains," provides:

All income, gain, or loss for the taxable year derived by a nonresident alien individual or foreign corporation engaged in a trade or business in the United States from sources within the United States which does not consist of income, gain, or loss described in section 871(a)(1) or 881(a), or of gain or loss from the sale or exchange of capital assets, shall, for purposes of paragraph (a) of this section, be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States. This income, gain, or loss shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States, whether or not the income, gain, or loss is derived from the trade or business being carried on in the United States during the taxable year.

[778] Reg. § 1.864-4(b).

payments on the sales which it had made in the United States during 1967. The income of M for 1968 from sources within the United States which is attributable to such installment payments is effectively connected for 1968 with the conduct of a business in the United States, even though such income is not connected with the business carried on in the United States during 1968 through its sales office located in the United States for the solicitation of orders for the machine tools it manufacturers.

Example (3). Foreign corporation S, which uses the calendar year as the taxable year, is engaged in the business of purchasing and selling electronic equipment. The home office of such corporation is also engaged in the business of purchasing and selling vintage wines. During 1968, S establishes a branch office in the United States to sell electronic equipment to customers, some of whom are located in the United States and the balance, in foreign countries. This branch office is not equipped to sell, and does not participate in sales of, wine purchased by the home office. Negotiations for the sales of the electronic equipment take place in the United States. By reason of the activity of its branch office in the United States, S is engaged in business in the United States during 1968. As a result of advertisements which the home office of S places in periodicals sold in the United States, customers in the United States frequently place orders for the purchase of wines with the home office in the foreign country, and the home office makes sales of wine in 1968 directly to such customers without routing the transactions through its branch office in the United States. The income or loss from sources within the United States for 1968 from sales of electronic equipment by the branch office, together with the income or loss from sources within the United States for that year from sales of wine by the home office, is treated as effectively connected for that year with the conduct of a business in the United States by S.

Special rules apply to whether income, gain or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual. Code § 864(c)(4), "Income from sources without United States," provides:

(A) Except as provided in subparagraphs (B) and (C), no income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States.

(B) Income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual or a foreign corporation if such person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable and such income, gain, or loss-[779]

[779] [my footnote – not in statute]: Code § 864(c)(5), which is discussed in case at fns 782 (together with Code § 864(c)(4)(B)) and 784 of this part II.E.1.c.ix QBI and Effectively Connected Income, provides the following rules in applying Code § 864(c)(4)(B):

(A) in determining whether a nonresident alien individual or a foreign corporation has an office or other fixed place of business, an office or other fixed place of business of an agent shall be disregarded unless such agent (i) has the authority to negotiate and conclude contracts in the name of the nonresident alien individual or foreign corporation and regularly exercises that authority or has a stock of merchandise from which he regularly fills orders on behalf of such

(i) consists of rents or royalties for the use of or for the privilege of using intangible property described in section 862(a)(4) derived in the active conduct of such trade or business;

(ii) consists of dividends, interest, or amounts received for the provision of guarantees of indebtedness, and either is derived in the active conduct of a banking, financing, or similar business within the United States or is received by a corporation the principal business of which is trading in stocks or securities for its own account; or

(iii) is derived from the sale or exchange (outside the United States) through such office or other fixed place of business of personal property described in section 1221(a)(1) , except that this clause shall not apply if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country participated materially in such sale.

Any income or gain which is equivalent to any item of income or gain described in clause (i), (ii) , or (iii) shall be treated in the same manner as such item for purposes of this subparagraph.

(C) In the case of a foreign corporation taxable under part I or part II of subchapter L, any income from sources without the United States which is attributable to its United States business shall be treated as effectively connected with the conduct of a trade or business within the United States.

(D) No income from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States if it either -

(i) consists of dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns (within the meaning of section 958(a)), or is considered as owning (by applying the ownership rules of section 958(b)), more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or

(ii) is subpart F income within the meaning of section 952(a).

Reg. § 1.864-5(a), "In general," provides:

This section applies only to a nonresident alien individual or a foreign corporation that is engaged in a trade or business in the United States at some time during a taxable year

---

individual or foreign corporation, and (ii) is not a general commission agent, broker, or other agent of independent status acting in the ordinary course of his business,

(B) income, gain, or loss shall not be considered as attributable to an office or other fixed place of business within the United States unless such office or fixed place of business is a material factor in the production of such income, gain, or loss and such office or fixed place of business regularly carries on activities of the type from which such income, gain, or loss is derived, and

(C) the income, gain, or loss which shall be attributable to an office or other fixed place of business within the United States shall be the income, gain, or loss property allocable thereto, but, in the case of a sale or exchange described in clause (iii) of such subparagraph , the income which shall be treated as attributable to an office or other fixed place of business within the United States shall not exceed the income which would be derived from sources within the United States if the sale or exchange were made in the United States.

> beginning after December 31, 1966, and to the income, gain, or loss of such person from sources without the United States. The income, gain, or loss of such person for the taxable year from sources without the United States which is specified in paragraph (b) of this section shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States, only if he also has in the United States at some time during the taxable year, but not necessarily at the time the income, gain, or loss is realized, an office or other fixed place of business, as defined in § 1.864-7, to which such income, gain, or loss is attributable in accordance with § 1.864-6. The income of such person for the taxable year from sources without the United States which is specified in paragraph (c) of this section shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States when derived by a foreign corporation carrying on a life insurance business in the United States. Except as provided in paragraphs (b) and (c) of this section, no income, gain, or loss of a nonresident alien individual or a foreign corporation for the taxable year from sources without the United States shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that person. Any income, gain, or loss described in paragraph (b) or (c) of this section which, if it were derived by the taxpayer from sources within the United States for the taxable year, would not be treated under § 1.864-4 as effectively connected for the taxable year with the conduct of a trade or business in the United States shall not be treated under this section as effectively connected for the taxable year with the conduct of a trade or business in the United States.

Reg. § 1.864-5(b)(1) provides that rents, royalties, or gains on sales of intangible property related to the use of the intangible property outside the United States are taken into account under Reg. § 1.864-5(a) only if "derived in the active conduct of the trade or business in the United States."

Reg. § 1.864-5(b)(2) provides that dividends or interest, or gains or loss from sales of stocks or securities are taken into account under Reg. § 1.864-5(a) if "realized by (a) a nonresident alien individual or a foreign corporation in the active conduct of a banking, financing, or similar business in the United States or (b) a foreign corporation engaged in business in the United States whose principal business is trading in stocks or securities for its own account," with "engaged in the active conduct of a banking, financing, or similar business in the United States" being determined under Reg. § 1.864-4(c)(5)(i).

Reg. § 1.864-5(b)(3)(i) provides that, to the extent not covered above:

> Income, gain, or loss from the sale of inventory items or of property held primarily for sale to customers in the ordinary course of business, as described in section 1221(1), where the sale is outside the United States but through the office or other fixed place of business which the nonresident alien or foreign corporation has in the United States, irrespective of the destination to which such property is sent for use, consumption, or disposition.

However, Reg. § 1.864-6(a) provides that Reg. § 1.864-5(b) does not make income effectively connected for the taxable year with the conduct of a trade or business in the United States unless:

> the income, gain, or loss is attributable under paragraphs (b) and (c) of this section to an office or other fixed place of business, as defined in § 1.864-7, which the taxpayer has in the United States at some time during the taxable year.

However, Reg. § 1.864-6(b)(1) provides:[780]

> For purposes of paragraph (a) of this section, income, gain, or loss is attributable to an office or other fixed place of business which a nonresident alien individual or a foreign corporation has in the United States only if such office or other fixed place of business is a material factor in the realization of the income, gain, or loss, and if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business. For this purpose, the activities of the office or other fixed place of business shall not be considered to be a material factor in the realization of the income, gain, or loss unless they provide a significant contribution to, by being an essential economic element in, the realization of the income, gain, or loss. Thus, for example, meetings in the United States of the board of directors of a foreign corporation do not of themselves constitute a material factor in the realization of income, gain, or loss. It is not necessary that the activities of the office or other fixed place of business in the United States be a major factor in the realization of income, gain, or loss. An office or other fixed place of business located in the United States at some time during a taxable year may be a material factor in the realization of an item of income, gain, or loss for that year even though the office or other fixed place of business is not present in the United States when the income, gain, or loss is realized.

Reg. § 1.864-6(b)(2) provides special rules for rents, royalties, or gains or losses, from intangible personal property, and dividends or interest from any transaction, or gains or losses on the sale or exchange of stocks or securities:[781]

> (i) *Rents, royalties, or gains on sales of intangible property*. Rents, royalties, or gains or losses, from intangible personal property specified in paragraph (b)(1) of § 1.864-5, if the office or other fixed place of business either actively participates in soliciting, negotiating, or performing other activities required to arrange, the lease, license, sale, or exchange from which such income, gain, or loss is derived or performs significant services incident to such lease, license, sale, or exchange. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because the office or other fixed place of business conducts one or more of the following activities: (a) develops, creates, produces, or acquires and adds substantial value to, the property which is leased, licensed, or sold, or exchanged, (b) collects or accounts for the rents, royalties, gains, or losses, (c) exercises general supervision over the activities of the persons directly responsible for carrying on the activities or services described in the immediately preceding sentence, (d) performs merely clerical functions incident to the lease, license, sale, or exchange or (e) exercises final approval over the execution of the lease, license, sale, or exchange. The application of this subdivision may be illustrated by the following examples:
>
> *Example (1)*. F, a foreign corporation, is engaged in the active conduct of the business of licensing patents which it has either purchased or developed in the United States. F has a business office in the United States. Licenses for the use of such patents outside the United States are negotiated by offices of F located outside the United States, subject to

[780] A case discusses Reg. § 1.864-6(b)(1) at fns 782, 783 and 785 in this part II.E.1.c.ix QBI and Effectively Connected Income.
[781] A case discusses Reg. § 1.864-6(b)(2)(i) at fn 784 in this part II.E.1.c.ix QBI and Effectively Connected Income.

approval by an officer of such corporation located in the U.S. office. All services which are rendered to F's foreign licenses are performed by employees of F's offices located outside the United States. None of the income, gain, or loss resulting from the foreign licenses so negotiated by F is attributable to its business office in the United States.

Example (2). N, a foreign corporation, is engaged in the active conduct of the business of distributing motion picture films and television programs. N does not distribute such films or programs in the United States. The foreign distribution rights to these films and programs are acquired by N's U.S. business office from the U.S. owners of these films and programs. Employees of N's offices located in various foreign countries carry on in such countries all the solicitations and negotiations for the licensing of these films and programs to licensees located in such countries and provide the necessary incidental services to the licensees. N's U.S. office collects the rentals from the foreign licensees and maintains the necessary records of income and expense. Officers of N located in the United States also maintain general supervision over the employees of the foreign offices, but the foreign employees conduct the day to day business of N outside the United States of soliciting, negotiating, or performing other activities required to arrange the foreign licenses. None of the income, gain, or loss resulting from the foreign licenses so negotiated by N is attributable to N's U.S. office.

(ii) *Dividends or interest, or gains or losses from sales of stock or securities*.

(a) *In general*. Dividends, or interest from any transaction, or gains or losses on the sale or exchange of stocks or securities, specified in paragraph (b)(2) of § 1.864-5, if the office or other fixed place of business either activity participates in soliciting, negotiating, or performing other activities required to arrange, the issue, acquisition, sale, or exchange, of the asset from which such income, gain, or loss is derived or performs significant services incident to such issue, acquisition, sale or exchange. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because the office or other fixed place of business conducts one or more of the following activities: (1) collects or accounts for the dividends, interest, gains, or losses, (2) exercises general supervision over the activities of the persons directly responsible for carrying on the activities or services described in the immediately preceding sentence, (3) performs merely clerical functions incident to the issue, acquisition, sale, or exchange, or (4) exercises final approval over the execution of the issue, acquisition, sale, or exchange.

(b) *Effective connection of income from stocks or securities with active conduct of a banking, financing, or similar business*. Notwithstanding (a) of this subdivision (ii), the determination as to whether any dividends or interest from stocks or securities, or gain or loss from the sale or exchange of stocks or securities which are capital assets, which is from sources without the United States and derived by a nonresident alien individual or a foreign corporation in the active conduct during the taxable year of a banking, financing, or similar business in the United States, shall be treated as effectively connected for such year with the active conduct of that business shall be made by applying the principles of paragraph (c)(5)(ii) of § 1.864-4 for determining whether income, gain, or loss of such type from sources within the United States is effectively connected for such year with the active conduct of that business.

(c) *Security defined*. For purposes of this subdivision (ii), a security is any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items.

(d) *Limitations on application of rules on banking, financing, or similar business*.

(1) *Trading for taxpayer's own account*. The provisions of (b) of this subdivision (ii) apply for purposes of determining when certain income, gain, or loss from stocks or securities is effectively connected with the active conduct of a banking, financing, or similar business in the United States. Any dividends, interest, gain, or loss from sources without the United States which by reason of the application of (b) of this subdivision (ii) is not effectively connected with the active conduct by a foreign corporation of a banking, financing, or similar business in the United States may be effectively connected for the taxable year, under (a) of this subdivision (ii), with the conduct by such taxpayer of a trade or business in the United States which consists of trading in stocks or securities for the taxpayer's own account.

(2) *Other income*. For rules relating to dividends or interest from sources without the United States (other than dividends or interest from, or gain or loss from the sale or exchange of, stocks or securities referred to in (b) of this subdivision (ii)) derived in the active conduct of a banking, financing, or similar business in the United States, see (a) of this subdivision (ii).

(iii) *Sale of goods or merchandise through U.S. office*. Income, gain, or loss from sales of goods or merchandise specified in paragraph (b)(3) of § 1.864-5, if the office or other fixed place of business actively participates in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and the buyer. The office or other fixed place of business in the United States shall be considered a material factor in the realization of income, gain, or loss from a sale made as a result of a sales order received in such office or other fixed place of business except where the sales order is received unsolicited and that office or other fixed place of business is not held out of potential customers as the place to which such sales should be sent. The income, gain, or loss must be realized in the ordinary course of the trade or business carried on through the office or other fixed place of business in the United States. Thus, if a foreign corporation is engaged solely in a manufacturing business in the United States, the income derived by its office in the United States as a result of an occasional sale outside the United States is not attributable to the U.S. office if the sales office of the manufacturing business is located outside the United States. On the other hand, if a foreign corporation establishes a sales office in the United States to sell for consumption in the Western Hemisphere merchandise which the corporation produces in Africa, the income derived by the sales office in the United States as a result of an occasional sale made by it in Europe shall be attributable to the U.S. sales office. An office or other fixed place of business in the United States shall not be considered to be a material factor in the realization of income, gain, or loss for purposes of this subdivision merely because of one or more of the following activities: (a) the sale is made subject to the final approval of such office or other fixed place of business, (b) the property sold is held in, and distributed from, such office or other fixed place of business, (c) samples of the property sold are displayed (but not otherwise promoted or sold) in such office or other fixed place of

> business, or (d) such office or other fixed place of business performs merely clerical functions incident to the sale. Activities carried on by employees of an office or other fixed place of business constitute activities of that office or other fixed place of business.

For purposes of that provision, Reg. § 1.864-6(c) defines a security as "any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items."

Reg. § 1.864-7 defines "an office or other fixed place of business in the United States."

Reg. § 1.864-5(c) relates to income attributable to certain foreign corporations' U.S. life insurance business.

The above analysis is informed by *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (7/13/2017), which is described in in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, especially fns. 4690-4692. That case dealt with the sale of a partnership interest by a nonresident alien that was a passive investor in a U.S. business. The IRS argued that one must look through the partnership to determine whether gain on sale was ECI, and the taxpayer argued that the taxpayer did not participate in the business and that a partnership interest should be treated as ownership of an entity – not of the underlying assets. As described further below, 2017 tax reform added the rules relating to the sale of a partnership interest, but it did not overturn any other aspect of that ruling.

The court provided an overview of whether the redemption of the taxpayer's partnership interest was ECI:[782]

> Section 865(e)(3) provides that, in order to determine whether income from a sale is attributable to a U.S. office or fixed place of business, we must look to "[t]he principles of section 864(c)(5)", which provides rules for applying section 864(c)(4)(B) to determine what tax items are "attributable to" a U.S. office.[20] Under section 864(c)(5)(B), income, gain, or loss is attributable to a U.S. office only if: (a) the U.S. office is "a *material factor* in the production of such income", and (b) the U.S. office "*regularly carries* on activities of the type from which such income, gain, or loss is derived."[21] (Emphasis added.) 26 C.F.R. section 1.864-6, Income Tax Regs., refers to these two elements together as the "material factor" test, explaining "regularly carries on activities of the type", see sec. 864(c)(5)(B), as "realized in the ordinary course". Because the regulation employs the phrase "in the ordinary course" in its application of the statute, we also use "ordinary course" here as a synonym for "regularly carries on activities of the type".
>
> [20] By its terms, section 864(c)(4)(B) and (c)(5) does not apply to gains from dispositions of partnership interests, because such gains are not one of the three types of income denoted in section 864(c)(4)(B)(i)-(iii). Thus, section 865(e)(3) does not incorporate section 864(c)(5) per se but rather invokes only "*[t]he principles* of section 864(c)(5)". (Emphasis added.)

[782] Reg. § 1.864-6(b)(1) is quoted at fn 780 in this part II.E.1.c.ix QBI and Effectively Connected Income. Code § 864(c)(5) is quoted at fn 779 in this part II.E.1.c.ix QBI and Effectively Connected Income. After 2017 tax reform, these provisions no longer apply to partnership interests, but they would apply to stock.

> [21] The parties have not directed us to any caselaw applying these "material factor" and "ordinary course" standards, and we find none.

The court discussed Reg. § 1.864-6(b)(1):[783]

> … the Commissioner argues in the alternative that because Premier increased the value of its underlying assets and increased its overall value as a going concern during the period that GMM was a partner, thereby increasing the value of GMM's interest, Premier's U.S. offices were an essential economic element in GMM's realization of gain in the redemption. In so arguing, the Commissioner conflates the ongoing value of a business operation with gain from the sale of an interest in that business. As we have explained previously, GMM's gain in the redemption was not realized from Premier's trade or business of mining magnesite, that is, from activities at the partnership level; rather, GMM realized gain at the partner level from the distinct sale of its partnership interest.

The court discussed Reg. § 1.864-6(b)(2)(i), to which the taxpayer pointed as requiring a higher level of activity than the taxpayer's:[784]

> The Commissioner dismisses this argument with the observation, correct as far as it goes, that the regulation concerns "[r]ents, royalties, or gains on sales of intangible property", whereas here the income at issue is different - *i.e.*, proceeds from the redemption of a partnership interest. The Commissioner is correct in the sense that this regulation is not directly on point; however, in determining whether a sale is attributable to an office, we are directed by section 865(e)(3) to consult not "section 864(c)(5)" (which by its terms does not apply here, see supra note 19) but rather "*the principles of* section 864(c)(5)". (Emphasis added.) It therefore seems we must take guidance as appropriate from section 864(c)(5) and the regulations promulgated thereunder *without* dismissing, as the Commissioner would, provisions that are not directly on point, since the set of provisions that are directly on point is an empty set. We acknowledge it is fair to observe that a provision applicable to one kind of income might not be suited to a "material factor" analysis for another kind of income. But we see no reason to disregard this "[r]ents, royalties", etc., provision insofar as it provides an instance in which a U.S. office that "[d]evelops" and "adds substantial value to" an income-generating asset is nonetheless not a "material factor" in the realization of income from that asset. GMM reasonably derives from this regulation the principle that the creation of underlying value is simply a distinct function from being a material factor in the realization of income in a specific transaction.
>
> The material factor test is not satisfied here because Premier's actions to increase its overall value were not "an essential economic element in the realization of the income", 26 C.F.R. sec. 1.864-6(b)(1), that GMM received upon the sale of its interest. Increasing the value of Premier's business as a going concern, without a subsequent sale, would not have resulted in the realization of gain by GMM.
>
> To be sure, GMM's investment in Premier increased in value, presumably from Premier's business activities; but GMM did not realize gain from holding its interest in Premier until that

[783] Reg. § 1.864-6(b)(1) is quoted at fn 780 in this part II.E.1.c.ix QBI and Effectively Connected Income. Code § 864(c)(5) is quoted at fn 779 in this part II.E.1.c.ix QBI and Effectively Connected Income. After 2017 tax reform, these provisions no longer apply to partnership interests, but they would apply to stock.

[784] Reg. § 1.864-6(b)(2)(i) is quoted at fn 781 in this part II.E.1.c.ix QBI and Effectively Connected Income. After 2017 tax reform, these provisions no longer apply to partnership interests, but they would apply to stock.

> amount became liquid, that is, until its partnership interest was redeemed. The regulations call for this focus in two ways—by providing that adding value alone is not a material factor, see *id.* subpara. (2)(i)(a), and by providing that performing merely clerical functions incident to the sale or exchange (*i.e.*, a reasonable description of Premier's role in effecting the liquidation)[23] is not a material factor, see *id.* subdiv. (i)(d). Thus, Premier's efforts to develop, create, or add substantial value to the property sold are not considered to be a material factor in the realization of the disputed gain pursuant to 26 C.F.R. section 1.864-6(b)(1), and the Commissioner therefore fails to show that the first test for attributing the disputed gain to a U.S. office - "material factor" - is met.
>
> [23] The Commissioner would dispute the reasonableness of that description, but in part IV.B.3.b below we discuss the nature and modest quantum of Premier's activity in the redemption

Finally, the court concluded that the taxpayer's gain on redemption of its partnership interest was not in the ordinary course of the partnership's business:[785]

> The second part of the U.S.-source attribution inquiry—"ordinary course"— is found in 26 C.F.R. section 1.864-6(b)(1), which provides:
>
>> [I]ncome, gain, or loss is attributable to an office or other fixed place of business which *** a foreign corporation has in the United States only *** *if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business.* *** [Emphasis added.]
>
> Even if we were to decide that Premier's office was a "material factor" in the production of the disputed gain (which we do not), we would also need to find that the disputed gain was realized in the ordinary course of Premier's business conducted through its U.S. office in order for the gain to be attributable to that office, and thereby to be U.S.-source income.[24]
>
> As required by its bylaws, Premier extended to GMM an offer to redeem its interest according to the terms of Premier's prior transaction with IMin. GMM accepted Premier's offer without any negotiation of the terms of the deal.
>
> According to GMM, the redemption of its interest in Premier was a one-time, extraordinary event and therefore was not undertaken in the ordinary course of Premier's business. GMM argues that Premier's U.S. office is in the business of selling and producing magnesite, not buying and selling partnership interests. Because the disputed gain was realized in the redemption of GMM's partnership interest in Premier, not from Premier's ordinary business - magnesite production and sale - it does not satisfy the ordinary course requirement and is not U.S. source.
>
> The Commissioner disagrees with GMM's characterization of Premier, and points to Premier's other actions - admitting a new partner and redeeming IMin's interest - to show that Premier's redemption of GMM's interest was not an isolated event. The Commissioner takes the position that the wording of section 865(e)(2)(A) ("any sale of

[785] Reg. § 1.864-6(b)(1) is quoted at fn 780 in this part II.E.1.c.ix QBI and Effectively Connected Income. After 2017 tax reform, this provision no longer apply to partnership interests, but they would apply to stock.

personal property") is broad enough to cover all sales of personal property, including occasional sales. The Commissioner explains:

> The language of section 864(c)(5)(B) does not require that the sale of personal property occur regularly; it requires that the type of activities giving rise to the income occur regularly. In this regard, the language is amply broad to support attribution to an office of income from an occasional sale of personal property, *if the gain on the sale is derived from the business activities regularly conducted* through the office or other fixed place of business. [Emphasis added.]

The Commissioner again conflates the ongoing income-producing activities of Premier (magnesite production and sale), which certainly occurred in the ordinary course, and the redemption of GMM's partnership interest in Premier, which was an extraordinary event; and he thereby would effectively eliminate the "ordinary course" test and would allow the "material factor" test to stand for both tests. Premier's business did regularly produce income (and GMM paid tax on its distributive share of that income each year). However, contrary to the Commissioner's assertion, Premier was not engaged in the business of buying or selling interests in itself and did not do so in the ordinary course of its business. Premier engaged in only two such transactions (other than the redemption of GMM's interest) over the course of seven years, and this quantum of activity is not sufficient to show that Premier was in the business of redeeming and selling partnership interests. Rather, Premier is of course in the business of producing and selling magnesite products, and therefore GMM's gain realized on the redemption of its partnership interest in Premier was not realized in the ordinary course of the trade or business carried on through Premier's U.S. offices.

Since we have held that GMM's disputed gain on its redemption was not attributable to a U.S. office or other fixed place of business, it is therefore not U.S.-source income under section 865(e)(2)(A). As noted above, the Commissioner concedes that the disputed gain is not one of the types of foreign-source income treated as effectively connected by section 864(c)(4)(B). Consequently, the disputed gain is not effectively connected income.

[24] Rev. Rul. 91-32 *supra*, makes no mention of the "ordinary course" prong of the "attributable to" analysis, and this detracts from the persuasiveness of its conclusion that gain such as the disputed gain is attributable to U.S. offices.

Also, certain dividends, interest, or royalties paid by a related foreign corporation and certain Subpart F income from a controlled foreign corporation, which are from sources without the United States, are excluded from treatment as effectively connected for any taxable year with the conduct of a trade or business in the United States by a nonresident alien individual or a foreign corporation.[786]

[786] Reg. § 1.864-5(d). Reg. § 1.864-5(d)(3) also coordinates with Reg. § 1.864-4:

> Interest which, by reason of section 861(a)(1)(A) (relating to interest on deposits with banks, savings and loan associations, and insurance companies paid or credited before January 1, 1976) and paragraph (c) of § 1.864-4, is determined to be income from sources without the United States because it is not effectively connected for the taxable year with the conduct of a trade or business in the United States by the nonresident alien individual or foreign corporation.

Additional rules apply to deferred payment[787] and to property disposed of within 10 years after it to be used or held for use in connection with the conduct of a trade or business within the United States.[788]

In response to *Grecian Magnesite*,[789] 2017 tax reform added Code § 864(c)(8), which provides:[790]

> *Gain or loss of foreign persons from sale or exchange of certain partnership interests*.
>
> (A) *In general*. Notwithstanding any other provision of this subtitle, if a nonresident alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership which is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or any portion of) such interest shall be treated as effectively connected with the conduct of such trade or business to the extent such gain or loss does not exceed the amount determined under subparagraph (B).
>
> (B) *Amount treated as effectively connected*. The amount determined under this subparagraph with respect to any partnership interest sold or exchanged-
>
> (i) in the case of any gain on the sale or exchange of the partnership interest, is-
>
> (I) the portion of the partner's distributive share of the amount of gain which would have been effectively connected with the conduct of a trade or business within the United States if the partnership had sold all of its assets at their fair market value as of the date of the sale or exchange of such interest, or
>
> (II) zero if no gain on such deemed sale would have been so effectively connected, and
>
> (ii) in the case of any loss on the sale or exchange of the partnership interest, is-

---

787 Code § 864(c)(6).

788 Code § 864(c)(7).

789 *Grecian Magnesite Mining v. Commissioner*, which is described above and further described in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, especially fns. 4690-4692. The Conference report provided:

> Under a 1991 revenue ruling, in determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the IRS applied the asset-use test and business activities test at the partnership level to determine the extent to which income derived from the sale or exchange is effectively connected with that U.S. business.[1107] Under the ruling, if there is unrealized gain or loss in partnership assets that would be treated as effectively connected with the conduct of a U.S. trade or business if those assets were sold by the partnership, some or all of the foreign person's gain or loss from the sale or exchange of a partnership interest may be treated as effectively connected with the conduct of a U.S. trade or business. However, a 2017 Tax Court case rejects the logic of the ruling and instead holds that, generally, gain or loss on sale or exchange by a foreign person of an interest in a partnership that is engaged in a U.S. trade or business is foreign-source.[1108]
>
> 1107 Rev. Rul. 91-32, 1991-1 C.B. 107.
>
> 1108 *See Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 13, 2017).

790 For further discussion, see part II.E.1.c.viii.(c) Sale of an Interest in a Partnership Conducting a Trade or Business.

(I) the portion of the partner's distributive share of the amount of loss on the deemed sale described in clause (i)(I) which would have been so effectively connected, or

(II) zero if no loss on such deemed sale would be have been so effectively connected.

For purposes of this subparagraph, a partner's distributive share of gain or loss on the deemed sale shall be determined in the same manner as such partner's distributive share of the non-separately stated taxable income or loss of such partnership.

(C) *Coordination with United States real property interests*. If a partnership described in subparagraph (A) holds any United States real property interest (as defined in section 897(c)) at the time of the sale or exchange of the partnership interest, then the gain or loss treated as effectively connected income under subparagraph (A) shall be reduced by the amount so treated with respect to such United States real property interest under section 897.

(D) *Sale or exchange*. For purposes of this paragraph, the term "sale or exchange" means any sale, exchange, or other disposition.

(E) *Secretarial authority*. The Secretary shall prescribe such regulations or other guidance as the Secretary determines appropriate for the application of this paragraph, including with respect to exchanges described in section 332, 351, 354, 355 , 356, or 361.

Code § 897(a)(1) provides:

Treatment as effectively connected with United States trade or business. For purposes of this title, gain or loss of a nonresident alien individual or a foreign corporation from the disposition of a United States real property interest shall be taken into account-

(A) in the case of a nonresident alien individual, under section 871(b)(1), or

(B) in the case of a foreign corporation, under section 882(a)(1),

as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business.

Code § 897(c), "United States Real Property Interest," provides:

For purposes of this section-

(1) *United States real property interest*.

(A) *In general*. Except as provided in subparagraph (B) or subsection(k), the term "United States real property interest" means-

(i) an interest in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the Virgin Islands, and

(ii) any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes (at such time and in such manner as the Secretary by regulations prescribes) that such corporation was at no time a United States real property holding corporation during the shorter of-

(I) the period after June 18, 1980, during which the taxpayer held such interest, or

(II) the 5-year period ending on the date of the disposition of such interest.

(B) *Exclusion for interest in certain corporations*. The term "United States real property interest" does not include any interest in a corporation if-

(i) as of the date of the disposition of such interest, such corporation did not hold any United States real property interests,

(ii) all of the United States real property interests held by such corporation at any time during the shorter of the periods described in subparagraph (A)(ii)-

(I) were disposed of in transactions in which the full amount of the gain (if any) was recognized, or

(II) ceased to be United States real property interests by reason of the application of this subparagraph to 1 or more other corporations, and

(iii) such corporation nor any predecessor of such corporation was a regulated investment company or a real estate investment trust at any time during the shorter of the periods described in subparagraph (A)(ii).

(2) *United States real property holding corporation*. The term "United States real property holding corporation" means any corporation if-

(A) the fair market value of its United States real property interests equals or exceeds 50 percent of

(B) the fair market value of-

(i) its United States real property interests,

(ii) its interests in real property located outside the United States, plus

(iii) any other of its assets which are used or held for use in a trade or business.

(3) *Exception for stock regularly traded on established securities markets*. If any class of stock of a corporation is regularly traded on an established securities market, stock of such class shall be treated as a United States real property interest only in the case of a person who, at some time during the shorter of the periods described in paragraph (1)(A)(ii), held more than 5 percent of such class of stock.

(4) *Interests held by foreign corporations and by partnerships, trusts, and estates*. For purpose of determining whether any corporation is a United States real property holding corporation-

(A) *Foreign corporations*. Paragraph (1)(A)(ii) shall be applied by substituting "any corporation (whether foreign or domestic)" for "any domestic corporation".

(B) *Assets held by partnerships, etc.* Under regulations prescribed by the Secretary, assets held by a partnership, trust, or estate shall be treated as held proportionately by its partners or beneficiaries. Any asset treated as held by a partner or beneficiary by reason of this subparagraph which is used or held for use by the partnership, trust, or estate in a trade or business shall be treated as so used or held by the partner or beneficiary Any asset treated as held by a partner or beneficiary by reason of this subparagraph shall be so treated for purposes of applying this subparagraph successively to partnerships, trusts, or estates which are above the first partnership, trust, or estate in a chain thereof.

(5) *Treatment of controlling interests*.

(A) *In general*. Under regulations, for purposes of determining whether any corporation is a United States real property holding corporation, if any corporation (hereinafter in this paragraph referred to as the "first corporation") holds a controlling interest in a second corporation-

(i) the stock which the first corporation holds in the second corporation shall not be taken into account,

(ii) the first corporation shall be treated as holding a portion of each asset of the second corporation equal to the percentage of the fair market value of the stock of the second corporation represented by the stock held by the first corporation, and

(iii) any asset treated as held by the first corporation by reason of clause (ii) which is used or held for use by the second corporation in a trade or business shall be treated as so used or held by the first corporation.

Any asset treated as held by the first corporation by reason of the preceding sentence shall be so treated for purposes of applying the preceding sentence successively to corporations which are above the first corporation in a chain of corporations.

(B) *Controlling interest*. For purposes of subparagraph (A), the term "controlling interest" means 50 percent or more of the fair market value of all classes of stock of a corporation.

(6) *Other special rules*.

(A) *Interest in real property*. The term "interest in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

(B) *Real property includes associated personal property*. The term "real property" includes movable walls, furnishings, and other personal property associated with the use of the real property.

(C) *Constructive ownership rules*. For purposes of determining under paragraph (3) whether any person holds more than 5 percent of any class of stock and of determining under paragraph (5) whether a person holds a controlling interest in any corporation, section 318(a) shall apply (except that paragraphs (2)(C) and (3)(C) of section 318(a) shall be applied by substituting "5 percent" for "50 percent").

II.E.1.c.x. Bonus Depreciation and the Code § 199A Deduction

By reducing qualified business income, bonus depreciation reduces the 20% deduction.

The 20% deduction will eventually go away, whereas the lack of future depreciation deductions will come back to haunt taxpayers when rates increase and the 20% deduction is not available.

In 2018, taking bonus depreciation is an easy decision for most property, in that most property eligible for bonus depreciation has a depreciable life of 7 years or less, and the 20% deduction lasts for 7 years.

If the law does not change, then taking bonus depreciation in 2025 may be inadvisable, because it reduces the 20% deduction and eliminates depreciation deductions in more highly taxed future years.

Between 2018 and 2025 (or any change in the tax law affecting these issues), the trade-off between bonus depreciation and the 20% deduction moves over time from being not worthy of consideration to being very worthy of consideration.

See part II.G.4.b Bonus Depreciation.

II.E.1.d. Partnerships Compared to S corporations for Code § 199A

Suppose, before considering the owner's compensation, a business has $300,000 of qualified business income ("QBI"), reasonable compensation would be $200,000, distributions to the owner are at least $200,000, and the owner's taxable income is below the $315,000 threshold for married filing jointly.

The wage limitation would not apply. See part II.E.1.c.v.(a) Taxable Income "Threshold.

If the business is an S corporation, then the $200,000 wages the S corporation pays its owner will reduce the QBI from $300,000 down to $100,000. If the taxpayer argues that the payments to the owner-employee were distributions and not wages, the IRS will have the upper hand in the dispute, because in 2017 the IRS figured out (and instructed its examiners) how to effectively keep taxpayers out of Tax Court on this issue[791] – meaning that taxpayers would have to pay the tax and sue for a refund.

However, if the wage limitation reduces the QBI deduction,[792] the S corporation may wish to increase compensation payments to get a better deduction. Given that FICA is 15.3% combined employer and employee up to the taxable wage base, this strategy would tend to be beneficial

[791] See part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax, especially fns 87-88.
[792] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

only when compensation is above the taxable wage base ($128,400 for 2018 and $132,900 in 2019)[793] and is ultimately in a range that is neither too high not too low.

In addition to an S corporation tending to generate less QBI, the sale of a partnership interest may be easier to constitute QBI than the sale of stock in an S corporation. Compare part II.E.1.c.viii.(c) Sale of an Interest in a Partnership Conducting a **Trade** or **Business** with part II.E.1.c.viii.(d) Sale of a Stock in an S corporation Conducting a **Trade** or **Business**.

II.E.1.e. Whether Real Estate Qualifies As a Trade or Business

Part II.E.1.e.i General Rules Regarding Real Estate As a Trade or Business describes the definitions of a trade or business generally applied to real estate.

For nonresident aliens, Part II.E.1.e.ii Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules explains when real estate may be eligible for a Code § 199A deduction.

II.E.1.e.i. General Rules Regarding Real Estate As a Trade or Business

To constitute qualified business income, the income must be from a trade or business.[794] However:

- Rental activity that is not a trade or business can qualify as if it were a trade or business if it is rented or licensed to a trade or business which is commonly controlled under Prop. Reg. § 1.199A-4(b)(1)(i), meaning that the same person or group of persons, directly or indirectly, owns 50% percent or more of the renting trade or business, including 50% or more of the issued and outstanding shares of an S corporation or 50% or more of the capital or profits in a partnership.[795] This is described in part II.E.1.c.iii.(a) General Standards for "Trade or Business" for Code § 199A[796] and illustrated in part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A,[797] but it applies whether or not the real estate is aggregated (see fn 796).

- On the other hand, if rental is tied too closely to a specified service trade or business (SSTB), part or all of the rental income could be disqualified, even the rental on its own qualifies as a trade or business. See part II.E.1.c.iv.(o) SSTB Very Broad Anti-Abuse Rules.

Each RPE separately determines whether its real estate qualifies as a trade or business. Real estate owners might want to combine their RPEs into a master partnership in which each LLC is

[793] See text accompanying fn 2783 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.
[794] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction, especially fn. 671.
[795] Prop. Reg. § 1.199A-4(b)(1)(i) is reproduced in full in part II.E.1.c.iii.(b) Aggregating Activities for Code § 199A and illustrated by various Examples accompanying fn 683, including those demonstrating that a pass-through entity that owns a business can be in a different type of pass-through entity (S corporation compared to partnership) than the type that owns the real estate.
[796] See Reg. § 1.199A-1(b)(13), which is reproduced in full in fn 678 in that part.
[797] Within that part, see text accompanying fn 696, analyzing Prop. Reg. § 1.199A-4(d), Example (8) and Example (9).

a disregarded entity. See the discussion at the end of the introductory portion of part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.[798]

The rest of the discussion in this part II.E.1.e.i discusses whether the real estate activity constitutes a trade or business under Code § 162.

Before getting into general principles, consider a real estate activity Prop. Reg. § 1.199A-1 views as a trade or business. Prop. Reg. § 1.199A-1(d)(4), Examples (1) and (2) assume that leasing several parcels of land to several suburban airports for parking lots constitutes QBI.[799] The Examples assumed that the activity qualified as a trade or business but did not state that this activity would always qualify.

Whether real estate is a trade or business depends on the circumstances. The best discussion of the issue in this document is in part II.I.8.c.iii Rental as a Trade or Business, fns 1981-1991. Another discussion on what is a trade or business is in part II.G.3.i.i.(a) "Trade or Business" Under Code § 162. These and other items are summarized near the beginning of part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction.

If all the taxpayer does is lease one property to one tenant on a triple net lease and merely collect rent, consider changing the responsibilities. Instead of the tenant arranging for and paying for maintenance, have the landlord take care of that and obtain reimbursement from the tenant. Consider having the landlord hire the janitors and maintenance staff and the tenant reimburse the landlord for those expenses, which helps not only move the real estate toward being a trade or business but also may improve the landlord's Code § 199A deduction:

- The tenant may have plenty of wages for purposes of the wage limitation for the Code § 199A deduction, whereas paying those wages may provide the landlord with a higher Code § 199A deduction (because the wage limitation will not reduce the deduction as much).[800] However, if the real estate activity is aggregated with a business under common control,[801] that business' wages and property count toward the Code § 199A deduction relating to the real estate's income.

- If the landlord and tenant have similar ownership, then moving duties from one entity to another may be an easy decision. On the other hand, if they have different owners and the landlord does not want an increased role, these changes may be impractical.

- Consider asset protection issues. If the landlord hires janitors and maintenance staff, the landlord would be liable if they fail to remedy any hazardous conditions. Furthermore, if an owner of the landlord is personally involved in hiring decisions, that owner may be personally liable for negligent hiring. Liability insurance may ameliorate these concerns, and every landlord should have such insurance anyway to try to avoid corporate veil piercing. This is very much a judgment call. For more on asset protection, see part II.F Asset Protection Planning.

[798] See text accompanying fn 647.
[799] The Examples are reproduced in the text accompanying fn 724 in part II.E.1.c.v.(c) Calculation When Taxable Income Exceeds the Threshold Amount.
[800] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[801] See fns 796-795.

Even the long-term rental of one property to one tenant can constitute a trade or business.[802] For further thoughts on how to make real estate a trade or business, see my summary at the end of part II.I.8.c.iii Rental as a Trade or Business.

Note also what is required for real estate not to be passive income for purposes of restrictions on S corporations that used to be C corporations, described in part II.P.3.c.iii Excess Passive Investment Income. A triple net lease would not work for that test, but incurring expenses and having them reimbursed by the tenant would work.[803] Following these rules for S corporations does not directly address the "trade or business" issue, but if the IRS views it as nonpassive for one purpose (the S corporation test) then an examiner might have a positive view for other purposes (trade or business qualification).

Ultimately, one needs to decide whether the effort of and exposure from rearranging lease arrangements are worth the potential tax benefits, and it is impossible to provide a one-size-fits-all solution.

II.E.1.e.ii. Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules

A nonresident alien may be eligible for the Code § 199A deduction only for income qualifying under Part II.E.1.c.ix QBI and Effectively Connected Income. Within that part, the text accompanying and immediately preceding fn 766 cross-references Code § 871(a)(1)(A), which taxes rents (among other income) and therefore is the subject of this part II.E.1.e.ii. Below is guidance on when rent constitutes QBI.

Rev. Rul. 73-522 discussed the following situation involving triple net leases:

> The taxpayer owned rental property situated in the United States that was subject to long-term leases each providing for a minimum monthly rental and the payment by the lessee of real estate taxes, operating expenses, ground rent, repairs, interest and principal on existing mortgages, and insurance in connection with the property leased. The leases are referred to as "net leases" and were entered into by the taxpayer on December 1, 1971. The taxpayer visited the United States for approximately one week during November 1971 for the purpose of supervising new leasing negotiations, attending conferences, making phone calls, drafting documents, and making significant decisions with respect to the leases. This was his only visit to the United States in 1971. The leases were identical in form (net leases) to those applicable to the properties owned by the taxpayer prior to December 1, 1971, and were entered into with lessees unrelated to each other or to the taxpayer.

Rev. Rul. 73-522 held:

> Court decisions involving nonresident alien individual owners of real estate in the United States have developed a test for determining when such individuals are engaged in trade or business within the United States as a result of such ownership. These cases hold that activity of nonresident alien individuals (or their agents) in connection with domestic real estate that is beyond the mere receipt of income from rented property, and the payment of expenses incidental to the collection thereof, places the owner in a trade or business

[802] See part II.I.8.c.iii Rental as a Trade or Business, fn 1988.
[803] See fns 3305-3308.

within the United States, provided that such activity is considerable, continuous, and regular. *Jan Casimir Lewenhaupt*, 20 T.C. 151 (1953), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955); *Elizabeth Herbert*, 30 T.C. 26 (1958), *acq.* 1958-2 C.B. 6; *Inez De Amodio*, 34 T.C. 894 (1960), *aff'd* 229 F.2d 623 (3rd Cir. 1962).

In the instant case the taxpayer's only activity in the United States during the taxable year ended December 31, 1971, was the supervision of the negotiation of leases covering rental property that he owned during that year. No other activity was necessary on the part of the lessor in connection with the properties because of the provisions of the net leases. The taxpayer's supervision of the negotiation of new leases is not considered to be beyond the scope of mere ownership of real property or the mere receipt of income from real property since such activity was sporadic rather than continuous (that is a day-to-day activity), irregular rather than regular, and minimal rather than considerable.

Accordingly, the taxpayer in the instant case is not considered to be engaged in trade or business within the United States during the taxable year ended December 31, 1971, within the meaning of section 871 of the Code. See *Evelyn M. L. Neil*, 46 B.T.A. 197 (1942), wherein the operation of one parcel of real estate by the lessee did not result in the owner being considered to be engaged in trade or business.[804] Compare *Adolph Schwarcz*, 24 T.C. 733, *acq.* 1956-1, C.B. 5, wherein an owner operating one parcel of rental property in all its aspects was considered to be engaging in trade or business.

With regard to the second question presented, section 1.871-7(b)(1) of the Income Tax Regulations provides that for purposes of section 871(a)(1) of the Code "amounts" received (including rents) means "gross income." Section 1.61-8(c), to the extent pertinent, provides that if a lessee pays any of the expenses of the lessor such payments are additional rental income of the lessor.

Accordingly, "rents," as used in section 871 of the Code, includes considerations other than the payment of a stipulated rental, *i.e.*, amounts paid by the lessee for taxes, repairs, etc., in accordance with the terms of a net lease.

---

[804] [My footnote, not from the ruling:] *Neill v. Commissioner*, 46 B.T.A. 197 (1942), found that a net lease held by a NRA did not constitute carrying on a business. The facts were:

> … It is held under a long term lease by a tenant who, under the terms of that lease, erected a building thereon and is obligated under the lease to pay taxes and insurance and maintain the property.
>
> The property referred to is encumbered by a mortgage …, the ground lease on the property having been assigned at that time to the mortgagee as collateral security for the mortgage. For many years petitioner has employed a firm of attorneys with offices in Philadelphia, to whom the tenant pays the rentals due petitioner under her direction. These attorneys then pay for her the interest due upon the mortgage and such incidental expenses for which petitioner may be obligated.

The Board of Tax Appeals held:

> The ownership of this property by petitioner is no more a business activity carried on within the United States than her ownership of stocks or bonds of American companies held for her by an American agent. *Cf. Higgins v. Commissioner*, 312 U.S. 212. We think the rule is settled that the mere ownership of property from which income is drawn does not constitute the carrying on of business within the purview of the cited section. *McCoach v. Minehill & Schuylkill Haven Railroad Co.*, 228 U.S. 295; *Stafford Owners, Inc. v. United States*, 39 Fed.(2d) 743.

For a discussion of *Higgins*, see part II.G.3.i.i.(a) "Trade or Business" Under Code § 162, fn 1084.

Note that the taxpayer held more than one property with triple-net-leases, and the taxpayer's triple-net-lease was not part of a trade or business notwithstanding the taxpayer owning multiple properties.

Also note that expense reimbursements constituted rent.

As to rental that is not a triple-net-lease, *Schwarcz v. Commissioner*, 24 T.C. 733 (1955), cited with approval in Rev. Rul. 73-522, stated, "We take it to be well settled that the operation of even a single parcel of rental realty may constitute the regular operation of a business."[805] Furthermore, the "fact that the taxpayer operates the rental property through an agent does not prevent him from being regularly engaged in the business,[806] and "the rule applies even though the property and the agent are in a foreign country (Austria)."[807] The court concluded:

> The record shows that petitioner actively managed the properties prior to his departure for the United States and that he was in frequent contact with his partner who managed the properties after petitioner left. We are of the opinion, accordingly, that petitioner was regularly engaged in the business of operating the … properties ….

The NRA handling repairs – even through an agent – seemed to be a tipping point in *Amodio v. Commissioner*, 34 T.C. 894 (1960) (trade or business found),[808] *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), *aff'd*. 221 F.2d 227 (9th Cir. 1955) (trade or business found),[809] and *Herbert*

---

805 The court continued:

> In *Anders I. Lagreide*, 23 T.C. 508, 511 , we said:
>
> > The first issue to be considered is whether or not the renting out in 1949, by Alice Lagreide, of a single piece of residential real estate, amounted to the operation by her of a trade or business regularly carried on. She inherited the property from her mother in 1948 and never occupied or maintained it as her own residence. Since the time of the mother's death, the property was either rented or available for renting, and was actually rented during part of 1948 and almost all of 1949.
> >
> > It is clear from the facts that the real estate was devoted to rental purposes, and we have repeatedly held that such use constitutes use of the property in trade or business, regardless of whether or not it is the only property so used. *Leland Hazard*, 7 T.C. 372 (1946). See also *Quincy A. Shaw McKean*, 6 T.C. 757 (1946); *N. Stuart Campbell*, 5 T.C. 272 (1945); *John D. Fackler*, 45 B.T.A. 708, 714 (1941), *affd.* (C.A. 6, 1943) 133 F.2d 509. We add that the use of the property in trade or business was, upon the facts, an operation of the trade or business in which it was so used (see *Industrial Commission v. Hammond*, 77 Colo. 414, 236 Pac. 1006, 1008). It is clear, also, that the business was "regularly" carried on, there having been no deviation, at any time, from the obviously planned use.

806 Citing "*Gilford v. Commissioner*, 201 F.2d 735, affirming a Memorandum Opinion of this Court."

807 Citing *Reiner v. United States*, 222 F.2d 770 (7th Cir. 1955).

808 The court held:

> The properties were managed by local real estate agents who negotiated or renewed leases, arranged for repairs, collected rents, paid taxes and assessments, and remitted net proceeds to Fidelity after deducting commissions. From the proceeds Fidelity or the local agent paid principal and interest on the mortgages, insurance premiums, and taxes. Fidelity retained its commissions and amounts to be applied on Amodio's income taxes and the remainder was sent to him. The acts of the agents are attributable to Amodio. These activities were beyond the scope of mere ownership of property and the receipt of income. They were considerable, continuous, and regular, as in the *Lewenhaupt* case. Such activities of a nonresident alien through his agents in the United States constitute engaging in business in the United States. Amodio is taxable as a nonresident alien engaged in trade or business in the United States.

809 The Tax Court described the agent's activities:

v. Commissioner, 30 T.C. 26, 33 (1958) (isolated minor repairs not a trade or business).[810] Letter Ruling 7904019 asserted that paying mortgages and reimbursing tenant expenses was insufficient to move the taxpayer out of the holding of Rev. Rul. 73-522.[811] However, *Pinchot v. Commissioner*, 113 F.2d 718 (2nd Cir. 1940), held that maintaining a portfolio of 11 rental

---

> LaMontagne's activities, during the taxable year, in the management and operation of petitioner's real properties included the following: executing leases and renting the properties, collecting the rents, keeping books of account, supervising any necessary repairs to the properties, paying taxes and mortgage interest, insuring the properties, executing an option to purchase the El Camino Real property, and executing the sale of the Modesto property. In addition, the agent conducted a regular correspondence with the petitioner's father in England who held a power of attorney from petitioner identical with that given to LaMontagne; he submitted monthly reports to the petitioner's father; and he advised him of prospective and advantageous sales or purchases of property.
>
> The aforementioned activities, carried on in the petitioner's behalf by his agent, are beyond the scope of mere ownership of real property, or the receipt of income from real property. The activities were considerable, continuous, and regular and, in our opinion, constituted engaging in a business within the meaning of section 211(b) of the Code. See *Pinchot v. Commissioner*, 113 F.2d 718.

[810] The Tax Court held:

> In the instant case the real property consisted of one building rented in its entirety to one tenant who has occupied it since 1940, has complete charge of its operation, and is responsible for all repairs except as to outer walls and foundation. This property (the only real property owned by petitioner in the United States) was acquired by petitioner 50 years ago, not as the result of a business transaction entered into for profit (*cf. Fackler v. Commissioner*, 133 F.2d 509) but by gift from petitioner's father when she was a very young girl (see *Grier v. United States*, 120 F.Supp. 395). During the taxable years her only activities, in addition to the receipt of rentals, were the payment of taxes, mortgage principal and interest, and insurance premiums. See *Evelyn M. L. Neill*, *supra*. The record also shows that petitioner executed a lease of the property in 1940 and a modified renewal thereof in 1946, and made minor repairs to the walls and roof in 1954 and 1955.
>
> We are of the opinion that petitioner's activities with regard to the real property here involved, which might be considered as "beyond the scope of mere ownership of real property, or the receipt of income from real property," were sporadic rather than "continuous," were irregular rather than "regular," and were minimal rather than "considerable." We therefore conclude that petitioner was "not engaged in trade or business in the United States" during the taxable years within the meaning of article IX (1) of the United States-United Kingdom tax convention.

[811] The IRS pointed out:

> The Lease between Corp M and Corp P, although not identical to the net leases described in Rev. Rul. 73-522, differs only in three respects. One, the lessor rather than the lessee pays real estate taxes imposed on the leased property; two, the lessor rather than the lessee pays installments on existing encumbrances; and three, the lessor, Corp M, pays a yearly fee to the lessee as reimbursement for grass, pest, and weed control and fertilization.

The IRS reasoned:

> With respect to the payment of a yearly fee by Corp M to Corp P as reimbursement for grass, pest, and weed control and fertilization, we note that Corp M does not supervise or participate in any way in the activities for which it pays the fee. Further, the fee is paid once each year and does not involve Corp M in the farming of the land. Consequently, the payment of the fee is sporadic, irregular, and minimal and does not, in and of itself, cause Corp M to be engaged in a trade or business within the United States.

properties, which probably were not triple-net leases, constituted a business;[812] *Lewenhaupt* cited *Pinchot* with approval.[813]

A small interest in oil & gas that did not influence annual operations did not contribute a trade or business.[814]

---

[812] The court summarized the facts and reasoned:

> The essential facts were stipulated and, so far as now important, are that the decedent, Antoinette Eno Johnstone, died July 1, 1934, a British subject and a non-resident. Much of her property in this country consisted of improved real estate in the City of New York owned in common by her and her two brothers of whom one is her executor and the petitioner herein. This real estate was made up of eleven parcels of which the decedent's share had a gross value of about one million dollars. The petitioner, Amos R.E. Pinchot, managed the properties for her and the third owner under broad powers of attorney which included also the management of certain personal property owned by the three. He bought and sold property for the co-owners in his discretion without consulting the decedent who did not personally take part in the transactions. This management "consisted of the leasing and renting of the properties when they became idle, collection of rents and payment of operating expenses, taxes, mortgage interest and other necessary obligations." Over a period of eighteen years five parcels of real estate had been sold and five had been purchased. There were no sales or purchases during the last three years before the decedent's death.
>
> Though the stipulation does not show the number or the amount of the transactions of the petitioner in managing these eleven buildings in New York, it is certain that they must have been considerable in both respects as well as continuous and regular. Their maintenance required the care and attention of the owners and the decedent supplied her part of that by means of her agent and attorney in fact. *Richards v. Commissioner*, 9 Cir., 81 F.2d 369, 106 A.L.R. 249. What was done was more than the investment and re-investment of funds in real estate. It was the management of the real estate itself for profit. Whether or not that was engaging in business within the meaning of federal tax statutes is a federal question which cannot be controlled by state decisions. *Lyeth v. Hoey*, 305 U.S. 188, 59 S.Ct. 155, 83 L.Ed. 119, 119 A.L.R. 410. It necessarily involved alterations and repairs commensurate with the value and number of buildings cared for and such transactions as were necessary constitute a recognized form of business. The management of real estate on such a scale for income producing purposes required regular and continuous activity of the kind which is commonly concerned with the employment of labor; the purchase of materials; the making of contracts; and many other things which come within the definition of business in *Flint v. Stone Tracy Co.*, 220 U.S. 107, 31 S.Ct. 342, 55 L.Ed. 389, Ann.Cas.1912B, 1312, and within the commonly accepted meaning of that word. We think the Board was right in deciding that this decedent was engaged in business in this country at the time of her death. The bank deposits in the United States were, therefore, properly treated as property in this country. Our decision in *Higgins v. Commissioner*, 2 Cir., 111 F.2d 795, did not touch the question of real estate management as a business.

[813] See text at end of fn 809.

[814] After citing *Pinchot*, which was discussed in fn 812, *Di Portanova v. U.S.*, 690 F.2d 169 (Ct. Cl. 1982), held:

> In this respect, an oil lease is similar to real estate. "Whether coownership in a mineral lease constitutes the carrying on of a 'trade or business' is dependent upon all the facts and circumstances in the particular case." Rev. Rul. 58-166, 1958-1 C.B. 324, 325.
>
> The oil and gas business is complex. "The proper development of an oil and gas lease requires a high degree of skill and discretion." Rev. Rul. 58-166, 1958-1 C.B. at 326. To be engaged in the oil business requires active involvement, personally or through an agent, in the operation of that business. *Cataphote Corp. v. United States*, 210 Ct.Cl. 125, 143-46, 535 F.2d 1225, 1235-37 (1976); *Wier v. Enochs*, 64-1 U.S.T.C. ¶ 9387 at 92,009, 92,011 (S.D. Miss. 1963); *aff'd* per curiam, 353 F.2d 211 (5th Cir. 1965); *Nemours Corp. v. Commissioner*, 38 T.C. 585, 601 & n.3

II.E.1.f. Trusts/Estates and the Code § 199A Deduction

Estates and nongrantor trusts may present special opportunities in working with the taxable income thresholds described in part II.E.1.c.v.(a) Taxable Income "Threshold Amount". Estates and nongrantor trusts would have the same taxable income threshold as a single individual. Recognizing these opportunities, the proposed regulations issued August 2018 express significant antipathy towards trusts:

- Their Code § 199A anti-abuse rule provides a very low threshold for having an evil intent, resulting in zero deduction, to the point of taking away the entire Code § 199A deduction for a later year in which the QBI is not from an SSTB and each business has sufficient W-2 wages to support a full Code § 199A deduction without considering any benefits from being below the taxable income threshold.[815]

- Contrary to Code § 199A(e)(1), Prop. Reg. § 1.199A-6(d)(3)(iii) would prevent a trust from taking a distribution deduction in applying the taxable income thresholds. As is explained further below in this part II.E.1.f, in applying the taxable income thresholds that rule would double-count any income distributed to beneficiaries.

- Despite Code § 641(c)(1)(A) and the regulations thereunder treating the S portion of an electing small business trust (ESBT) as a different taxpayer than the non-S portion of an ESBT, my understanding is that the government intends to add together the taxable income of both portions in determining the taxable income thresholds.[816]

- Proposed regulations described in part II.J.9.c Multiple Trusts Created for Tax Avoidance would undermine the use of multiple trusts. Aspects of the proposed regulations are too tilted in the government's favor, but other aspects are poorly written simply because they track the poorly written legislative history of Code § 643(f).

The details provided in part II.E.1.f.i Allocation under Former Code § 199 That Applies for Code § 199A show that, until proposed regulations apply to Code § 199A:

(1962) *aff'd* per curiam, 325 F.2d 559 (3d Cir. 1963); *John Provence #1 Well v. Commissioner*, 37 T.C. 376 (1961), *aff'd*, 321 F.2d 840 (3d Cir. 1963).

(3.) The government properly has conceded that the activities of the trusts regarding the properties subject to the 1953 and 1965 agreements do not constitute a trade or business and we so hold. The activities are functionally indistinguishable from the mere receipt of income from investments and the payment of expenses incidental to that receipt. The trusts do not manage or control the field operations or participate actively in them. Indeed, the agreements give Quintana exclusive control over "all operations of every kind." The trusts have little power under the agreements. Moreover, in view of their meager percentage of the total interest and the plaintiff's estrangement from the Cullen family, they also have virtually no informal influence over the operations.

Although the trusts have the right to receive their actual share of the oil and gas produced and Quintana negotiates the sale of the minerals as an agent of the trusts, the Service by its concession recognizes that this is not enough to constitute a trade or business. Considering all the circumstances, we hold that the trusts' activities under the 1953 operating agreement and its amendments did not constitute trade or business.

[815] See text accompanying and preceding fn 820 in this part II.E.1.f.

[816] See part II.E.1.f.iii Electing Small Business Trusts (ESBTs), text accompanying and following fn 837.

- Grantor trusts are disregarded, and their items attributed to their deemed owners.

- The trust and beneficiaries are allocated the various items in proportion to their respective portions of distributable net income ("DNI"), determined after applying the separate share rules, if relevant.[817]

- The Code § 199A deduction is not included in calculating DNI. Considering that both deductions are artificial deductions rather than deductions of actual expenditures, there is some logic to this.

- Taxable income thresholds are applied separately at the trust and beneficiary levels.[818] However, the last sentence of Prop. Reg. § 1.199A-6(d)(3)(iii) would require trusts to apply the taxable income before the income distribution deduction, thereby counting twice (at the trust level and at the beneficiary level) any taxable income on the beneficiaries' K-1s.

The preamble to Prop. Reg. § 1.199A-6(d), REG-107892-18 (8/16/2018), explains:

> **B. Application to Trusts, Estates, and Beneficiaries**
>
> Proposed § 1.199A-6(d) contains special rules for applying Section 199A to trusts and decedents' estates. To the extent that a grantor or another person is treated as owning all or part of a trust under sections 671 through 679 (grantor trust), including qualified subchapter S trusts (QSSTs) with respect to which the beneficiary has made an election under section 1361(d), the owner will compute its QBI with respect to the owned portion of the trust as if that QBI had been received directly by the owner.
>
> In the case of a Section 199A deduction claimed by a non-grantor trust or estate, Section 199A(f)(1)(B) applies rules similar to the rules under former section 199(d)(1)(B)(i) for the apportionment of W-2 wages and the apportionment of UBIA of qualified property. In the case of a non-grantor trust or estate, the QBI and expenses properly allocable to the business, including the W-2 wages relevant to the computation of the wage limitation, and relevant UBIA of depreciable property must be allocated among the trust or estate and its various beneficiaries. Specifically, proposed § 1.199A-6(d)(3)(ii) provides that each beneficiary's share of the trust's or estate's W-2 wages is determined based on the proportion of the trust's or estate's DNI that is deemed to be distributed to that beneficiary for that taxable year. Similarly, the proportion of the entity's DNI that is not deemed distributed by the trust or estate will determine the entity's share of the QBI and W-2 wages. In addition, if the trust or estate has no DNI in a particular taxable year, any QBI and W-2 wages are allocated to the trust or estate, and not to any beneficiary.
>
> In addition, proposed § 1.199A-6(d)(3)(ii) provides that, to the extent the trust's or estate's UBIA of qualified property is relevant to a trust or estate and any beneficiary, the trust's or estate's UBIA of qualified property will be allocated among the trust or estate and its beneficiaries in the same proportion as DNI of the trust or estate is allocated. This is the case regardless of how any depreciation or depletion deductions resulting from the same

[817] See parts II.J.8.f.i.(a) Allocating Deductions to Various Income Items, II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It, and II.J.9.a Separate Share Rule.
[818] See Reg. § 1.199-5(e)(4), Example, part (ii), "Section 199 deduction," subpart (C), reproduced in the text accompanying fns 821-822 in part II.E.1.f.i Allocation under Former Code § 199 That Applies for Code § 199A.

> property may be allocated under section 643(c) among the trust or estate and its beneficiaries for purposes other than Section 199A.
>
> Under Section 199A, the threshold amount is determined at the trust level without taking into account any distribution deductions. Commenters have noted that taxpayers could circumvent the threshold amount by dividing assets among multiple trusts, each of which would claim its own threshold amount. This result is inappropriate and inconsistent with the purpose of Section 199A. Therefore, proposed § 1.199A-6(d)(3)(v) provides that trusts formed or funded with a significant purpose of receiving a deduction under Section 199A will not be respected for purposes of Section 199A.
>
> The Treasury Department and the IRS request comments with respect to whether taxable recipients of annuity and unitrust interests in charitable remainder trusts and taxable beneficiaries of other split-interest trusts may be eligible for the Section 199A deduction to the extent that the amounts received by such recipients include amounts that may give rise to the deduction. Such comments should include explanations of how amounts that may give rise to the Section 199A deduction would be identified and reported in the various classes of income of the trusts received by such recipients and how the excise tax rules in section 664(c) would apply to such amounts.

For nongrantor trusts or estates, Prop. Reg. § 1.199A-6(d)(1) provides:

> *In general*. A trust or estate computes its Section 199A deduction based on the QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income that are allocated to the trust or estate. An individual beneficiary of a trust or estate takes into account any QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income allocated from a trust or estate in calculating the beneficiary's Section 199A deduction, in the same manner as though the items had been allocated from an RPE. For purposes of this section and §§ 1.199A-1 through 1.199A-5, a trust or estate is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries, and is treated as an individual to the extent it retains the QBI and other items.

This last sentence is important not just as a matter of calculation but also because it allows estates with fiscal years straddling 2017-2018 to pass to their beneficiaries 2017 business income that gets treated as QBI.[819]

Consistent with the Code § 199 rules regarding grantor trusts, Prop. Reg. § 1.199A-6(d)(2) provides:

> *Grantor trusts*. To the extent that the grantor or another person is treated as owning all or part of a trust under sections 671 through 679, such person computes its Section 199A deduction as if that person directly conducted the activities of the trust with respect to the portion of the trust treated as owned by the grantor or another person.

Prop. Reg. § 1.199A-6(d)(3)(i), "Calculation at entity level," provides:

> A trust or estate must calculate its QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income. The QBI of a trust or estate must be computed

[819] See part II.E.1.c.i What Kind of Deduction; Maximum Impact of Deduction, especially the paragraph accompanying fn 638.

> by allocating qualified items of deduction described in Section 199A(c)(3) in accordance with the classification of those deductions under § 1.652(b)-3(a), and deductions not directly attributable within the meaning of § 1.652(b)-3(b) (other deductions) are allocated in a manner consistent with the rules in § 1.652(b)-3(b). Any depletion and depreciation deductions described in section 642(e) and any amortization deductions described in section 642(f) that otherwise are properly included in the computation of QBI are included in the computation of QBI of the trust or estate, regardless of how those deductions may otherwise be allocated between the trust or estate and its beneficiaries for other purposes of the Code.

See parts II.J.8.f.i.(a) Allocating Deductions to Various Income Items and II.J.8.f.i.(a) Allocating Deductions to Various Income Items. See also part II.J.11.a Depreciation Advantages and Disadvantages.

Prop. Reg. § 1.199A-6(d)(3)(ii), "Allocation among trust or estate and beneficiaries," provides:

> The QBI (including any amounts that may be less than zero as calculated at the trust or estate level), W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI), as defined by section 643(a), for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. For this purpose, the trust's or estate's DNI is determined with regard to the separate share rule of section 663(c), but without regard to Section 199A. If the trust or estate has no DNI for the taxable year, any QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income are allocated entirely to the trust or estate.

Prop. Reg. § 1.199A-6(d)(3)(iii), "Threshold amount," provides:

> The threshold amount applicable to a trust or estate is $157,500 for any taxable year beginning before 2019. For taxable years beginning after 2018, the threshold amount shall be $157,500 increased by the cost-of-living adjustment as outlined in § 1.199A-1(b)(11). For purposes of determining whether a trust or estate has taxable income that exceeds the threshold amount, the taxable income of a trust or estate is determined before taking into account any distribution deduction under sections 651 or 661.

The last sentence above is consistent with the preamble quoted above, which says, "Under Section 199A, the threshold amount is determined at the trust level without taking into account any distribution deductions." However, I have been unable to find support for that statement in the statute or legislative history; Code § 199A(e)(1) says that taxable income is computed without reference to the Code § 199A deduction and provides no other exceptions. In my view, the approach of the preamble and Prop. Reg. § 1.199A-6(d)(3)(iii) creates double-counting – the beneficiary's K-1 income is counted toward the beneficiary's and the trust's taxable income threshold. For example, if a trust and beneficiary have no income or deductions other than $300,000 of QBI and the trust distributes half to the beneficiary, then (ignoring the trust's exemption and the beneficiary's standard deduction, Prop. Reg. § 1.199A-6(d)(3)(iii) would say that the trust has $300,000 taxable income towards its threshold and the beneficiary has $150,000 towards the beneficiary's taxable income threshold, thereby counting a total of $450,000 towards the trust's and beneficiary's thresholds when combined they had only $300,000 of taxable income. Furthermore, Code § 199A(f)(1)(B) directs that rules similar to the rules under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W 2 wages shall apply to the apportionment of W 2 wages and the apportionment of unadjusted basis immediately after acquisition of qualified property under this section, and the regulations under that provision looked to the trust's and beneficiaries' taxable incomes independently of each other; see part II.E.1.f.i Allocation under Former Code § 199 That Applies for Code § 199A.

Prop. Reg. § 1.199A-6(d)(3)(iv), "Electing small business trusts," is quoted and discussed in part II.E.1.f.iii Electing Small Business Trusts (ESBTs).

Prop. Reg. § 1.199A-6(d)(3)(v), "Anti-abuse rule for creation of multiple trusts to avoid exceeding the threshold amount," provides:

> Trusts formed or funded with a significant purpose of receiving a deduction under Section 199A will not be respected for purposes of Section 199A. See also § 1.643(f)-1 of the regulations.

Informal remarks made by government representatives at a September 13, 2018 webinar of the American Bar Association's Section of Real Property, Trust & Estate Law in which I also spoke indicate that the government's intent is to deny any Code § 199A deduction whatsoever if a trust triggers that regulation. I view that as a punitive approach – the regulation should provide that any abusive trust merely be denied the benefits of taxable income under the threshold.[820] For example, consider a trust with intent to benefit from having taxable income below the threshold in 2018. In 2019, its QBI is supported by wages such that it does not need to turn to the exception to the wage limitation to get a full Code § 199A deduction. Why should the deduction be denied in that case?

Prop. Reg. § 1.643(f)-1 is discussed in part II.J.9.c Multiple Trusts Created for Tax Avoidance.

Prop. Reg. § 1.199A-6(d)(3)(vi), Example (1) (the only example), begins with (i), "Computation of DNI and inclusion and deduction amounts":

> (A) *Trust's distributive share of partnership items*. Trust, an irrevocable testamentary complex trust, is a 25% partner in PRS, a family partnership that operates a restaurant that generates QBI and W-2 wages. In 2018, PRS properly allocates gross income from the restaurant of $55,000, and expenses directly allocable to the restaurant of $50,000 (including W-2 wages of $25,000, miscellaneous expenses of $20,000, and depreciation deductions of $5,000) to Trust. These items are properly included in Trust's DNI. Trust's share of PRS' unadjusted basis of qualified depreciable property is $125,000. PRS distributes $5,000 of cash to Trust in 2018.
>
> (B) *Trust's activities*. In addition to its interest in PRS, Trust also operates a family bakery conducted through an LLC wholly-owned by the Trust that is treated as a disregarded entity. In 2018, the bakery produced $100,000 of gross income and $150,000 of expenses directly allocable to operation of the bakery (including W-2 wages of $50,000, rental expense of $75,000, and miscellaneous expenses of $25,000). (The net loss from the bakery operations is not subject to any loss disallowance provisions outside of Section 199A.) Trust also has zero unadjusted basis of qualified depreciable property in the bakery. For purposes of computing its Section 199A

[820] See parts II.E.1.c.v.(a) Taxable Income "Threshold Amount" and II.E.1.c.v.(b) Calculation When Taxable Income Does Not Exceed the Threshold Amount, which are a subset of the general rules introduced in part II.E.1.c.v Calculation of Deduction Generally.

deduction, Trust has properly chosen to aggregate the family restaurant conducted through PRS with the bakery conducted directly by Trust under § 1.199A-4. Trust also owns various investment assets that produce portfolio-type income consisting of dividends ($25,000), interest ($15,000), and tax-exempt interest ($15,000). Accordingly, Trust has the following items which are properly included in Trust's DNI:

Interest Income	15,000
Dividends	25,000
Tax-exempt interest	15,000
Net business loss from PRS and bakery	(45,000)
Trustee commissions	3,000
State and local taxes	5,000

(C) *Allocation of deductions under § 1.652(b)-3*.

(1) *Directly attributable expenses*. In computing Trust's DNI for the taxable year, the distributive share of expenses of PRS are directly attributable under § 1.652(b)-3(a) to the distributive share of income of PRS. Accordingly, Trust has gross business income of $155,000 (55,000 from PRS and 100,000 from the bakery) and direct business expenses of $200,000 ($50,000 from PRS and $150,000 from the bakery). In addition, $1,000 of the trustee commissions and $1,000 of state and local taxes are directly attributable under § 1.652(b)-3(a) to Trust's business income. Accordingly, Trust has excess business deductions of $47,000. Pursuant to its authority recognized under § 1.652(b)-3(d), Trust allocates the $47,000 excess business deductions as follows: $15,000 to the interest income, resulting in $0 interest income, $25,000 to the dividends, resulting in $0 dividend income, and $7,000 to the tax exempt interest.

(2) *Non-directly attributable expenses*. The trustee must allocate the sum of the balance of the trustee commissions ($2,000) and state and local taxes ($4,000) to Trust's remaining tax-exempt interest income, resulting in $2,000 of tax exempt interest.

(D) *Amounts included in taxable income*. For 2018, Trust has DNI of $2,000. Pursuant to Trust's governing instrument, Trustee distributes 50%, or $1,000, of that DNI to A, an individual who is a discretionary beneficiary of Trust. In addition, Trustee is required to distribute 25%, or $500, of that DNI to B, a current income beneficiary of Trust. Trust retains the remaining 25% of DNI. Consequently, with respect to the $1,000 distribution A receives from Trust, A properly excludes $1,000 of tax-exempt interest income under section 662(b). With respect to the $500 distribution B receives from Trust, B properly excludes $500 of tax exempt interest income under section 662(b). Because the DNI consists entirely of tax-exempt income, Trust deducts $0 under section 661 with respect to the distributions to A and B.

I believe that the calculations above and below are flawed, because they do not reflect part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses). Although I believe that depreciation is deducted in calculating QBI, it is separately allocated to the beneficiaries in determining the trust's and their taxable income.

Prop. Reg. § 1.199A-6(d)(3)(vi), Example (1) (the only example), ends with (ii), "Section 199A deduction":

(A) *Trust's W-2 wages and QBI*. For the 2018 taxable year, Trust has $75,000 ($25,000 from PRS + $50,000 of Trust) of W-2 wages. Trust also has $125,000 of unadjusted basis in qualified depreciable property. Trust has negative QBI of ($47,000) ($155,000 gross income from aggregated businesses less the sum of $200,000 direct expenses from aggregated businesses and $2,000 directly attributable business expenses from Trust under the rules of § 1.652(b)-3(a)).

(B) *Section 199A deduction computation*.

(1) *A's computation*. Because the $1,000 Trust distribution to A equals one-half of Trust's DNI, A has W-2 wages from Trust of $37,500. A also has W-2 wages of $2,500 from a trade or business outside of Trust (computed without regard to A's interest in Trust), which A has properly aggregated under § 1.199A-4 with the Trust's trade or businesses (the family's restaurant and bakery), for a total of $40,000 of W-2 wages from the aggregate trade or businesses. A has $100,000 of QBI from non-Trust trade or businesses in which A owns an interest. Because the $1,000 Trust distribution to A equals one-half of Trust's DNI, A has (negative) QBI from Trust of ($23,500). A's total QBI is determined by combining the $100,000 QBI from non-Trust sources with the ($23,500) QBI from Trust for a total of $76,500 of QBI. Assume that A's taxable income exceeds the threshold amount for 2018 by $200,000. A's tentative deduction is $15,300 (.20 x $76,500), limited under the W-2 wage limitation to $20,000 (50% x $40,000 W-2 wages). Accordingly, A's section 199A deduction for 2018 is $15,300.

(2) *B's computation*. For 2018, B's taxable income is below the threshold amount so B is not subject to the W-2 wage limitation. Because the $500 Trust distribution to B equals one-quarter of Trust's DNI, B has a total of ($11,750) of QBI. B also has no QBI from non-Trust trades or businesses, so B has a total of ($11,750) of QBI. Accordingly, B's section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of B pursuant to section 199A(c)(2).

(3) *Trust's computation*. For 2018, Trust's taxable income is below the threshold amount so it is not subject to the W-2 wage limitation. Because Trust retained 25% of Trust's DNI, Trust is allocated 25% of its QBI, which is ($11,750). Trust's section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of Trust pursuant to section 199A(c)(2).

Prop. Reg. § 1.199A-6(e), "Effective/applicability date," provides:

(1) *General rule*. Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. However, taxpayers may rely on the rules of this section until the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register.

(2) *Exceptions*.

(i) *Anti-abuse rules*. The provisions of paragraph (d)(3)(v) of this section apply to taxable years ending after December 22, 2017.

(ii) *Non-calendar year RPE*. For purposes of determining QBI, W-2 wages, and UBIA of qualified property, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018 and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

II.E.1.f.i. Allocation under Former Code § 199 That Applies for Code § 199A

For trusts and estates, rules similar to those that applied to the former Code § 199 deduction for domestic production activities apply. Code § 199A(f)(1)(B) provides:

> *Application To Trusts And Estates*. Rules similar to the rules under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W-2 wages shall apply to the apportionment of W-2 wages and the apportionment of unadjusted basis immediately after acquisition of qualified property under this section.

Code § 199(d)(1)(B)(i) provided:

> In the case of a trust or estate…the items referred to in subparagraph (A)(ii) (as determined therein) and the W-2 wages of the trust or estate for the taxable year, shall be apportioned between the beneficiaries and the fiduciary (and among the beneficiaries) under regulations prescribed by the Secretary…

Code § 199(d)(1)(A)(ii) provided:

> In the case of a partnership or S corporation … each partner or shareholder shall take into account such person's allocable share of each item described in subparagraph(A) or (B) of subsection (c)(1) (determined without regard to whether the items described in such subparagraph (A) exceed the items described in such subparagraph (B)),

Code § 199(c)(1) provided:

> *In general*. The term "qualified production activities income" for any taxable year means an amount equal to the excess (if any) of-
>
> (A) the taxpayer's domestic production gross receipts for such taxable year, over
>
> (B) the sum of-
>
> (i) the cost of goods sold that are allocable to such receipts, and
>
> (ii) other expenses, losses, or deductions (other than the deduction allowed under this section), which are properly allocable to such receipts.

Reg. § 1.199-5(d) provides:

> *Grantor trusts*. To the extent that the grantor or another person is treated as owning all or part (the owned portion) of a trust under sections 671 through 679, such person (owner)

computes its QPAI with respect to the owned portion of the trust as if that QPAI had been generated by activities performed directly by the owner. Similarly, for purposes of the W-2 wage limitation, the owner of the trust takes into account the owner's share of the paragraph (e)(1) wages of the trust that are attributable to the owned portion of the trust. The provisions of paragraph (e) of this section do not apply to the owned portion of a trust.

What is QPAI, as used above and further below? Reg. § 1.199-1(c) provides:

> *Qualified production activities income*. QPAI for any taxable year is an amount equal to the excess (if any) of the taxpayer's domestic production gross receipts (DPGR) (as defined in § 1.199-3) over the sum of-
>
> (1) The cost of goods sold (CGS) that is allocable to such receipts; and
>
> (2) Other expenses, losses, or deductions (other than the deduction allowed under this section) that are properly allocable to such receipts. See §§ 1.199-3 and 1.199-4.

Reg. § 1.199-5(e), "Non-grantor trusts and estates," includes:

> (1) *Allocation of costs*. The trust or estate calculates each beneficiary's share (as well as the trust's or estate's own share, if any) of QPAI and W-2 wages from the trust or estate at the trust or estate level. The beneficiary of a trust or estate may not recompute its share of QPAI or W-2 wages from the trust or estate by using another method to reallocate the trust's or estate's qualified production costs or paragraph (e)(1) wages, or otherwise. Except as provided in paragraph (d) of this section, the QPAI of a trust or estate must be computed by allocating expenses described in section 199(d)(5) in one of two ways, depending on the classification of those expenses under § 1.652(b)-3. Specifically, directly attributable expenses within the meaning of § 1.652(b)-3 are allocated pursuant to § 1.652(b)-3, and expenses not directly attributable within the meaning of § 1.652(b)-3 (other expenses) are allocated under the simplified deduction method of § 1.199-4(e) (unless the trust or estate does not qualify to use the simplified deduction method, in which case it must use the section 861 method of § 1.199-4(d) with respect to such other expenses). For this purpose, depletion and depreciation deductions described in section 642(e) and amortization deductions described in section 642(f) are treated as other expenses described in section 199(d)(5). Also for this purpose, the trust's or estate's share of other expenses from a lower-tier pass-thru entity is not directly attributable to any class of income (whether or not those other expenses are directly attributable to the aggregate pass-thru gross income as a class for purposes other than section 199). A trust or estate may not use the small business simplified overall method for computing its QPAI. See § 1.199-4(f)(5).
>
> (2) *Allocation among trust or estate and beneficiaries*.
>
> (i) *In general*. The QPAI of a trust or estate (which will be less than zero if the CGS and deductions allocated and apportioned to DPGR exceed the trust's or estate's DPGR) and W-2 wages of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI), as defined by section 643(a), for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. For this purpose, the trust or estate's DNI is determined with

regard to the separate share rule of section 663(c), but without regard to section 199. To the extent that the trust or estate has no DNI for the taxable year, any QPAI and W-2 wages are allocated entirely to the trust or estate. A trust or estate is allowed the section 199 deduction in computing its taxable income to the extent that QPAI and W-2 wages are allocated to the trust or estate. A beneficiary of a trust or estate is allowed the section 199 deduction in computing its taxable income based on its share of QPAI and W-2 wages from the trust or estate, which are aggregated with the beneficiary's QPAI and W-2 wages from other sources, if any.

(ii) *Treatment of items from a trust or estate reporting qualified production activities income*. When, pursuant to this paragraph (e), a taxpayer must combine QPAI and W-2 wages from a trust or estate with the taxpayer's total QPAI and W-2 wages from other sources, the taxpayer, when applying §§ 1.199-1 through 1.199-8 to determine the taxpayer's total QPAI and W-2 wages from such other sources, does not take into account the items from such trust or estate. Thus, for example, a beneficiary of an estate that receives QPAI from the estate does not take into account the beneficiary's distributive share of the estate's gross receipts, gross income, or deductions when the beneficiary determines whether a threshold or de minimis rule applies or when the beneficiary allocates and apportions deductions in calculating its QPAI from other sources. Similarly, in determining the portion of the beneficiary's paragraph (e)(1) wages from other sources that is attributable to DPGR (thus, the W-2 wages from other sources), the beneficiary does not take into account DPGR and non-DPGR from the trust or estate.

(3) *Transition rule for definition of W-2 wages and for W-2 wage limitation*. The definition of W-2 wages of a trust or estate and the section 199(d)(1)(A)(iii) rule for determining the respective shares of wages from that trust or estate, and thus the beneficiary's share of W-2 wages from that trust or estate, is determined under the law applicable to pass-thru entities based on the beginning date of the taxable year of the trust or estate, regardless of the beginning date of the taxable year of the beneficiary.

Reg. § 1.199-5(e)(4) provides a detailed example:

Example. The following example illustrates the application of this paragraph (e). Assume that the partnership, trust, and trust beneficiary all are calendar year taxpayers. The example reads as follows:

Example. (i) *Computation of DNI and inclusion and deduction amounts*.

(A) *Trust's distributive share of partnership items*. Trust, a complex trust, is a partner in PRS, a partnership that engages in activities that generate DPGR and non-DPGR. In 2010, PRS distributes $10,000 cash to Trust. PRS properly allocates (in the same manner as wage expense) paragraph (e)(1) wages of $3,000 to Trust. Trust's distributive share of PRS items, which are properly included in Trust's DNI, is as follows:

Gross income attributable to DPGR ($15,000 DPGR - $5,000 CGS (including wage expense of $1,000))	$10,000

Gross income attributable to non-DPGR ($5,000 other gross receipts - $0 CGS)	5,000
Selling expenses attributable to DPGR (includes wage expense of $2,000)	3,000
Other expenses (includes wage expense of $1,000)	2,000

(B) *Trust's direct activities*. In addition to its cash distribution in 2010 from PRS, Trust directly has the following items which are properly included in Trust's DNI:

Dividends	$10,000
Tax-exempt interest	10,000
Rents from commercial real property operated by Trust as a business	10,000
Real estate taxes	1,000
Trustee commissions	3,000
State income and personal property taxes	5,000
Wage expense for rental business	2,000
Other business expenses	1,000

(C) *Allocation of deductions under § 1.652(b)-3*.

(1) *Directly attributable expenses*. In computing Trust's DNI for the taxable year, the distributive share of expenses of PRS are directly attributable under § 1.652(b)-3(a) to the distributive share of income of PRS. Accordingly, the $5,000 of CGS, $3,000 of selling expenses, and $2,000 of other expenses are subtracted from the gross receipts from PRS ($20,000), resulting in net income from PRS of $10,000. With respect to the Trust's direct expenses, $1,000 of the trustee commissions, the $1,000 of real estate taxes, and the $2,000 of wage expense are directly attributable under § 1.652(b)-3(a) to the rental income.

(2) *Non-directly attributable expenses*. Under § 1.652(b)-3(b), the trustee must allocate a portion of the sum of the balance of the trustee commissions ($2,000), state income and personal property taxes ($5,000), and the other business expenses ($1,000) to the $10,000 of tax-exempt interest. The portion to be attributed to tax-exempt interest is $2,222 ($8,000 x ($10,000 tax exempt interest / $36,000 gross receipts net of direct expenses)), resulting in $7,778 ($10,000-$2,222) of net tax-exempt interest. Pursuant to its authority recognized under § 1.652(b)-3(b), the trustee allocates the entire amount of the remaining $5,778 of trustee commissions, state income and personal

property taxes, and other business expenses to the $6,000 of net rental income, resulting in $222 ($6,000-$5,778) of net rental income.

(D) *Amounts included in taxable income*. For 2010, Trust has DNI of $28,000 (net dividend income of $10,000 + net PRS income of $10,000 + net rental income of $222 + net tax-exempt income of $7,778). Pursuant to Trust's governing instrument, Trustee distributes 50%, or $14,000, of that DNI to B, an individual who is a discretionary beneficiary of Trust. Assume that there are no separate shares under Trust, and no distributions are made to any other beneficiary that year. Consequently, with respect to the $14,000 distribution B receives from Trust, B properly includes in B's gross income $5,000 of income from PRS, $111 of rents, and $5,000 of dividends, and properly excludes from B's gross income $3,889 of tax-exempt interest. Trust includes $20,222 in its adjusted total income and deducts $10,111 under section 661(a) in computing its taxable income.

(ii) *Section 199 deduction*.

(A) *Simplified deduction method*. For purposes of computing the section 199 deduction for the taxable year, assume Trust qualifies for the simplified deduction method under § 1.199-4(e). The determination of Trust's QPAI under the simplified deduction method requires multiple steps to allocate costs. First, the Trust's expenses directly attributable to DPGR under § 1.652(b)-3(a) are subtracted from the Trust's DPGR. In this step, the directly attributable $5,000 of CGS and selling expenses of $3,000 are subtracted from the $15,000 of DPGR from PRS. Second, the Trust's expenses directly attributable under § 1.652(b)-3(a) to non-DPGR from a trade or business are subtracted from the Trust's trade or business non-DPGR. In this step, $4,000 of Trust expenses directly allocable to the real property rental activity ($1,000 of real estate taxes, $1,000 of Trustee commissions, and $2,000 of wages) are subtracted from the $10,000 of rental income. Third, Trust must identify the portion of its other expenses that is attributable to Trust's trade or business activities, if any, because expenses not attributable to trade or business activities are not taken into account in computing QPAI. In this step, in this example, the portion of the trustee commissions not directly attributable to the rental operation ($2,000) is directly attributable to non-trade or business activities. In addition, the state income and personal property taxes are not directly attributable under § 1.652(b)-3(a) to either trade or business or non-trade or business activities, so the portion of those taxes not attributable to either the PRS interests or the rental operation is not a trade or business expense and, thus, is not taken into account in computing QPAI. The portion of the state income and personal property taxes that is treated as an other trade or business expense is $3,000 ($5,000 x $30,000 total trade or business gross receipts/$50,000 total gross receipts). Fourth, Trust then allocates its other trade or business expenses (not directly attributable under § 1.652(b)-3(a)) between DPGR and non-DPGR on the basis of its total gross receipts from the conduct of a trade or business ($20,000 from PRS + $10,000 rental income). Thus, Trust combines its non-directly attributable (other) business expenses ($2,000 from PRS + $4,000 ($1,000 of other business expenses + $3,000 of income and property taxes allocated to a trade or business) from its own activities) and then apportions this total ($6,000) between DPGR and other receipts on the basis of Trust's total trade or business gross receipts ($6,000 of such expenses x $15,000 DPGR/$30,000 total trade or business gross receipts = $3,000). Thus, for purposes of computing Trust's and B's section 199 deduction, Trust's QPAI is $4,000 ($7,000 ($15,000 DPGR - $5,000 CGS - $3,000 selling expenses) - $3,000). Because the distribution of Trust's DNI to B equals one-half of Trust's DNI, Trust and B each has QPAI from PRS for purposes of the section 199 deduction of $2,000. B has $1,000 of QPAI from non-Trust activities that is added to the $2,000 QPAI from Trust for a total of $3,000 of QPAI.

(B) *W-2 wages*. For the 2010 taxable year, Trust chooses to use the wage expense safe harbor under § 1.199-2(e)(2)(ii) to determine its W-2 wages. For its taxable year ending December 31, 2010, Trust has $5,000 ($3,000 from PRS + $2,000 of Trust) of paragraph (e)(1) wages reported on 2010 Forms W-2. Trust's W-2 wages are $2,917, as shown in the following table:

Wage expense included in CGS directly attributable to DPGR	$1,000
Wage expense included in selling expense directly attributable to DPGR	2,000
Wage expense included in non-directly attributable deductions ($1,000 in wage expense x ($15,000 DPGR/$30,000 total trade or business gross receipts))	500
Wage expense allocable to DPGR	3,500
W-2 wages (($3,500 of wage expense allocable to DPGR/$6,000 of total wage expense) x $5,000 in paragraph (e)(1) wages)	$2,917

(C) *Section 199 deduction computation*.

(1) *B's computation*. B is eligible to use the small business simplified overall method. Assume that B has sufficient adjusted gross income so that the section 199 deduction is not limited under section 199(a)(1)(B).[821] Because the $14,000 Trust distribution to B equals one-half of Trust's DNI, B has W-2 wages from Trust of $1,459 (50% x $2,917). B has W-2 wages of $100 from trade or business activities outside of Trust and attributable to DPGR (computed without regard to B's interest in Trust pursuant to § 1.199-2(e)) for a total of $1,559 of W-2 wages. B has $1,000 of QPAI from non-Trust activities that is added to the $2,000 QPAI from Trust for a total of $3,000 of QPAI. B's tentative deduction is $270 (.09 x $3,000), limited under the W-2 wage limitation to $780 (50% x $1,559 W-2 wages). Accordingly, B's section 199 deduction for 2010 is $270.

[821] [My note – not from the regulation itself:] When this regulation was finalized, Code § 199(a)(1)(B) limited the Code § 199 deduction to taxable income (computed before applying the Code § 199 deduction). That limitation was in Code § 199(a)(2) immediately before its repeal by 2017 tax reform.

(2) *Trust's computation*. Trust has sufficient adjusted gross income so that the section 199 deduction is not limited under section 199(a)(1)(B).[822] Because the $14,000 Trust distribution to B equals one-half of Trust's DNI, Trust has W-2 wages of $1,459 (50% x $2,917). Trust's tentative deduction is $180 (.09 x $2,000 QPAI), limited under the W-2 wage limitation to $730 (50% x $1,459 W-2 wages). Accordingly, Trust's section 199 deduction for 2010 is $180.

The Example does not seem to consider part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

II.E.1.f.ii. Nongrantor Trusts Other Than ESBTs

II.E.1.f.ii.(a). How Qualified Business Income Flows to Beneficiaries

By managing their taxable income through the income distribution deduction, trusts may be able to get below the desired threshold to qualify for a better deduction. Planning for estates and nongrantor trusts generally is discussed in part II.J Fiduciary Income Taxation.

Suppose a partnership distributes its entire $1 million K-1 income (all "QBI" - qualified business income) to a trust. Suppose the partnership then distributes enough income so that its taxable income, before the Code § 199A deduction, is $157,500. The trust's allocable portion of QBI receives the 20% deduction, without regard to the wage limitation[823] and without regard to whether the partnership conducts otherwise disqualified professional services.[824] The beneficiary's K-1 income from the trust pushes the beneficiary's taxable income way above the taxable income threshold. The beneficiary might very well have been above the taxable income threshold anyway.

Thus, we might have two taxpayers that might have been above the taxable income threshold, yet one of them gets the full benefit of being below the threshold.

Suppose each of the trust and beneficiary has zero taxable income but for a $315,000 K-1 that the trust receives. If the trust distributes to the beneficiary $157,500 plus all of its other income, each of the trust and the beneficiary may have $157,500 of taxable income. Thus, each one should be able to qualify fully for all of the benefits that taxable income below the thresholds provides, even though if the trust had retained all of the K-1 income it would have not received any of those benefits (with $315,000taxable income, which is above $207,500); however, the last sentence of Prop. Reg. § 1.199A-6(d)(3)(iii), as well as the preamble,[825] would double-count the beneficiary's K-1 income, giving the trust $315,000 taxable income and the beneficiary $157,500 taxable income. Therefore, under the proposed regulations, the trust would not benefit from being within the taxable income threshold, but the beneficiary would.

---

[822] [My note – not from the regulation itself:] When this regulation was finalized, Code § 199(a)(1)(B) limited the Code § 199 deduction to taxable income (computed before applying the Code § 199 deduction). That limitation was in Code § 199(a)(2) immediately before its repeal by 2017 tax reform.
[823] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
[824] See part II.E.1.f Trusts/Estates and the Code § 199A Deduction.
[825] For complete quotes of both the preamble and the regulation, see part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

II.E.1.f.ii.(b). When to Shift Qualified Business Income (QBI) to Beneficiaries

Before focusing on QBI, consider planning for the trust and beneficiaries generally. See part II.J Fiduciary Income Taxation, especially part II.J.3 Strategic Fiduciary Income Tax Planning.

Generally, distributions effectively shift the trust's income to its beneficiaries.[826]

After allocating deductions to the trust's income,[827] the trustee usually needs to allocate all items of distributable net income to beneficiaries in proportion to the distributions they receive,[828] subject to the separate share rule.[829]

Be sure to consider planning opportunities described in part II.J.11.a Depreciation Advantages and Disadvantages.

A beneficiary may have business losses, deductions against gross income, or the itemized or standard deduction against which to offset income, so that shifting income to the beneficiary may provide more.

Also, if a beneficiary is a married person filing jointly, then the beneficiary's taxable income threshold is double that of a trust's, so shifting QBI to the beneficiary may allow a more favorable threshold, even if the beneficiary's losses and deductions don't make much of a difference.

II.E.1.f.ii.(c). Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs

Suppose a trust holds a partnership but would like to take advantage of the benefits provided for S corporation shareholders by part II.E.1.f.iii Electing Small Business Trusts (ESBTs) or II.E.1.f.iv Grantor Trusts. It could contribute the partnership to an S corporation and then take advantage of those benefits. See parts II.J.4.g Making the Trust a Complete Grantor Trust as to the Beneficiary and II.J.4.h Trapping Income in Trust Notwithstanding Distributions – ESBT. This possibility is discussed in part II.E.1.f.iii Electing Small Business Trusts (ESBTs).

Such a strategy would also have the benefit of not qualifying the partnership from electing out of the Bipartisan Budget Act partnership audit rules that became effective for years beginning after December 31, 2017; when I wrote this paragraph, the proposed regulations had not approved of trusts as eligible partners for purposes of opting out, and an S corporation's shareholders are not counted in determining the S corporation's eligibility. See part II.G.18.c Audits of Partnership Returns.

However, given that an S corporation that does not itself conduct a business cannot be divided tax-free, consider creating the same number of S corporations as there are remaindermen. That way, each remainderman will have his or her own S corporation and independently determine distributions from the S corporation or whether the S corporation should sell the partnership

---

826 See part II.J.1 Trust's Income Less Deductions and Exemptions Is Split Between Trust and Beneficiaries.
827 See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items.
828 See part II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It.
829 See part II.J.9.a Separate Share Rule.

interest. For more thoughts on this, see part III.A.3.e.vi.(b), the title of which focuses on QSSTs, but which also applies to ESBTs.

II.E.1.f.iii. Electing Small Business Trusts (ESBTs)

As described in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview,[830] ESBT income taxation is complicated. An ESBT is treated as two separate trusts for purposes of chapter 1 of Subtitle A of the Code. The portion that consists of stock in one or more S corporations is treated as one trust, and the portion that consists of all the other assets in the trust is treated as a separate trust. The grantor trust rules trump this treatment. However, the ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return. (A side benefit is that the $10,000 limit on state income tax deductions would apply separately to the S portion and the non-S portion, allowing the trust to deduct up to $20,000 in state income tax.)[831]

Code § 641(c)(2) limits the deductions that an ESBT can take. However, Code § 641(c)(2)(C)[832] and Reg. § 1.641(c)-1(d)(2)(i)[833] provide that one takes into items reported on Schedule K-1 that the S corporation issues to the trust.[834] Code § 199A(f)(1)(B) refers back to Code § 199 for the apportionment of W-2 wages and the apportionment of unadjusted basis.[835] Code § 199 items were separately stated on Schedules K-1. [836] Consistent with this framework, Prop. Reg. § 1.199A-6(d)(3)(iv), "Electing small business trusts," provides:

> An electing small business trust (ESBT) is entitled to the deduction under section 199A. The S portion of the ESBT must take into account the QBI and other items from any

---

we[830] This is part of part III.A.3.e.ii ESBTs.

[831] See text accompanying fns 5118-5121 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview.

[832] Code § 641(c)(2)(C) provides:

> The only items of income, loss, deduction, or credit to be taken into account are the following:
> (i) The items required to be taken into account under section 1366….

[833] Reg. § 1.641(c)-1(d)(2)(i) provides:

> *In general*. The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. See § 1.1361-1(m)(3)(iv) for allocation of those items in the taxable year of the S corporation in which the trust is an ESBT for part of the year and an eligible shareholder under section 1361(a)(2)(A)(i) through (iv) for the rest of the year.

[834] Reg. § 1.1366-1(a)(2) provides:

> Each shareholder must take into account separately the shareholder's pro rata share of any item of income (including tax-exempt income), loss, deduction, or credit of the S corporation that if separately taken into account by any shareholder could affect the shareholder's tax liability for that taxable year differently than if the shareholder did not take the item into account separately.

[835] See part II.E.1.f.i Allocation under Former Code § 199 That Applies for Code § 199A.

[836] Reg. § 1.1366-1(a)(2)(x) provides that among the items a shareholder takes into account is:

> Any item identified in guidance (including forms and instructions) issued by the Commissioner as an item required to be separately stated under this paragraph (a)(2).

2017 Instructions for Form 1120S, Schedule K-1, Box 12, page 15, includes:

> **Code P. Domestic production activities information.** The corporation will provide you with a statement with information that you must use to figure the domestic production activities deduction. Use Form 8903, Domestic Production Activities Deduction, to figure this deduction. For details, see the Instructions for Form 8903.

S corporation owned by the ESBT, the grantor portion of the ESBT must take into account the QBI and other items from any assets treated as owned by a grantor or another person (owned portion) of a trust under sections 671 through 679, and the non-S portion of the ESBT must take into account any QBI and other items from any other entities or assets owned by the ESBT. See § 1.641(c)-1.

Query how the taxable income thresholds will apply. Code § 199A is found within chapter 1 of Subtitle A of the Code, so the S corporation portion should be treated as a separate trust with its own taxable income. Even the 3.8% tax on net investment income, which is in chapter 2A, respects an ESBT's separateness.[837]

If this separateness is respected as appears to be the case, then a trust with other taxable income but no more than $157,500 of S corporation taxable income would get the full benefit of being no more than the taxable income threshold.

If that idea holds up, a trust with taxable income over the threshold that holds a partnership interest might contribute enough of the partnership interest to an S corporation to trap less than $157,500 inside the ESBT. Perhaps the trust might even have two taxable income thresholds – one for the partnership owned by the corporation inside the ESBT, and another for the partnership owned directly by the trust. However, informal remarks made by government representatives at a September 13, 2018 webinar of the American Bar Association's Section of Real Property, Trust & Estate Law in which I also spoke indicate that the government's intent is to add the S portion's taxable income to the non-S portion's taxable income to see whether the taxable income threshold is exceeded. Not only would that be inconsistent with Reg. § 1.641(c)-1(a), it would violate Code § 641(c)(1)(A), which provides that, for all federal income tax purposes, "the portion of any electing small business trust which consists of stock in 1 or more S corporations shall be treated as a separate trust."

Before considering this, carefully read part II.E.1.f.ii.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

II.E.1.f.iv. Grantor Trusts (Including QSSTs)

"Grantor trust" means that one or more person is treated for income tax purposes as owning the trust's assets. Often this person is the grantor, but it can also be a beneficiary. See part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust, especially parts III.B.2.h How to Make a Trust a Grantor Trust and III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

The most common grantor trust is the revocable trust, but that's just a probate avoidance tool that doesn't inform planning. During the settlor's life, we often look to whether the settlor of an irrevocable trust may be the deemed owner, although significant tools allow us to plan to have the primary beneficiary be the deemed owner. After the settlor's death, making the beneficiary the deemed owner is the only grantor trust planning option.

Given that all Code § 199A items are attributable to the relevant grantor(s), a grantor trust is helpful when the beneficiary has low income.

[837] See part II.J.14 Application of 3.8% NII Tax to ESBTs.

Suppose a trust has huge taxable income, as well as having a partnership K-1 with no more than \$157,500 of taxable income (before applying Code § 199A). As discussed in part II.E.1.f.iii, the trust could form an S corporation, contribute the partnership interest to the S corporation, and make an ESBT election, thereby qualifying for the full Code § 199A deduction – but at the highest taxable income rates. Another alternative is to do the same, only the beneficiary elects QSST taxation.[838] All of the partnership's K-1 items are reported directly on the beneficiary's return, using the beneficiary's taxable income threshold and being taxed at the beneficiary's income tax rates. Before considering this, carefully read part II.E.1.f.ii.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

II.E.1.f.v. Interaction with Net Investment Income Tax

The 3.8% tax on net investment income (NII) applies not only to investments but also to passive business income. See part II.I.8 Application of 3.8% Tax to Business Income.

To avoid the tax on passive business income, the trustee of a nongrantor trust or the deemed owner of a grantor trust must sufficiently participate in the business. See part II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business.

If the trust is a QSST, then consider having the trustee sufficiently participate, to avoid NII tax in case the business is sold. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and II.I.8.g Structuring Businesses in Response to 3.8% Tax.

II.E.1.f.vi. Example Using Trusts to Split Income

Suppose Marla Alexander, a widow, owns an S corporation, which annually generates \$1.5 million of taxable income each year.

Being in a state with a 5% income tax rate, Marla pays \$75,000 of state income tax each year. Unfortunately, for any taxable year beginning after December 31, 2017 and before January 1, 2026, Code § 164(b)(6) limits her deductions for state taxes to \$10,000.[839] Given that Marla pays some real estate tax on her residence, more than \$65,000 of her state income tax deduction is disallowed.

Marla has two children, Sam and Dolly. Marla needs only 60% of her stock to live quite comfortably. After converting the stock in 5 shares of voting and 95 shares of nonvoting stock,[840] Marla gifts 40 shares of nonvoting stock, 10 into each of four trusts: a discretionary trust for Sam, a QSST for Sam, a discretionary trust for Dolly, and a QSST for Dolly. See part III.A.3.e QSSTs and ESBTs.

Each ESBT will deduct its \$7,500 share of state income tax. Because QSSTs are taxable as grantor trusts, each of Sam and Dolly will deduct up to \$7,500 of state income tax if he or she itemizes deductions ("up to" because they may have real estate tax or other state tax deductions). Although part II.J.9.c Multiple Trusts Created for Tax Avoidance is concerning, Marla's desire to distribute some income and accumulate the rest of the income, combined with the fact that a

---

[838] See part III.A.3.e.i.(a) QSSTs Generally.

[839] It does not apply this limit to property taxes attributable to Code § 212 trade or business (which generally would be rental real estate, if it is a trade or business). See part II.G.3.i.i Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit.

[840] See part II.A.2.i.i Voting and Nonvoting Stock.

QSST must distribute all of its income, may suffice. More conservative from an income tax viewpoint would be to make gifts outright instead of using QSSTs, but that might not meet Marla's estate planning objectives.

Also consider that each trust's distributive share of income is $150,000 (10% of $1.5 million). This means that each ESBT's taxable income will be less than $157,500; thus, in computing their Code § 199A deduction, any disallowance of specific service business income[841] and any limitations placed on insufficient wages[842] would not apply. See part II.E.1.f.iii Electing Small Business Trusts (ESBTs). Whether Sam and Dolly will benefit from eliminating these potential disallowances regarding the QSST's distributive shares that are taxed to them depends on their other income and deductions; see part II.E.1.f.iv Grantor Trusts (Including QSSTs).

Also consider part II.I 3.8% Tax on Excess Net Investment Income (NII), especially part II.I.8 Application of 3.8% Tax to Business Income:

- If Sam or Dolly's adjusted gross income exceeds $200,000 so that the 3.8% NII tax may apply to them, does Sam or Dolly work enough in the business to prevent the NII tax from applying to his or her distributive share of business income through his or her QSST? Working more than 100 hours per year – a mere 2 hours per week – may suffice; see part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

- Because an ESBT's threshold for the NII tax is so low, we also need to consider whether the trustee of each ESBT works enough in the business on behalf of the relevant trust to avoid NII tax. See part II.J.14 Application of 3.8% NII Tax to ESBTs. If the trustee works in the business as an individual, on audit the IRS is likely to assert that work as an individual does not count – it needs to be work expressly as a trustee. However, one can plan to avoid that argument. For all of these issues, see part II.K.2.b Participation by an Estate or Nongrantor Trust.

- The trustee of the QSSTs should also consider the planning mentioned for the ESBT. That's because the gain on sale of S corporation stock is taxed to the trust itself, rather than to the beneficiary; see parts II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

Suppose, instead of Marla's business being in an S corporation, it were held in an LLC taxed as a partnership. Let's first consider the state income tax issue, then consider the QBI issue.

Because there is no partnership income tax equivalent of a QSST, the mandatory income trust would apply the state income deduction at the trust level rather than at the beneficiary level. That may be more favorable, given that Sam's and Dolly's other state tax issues would not impinge on the benefits of the deduction for state income tax on the pass-through income. On the other hand, it may be more difficult to justify two separate trusts, given that a trust holding a partnership interest does not have the same type of drafting considerations that a QSST would have; therefore, one may be more wary of possible application of part II.J.9.c Multiple Trusts Created for Tax Avoidance. In response to this concern, one may consider the mandatory income trust placing the partnership in an S corporation, with the trust's beneficiary electing QSST treatment; query, however, whether such a strategy is more trouble than it's worth, as pointed out in

[841] See part II.E.1.c.iv Specified Service Trade or Business.
[842] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

part II.E.1.f.ii.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

Moving to the QBI issues, issues with the specific service business income[843] and any limitations placed on insufficient wages[844] would be divided between the trust and beneficiaries who receive distributions, as described in part II.E.1.f.ii Nongrantor Trusts Other Than ESBTs. However, if the LLC does not distribute much more than enough to pay taxes, then the beneficiaries might not receive much of a distribution, because the trust would use all or most of the distribution to pay the trust's own taxes; see parts III.A.4 Trust Accounting Income Regarding Business Interests and III.D.2 Trust Accounting and Taxation. To shift half of the gifted distributive shares of income to Sam or Dolly, one may need to consider having a separate mandatory income trust that places its LLC interest in an S corporation, with the trust's beneficiary electing QSST treatment; again, consider whether such a strategy is more trouble than it's worth, as pointed out in part II.E.1.f.ii.(c) Shifting or Trapping Income Other Than by Making Distributions; Collateral Advantages and Disadvantages of ESBTs and QSSTs.

Also consider the same NII tax issues we did for the ESBTs.

II.E.1.f.vii. Ownership Restrictions

If an ownership interest cannot be transferred to a trust because it is a professional firm, consider which services can be split off into an entity that does not require professional ownership.

For example, CPA firms could split off their tax return and personal financial planning services.

However, if the business is inside a corporation, consider whether goodwill is personal or corporate,[845] the latter causing taxation when moving the line of business unless one can do a tax-free split-up.[846]

II.E.1.g. Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation

As mentioned earlier:

- Dividends a C corporation receives from another domestic C corporation are subjected to federal income tax of no more than 10.5%.[847]

- Taxable interest and capital gains are subjected to 21% federal income tax.[848]

---

843 See part II.E.1.c.iv Specified Service Trade or Business.
844 See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.
845 See part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees?
846 See part II.Q.7.f Corporate Division into More Than One Corporation.
847 See part II.E.1.a Taxes Imposed on C Corporations, especially the text accompanying fn 614, referring to fns. 10-14 in part II.A.1.a C Corporations Generally.
848 Code § 11(a), (b). Code § 11(c) provides that corporate income tax does not apply to a corporation subject to a tax imposed by:

(1) section 594 (relating to mutual savings banks conducting life insurance business),
(2) subchapter L (sec. 801 and following, relating to insurance companies), or

Contrast this to a taxpayer in the highest tax bracket, who is subjected to federal income tax of:

- 23.8% on qualified dividends[849] and net long-term capital gains, considering the 20% top capital gain rate[850] and 3.8% net investment income tax.[851]

- 40.8% on taxable interest income, nonqualified dividends, and net short-term capital gains, considering the 37% top ordinary income tax rate[852] and 3.8% net investment income tax.[853]

- For any taxable year beginning after December 31, 2017 and before January 1, 2026, individuals cannot deduct investment management fees relating to managing their own marketable securities.[854] This disallowance does not apply to C corporations, because C corporation deductions are not itemized deductions.

However, the chart in part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, which also considers moderate state income tax, illustrates that the C corporation advantage quickly dissipates if the corporation makes distributions.

The personal holding company tax or accumulated earnings tax may essentially force a corporation to declare dividends – especially if the corporation accumulates more than $125,000 in earnings.[855]

Eventually, however, income will need to be distributed so that the owner actually benefits from the investment return, imposing dividend tax at that time and undermining – to some extent (small or large) the advantage of C corporation income tax savings. Another option, which can make this strategy much more tenable, is: the investor grows the assets at smaller income tax rates, increasing future annual income, then converts to an S corporation and distributes current income while leaving prior years' income in the corporation to grow; see part II.E.2.c Converting a C Corporation to an S corporation, which also includes warnings regarding investment mix after making the S election.

Harvesting the accumulated income by simply selling the C corporation does not produce good results. See part II.E.2 Comparing Exit Strategies from C Corporations and Pass-Through Entities.

Finally, if one decides to use a corporation to hold investments, consider what happens when one passes them to one's children or other various beneficiaries. A similar but perhaps more predictable termination concern applies to trusts. A corporation that invests in portfolio assets cannot divide without triggering income tax. One might consider creating a few corporations (in

---

(3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts).

Code § 11(d), "Foreign corporations," provides:

> In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882.

849 See part II.E.1.a Taxes Imposed on C Corporations, fns 615-616 and text accompanying them.

850 Code § 1(h)(1), with exceptions under Code § 1(h)(3)-(8) for depreciation recapture, collectibles and Code § 1202 gain taxed as a capital gain at 28%

851 See part II.I 3.8% Tax on Excess Net Investment Income (NII).

852 Code § 1(j), for any taxable year beginning after December 31, 2017, and before January 1, 2026.

853 See part II.I 3.8% Tax on Excess Net Investment Income (NII).

854 Code § 67(g).

855 See text accompanying and preceding fn 620 in part II.E.1.a Taxes Imposed on C Corporations.

the case of a trust, one for each remainderman). These corporations then invest in a partnership, which can divide without triggering income tax. That way, each corporation can receive a mix of assets more along the lines of the beneficiary's preferences. For more details, see part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made), which describes the corporate division issue and a solution.

I cannot emphasize enough the need to consider an exit strategy. Political winds change over time, and it is very likely that at some point Congress will increase corporate taxes to bring them closer to individual rates. Beware getting into a structure that has costly exit steps and then being stuck there because of that high exit tax. Consider that the Tax Reform Act of 1986 taxed all income, including long-term capital gains, at a top rate of 28%, and the paradigm before 2017 tax reform was very different. The paradigm from 2017 tax reform will change, whether by creeping as the 1986 one did or by dramatic changes needed to reduce the exploding national debt or pay for Medicare or Social Security.

II.E.1.h. Effect of 2017 Tax Reform on Debt-Equity Structure

See part II.G.19.a Limitations on Deducting Business Interest Expense.

Business interest deduction limitations vary by industry.

Businesses with average annual gross receipts of no more than $ 25 million are exempt from this limitation.[856]

II.E.1.i. Conducting Businesses in Different Entities to Facilitate Using the Code § 199A Deduction

Each separate trade or business applies the Code § 199A separately,[857] which may at first glance seem to make shifting operations around meaningless. However, each business activity may have, within the same entity, one or more sets of functions that support that activity, which functions might themselves be viewed as a separate business if conducted in that manner.

A prime example is real estate used in a business. Suppose a law partnership owned its own real estate. If a partner's income is too high, her partnership income would not generate a Code § 199A deduction, because the income is derived from a specific service business.[858] The benefit of owning the real estate is subsumed in the disqualified income. However, if instead the real estate were owned by a separate LLC that was the landlord, the real estate could generate qualified business income (QBI) if the landlord undertook sufficient activity to qualify it as a trade or business; see part II.E.1.e Whether Real Estate Qualifies As a Trade or Business.

Unlike real estate, equipment leasing almost automatically qualifies as a trade or business, according to cases and rulings in the self-employment tax and unrelated business income tax areas.[859] So consider forming a separate equipment leasing venture that services the equipment, with the services perhaps not needed to qualify as a business but helpful to prevent the wage limitation from reducing the Code § 199A deduction.[860] To avoid self-employment tax, be sure to

[856] See text accompanying fns 1509-1510.
[857] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction, especially text before and after fn 698.
[858] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction, fns 671-700.
[859] See part II.L.2.a.ii Rental Exception to SE Tax, fns 2817-2821.
[860] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

make the venture be a limited partnership with an S corporation general partner or an S corporation; see parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons, II.E.6 Recommended Partnership Structure – Flowchart and II.E.7 Migrating into Partnership Structure (with the latter not as important because a new leasing venture could be started for new equipment). Also, as the Code § 199A deduction approaches its termination, consider part II.E.1.c.ix QBI and Effectively Connected Income.

If a professional service firm also sells goods, consider separating the sale of goods from the provision of services. Depending on how the government approaches classifying trades or business as separate,[861] a separate entity may not be needed.

II.E.2. Comparing Exit Strategies from C Corporations and Pass-Through Entities

II.E.2.a. Transferring the Business

Part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis shows that, when doing a seller-financed sale of a business, such as to key employees, other owners, or family members, the value of a business attributable to goodwill can be transferred much more tax-efficiently when using a partnership compared to a C corporation or an S corporation. Part or all of these dynamics can be replicated in other transactions.

A shareholder's stock's basis does not increase as a result of a C corporation's reinvested income. However, part or all of the gain on the sale of original issue stock in a qualified corporation that runs a qualified business is excluded from income. See part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation, explaining Code § 1202.

However, to the extent that an owner's distributive share of a partnership's or S corporation's income is reinvested, the owner's basis in the partnership interest[862] or stock[863] increases. Thus, the gain on sale usually is much lower when selling a partnership interest or S corporation stock than when selling C corporation stock.

S corporations and partnerships are ideal candidates for estate planning transfers using irrevocable grantor trusts. See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust, especially the text preceding fn 5502. When the pass-through entity makes distributions to pay its owners' taxes, the irrevocable grantor trust that bought the stock or partnership interest uses those distributions to pay down the note owed to seller, and the seller uses this to pay taxes. Thus, tax distributions are used to build equity in the purchasing irrevocable grantor trust. Contrast this with C corporations, where the corporation pays taxes directly to the government, and any distributions are subject to double taxation. See part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, using the scenario of a C corporation distributing all of its earnings to its shareholders.

---

[861] See part II.E.1.c.ii Types of Income and Activities Eligible or Ineligible for Deduction, especially text before and after fn 698.
[862] Code § 705.
[863] Code § 1367.

Also, gain on the sale of C corporation stock is subject to the 3.8% tax on net investment income.[864] Gain on the sale of an S corporation or partnership that conducts a trade or business may be largely excluded from that tax when the owner sufficiently participates.[865]

Furthermore, when an owner dies, the assets of a sole proprietorship (including an LLC owned by an individual that has not elected corporate taxation) or a partnership (including an LLC owned by more than one person that has not elected corporate taxation) can obtain a basis step-up (or down) when an owner dies, whereas the assets of a C corporation or an S corporation do not receive a new basis.[866]

Part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons describes more reasons why I tend to prefer partnerships over S corporations and S corporations over C corporations.

II.E.2.b. Converting from S corporation to C Corporation

See parts II.A.2.k Terminating an S Election and II.P.3.e Conversion from S corporation to C Corporation for short-term planning. Ideas include:

- A conversion may be taxable, with the main issue being that an S corporation that was on the cash method that may be required to convert to the accrual method.

- Additional steps may be needed to preserve or distribute the S corporation's accumulated adjustment account (which generally lets S corporations distribute its reinvested taxable earnings later without taxing it shareholders – see part II.Q.7.b Redemptions or Distributions Involving S corporations). Note that, if the corporation distributes a note before converting, interest income on the note will be taxable at its shareholders' full ordinary income rates and subject to net investment income tax, which together combine to impose a 40.8% federal tax rate, whereas the corporation may receive (see part II.G.19.a Limitations on Deducting Business Interest Expense) a deduction at a 21% federal rate.

However, one always needs to consider what if that decision needs to be reversed when a new Congress changes the income tax paradigm. See parts II.P.3.c Conversion from C Corporation to S corporation and II.P.3.c.v Conversion from S corporation to C Corporation then Back to S corporation.

Generally, I recommend forming an S corporation parent and then converting the original corporation to a C corporation, for the reasons and using the method described in fns 3332-3338 in part II.P.3.c.v Conversion from S corporation to C Corporation then Back to S corporation, which in a nutshell include:

- Preserving the corporation's AAA in case it converts back to being an S corporation.

- Avoiding (so it appears) having to wait 5 years before converting back to being an S corporation.[867]

[864] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[865] See part II.I.8 Application of 3.8% Tax to Business Income.
[866] See part II.H.2 Basis Step-Up Issues.
[867] See fns 185-187 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

- Potentially qualifying for the benefits described in part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation, which does not apply to former S corporations but does apply to C corporation subsidiaries of S corporations.

II.E.2.c. Converting a C Corporation to an S corporation

A C corporation that revoked its S election must wait 5 years to convert back to an S corporation. See part II.A.2.k Terminating an S Election.

See part II.P.3.c Conversion from C Corporation to S corporation, including II.P.3.c.v Conversion from S corporation to C Corporation then Back to S corporation. Issues discussed there include the following:

- Generally, an asset sold within 5 years after converting from a C corporation to an S corporation will be taxed at the entity level and again to the shareholders. See part II.P.3.c.ii Built-in Gain Tax on Former C Corporations under Code § 1374. Therefore, before converting, one might sell assets that are likely to sold within 5 years. If the taxpayer uses the cash receipts and disbursements method of accounting, consider switching to accrual before converting, so that accounts receivable do not get hit with this tax.

- Although an S corporation that has accumulated earnings and profits from when it was a C corporation cannot have excess passive investment income, that issue is easily managed through the corporation's investment mix – if one considers the issue and plans for it; investment mix may not need to be managed if the corporation is a partner in an active business that has substantial gross receipts (which is tested rather than the partnership's profits). See part II.P.3.c.iii Excess Passive Investment Income, especially fns 3309-3312.

- Also, an S corporation that has accumulated earnings and profits from when it was a C corporation should not invest in tax-exempt investments, the income from which does not generate AAA and therefore may trigger a taxable dividend when distributed. See part II.P.3.c.iv Problem When S corporation with Earnings & Profits Invests in Municipal Bonds.

- If the corporation maintains an inventory, converting from a C corporation to an S corporation may incur tax. See part II.P.3.c.i LIFO Recapture.

II.E.3. Recommended Structure for Start-Ups

The structure should start as a simple one and then, when the entity is making a lot money, would be transitioned to a more complex structure. For long-term reasons why an entity taxed as a sole proprietorship or partnership makes sense, see part II.E.5.a Strategic Income Tax Benefits of Recommended Structure.

Consider starting with an LLC. Start-up businesses often lose money initially, and an LLC taxed as a sole proprietorship or partnership facilitate loss deductions better than other entities[868]

[868] See part II.G.3 Limitations on Losses.

(although deducting start-up losses might not always generate the best result).[869] Also, often owners of closely-held businesses operate with a high degree of informality, and owners of corporations can get into trouble by taking money out without documenting compensation or documenting loans;[870] contrast that to an LLC that for income tax purposes is either disregarded entity or a partnership,[871] in which case distributions are either disregarded or generally nontaxable.[872]

A business with owners that work more than 100 but not more than 500 hours per year might want to move its real estate into the desired structure to avoid the 3.8% net investment income tax on the rental income (because the rental income and expense are disregarded for income tax purposes, being in the same umbrella as the operating business) or on the sale of the rental property. For example, a parent LLC might own an operating LLC and a real estate LLC. See parts II.I.8.c.i If Not Self-Rental, Most Rental Income Is *Per Se* Passive Income, II.I.8.a.iii Qualifying Self-Charged Interest or Rent Is Not NII, II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax, and II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

However, deducting start-up losses may not be desirable, because the owner is in a lower tax bracket now and expects not to be in a low tax bracket in the future. In that case, consider using an entity taxed as an S corporation, with the owners guaranteeing loans by third parties but not investing or lending a lot of money themselves. If that, too, generates more losses than desirable, then try a C corporation, which will just roll forward the losses. When using a C corporation or an S corporation, consider planning to qualify for the requirements of part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244 (which is not available to trusts).[873] Beware, however, that using either kind of corporation can make getting into an ideal long-term structure more difficult, because one needs to avoid triggering taxation on a deemed distribution of assets. See part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure. Often a trigger for moving a corporation into the structure is the desire to avoid capital gain tax on the seller-financed sale of the business, which often makes the costs of transition

---

[869] If the owner is in a lower bracket in start-up years than in later years, losses might best be deferred, if possible. A variation of this idea is in part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. If deferring losses is expected to be particularly beneficial, consider:

- If loans are bank-financed, an S corporation can easily ensure that its owners' distributive share of losses be suspended due to basis limitations until the S corporation becomes profitable. See part II.G.3.c.i.(a) Limitations on Using Debt to Deduct S corporation Losses.
- A start-up C corporation's losses are simply carried forward and deducted against its later income. See part II.G.3.i.iii Code § 172 Net Operating Loss Deduction. In case the C corporation doesn't succeed, certain start-up documentation can generate ordinary loss (instead of capital loss) treatment when the stock becomes worthless. See part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244, subject to part II.J.11.b Code § 1244 Treatment Not Available for Trusts. The timing and documentation (including initial documentation in the case of a loan) of a worthless stock or bad debt deduction can be tricky. See part II.G.3.b C Corporations: Losses Incurred by Business, Owner, or Employee, especially fns. 1003-1004 (stock) and 1006-1008 (loans).

[870] Such payments are potentially taxable distributions to shareholders; see the text accompanying fns. 3970-3971 in part II.Q.7 Exiting from or Dividing a Corporation. The IRS attacks distributions from S corporations, asserting (often successfully) that they are disguised compensation (and perhaps assessing penalties as well); see part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax, especially fns. 81-82.

[871] See part II.B Limited Liability Company (LLC).

[872] See part II.Q.8.b.i Distribution of Property by a Partnership.

[873] See part II.J.11.b Code § 1244 Treatment Not Available for Trusts.

worthwhile if the business has significant goodwill. See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis.

When the business starts making money but only enough to pay owner compensation and equipment that is expensed immediately, no additional self-employment tax is due relative to if the entity were a corporation paying compensation to its owners. Furthermore, if the business is investing profits in equipment, etc., generous write-offs are available.[874] However, note that wages paid by an S corporation may provide a higher Code § 199A deduction relative to compensation paid to a partner, so consider this corporate advantage.[875]

Then, when the client is ready for the ideal entity (for example, when self-employment tax on reinvested earnings becomes a significant number), the client can simply assign the LLC to the limited partnership described in parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart; see part II.E.7.b Flowcharts: Migrating LLC into Preferred Structure. However, the client might express a preference in the long-run to use part II.E.8 Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary. If so, the client might want to start with that structure instead of starting with an LLC. If one starts with an entity taxed as an S or C corporation instead of an LLC, then the presence of non-compete agreements would make migration to a partnership structure less effective, because the value of the goodwill at the time of the migration would remain inside the corporation.

Suppose that one concludes that a C corporation would be ideal. Starting with an LLC taxed as a partnership and then converting to a C corporation the earlier of five years before a sale is anticipated or shortly before its gross assets reach $50 million might be the most tax-efficient approach.[876]

Whether or not one likes the above recommendations, consider asset protection with a business' net profits. An entity's creditors' claims take priority over distributions to owners. If an entity distributes to its owners any profits not needed to keep the entity fiscally responsible, generally those assets will not be subjected to the claims of the entity's future creditors. For tax purposes, investments are best kept outside the entity, particularly for a C or an S corporation,[877] but also, to a certain but more limited extent, for a partnership.[878] The owners might consider loaning the distributions back to the entity, becoming creditors, rather than owners, to that extent. The owners might also consider forming an LLC taxed as a partnership to hold any distributions that they

---

[874] See part II.G.4 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation.

[875] See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

[876] See part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation, especially part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold, especially part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? (particularly the text accompanying fns. 4374-4380).

[877] Any distributions of appreciated assets trigger corporate-level income tax, whether paid by the corporation (C corporation) or shareholders (S corporation). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders. Note also that S corporations that have accumulated earnings and profits from prior periods as an S corporation might want to avoid investments that generate tax-free income; see part II.P.3.c.iv Problem When S corporation with Earnings & Profits Invests in Municipal Bonds.

[878] See part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them). Such distributions have more potential to trigger tax than do distributions of other assets, but tax can be avoided with careful planning.

neither loan to the company nor keep for personal purposes, viewing the LLC as a source for funding future capital projects or exit strategies or perhaps for providing or securing a line of credit for the business;[879] however, S corporations might want to avoid any formal requirement in their governing documents that distributions be made to such an LLC.[880]

II.E.4. Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure

In part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, we learned that:

- To the extent that a C corporation reinvests profits, it is more tax-efficient from the perspective of annual income from operations.

- To the extent that it distributes profits, it is not more tax-efficient.

Given that pass-through entities tend to have superior exit strategies,[881] the portion of the business that distributes profits should be in a pass-through entity.

Consider forming a limited partnership owned by a C corporation and a pass-through entity, with ownership based on the desired long-term goal for distributions:\

- This might be worked in with the general ideas of parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart.

- If the entity is already a C corporation or an S corporation, see part II.E.7 Migrating into Partnership Structure.

The C corporation would annually receive any earnings that are to be reinvested, whereas the balance would be owned by limited partners receiving distributions. The C corporation would loan back to the partnership the earnings to be reinvested:

---

[879] If there is a risk that the corporation will have losses but the shareholders' basis will be insufficient to deduct those losses, then the LLC should loan the funds to its members who should then lend them to the corporation. See part II.G.3.c.i Basis Limitations for S corporation Owners Beyond Just Stock Basis. Presumably, if the loan from the LLC to the corporation is already in place, the LLC could simply distribute the loan to its members. See fn. 1023.

[880] A partnership is not an eligible shareholder of an S corporation; see part II.A.2.f Shareholders Eligible to Hold S corporation Stock. Therefore, one might consider avoiding any distribution arrangements that might make a partnership appear to be a shareholder. However, distribution arrangements that are not baked into the governing documents do not count for determining whether a second class of stock exists (see part II.A.2.i.iii Disproportionate Distributions, and within that see fn. 231 for what constitutes governing documents and the effect, if any, given to certain arrangements), so presumably they would not count as creating a shareholder relationship. Although I have not seen anything directly on point, presumably an S corporation can contribute to a partnership in exchange for a partnership interest and then distribute that partnership interest to its shareholders; the parties would have substantial authority for not applying undesirable valuation discounts to that distribution – see part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders for general rules, fn. 4231 for authority for no valuation discounts, and part II.Q.7.h.iii.(b) Nondeductible Loss to Corporation When It Distributes Property to Shareholders for why valuation discounts are undesirable.

[881] See part II.E.2.a Transferring the Business.

- The corporation's interest income would be taxed at a federal rate of 21%, whereas the interest would be deducted at the higher individual rate, causing a taxpayer-favorable tax arbitrage. However, the Code § 199A deduction of up to 20% of qualified business income[882] may reduce this benefit, and the interest might not be fully deductible.[883]

- If the interest income becomes too significant, consider whether the personal holding company tax[884] or accumulated earnings tax[885] may be triggered. If these possible taxes eventually become a factor, consider part II.E.2.c Converting a C Corporation to an S corporation.

Before doing any of this, consider that investing in a partnership might make a C corporation ineligible for part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation. However, as described in part II.Q.7.k, not all businesses are eligible for the exclusion, and the exclusion applies only to stock originally issued to the owner (or to the person who gifted or bequeathed the stock to the current owner).

An S corporation with separate business lines could also reorganize into an S corporation parent with various subsidiaries, some of which might be disregarded entity LLCs and others of which might be C corporations that reinvest their profits and may qualify for part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation. See part II.E.2.b Converting from S corporation to C Corporation.

II.E.5. Recommended Long-Term Structure for Pass-Throughs – Description and Reasons

II.E.5.a. Strategic Income Tax Benefits of Recommended Structure

To maximize basis step-up of assets used in a business[886] and promote tax-efficient exit strategies,[887] the main entity should be a partnership. A partnership often is a better exit vehicle than a C corporation, notwithstanding part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock

[882] See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.
[883] See part II.G.19.a Limitations on Deducting Business Interest Expense.
[884] See part II.A.1.e Personal Holding Company Tax. I am not too concerned about this tax, because the corporation's distributive share of the partnership's gross income – not net income – would be compared against the interest income. In part II.A.1.e, see fn 67.
[885] See part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax,
[886] See parts II.H.2 Basis Step-Up Issues, II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S corporation, and II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S corporations.
[887] See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis, for how to save capital gain tax on the seller-financed sale of an interest in a business. Also compare part II.Q.7.f Corporate Division into More Than One Corporation (including the cumbersome requirements of Code § 355 mentioned in parts II.Q.7.f.ii Code § 355 Requirements and II.Q.7.f.iii Active Business Requirement for Code § 355), with part II.Q.8 Exiting From or Dividing a Partnership (partnership divisions are generally tax-free, subject to certain rules about shifting unrealized gain in property whose value had been used to determine partnership percentage interests). Also, corporate redemptions might be recharacterized as distributions (see part II.Q.7.a.iii Redemption Taxed Either as Sale of Stock or Distribution; Which Is Better When) and lose installment sale treatment, whereas partnership redemptions are nontaxable until basis is fully recovered (see part II.Q.7.b.ii Redemptions or Distributions Involving S corporations Compared with Partnerships).

in a C Corporation;[888] if the exclusion of gain on sale of a C corporation is particularly compelling, consider instead starting as an LLC taxable as a partnership then later converting to a corporation.[889] However, corporate structure has some advantages:

- The partnership audit rules are becoming onerous and may artificially increase tax.[890] Even though S corporations generally are pass-throughs, Congress has not targeted them, and the IRS needs to consider the burdens of making adjustments at both the entity and shareholder level.[891]

- If the owners find a corporate buyer and can, on a tax-free basis, merge the business into the buyer and receive the buyer's stock, and they don't mind having low basis publicly-traded stock, then note that a tax-free merger or similar reorganization under Code § 368 is available only to corporations. Forming a corporation immediately before the sale might not work;[892] I am unsure whether checking-the-box to elect corporate treatment helps any.

- If the owners would like for a qualified retirement plan to own the business, then an S corporation owned by an ESOP would be the ideal structure;[893] on the other hand, an entity can start in the structure set forth below and then easily assign the interests in the operating LLCs to the S corporation general partner, in what generally would be a tax-free transaction.[894]

Also, incentive pay and deferred compensation can be more difficult in a corporate setting than in a partnership setting.[895]

Furthermore, a partnership often is a better vehicle for deducting start-up losses.[896]

II.E.5.b. Self-Employment Tax and State Income Tax Implications of Recommended Structure

To avoid self-employment tax, the entity should be a limited partnership, since an interest as a limited partner is not subject to self-employment (SE) tax.[897] However, in Tennessee, if one

---

888 See parts II.Q.1.a.ii.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill and II.Q.1.a.ii.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill (California).
889 See part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? (especially the text accompanying fns. 4374-4380).
890 See part II.G.18.c Audits of Partnership Returns.
891 See part II.G.18.b Audits of S corporation Returns.
892 See part and II.P.3.d Conversions from Partnerships and Sole Proprietorships to C Corporations or S corporations, especially fn. 2913.
893 See part II.G.20 Employee Stock Ownership Plans (ESOPs, which also explains that a partnership interest does not qualify as employer stock.
894 See parts II.M.2.c Contribution of Partnership Interest to Corporation and II.P.3.d Conversions from Partnerships and Sole Proprietorships to C Corporations or S corporations.
895 See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.
896 See part II.G.3 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner.
897 See part II.L.4 Self-Employment Tax Exclusion for Limited Partner.

already has earnings that exceed the FICA/SE taxable wage base,[898] SE tax is actually good, because one is paying 2.9% or 3.8% SE tax, not worrying about the 3.8% net investment income tax,[899] and avoids paying the "Hall tax," a 6.5% excise tax on a limited liability entity's income;[900] using an LLC subject to SE tax allows one to avoid the Hall tax by paying possibly unreasonably high compensation,[901] and such compensation strategies tend to prevent an S or a C corporation form accumulating the war chest it needs for a rainy day or to buy out an owner who retires or becomes uninsurable. One should involve a local tax expert regarding any state or local taxes on pass-through entities in the states in which the entity does business.[902]

II.E.5.c. Operating the Recommended Structure

II.E.5.c.i. General Considerations

This paradigm might not work well if owner compensation is needed to get the full Code § 199A deduction. See part II.E.5.c.ii Code § 199A Deduction under Recommended Structure. This concern applies only if the ultimate taxpayer computing the deduction has taxable income in excess of certain thresholds. See part II.E.1.c.vi Wage Limitation If Taxable Income Is Above Certain Thresholds.

To protect any real estate from business losses, maximize protection from creditors, and facilitate future restructuring of the business:

- Operations should be conducted in one or more LLCs, wholly owned by the limited partnership.

- Real estate should be held in one or more LLCs, wholly owned by the limited partnership. However, it would also be fine for the real estate to be held in a separate LLC outside of the limited partnership structure,[903] if the owner materially participates in the business.[904] Note

---

[898] See parts II.L.2.a.i General Rules for Income Subject to Self-Employment Tax and II.Q.1.d.iii Timeline for FICA and Income Taxation of Deferred Compensation, especially fn. 3536, the latter for rates.

[899] SE income is not subject to the net investment income tax. See fn. 1874.

[900] Tenn. Code § 67-4-2007 imposes a 6.5% excise tax on all persons, other than not-for-profit entities, doing business in Tennessee. "'Person' or 'taxpayer' means every corporation, subchapter S corporation, limited liability company, professional limited liability company, registered limited liability partnership, professional registered limited liability partnership, limited partnership, cooperative, joint-stock association, business trust, regulated investment company, REIT, state-chartered or national bank, or state-chartered or federally chartered savings and loan association," Tenn. Code § 67-4-2004(38). Just to drive home the point for LLCs, Tenn. Code § 67-4-2105 expressly includes "any limited liability company regardless of how it is treated for federal income tax purposes." The tax does not apply to self-employment income. Tenn. Code § 67-4-2006(4)(B).

[901] See fn. 28 for federal unreasonable compensation cases.

[902] See part II.G.2 State Taxation.

[903] The 2012 proposed regulations on the 3.8% tax on net investment income called into question the treatment of real estate rented to one's business. However, under the final regulations, any rental income considered nonpassive income under the self-charged rental rules would not be subject to the 3.8% tax. However, self-rental might not fully work, in that ownership of the real estate and the operating business might change over time. See parts II.I.8.c Application of 3.8% Tax to Rental Income. These issues can be addressed through special allocations and preferred returns inside the partnership structure.

[904] The self-charged rental rules require that the landlord materially participate in the tenant's business (which the landlord must also own at least in part). See part II.I.8.c Application of 3.8% Tax to Rental Income and II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity. If a business owner wants to

that keeping the real estate inside the master LP umbrella would take the place of or facilitate grouping under the passive loss rules,[905] which might be more important in the case of a real estate professional, because grouping does not help with the real estate professional test under part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity, although those rules do provide a separate aggregation election.[906]

- The real estate LLC(s) should lease the property to the operating LLC(s) for fair rental, which will be ignored for tax purposes but should allow the LLCs' respective assets to be segregated for purposes of protection from creditors.

The individuals involved in the business would own:

- An S corporation[907] that is a 1% general partnership, and

- In the aggregate, the remaining 99% interest as limited partners.

To respect the S corporation's role as a general partner and to prevent the 3.8% tax from applying to their distributive shares of the S corporation's 1% interest as a general partner, the individuals would be employees of the S corporation and receive reasonable compensation for the services they perform. The employment arrangement also keeps the individual owners from tainting their limited partnership interests. The individuals' participation would be attributed to both the corporation (if applicable) and themselves.[908]

On a daily basis, the operation is simple:

- The S corporation, as general partner of the limited partnership, controls each LLC subsidiary, because the limited partnership is the LLC's sole member.

- In this capacity, the S corporation appoints its owners as the LLC's managers (and can give them more traditional titles, such as president, chief financial officer, etc.) who sign documents on behalf of the LLC showing their capacity as the LLC's managers or other officers.

- Each LLC subsidiary pays the S corporation a management fee to the S corporation to pay for the cost of the services provided by the owners and any other employees leased to the

---

rely on the more-than-100-hour significant participation rules rather than the material participation rules (which generally require more than 500 hours of work), then the business owner will not be able to rely on the self-rental exception and needs to keep the real estate inside the limited partnership umbrella so that the rent is disregarded for income tax purposes.

[905] See part II.K.1.b.ii Grouping Activities – General Rules, particularly fn. 2543.

[906] See fns. 2600-2601.

[907] The entity being an LLC taxed as an S corporation would facilitate material participation of any trust that is or might eventually become an owner of the general partner. See part II.K.2.b Participation by an Estate or Nongrantor Trust. (Material participation is important to avoid the 3.8% tax on net investment income that might otherwise apply. See part II.I.8 Application of 3.8% Tax to Business Income.) If one is concerned that an LLC taxed as an S corporation might be subjected to self-employment tax because of some regulations that appear to be obsolete (see part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election), using a statutory close corporation might be a safer approach. See text accompanying fn. 2720 within part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.

[908] See part II.K.1.c Limited Partnership with Corporate General Partner, particularly fn. 2578.

LLC. To protect each LLC's separateness from the other LLCs (if the partnership has more than one LLC subsidiary), it would be best for each LLC to have its own employees and not simply use the S corporation as a central payroll master; however, this might not be practical, depending on how the business is run. An entity that is disregarded for income tax purposes is also disregarded for self-employment tax purposes, notwithstanding that it is treated as a separate entity for payroll tax purposes.[909] ***Caution***: See part II.E.5.c.ii Code § 199A Deduction under Recommended Structure.

- Only the S corporation and limited partnership file federal income tax returns. No matter how many LLC subsidiaries the partnership owns, the partnership files one federal income return to report all of their activity. (These materials do not attempt to cover state income or other tax issues in any systematic way that would help with state issues here.)

The tiered structure comes into play more when quarterly distributions are made to pay taxes or otherwise provide investment return to the owners. The LLCs would distribute part or all of their profits to the limited partnership, which then makes appropriate distributions to the limited partners and the S corporation general partner.

II.E.5.c.ii. Code § 199A Deduction under Recommended Structure

The S corporation general partner ("GP") of the limited partnership ("LP") receives a K-1 with QBI, wages, and UBIA. However, because the GP is a separate RPE from the LP, any activity on the K-1 the GP receives is siloed from the GP's own activities.[910] In other words, K-1 income is QBI of the RPE that issues the K-1, not QBI of a business carried on by the K-1 recipient.

Thus, the GP needs to conduct its own trade or business for any wages it pays to count as being related to QBI.[911] Guaranteed payments for services are not QBI.[912]

When the GP receives a management fee and pays compensation to those working for the LP, those wages can be attributed back to the LP, but only if the W 2 wages were paid to the LP's common law employees or officers of the individual or RPE for employment by the LP – in other words, the GP leased the employees to the LP.[913] Thus, compensation for services rendered by the limited partners themselves would not qualify, because they cannot be common law employees of the LP.

II.E.5.d. Net Investment Income Tax and Passive Loss Rules Under Recommended Structure

If any individual participates no more than 500 hours per year, that person might be subjected to the 3.8% tax more readily as a limited partner than as the owner of an S corporation, because limited partners have fewer ways to satisfy the material participation test than do other owners of pass-through entities.[914] On the other hand, if one is concerned only about avoiding the 3.8% tax

---

[909] See part II.B Limited Liability Company (LLC), fns. 300-301.
[910] See Prop. Reg. § 1.199A-6(b), reproduced shortly before fn 646 in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.
[911] See Prop. Reg. § 1.199A-2(b)(1), reproduced in part II.E.1.c.vi.(a) W-2 Wages under Code § 199A.
[912] Prop. Reg. § 1.199A-3(b)(2)(ii)(I), (J), reproduced in part II.E.1.c.ii.(c) Items Excluded from Treatment as Qualified Business Income Under Code § 199A.
[913] See Prop. Reg. § 1.199A-2(b)(2)(ii), reproduced in part II.E.1.c.vi.(a) W-2 Wages under Code § 199A.
[914] See part II.K.1.a.ii Material Participation.

on net investment income and not about disallowing passive losses or credits,[915] then a limited partner who works for more than 100 hours generally would avoid the 3.8% tax.[916]

II.E.5.e. Estate Planning Aspects of Recommended Structure

II.E.5.e.i. Family Conflicts

When some family members are in the business and others outside the business, conflicts can develop. The insiders want to reinvest earnings to grow the business and would like compensation commensurate with the value they view they bring to the business, including incentive equity compensation. The outsiders want to distribute earnings for their own use and believe that they should share in the business' growth because that is part of the ownership legacy their parents left to them.

The first generation might want to put a long-term lease on real estate used in the business and bequeath the real estate to the outsiders. That allows the outsiders to have significant cash flow locked in for a while and allows more (or all) of the business to be bequeathed to the insiders.

The cleanest break would be for any LLCs holding real estate to be distributed from the limited partnership and then bequeathed. Generally, such a distribution would not generate any income tax.[917] To maximize income tax planning opportunities, all of the real estate LLCs might stay under one partnership umbrella.[918]

If insiders are pitted against insiders, generally a partnership structure is easier to divide than a corporate structure.[919]

II.E.5.e.ii. Estate Tax Deferral Using Recommended Structure

If long-term estate tax deferral is required,[920] deferring estate on a partnership interest involves more uncertainty than deferring estate on stock.[921]

II.E.5.e.iii. Grantor Trust Planning

When a business is sold, clients may wish to turn off grantor trust status[922] so that the income tax burden does not deplete their assets more than they are comfortable with.

For a grantor trust owning an S corporation, generally grantor trust status should be turned off before January 1 of the year of the sale if the grantor wishes to avoid all tax on the gain on sale. This concern is diminished or may not even exist for a partnership. See part III.B.2.j.i Changing Grantor Trust Status, especially the text accompanying fns. 5772-5774.

---

[915] See part II.K.1.h.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.
[916] For more details, see part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[917] See part II.Q.8 Exiting From or Dividing a Partnership.
[918] See part II.Q.8.a Partnership as a Master Entity.
[919] See parts II.Q.7 Exiting from or Dividing a Corporation (especially part II.Q.7.f Corporate Division into More Than One Corporation) and II.Q.8 Exiting From or Dividing a Partnership.
[920] See part III.B.5.d.ii Code § 6166 Deferral.
[921] See part III.B.5.d.ii.(b) Tiered Structures.
[922] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

II.E.5.f. Recommended Structure with C Corporation

Because 2017 tax reform caused C corporation annual income taxation to be quite attractive, one might the S corporation shown in the structure to instead be a C corporation, and give the corporation more than 1%.

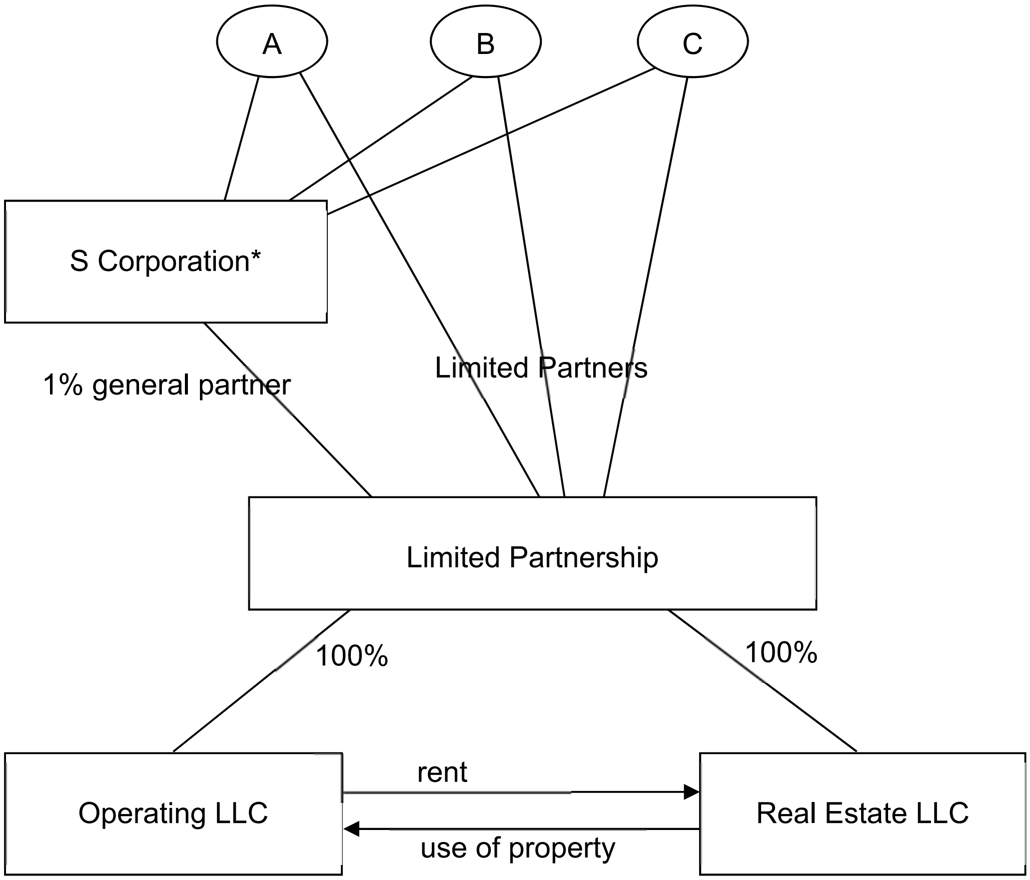
See part II.E.4 Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure.

II.E.5.g. Other Aspects of Recommended Structure

Parts II.E.7 Migrating into Partnership Structure discusses moving to the recommended structure. Consider not only it but also part II.E.9 Real Estate Drop Down into Preferred Limited Partnership for real estate, long-lived tangible personal property, or intangible assets. The latter might generate royalty income subject to the 3.8% tax on net investment income, but in the recommended structure royalties would be disregarded the same way rent would be.

If the client would prefer not to have an S corporation general partner, see part II.E.8 Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary. Note, however, that a corporation transitioning into that structure (instead of retaining a preferred partnership interest) would pay tax; see parts II.P.3.b From Corporations to Partnerships and Sole Proprietorships and II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially parts II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property and II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

II.E.6. Recommended Partnership Structure – Flowchart



* See part II.E.5.f. Recommended Structure with C Corporation.

If no real estate is ever held and the client balks at creating what the client perceives as too many entities, this structure could simply be a limited partnership without the LLCs. However, it would be much easier to start the operating business in its own LLC and later simply add other LLCs than it would be for the limited partnership to later transfer all of its business operations into a new LLC when real estate or a separate location or line of business is acquired.

II.E.7. Migrating into Partnership Structure

II.E.7.a. Overview of How to Migrate into Desired Structure

Moving an existing LLC, that is taxed as a partnership or as a disregarded entity, into this structure is relatively straightforward. The member or members form an S corporation. The S corporation contributes to a new limited partnership cash equal to 1/99 of the appraised value of the LLC's business, in exchange for a 1% interest as a general partner. The member or members contribute their interests in the LLC to the partnership in exchange.

Forming the S corporation and the limited partnership are not taxable events,[923] so long as the liabilities are not shifted (or reallocated) too much from the members of the LLC to the corporate general partner.[924] Any gain inherent in the contributed assets will be taxed to the original owners when those assets are sold.[925] The work-in-process, appreciated inventory, and accounts receivable would tend to be the assets to watch, and accounts receivable would not be a concern if the LLC's income was reported using the accrual method. Given that the S corporation would probably have been formed with a modest cash contribution and therefore would have not contributed such assets, the only gain likely to receive a special allocation would be those inherent in the LLC. Thus, the 99% owners would be allocated 100% of the gain on such assets. Presumably they would own the same proportion of the S corporation as they did of the LLC, so presumably they have the same economic interest in the partnership's income as they did before, and this allocation of income is of no practical consequence, although this special allocation of income would need separate accounting on the partnership's annual return. This could be avoided by the members forming a limited partnership as general and limited partners[926] and then contributing their interests as general partners to the S corporation. If reallocation of liability becomes an issue, the original members can guarantee the debts to get the debts allocated to them.

These two transactions are illustrated in part II.E.7.b Flowcharts: Migrating LLC into Preferred Structure, including parts II.E.7.b.i Using Cash Contribution to Fund New S corporation and II.E.7.b.ii Using LLC to Fund New S corporation.

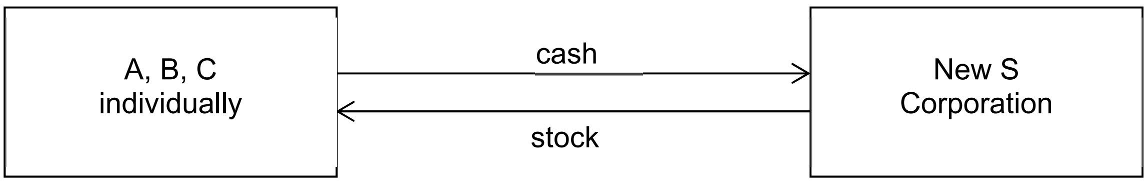
This migration would be much more involved if the business is operated inside a corporation. Converting a corporation into a partnership would trigger gain.[927] Instead, generally the corporation would move its assets into an LLC and then contribute that LLC to the limited partnership.[928] The corporate partner would receive a preferred return on this invested capital (for which it receives a capital account)[929] and a 1% interest in the residual profits as a general partner, and the individuals would receive 99% of the residual profits as limited partners.[930] The considerations about debt reallocation described above would also apply. In some cases a C corporation might retain certain assets, collect them in due course, and then make an

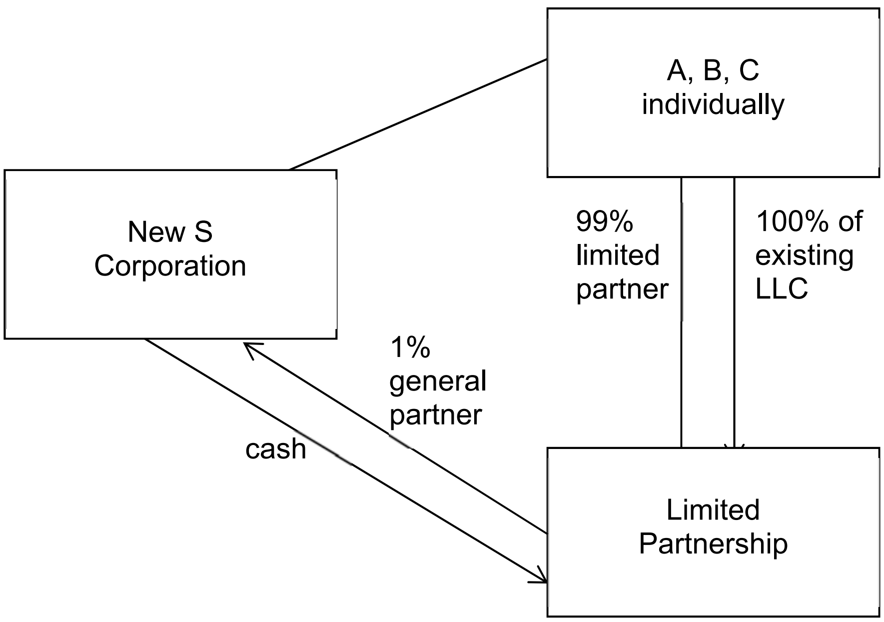
[923] See part II.M.1. Taxation on Formation of Entity: Comparison between Partnership and Corporation.
[924] If formed as described above, the concern would be that the reallocation of liabilities from a partner would be a deemed cash distribution that would generate gain if and to the extent that it exceeds the basis of that partner's partnership interest; see part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions. If formed as described below, where the partners contribute to the S corporation their interests as general partner, then, in addition to the issue described above, a shareholder would have gain to the extent that the debt the corporation assumed exceeds the basis of the partnership interest the shareholder contributes to the corporation; see part II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities.
[925] See part II.P.1.a.i Allocations of Income in Partnerships.
[926] See part II.C.5 Converting from One Entity Taxed as a Partnership to Another.
[927] See part II.P.3.b From Corporations to Partnerships and Sole Proprietorships.
[928] The corporation would do this either gradually or in one fell swoop, as described in part II.E.7.c.i Corporation Forms New LLC, including parts II.E.7.c.i.(a) Direct Formation of LLC and II.E.7.c.i.(b) Use F Reorganization to Form LLC.
[929] The exchange for a capital account (not intended to be redeemed in any manner in the first several years) and preferred payments (made from operating cash flow) can easily be done in a nontaxable manner that prevents the disguised sale rules from applying. See part II.M.3 Buying into or Forming a Partnership, particularly part II.M.3.e Exception: Disguised Sale. If any owners are members of the same family or if any owner might split up his ownership in the corporate general partner from his interest as a limited partner when making transfers to family members, see parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.
[930] As illustrated in part II.E.7.c.ii Moving New LLC into Preferred Structure.

S election. For more information on this conversion, see part II.Q.7.h.viii Value Freeze as Conservative Alternative.

II.E.7.b. Flowcharts: Migrating LLC into Preferred Structure

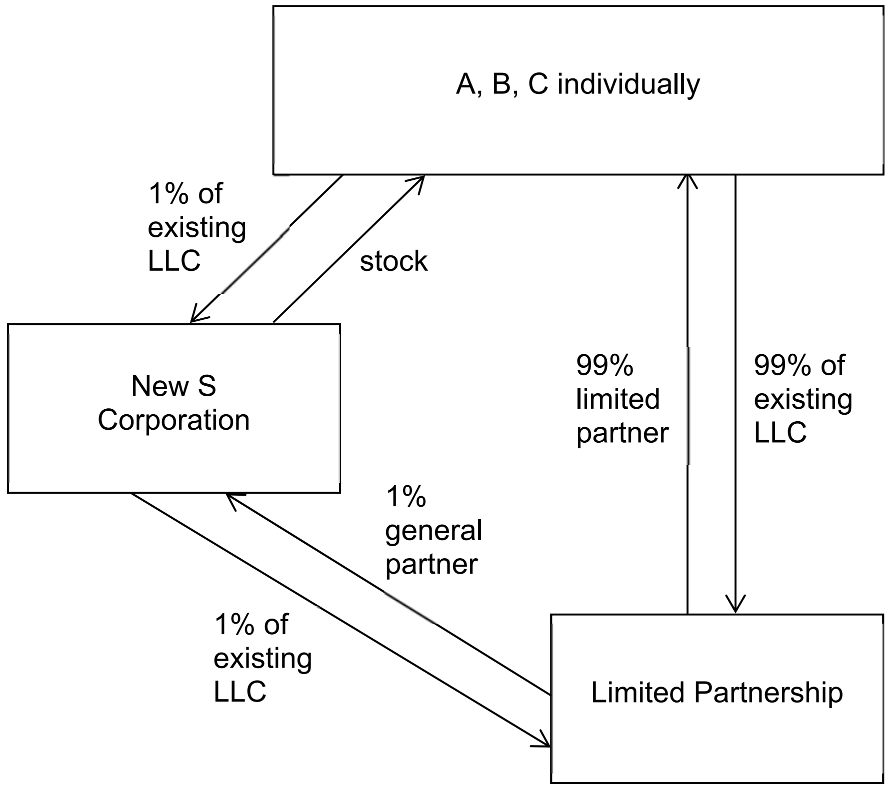
II.E.7.b.i. Using Cash Contribution to Fund New S corporation





6833577

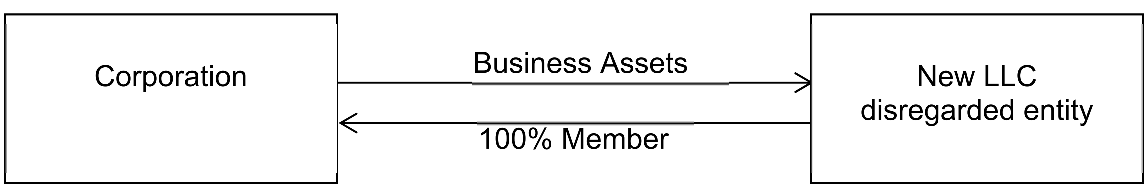
II.E.7.b.ii. Using LLC to Fund New S corporation



II.E.7.c. Flowcharts: Migrating Existing Corporation into Preferred Structure

II.E.7.c.i. Corporation Forms New LLC

II.E.7.c.i.(a). Direct Formation of LLC



<u>Advantages</u>

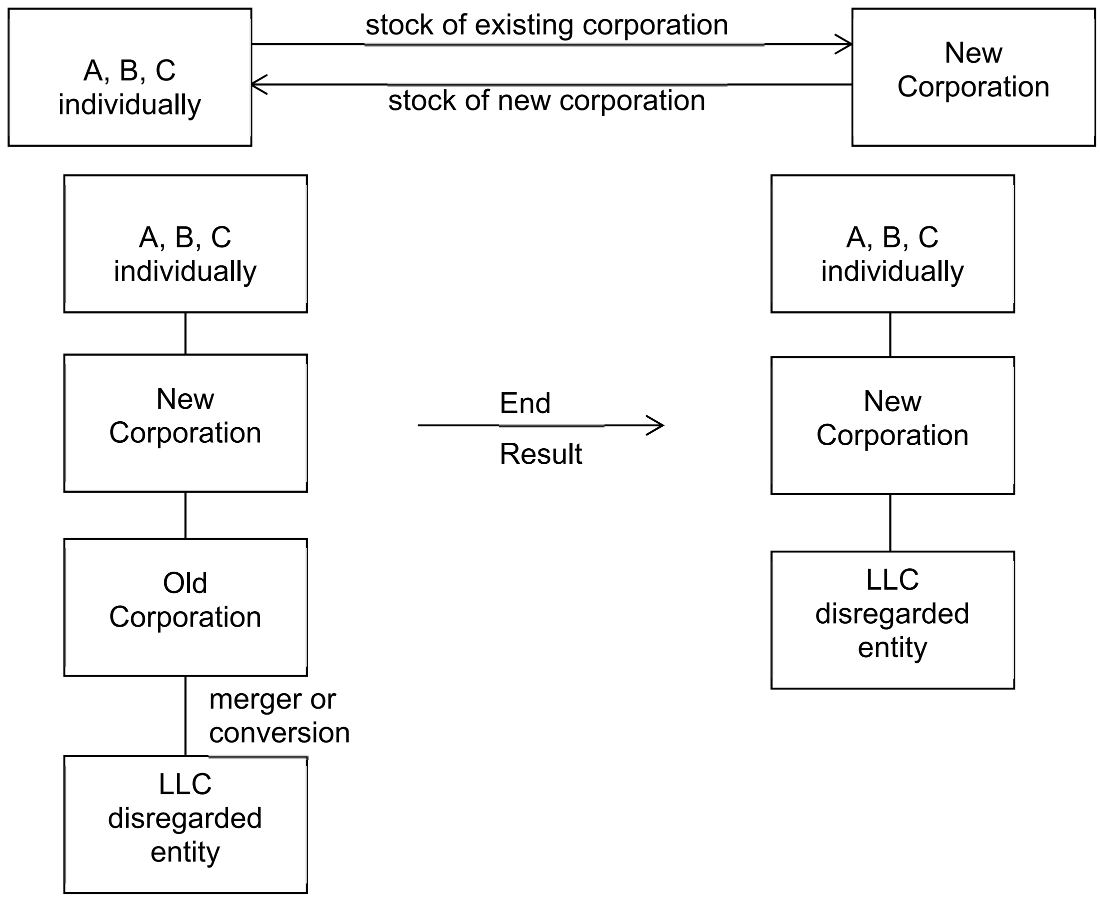
- Corporation can keep nonbusiness assets
- Corporation can keep business assets that would generate complications if transferred to the limited partnership structure and then had income recognition event
- New LLC can stay as a disregarded entity for a while as transition to new structure and get everyone used to working in LLC structure

<u>Disadvantages</u>

- Piecemeal transfer of assets

- Some assets not readily transferable

II.E.7.c.i.(b). Use F Reorganization to Form LLC



Advantage

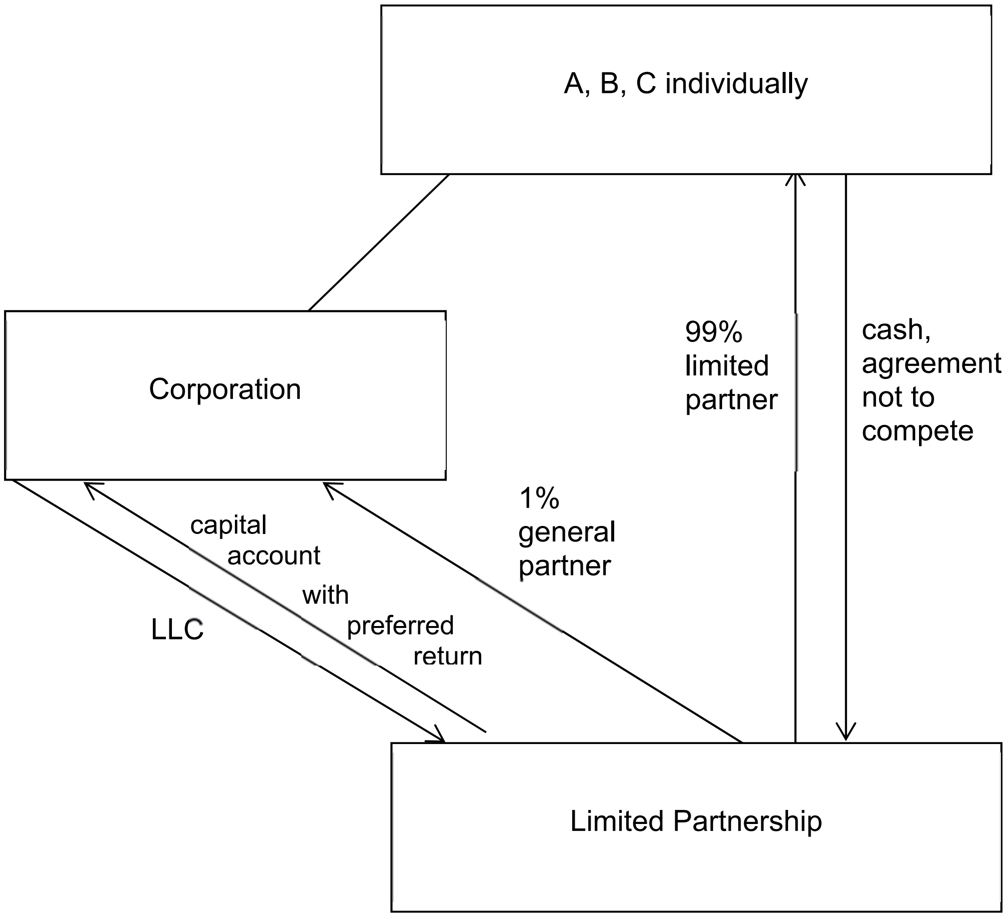
- Moves all assets in one fell swoop

Disadvantages

- No selectivity of retained assets
- Contribution of stock of old corporation to new corporation and merger or conversion of old corporation into new corporation need to be done at the same time
- If S corporation involved, new corporation does new S election and old corporation does qualified subchapter S subsidiary election.

See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. For an S corporation, see also part II.A.2.g Qualified Subchapter S Subsidiary (QSub), especially fn. 181.

II.E.7.c.ii. Moving New LLC into Preferred Structure



II.E.7.c.iii. Migrating Gradually Over Time

A company might have its employees and intellectual property locked down so tightly that the migrations described in the preceding provisions of this part II.E.7 Migrating into Partnership Structure result in a large value and large preferred return that might be so large that they cause very significant estate tax issues that seem impossible to overcome. Consider:

- A corporation that needs to migrate to these structures to obtain income tax efficiencies.
- Any type of company that is subject to estate tax and difficult to move into a structure outside the estate tax system. For example, it might have too low a cash flow to make a GRAT or a sale to an irrevocable grantor trust be efficient.

In those cases, consider that, in today's economy and global environment, businesses need to reinvent themselves – sometime gradually, sometimes quickly – to keep up with or try to out-perform their competitors.

The company might reinvent itself over time through a sister company that is held in the business structure recommended in this part II.E Recommended Structure for Entities. For example, the senior generation makes gifts or loans to new trusts that establish this structure. The new trusts own the S corporation and limited partnership (or LLC, in the case of a state such as Tennessee).

For examples of new activities, see part III.B.1.a Business Opportunities.

Certain IRS responses to such movement and generally successful taxpayer responses are described in parts III.B.1.a.v Sending Business and III.B.1.a.vi Asset Transfers to Children or Their Businesses.

If the business being transitioned is a corporation, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

II.E.8. Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary

II.E.8.a. Description of Structure; Nontax Issues

The structure would be one of the following:

- Limited Liability Limited Partnership (LLLP). An LLLP is a limited partnership (LP) (a partnership consisting of one or more general partners (GPs) and one or more limited partners) that registers for limited liability protection for its GPs.

- LP with LLC Subsidiary. The LP parents functions as a holding company and does business through one or more LLC subsidiaries, the latter which are disregarded entities for most tax purposes.[931]

See parts II.C.11 Limited Partnership and II.C.12 Limited Liability Partnership Registration for General Partners in General or Limited Partnerships, the latter covering LLLPs as variations of LPs.

If one were to choose between the two structure, I would tend to favor the LP with LLC Subsidiary structure, because it facilitates opening separate branches or lines of businesses as separate LLCs without the initial business being comingled with the ownership of these new branches or lines of business. I also tend to favor it in Missouri, because in Missouri the lapse of an LLLP's registration cannot be cured, leaving the GPs exposed, whereas a Missouri LLC does not require annual registration and cannot have any lapse in liability protection. A disadvantage of the LP with LLC Subsidiary structure is that two registrations might be required in each state in which the company does business, contrasted with one registration per state for a LLLP. However, the latter might not be a disadvantage relative to the LP with LLC Subsidiary structure when separate branches or lines of businesses operate as separate LLCs.

The LP with LLC Subsidiary structure also permits the general partner's name to be kept confidential in most business dealings if the general partner is not active in the business, in that each LLC can be run by a manager who is not an owner.

[931] See part II.B Limited Liability Company (LLC).

II.E.8.b. Tax Issues

Let's discuss FICA/ self-employment (SE) tax issues and passive loss issues.

According to the legislative history of the SE tax, a person who is not only a GP but also a limited partner is subjected to SE tax only with respect to the GP interest.[932] However, this is based on legislative history, and I am unaware of any cases or rulings applying this principle. Any compensation paid to a partner for services is subject to SE tax to the extent that the services are rendered in carrying out a trade or business,[933] whether or not the partner is a GP.[934] Presumably the IRS would seek to reclassify distributions to a limited partner as compensation for services rendered, in a manner similar to what it does in the S corporation arena.[935]

Although originally a limited partner lost liability protection by participating in the partnership's activities, that has not been the case for quite some time.[936] In the passive loss area, being a general partner has a different effect – it converts an interest as a limited partner into an interest as a general partner when determining material participation.[937]

---

[932] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner, especially fn. 2844 and accompanying text.

[933] See part II.L.3 Self-Employment Tax: General Partner or Sole Proprietor, especially the text accompanying fns. 2837-2839.

[934] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner, especially fn. 2840 and accompanying text.

[935] See part II.L.1 FICA: Corporation, especially fn. 2770, and part II.L.5.a S corporation Blocker Generally, especially fn. 2879.

[936] A prior version of Willis & Postlewaite, *Partnership Taxation*, ¶2.02. Requirements of Section 704(e), stated:

> As originally written, the Uniform Limited Partnership Act provided that "[a] limited partner shall not become liable as a general partner unless…he takes part in the control of the business." ULPA, § 7 (1916). The versions of the Revised Uniform Limited Partnership Act approved in 1976 and 1985 relaxed the control requirement by providing a safe harbor in the form of a lengthy list of activities deemed not to constitute participation in the control of the partnership and a limitation on a limited partner's liability for participation in activities not within the safe harbor to only those persons who transacted business with the limited partnership "reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." RULPA, § 303 (1985). Section 303 of the Uniform Limited Partnership Act approved in 2001 has eliminated the control requirement and provides that:
>
> > A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.
>
> RULPA, § 303 (2001). According to the commentary accompanying the act, this provision is intended to provide "a full, status-based liability shield for each limited partner" even when the limited partner participates in the management and control of the limited partnership. The purpose is to bring limited partners into parity with the members of a limited liability company, partners in a limited liability partnership, and corporate shareholders. It is unclear how this change in state partnership law might affect the application of federal tax law in the context of family partnerships. Nevertheless, if the limited partners are to have no role in the management of the partnership, the partnership agreement should expressly provide that the limited partners have no management power.

[937] See part II.K.1.a.ii Material Participation, especially fn. 2476.

The idea that an interest as a limited partner has passive loss characteristics that differ from its SE tax characteristics might cause confusion in reporting and auditing. A Tax Court case includes language about the self-employment exclusion as applied to active limited partners that concerns a tax expert I highly respect,[938] and I would rather not tempt fate. Thus, I would generally prefer to place a client in the recommended structure with an S corporation general partner described in part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and illustrated in part II.E.6 Recommended Partnership Structure – Flowchart. However, if the client resists that structure, the LLLP Alone and LP with LLC Subsidiary structures are alternatives to consider, after warning the client appropriately.

Also, if the business engages in domestic manufacturing, note that wages paid by a corporation would provide a small tax benefit relative to compensation paid to a partner.[939]

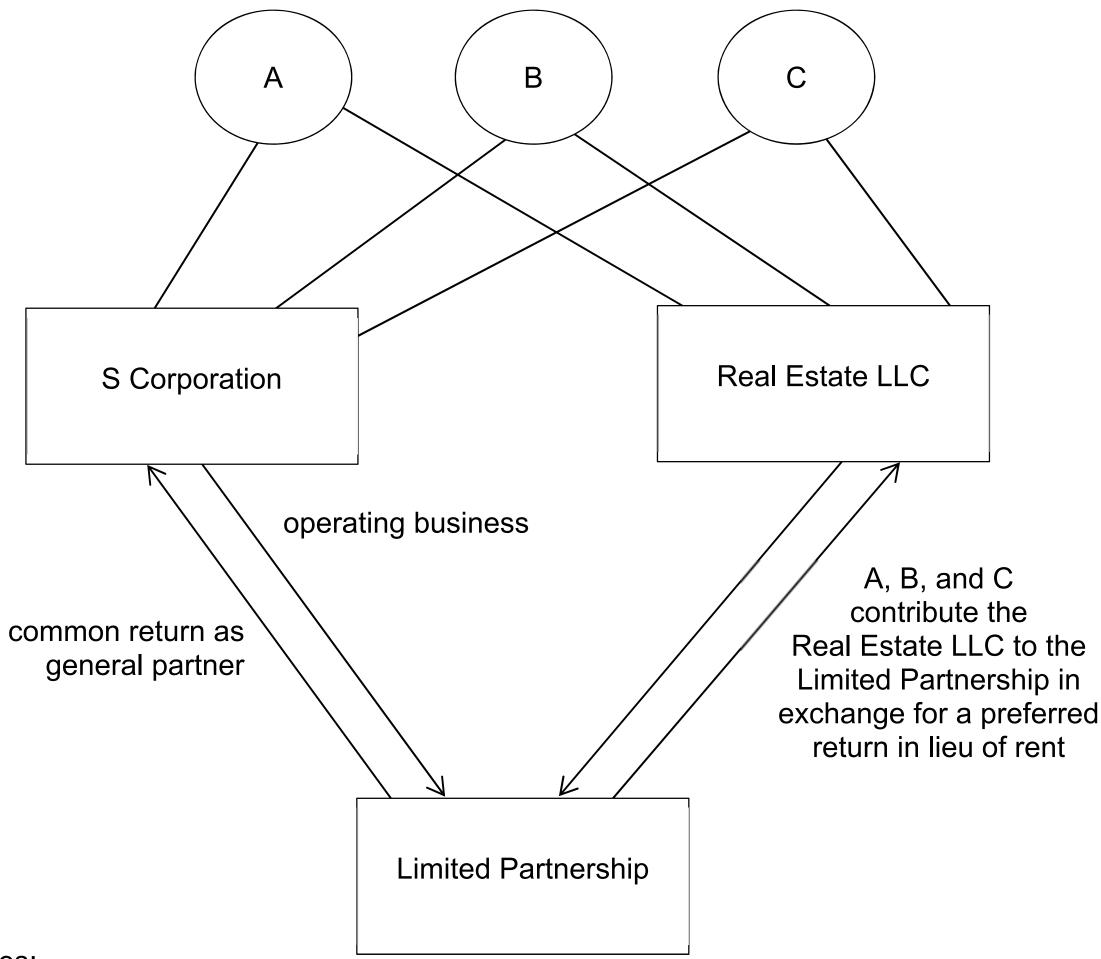
II.E.8.c. Migrating to LP with LLC Subsidiary Structure

Migrating from an LLC to an LP with LLC Subsidiary structure is much easier than migrating to my preferred recommended structure.[940]

The members of the LLC simply form the LP and then contribute their LLC interests to it. That transaction has no income tax consequences.[941] Both the LP and the LLC will continue to use LLC's tax ID – the LP because it has assumed the LLC's prior tax existence[942] and the LLC because it is a disregarded entity.[943] Presumably the LLC would need to obtain a new tax ID for payroll tax purposes, if it has its own payroll,[944] as well as for purposes of excise and certain other taxes.[945]

[938] See fn. 2873, found in part II.L.4 Self-Employment Tax Exclusion for Limited Partner.
[939] Note the W-2 limitation mentioned in part II.G.24 Code § 199 Deduction for Domestic Production Activities especially fn. 1592.
[940] For the latter, see part II.E.7.b Flowcharts: Migrating LLC into Preferred Structure.
[941] See part II.C.5 Converting from One Entity Taxed as a Partnership to Another.
[942] See part II.C.5 Converting from One Entity Taxed as a Partnership to Another, especially fn. 429.
[943] See part II.B Limited Liability Company (LLC), especially fn. 294.
[944] See part II.B Limited Liability Company (LLC), especially fn. 300.
[945] See part II.B Limited Liability Company (LLC), especially fn. 303-304.

II.E.9. Real Estate Drop Down into Preferred Limited Partnership



Notes:

- Assume A, B, and C are active in business (more than 500 hours) and receive reasonable compensation from the general partner for services rendered to the corporation, which is the general partner of the limited partnership.

- A, B, and C assign their interests in the LLC to the limited partnership, converting the LLC into a disregarded entity and making A, B, and C directly hold interests as a limited partner.

- Similarly, the S corporation might contribute its assets to a single member operating LLC that the limited partnership then owns, which would then rent the property from the Real Estate LLC. The rental payments would be disregarded for income tax purposes, and the properties would be separate for asset protection purposes.

- Even better would be for the S corporation also to hold a preferred interest preferred based on the value of its assets (and a small common interest) and for A, B and C to hold some or most of the common interests, maximizing the partnership component to obtain a basis step-up at death and minimize tax on a seller-financed sale of the business.

- This would not avoid self-employment tax on the limited partners if the long-ago proposed regulations defining limited partner for purposes of the self-employment tax were finalized.

For more details on this drop-down structure, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially part II.Q.7.h.viii Value Freeze as Conservative Alternative.

II.E.10. What if Self-Employment Tax Rules Change Unfavorably?

If self-employment tax would apply to the limited partners and the parties would prefer to have the operating business inside an S corporation structure, then the limited partnership dissolves.

The limited partners take all of the real estate LLC(s) and an appropriate portion of the operating LLC(s), with the S corporation taking its fair share of the operating LLC(s).[946]

Next, the limited partners contribute all of their interest in the operating LLC(s) to the S corporation.[947]

The final structure is the S corporation holding one or more LLCs that are disregarded for tax purposes and the individuals owning a real estate LLC taxed as a partnership. As a matter of state law, all of the transactions listed above are done by assigning LLC interests rather than more burdensome transfers of operating assets.

II.G.3.i. Business Deductions and Losses

II.G.3.i.i. Trade or Business; Limitations on Deductions Attributable to Activities Not Engaged in for Profit

This part II.G.3.i.i discusses what is a "trade or business" under Code § 162, expenses from which generally would be deductible.[1080] Then it discusses what are activities for the production of income under Code § 212, expenses from which generally would be deductible.[1081] Because both provisions require a profit motive, it then discusses what Code § 183 says about profit motive.[1082]

II.G.3.i.i.(a). "Trade or Business" Under Code § 162

Subject to the various limitations provided in the preceding parts of part II.G.3 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner and subject to other limitations on what can be deducted, Code § 162(a) allows a taxpayer to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," even if the business sustains a loss.[1083]

---

[946] If the business was started from scratch with only cash and labor, then generally this transaction will not be taxable. If a partner contributed any particular property within seven years of this dissolution, then it might be necessary for that partner to receive the LLC holding that property. For a general discussion of all of these ideas, see part II.Q.8 Exiting From or Dividing a Partnership.

[947] Code 351 precludes income taxation of this transaction.

[1080] See part II.G.3.i.i.(a) "Trade or Business" Under Code § 162.

[1081] See part II.G.3.i.i.(b) Requirements for Deduction Under Code § 212.

[1082] See part II.G.3.i.i.(c) Hobby Loss Benefits of Code § 183.

[1083] Reg. § 1.162-1(a) provides:

> Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162.... The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a

Higgins v. Commissioner, 312 U.S. 212 (1941), held:[1084]

> To determine whether the activities of a taxpayer are "carrying on a business" requires an examination of the facts in each case…. The petitioner merely kept records and collected interest and dividends from his securities, through managerial attention for his investments. No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board.

Commissioner v. Groetzinger, 408 U.S. 23 (1987), discussed various cases (footnotes in the quote below are mine):

> From these observations and decisions, we conclude (1) that, to be sure, the statutory words are broad and comprehensive (*Flint*);[1085] (2) that, however, expenses incident to caring for one's own investments, even though that endeavor is full-time, are not deductible as paid or incurred in carrying on a trade or business (*Higgins*; *City Bank*; *Pyne*);[1086] (3) that the opposite conclusion may follow for an active trader (*Snyder*)[1087]….

> business is deductible, even though such expenses exceed the gross income derived during the taxable year from such business.

[1084] *Higgins* dealt with the predecessor to Code § 162. Rev. Rul. 75-525 views the case as controlling in interpreting Code § 162. See fn. 2801 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax. *Commissioner v. Groetzinger*, 408 U.S. 23 (1987), commented on *Higgins* [footnote omitted]:

> The opinion, therefore,—although devoid of analysis and not setting forth what elements, if any, in addition to profit motive and regularity, were required to render an activity a trade or business—must stand for the propositions that full-time market activity in managing and preserving one's own estate is not embraced within the phrase "carrying on a business," and that salaries and other expenses incident to the operation are not deductible as having been paid or incurred in a trade or business.

After additional commentary on the case, *Groetzinger* continued:

> Less than three months later, the Court considered the issue of the deductibility, as business expenses, of estate and trust fees. In unanimous opinions issued the same day and written by Justice Black, the Court ruled that the efforts of an estate or trust in asset conservation and maintenance did not constitute a trade or business. *City Bank Farmers Trust Co. v. Helvering*, 313 U.S. 121 (1941); *United States v. Pyne*, 313 U.S. 127 (1941). The *Higgins* case was deemed to be relevant and controlling.

[1085] *Groetzinger* referred to *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911), about which *Groetzinger* commented:

> It said: " 'Business' is a very comprehensive term and embraces everything about which a person can be employed." 220 U.S., at 171. It embraced the *Bouvier Dictionary* definition: "That which occupies the time, attention and labor of men for the purpose of a livelihood or profit." *Ibid*. See also *Helvering v. Horst*, 311 U.S. 112, 1181 (1940). And Justice Frankfurter has observed that "we assume that Congress uses common words in their popular meaning, as used in the common speech of men." Frankfurter, Some Reflections on the Reading of Statutes, 47 Colum. L. Rev. 527, 536 (1947).

[1086] See fn. 1084 for the Court's discussion of these cases.

[1087] *Groetzinger* commented:

> *Snyder v. Commissioner*, 295 U.S. 134 (1935), had to do with margin trading and capital gains, and held, in that context, that an investor, seeking merely to increase his holdings, was not engaged in a trade or business. Justice Brandeis, in his opinion for the Court, noted that the Board of Tax Appeals theretofore had ruled that a taxpayer who devoted the major portion of his time to transactions on the stock exchange for the purpose of making a livelihood could treat losses

> One also must acknowledge that *Higgins*, with its stress on examining the facts in each case, affords no readily helpful standard, in the usual sense, with which to decide the present case and others similar to it. The Court's cases, thus, give us results, but little general guidance.

Pointing out that the cases provide little guidance, *Groetzinger* said they provided "some helpful indicators" and reasoned:

> If a taxpayer, as Groetzinger is stipulated to have done in 1978, devotes his full-time activity to gambling, and it is his intended livelihood source, it would seem that basic concepts of fairness (if there be much of that in the income tax law) demand that his activity be regarded as a trade or business just as any other readily accepted activity, such as being a retail store proprietor or, to come closer categorically, as being a casino operator or as being an active trader on the exchanges.
>
> It is argued, however, that a full-time gambler is not offering goods or his services…. One might well feel that a full-time gambler ought to qualify as much as a full-time trader,[12] as Justice Brandeis in Snyder implied and as courts have held.[13] The Commissioner, indeed, accepts the trader result. Tr. Of Oral Arg. 17. In any event, while the offering of goods and services usually would qualify the activity as a trade or business, this factor, it seems to us, is not an absolute prerequisite.
>
> [12] "It takes a buyer to make a seller and it takes an opposing gambler to make a bet." Boyle, What is a Trade or Business?, 39 Tax Lawyer 737, 763 (1986).
>
> [13] *Levin v. United States*, 597 F.2d 760, 765 (Ct. Cl. 1979); *Commissioner v. Nubar*, 185 F.2d 584, 588 (CA4 1950), *cert. denied*, 341 U.S. 925 (1961); *Fuld v. Commissioner*, 139 F.2d 465, 468-469 (CA2 1943). See also *Moller v. United States*, 721 F.2d 810 (CA Fed. 1983), *cert. denied*, 467 U.S. 1251 (1984); *Purvis v. Commissioner*, 580 F.2d 1332, 1334 (CA9 1976).

After specifically rejecting the idea that offering goods or services is a prerequisite for engaging in a "trade or business," *Groetzinger* concluded (highlighting added):

> Of course, not every income-producing and profit-making endeavor constitutes a trade or business. The income tax law, almost from the beginning, has distinguished between a business or trade, on the one hand, and "transactions entered into for profit but not connected with ... business or trade," on the other. See Revenue Act of 1916, § 5(a) Fifth, 39 Stat. 759. Congress "distinguished the broad range of income or profit producing activities from those satisfying the narrow category of trade or business." *Whipple v. Commissioner*, 373 U.S. 193, 197 (1963). We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

---

incurred as having been sustained in the course of a trade or business. He went on to observe that no facts were adduced in Snyder to show that the taxpayer "might properly be characterized as a 'trader on an exchange who makes a living in buying and selling securities.' " *Id.*, at 139. These observations, thus, are dicta, but, by their use, the Court appears to have drawn a distinction between an active trader and an investor.

It is suggested that we should defer to the position taken by the Commissioner and by the Solicitor General, but, in the absence of guidance, for over several decades now, through the medium of definitive statutes or regulations, we see little reason to do so. We would defer, instead, to the Code's normal focus on what we regard as a common-sense concept of what is a trade or business. Otherwise, as here, in the context of a minimum tax, it is not too extreme to say that the taxpayer is being taxed on his gambling losses,[15] a result distinctly out of line with the Code's focus on income.

We do not overrule or cut back on the Court's holding in *Higgins* when we conclude that if one's gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business within the meaning of the statutes with which we are here concerned. Respondent Groetzinger satisfied that test in 1978. Constant and large-scale effort on his part was made. Skill was required and was applied. He did what he did for a livelihood, though with a less than successful result. This was not a hobby or a passing fancy or an occasional bet for amusement.

We therefore adhere to the general position of the *Higgins* Court, taken 45 years ago, that resolution of this issue "requires an examination of the facts in each case." 312 U.S., at 217. This may be thought by some to be a less-than-satisfactory solution, for facts vary. See Boyle, What is a Trade or Business?, 39 Tax Lawyer 737, 767 (1986); Note, The Business of Betting: Proposals for Reforming the Taxation of Business Gamblers, 38 Tax Lawyer 759 (1985); Lopez, Defining "Trade of Business" under the Internal Revenue Code: A Survey of Relevant Cases, 11 Fla. St. L. Rev. 949 (1984). *Cf.* Comment, Continuing Vitality of the "Goods or Services" Test, 15 U. Balt. L. Rev. 108 (1985). But the difficulty rests in the Code's wide utilization in various contexts of the term "trade or business," in the absence of an all-purpose definition by statute or regulation, and in our concern that an attempt judicially to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code. We leave repair or revision, if any be needed, which we doubt, to the Congress where we feel, at this late date, the ultimate responsibility rests. *Cf. Flood v. Kuhn*, 407 U.S. 258, 269-285 (1972).[16]

[15] "The more he lost, the more minimum tax he has to pay." Boyle, 39 Tax Lawyer, at 754. The Commissioner concedes that application of the goods-or-services-test here "visits somewhat harsh consequences" on taxpayer Groetzinger, Brief for Petitioner 36, and "points to ... perhaps unfortunate draftsmanship." *Ibid*. See also Reply Brief for Petitioner 11.

[16] It is possible, of course, that our conclusion here may subject the gambler to self-employment tax, see §§ 1401-1403 of the Code, and therefore may not be an unmixed blessing for him. Federal taxes, however, rest where Congress has placed them.

Let's look at the requirement that "the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit." *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision) (footnote reproducing Code § 162(a) omitted below), seems to impose a higher standard:

It is well settled, that in order to constitute the carrying on of a trade or business under section 162(a), the activity must "be entered into, in good faith, with the dominant hope and intent of realizing a profit, i.e., taxable income, therefrom." *Hirsch v. Commissioner*,

> 315 F.2d 731, 736 (9th Cir. 1963), *affg*. a Memorandum Opinion of this Court. See also *Hager v. Commissioner*, 76 T.C. 759, 784 (1981); *Golanty v. Commissioner*, 72 T.C. 411, 425 (1979), *affd*. without published opinion 647 F.2d 170 (9th Cir. 1981).

However, *Brannen* was decided before *Groetzinger* and *Groetzinger* is a higher court), so *Groetzinger* would control.

Brannen suggests that the regulations reproduced in part II.G.3.i.i.(c) Hobby Loss Benefits of Code § 183 are a good summary of the cases on this issue; see fn. 1099 in that part. However, no inference is to be drawn from the provisions of Code § 183 and the regulations thereunder that any activity of a C corporation is or is not a business or engaged in for profit.[1088]

Losses for 12 years, when the taxpayer was 65 years of age when starting the activity, did not disqualify the activity, in which he engaged full time, from constituting a business.[1089]

1088 Reg. § 1.183-1(a).

1089 *Ellsworth v. Commissioner*, T.C. Memo. 1962-32, allowed the taxpayer to deduct losses. The taxpayer's testimony and corroborating expert testimony held persuade the court:

> Petitioner testified that he would not have reentered the breeding of dairy cattle in 1948 unless he "felt sure" he could make a profit, although, based on his past experience in breeding livestock, he realized that initial losses were inevitable since it would require about 10 to 15 years to develop superior strains in his Sybil cattle so that they would have substantial commercial value. Petitioner also ascribed his continuous losses from his farm enterprise in part to various causes such as climatic conditions, adverse effects on breeding establishments of artificial insemination, and economic depressions in the milk industry. Notwithstanding these latter factors, which were beyond his control, petitioner had more than a vain hope that a profit would result from his venture in the near future which would justify his expenditures.
>
> The record shows that petitioner's operation was conducted on an efficient, economical and sound scientific basis when compared to other breeding establishments; that the blood lines of his herd have been constantly improving; and that the prospects of making a profit from the sale of his cattle are considerably improved. Petitioner's expectation of realizing a profit in the very near future was corroborated by three experts in the breeding of livestock who testified, in general, as to the potential profit represented by petitioner's foundation herd, particularly in the "bull stud" market for use in artificial insemination establishments. J.F. Cavanaugh testified that petitioner's cattle "have arrived at a point where we think they would sell to good advantage." Likewise, Parodneck, another expert, testified that an individual who had a breeding herd during the taxable years involved, had "a reasonable expectancy of making a profit." We found their testimony in this respect convincing.

Although he had independent sources of income, he worked hard to minimize losses and set himself up for potential future profits:

> Admittedly, petitioner possessed an independent income and was not dependent on the success of the farm for a livelihood. He also may well have had pleasure from residing in a country home, but these facts alone do not negate his intent to operate the farm for profit. *Wilson v. Eisner*, 282 Fed. 38 (C.A. 2, 1922); *DuPont v: United States*, 28 F.Supp. 122, 124 (D. Delaware, 1939) (C.A. 2). Nor is such intent vitiated by the fact that petitioner received an annual income from dividends sufficient to offset substantial losses from his farm enterprise. No evidence was adduced that petitioner was indifferent to whether there was a loss or gain, or that the farm was an incident to the social or domestic aspects of his life. A substantial income from sources other than farming, or substantial sources of capital, was necessary as a basis for embarking on the farming project because of anticipated losses in the earlier years.
>
> We have no doubt upon the record that petitioner devoted himself assiduously to the economical operation of the farm with the reasonable hope of substantial future profits from the breeding operation. We further note that petitioner took affirmative steps to minimize losses derived in1958

An individual who earns a living working 40 hours per week may also have a trade or business working another 30 hours per week, even if the other activity has not yet produced a product.[1090]

When a taxpayer invests in a partnership, the partnership's profit motive is determinative.[1091]

> by reducing his herd, terminating his lease of a neighboring farm and reducing his working area further by renting some of his acreage. We are satisfied that all of his activities at the farm were influenced by the ambition to produce a valuable strain of dairy livestock which would be commercially acceptable.
>
> That petitioner was about 65 years of age in 1948 when he commenced his selective breeding enterprise and would be 75 or 80 before he could make a profit, in our opinion, is not determinative of the issue. More significant, we believe, is the fact that he gave such attention to the farm as is usually given to a business enterprise. Apart from his annual vacation, petitioner devoted virtually all of his personal attention to supervising the farm operations, including a staff of several full time employees who assisted him. Petitioner, whose average working day on the farm was in excess of eight hours, performed all of the functions of a farm manager. During the taxable years involved, detailed records were kept of daily milk production, of statistics relating to the breeding activities of his livestock, and of income and expenses attributable to the operation of the farm. The farm was a well equipped establishment and was operated in a businesslike manner. We find, on the whole picture, that the farm operation was not carried on for the purpose of display, social diversion, or for the gratification of a personal whim. *Samuel Riker, Jr., Executor*, 6 B.T.A. 890, 893 (1927).

The court concluded:

> Considering all of the evidence we hold that petitioner carried on his farm activities, and particularly his breeding operations, on a commercial basis with the reasonable hope of making it profitable and not for his recreation, pleasure or other personal reason. Accordingly, the expenses in question are deductible under section 162(a), *supra*.

[1090] *Snyder v. U.S.*, 674 F.2d 1359 (10th Cir. 1982), stated that the taxpayer's profit motive is only significant under Code § 162 insofar as it affords a means of *distinguishing* between an enterprise carried on in good faith as a "trade or business" and an enterprise merely carried on as a hobby. It pointed out:

> A taxpayer is clearly not engaged in a trade or business if his predominant purpose is recreation or a hobby. See, *e.g.*, *Carkhuff v. Commissioner*, 425 F.2d 1400, 1404 (6th Cir. 1970); *Schley v. Commissioner*, 375 F.2d 747, 750 (2d Cir. 1967). On the other hand, an author may be in a trade or business within the meaning of section 162 if he "participated in that endeavor with a good faith expectation of making a profit." *Stern v. United States*, No. 70-782-HP (C.D. Cal. Mar. 26, 1971), 71-1 U.S. Tax Cas. (CCH) ¶ 9375. The business need not yield an immediate profit. *Id*.

It also pointed out that it is more difficult to prove a business when activity is not the taxpayer's principal means of livelihood and is of a sporting or recreational nature, citing *Imbesi v. Commissioner*, 361 F.2d 640, 645 (3d Cir. 1966). It held:

> On remand, if the trial court finds taxpayer was primarily motivated by profit, the court must then determine whether taxpayer devoted sufficient time over a substantial enough period to be in a trade or business under section 162. If the trial court finds that taxpayer was not engaged in a trade or business in the relevant years, it must then determine whether the expenses were deductible under section 212 as ordinary and necessary expenses for the production of income.

[1091] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), stated:

> In order for a partnership to be entitled to a deduction for expenses attributable to a trade or business in computing its taxable income (or loss) under section 703(a), it must be established that the partnership engaged in the activity with the primary purpose and intent[14] of making a profit. *Hirsch v. Commissioner*, *supra* at 736; *Golanty v. Commissioner*, *supra* at 425; *Hager v. Commissioner*, *supra* at 784. Britton Properties need not have a reasonable expectation of profit, but the partnership must have the intent and objective of realizing a profit.[15] *Hirsch v. Commissioner*, *supra*; *Hager v. Commissioner*, *supra*; *Jasionowski v. Commissioner*, 66 T.C. 312, 321 (1976); *Bessenyey v. Commissioner*, 45 T.C. 261, 274 (1965), *affd*. 379 F.2d 252 (2d Cir. 1967).

Although an individual holding property for the production of income must look to Code § 212 rather than Code § 162,[1092] a corporation appears able to use Code § 162 to deduct expenses related to the production of income, as illustrated by Rev. Rul. 78-195:

> A corporation that was formed for the express purpose of investing in real property purchased a tract of unimproved, non-income-producing real property, which it held for two years and sold without having made any substantial improvements. The corporation did not make any significant efforts to sell the property and did not engage in any other transactions in real or personal property or in other commercial activities. During the period that it held the property, the corporation incurred expenses for interest, real property taxes, accounting fees, and general office costs.
>
> *Held*, the accounting fees and general office costs are expenses related to investment property of the corporation and are deductible by the corporation under section 162 of the Internal Revenue Code of 1954 in the year in which paid or incurred. The interest and real property taxes are deductible by the corporation under sections 163 and 164 of the Code, respectively. See section 266 and the Income Tax Regulations thereunder regarding amounts which may be charged to capital account.

II.G.3.i.i.(b). Requirements for Deduction Under Code § 212

Subject to the various limitations provided in the preceding parts of part II.G.3 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner and subject to other limitations on what can be deducted, Code § 212 allows an individual to deduct:

---

[14] While it may at first appear difficult to ascribe an "intent" to an entity such as the limited partnership herein, we have previously held that "It is the intent of the partnership and not that of any specific partner which is determinative in characterizing the income for purposes of taxation." *Podell v. Commissioner*, 55 T.C. 429, 433 (1970). See also *Miller v. Commissioner*, 70 T.C. 448, 456 (1978), where we looked to the "partnership's motives." In this same context, the taxpayer in *Estate of Freeland v. Commissioner*, 393 F.2d 573, 584 (9th Cir. 1968), *affg*. a Memorandum Opinion of this Court, argued that as a limited partner, the intent of the operating partners in the partnership should not be attributed to her. In rejecting this contention, the Second Circuit stated that while the limited partnership may have been an "investment" to her, the intent of the partnership controlled in determining whether the land owned by the partnership was property described in sec. 1221(1).

[15] We recognize that the standard we have used was recently reviewed in *Dreicer v. Commissioner*, 665 F.2d 1292 (D.C. Cir. 1982), *revg. and remanding* a Memorandum Opinion of this Court. In *Dreicer*, the Circuit Court, after a review of the legislative history, concluded that the applicable standard is not whether the taxpayer had "a bona fide expectation" of profit but, rather, whether he engaged in the activity with the "objective" of making a profit. The Court correctly stated that sec. 1.183-2(a), Income Tax Regs., provides that the facts must indicate that the taxpayer entered into the activity with "the objective of making a profit." The difference in the standard of "objective of making a profit" and a "bona fide expectation" of making a profit might be merely one of semantics. In any event, the Circuit Court in the *Dreicer* case recognized, as this Court has in many cases, that an activity is not engaged in for profit if the taxpayer does not have the "objective" or "intent" of making a profit, and that the "objective" or "intent" of the taxpayer is a question of fact to be decided in each case from all the evidence of record.

[1092] See part II.G.3.i.i.(d) Whether Managing Investments Constitutes a Trade or Business, especially fns 1118-1119.

all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

However, the activity need not produce a profit for the deductions to be allowable under Code § 212.[1093]

On the other hand, Reg. § 1.212-1(c) provides that:

> In the case of taxable years beginning before January 1, 1970, expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case. For example, consideration will be given to the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer. For provisions relating to activities not engaged in for profit applicable to taxable years beginning after December 31, 1969, see section 183 and the regulations thereunder.

[1093] Reg. § 1.212-1(b) provides:

> The term "income" for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter paid or incurred in connection with such bonds are deductible. Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.

II.G.3.i.i.(c). Hobby Loss Benefits of Code § 183

Code § 183(a) provides:

> *General rule*. In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

Code § 183 also applies to deductions passing through a partnership.[1094]

[1094] Rev. Rul. 77-320 concluded:

> *Held*, section 183 of the Code applies to the activities of a partnership, and the provisions of section 183 are applied at the partnership level and reflected in the partners' distributive shares.

See *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), quoted in fn. 1115. But the Fifth Circuit may have a different view, having stated in *Copeland v. Commissioner*, 290 F.3d 326 (2002) (but correctly pointing out how Code § 183 is sometimes incorrectly referred to as disallowing deductions):

> The Tax Court's wording to the contrary notwithstanding, however, the deductions were not actually disallowed under I.R.C. § 183, but under I.R.C. §§ 162 and 174, neither of which are limited — as is § 183 — to activities engaged in by individuals and S corporations, to the exclusion of partnerships.[26] I.R.C. § 183 provided the *Krause* court with only the factors for analysis, not statutory authority to allow or disallow deductions themselves. To say that the deductions are disallowed "under section 183" impermissibly conflates the I.R.C. sections in question and thereby glosses over this crucial distinction.
>
> [26] Even the Commissioner recognizes this limitation in his appellate brief when he states (emphasis ours): "The regulations under § 183 list a number of factors relevant to the determination of profit motive, and those factors have frequently been applied by the courts in determining whether a profit motive exists for all sorts of entities, including partnerships and corporations, *to which the limitations on deductibility of § 183 do not apply*."

Where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may constitute one activity.[1095] Income and deductions would be allocated between activities.[1096]

Code § 183(c) provides:[1097]

> *Activity not engaged in for profit defined*. For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

Thus, Code § 183 "is not a disallowance provision, but rather an allowance provision which operates only when the taxpayer's expenses are not allowable as deductions under section 162(a) or 212(1) and (2)," and "the profit motive analysis must be resolved *before* turning to section 183."[1098] However, courts often conflate Code §§ 162 and 183 and jump directly to

---

[1095] Reg. § 1.183-1(d)(1), which provides further:

> In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account. Generally, the most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various undertakings. Generally, the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities. The taxpayer's characterization will not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case. If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying section 183. Where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value. Thus, the farming and holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land).

[1096] Reg. § 1.183-1(d)(2) provides:

> *Rules for allocation of expenses*. If the taxpayer is engaged in more than one activity, an item of deduction or income may be allocated between two or more of these activities. Where property is used in several activities, and one or more of such activities is determined not to be engaged in for profit, deductions relating to such property must be allocated between the various activities on a reasonable and consistently applied basis.

[1097] Reg. § 1.183-1(a) reinforces this predicate by including:

> Whether an activity is engaged in for profit is determined under section 162 and section 212(1) and (2) except insofar as section 183(d) creates a presumption that the activity is engaged in for profit.

[1098] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision) (emphasis in original), quoted in fn. 1115. However, courts often fail to consider Code § 162 before turning to a Code § 183 analysis; for example, *Boneparte v. Commissioner*, T.C. Memo. 2017-193, correctly contrasted the consequences of being a professional gambler with being a casual gambler and dove right into Code § 183 with even mentioning Code § 162 (but the taxpayer, who was a toll bridge operator, prepared his own returns and represented himself in Tax Court, so the lack of rigor is not surprising).

whether a profit motive exists under Code § 183, presumably because a finding of profit motive under Code § 183 means that one does not need to consider a profit motive under Code § 162.

Code § 183(d) presumes an activity is engaged in for profit if it is profitable for a particular number of years. If the presumption does not apply, then Reg. § 1.183-2(b) kicks in [footnotes in the long quote below are mine, elaborating on each factor]:[1099]

> *Relevant factors*. In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:
>
> (1) *Manner in which the taxpayer carries on the activity*. The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.[1100]

[1099] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), held that:

> since the regulation is not unreasonable and plainly inconsistent as it deals with a specific issue raised in section 183 which requires a determination before that section is applicable, it should be given full force and effect. See *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 (1948). In addition, since many of the statements in the regulation, including the relevant factors listed, were derived from case law decided prior to the enactment of section 183, it is clear that the standards used in determining whether a profit motive exists for purposes of section 162 or 212 have remained the same. See *Jasionowski v. Commissioner*, *supra* at 321-322; *Benz v. Commissioner*, 63 T.C. 375, 383 (1974).

[1100] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Hendricks v. CIR*, 32 F3d 94, 98 (4th Cir. 1994) (physician's farm sustained losses in 20 of 21 years of operation; lack of profit motive evidenced by taxpayer's knowledge "of steps he might have taken, but failed to take, to improve the farm's profitability"); *Holmes v. CIR*, 74 TCM (CCH) 494 (1997) (farm found not to be carried on for profit because, among other things, taxpayers failed to keep records in businesslike way; negligence penalty sustained; extensive analysis); *Elliott v. CIR*, 90 TC 960, 973 (1988), *aff'd* without opinion, 899 F2d 18 (9th Cir. 1990) (Amway distributors not engaged in business for profit where they "made some small modifications in their routine social life [on entering the business], kept cursory notes about their activities, and claimed deductions for the cost of nearly everything they owned or did"; negligence penalty imposed); *Allen v. CIR*, 72 TC 28 (1979) (taxpayers operated ski lodge in businesslike manner, experimenting with different modes of operating it in hope of making profit); *Lyon v. CIR*, 36 TCM (CCH) 979 (1977) (failure to maintain records and unbusinesslike approach; activity not "engaged in for profit"); Lee, *supra* note 8, at 397–407. Compare *Rozzano v. CIR*, 94 TCM (CCH) 29 (2007) (holding horse farm was run for profit, notwithstanding large losses annually for eight years, largely because operation was carried on in business-like manner).

(2) *The expertise of the taxpayer or his advisors*. Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.[1101]

(3) *The time and effort expended by the taxpayer in carrying on the activity*. The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.[1102]

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974).

[1101] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *DeMattia v. CIR*, 75 TCM (CCH) 1903, 1906 (1998) (retired dentist's sponsorship of son's professional golf career not conducted in businesslike manner; no "goals or financial conditions," no prior investigation of profit potential, and no separate records); *Taras v. CIR*, 74 TCM (CCH) 1388, 1395 (1997) ("Petitioners initiated their activity [horse racing] without developing a business plan commensurate with that which would be expected from someone who was motivated primarily by a profit objective"); *Lucid v. CIR*, 73 TCM (CCH) 2892 (1997) (no profit motive for business of selling yachts; no business plan or training or experience in business; negligence penalty sustained); *Benz v. CIR*, 63 TC 375 (1974) (taxpayer was "relative novice"; breeding activity was hobby); Lee, *supra* note 8, at 407–412. *Taras* has been affirmed by an unpublished opinion, 187 F3d 627 (3d Cir. 1999) .

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974). *Ford v. Commissioner*, T.C. Memo. 2018-18, found no profit motive, starting its criticism of the taxpayer:

> She had no expertise in club ownership, maintained inadequate records, disregarded expert business advice, nonchalantly accepted Bell Cove's perpetual losses, and made no attempt to reduce expenses, increase revenue, or improve Bell Cove's overall performance.

[1102] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Hawkins v. CIR*, 38 TCM (CCH) 469 (1979) (publication of book of poetry not for profit; no evidence of continuous or repeated activity in literary field or intent to write with substantial regularity); Lee, *supra* note 8, at 412–416. But see *Cornfeld v. CIR*, 797 F2d 1049, 1052 (DC Cir. 1986) ("to have an honest profit objective a taxpayer need not run the business himself or have expertise in it; it suffices that he engage those who do"); *Nickerson v. CIR*, 700 F2d 402, 407 (7th Cir. 1983) (taxpayer engaged in farming for profit even though he had another full-time job and spent only spare time on farm; taxpayer's efforts were "prodigious" and farm did not provide recreation); *Perry v. CIR*, 74 TCM (CCH) 616 (1997) (taxpayers' horse breeding operation was for profit, even though taxpayers were both employed full-time in other jobs, because they had knowledge and experience needed for success).

(4) *Expectation that assets used in activity may appreciate in value*. The term "profit" encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of § 1.183-1 for definition of an activity in this connection.[1103]

(5) *The success of the taxpayer in carrying on other similar or dissimilar activities*. The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.[1104]

(6) *The taxpayer's history of income or losses with respect to the activity*. A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the

---

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974). *Ford v. Commissioner*, T.C. Memo. 2018-18, found no profit motive, concluding its criticism of the taxpayer:

> Owning Bell Cove elevated petitioner's status in the country music community, allowed her to further the careers of young performers, offered her weekly opportunities to interact with country music fans, and satiated her love promoting country music. Petitioner earnestly devoted time and energy to Bell Cove but was primarily motivated by personal pleasure, not profit, and simply used the club's losses to offset her trust and capital gain income. See *Bessenyey v. Commissioner*, 45 T.C. 261, 275 (1965), *aff'd*, 379 F.2d 252 (2d Cir. 1967); sec. 1.183-2(b)(3), (8), (9), Income Tax Regs.

[1103] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Bolaris v. CIR*, 776 F2d 1428 (9th Cir. 1985) (depreciation and operating expense deductions allowed for former principal residence that was rented pending sale; profit motive can exist even if gain on sale qualifies for nonrecognition); *Thompson v. US*, 90-1 USTC ¶ 50,043 (D. Conn. 1989) (in determining whether horse breeding operation was carried on for profit, jury could consider possibility of appreciation in value of land used in operation); *Dickson v. CIR*, 47 TCM (CCH) 509 (1983) (expectation of profit from appreciation in value of sailboat was major factor in finding boat chartering activity was for profit); Lee, *supra* note 8, at 416–418. But see *Jasionowski v. CIR*, 66 TC 312 (1976) (taxpayer's expectation of capital gains upon eventual sale of property not sufficient to supply profit motive for current lease of the property).

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974). Another footnote in Bittker & Lokken says:

> See *Landry v. CIR*, 86 TC 1284, 1306 (1986) (rejecting IRS's argument that § 183 applies where, notwithstanding conceded expectation of profit in the long run, intention to profit during the taxable year was lacking; § 183 inapplicable if taxpayer "intended to make a profit within a reasonable time"); *Lemmen v. CIR*, 77 TC 1326 (1981) (*acq*.) (expectation of profit from herd of breeding cattle over long range established).

Ford v. Commissioner, T.C. Memo. 2018-8, at fn 7 cited this regulation to add weight to its conclusion of no profit motive, pointing out:

> Further, Bell Cove's $420,253 of accumulated losses exceeded its $383,900 of appreciation.

[1104] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), cites Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347, 418-420 (1974).

operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.[1105]

(7) *The amount of occasional profits, if any, which are earned*. The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.[1106]

(8) *The financial status of the taxpayer*. The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.[1107]

[1105] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Taras v. CIR*, 74 TCM (CCH) 1388, 1395 (1997) ("Throughout all the years of continuous losses, petitioners did not materially alter their mode of operation"); *Allen v. CIR*, 72 TC 28 (1979) (ski lodge's losses explained by market saturation, low snowfall, and gasoline shortages); Lee, *supra* note 8, at 420–428; infra ¶ 22.5.5 (presumption arising from two successful years). Taras has been affirmed by an unpublished opinion, 99-1 USTC ¶ 50,489 (3d Cir. 1999). But see *Rabinowitz v. CIR*, 90 TCM (CCH) 113, 121 (2005) (finding charter aircraft business was carried on for profit, notwithstanding 12 successive years of losses, because taxpayers "used their considerable business skills to attempt to make the business profitable" and losses for later periods resulted from unforeseen factors); *Burrus v. CIR*, 86 TCM (CCH) 429, 439 (2003) (finding "actual and honest intent to profit from" cattle raising, even though activity generated losses exceeding revenues for all of six years before court and four succeeding years; "such losses are consistent with a startup period inherent in herd building and therefore do not necessarily indicate a lack of profit motive").

The citation to Lee is to Lee, "A Blend of Old Wines in a New Wineskin: Section 183 and Beyond," 29 Tax L. Rev. 347 (1974).

[1106] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), cites Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347, 428-431 (1974).

[1107] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

(9) *Elements of personal pleasure or recreation*. The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.[1108]

Reg. § 1.183-2(c) provides:

> *Example (1)*. The taxpayer inherited a farm from her husband in an area which was becoming largely residential, and is now nearly all so. The farm had never made a profit before the taxpayer inherited it, and the farm has since had substantial losses in each year. The decedent from whom the taxpayer inherited the farm was a stockbroker, and he also left the taxpayer substantial stock holdings which yield large income from dividends. The taxpayer lives on an area of the farm which is set aside exclusively for living purposes. A farm manager is employed to operate the farm, but modern methods are not used in operating the farm. The taxpayer was born and raised on a farm, and expresses a strong preference for living on a farm. The taxpayer's activity of farming, based on all the facts and circumstances, could be found not to be engaged in for profit.
>
> *Example (2)*. The taxpayer is a wealthy individual who is greatly interested in philosophy. During the past 30 years he has written and published at his own expense several

---

> See *Hendricks v. CIR*, 32 F3d 94 (4th Cir. 1994) (physician's substantial income from medical practice was evidence that farm, which consistently operated at loss, was not for profit); *Jasionowski v. CIR*, 66 TC 312 (1976) (taxpayer's substantial income from other sources and other rental experience indicated that lease under which substantial losses, as distinguished from usual start-up losses, would be incurred for several years was not for profit); *Hurd v. CIR*, 37 TCM (CCH) 499 (1978) (substantial outside income enabled taxpayers to absorb large losses from ranch; held, not for profit); Lee, *supra* note 8, at 431–436. Compare *Ranciato v. CIR*, 52 F3d 23, 26 (2d Cir. 1995) (Tax Court's finding of lack of profit motive reversed because court failed to consider all relevant factors, including that taxpayer was "a solid middle-class wage earner, not an individual of wealth whose unprofitable extracurricular activities would suggest an effort to shelter unrelated income through deliberate losses").

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974). Being a trust fund baby is not helpful; see *Ford* in fn 1102.

[1108] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Allen v. CIR*, 72 TC 28 (1979) (taxpayers never used ski lodge for personal recreation); Lee, *supra* note 8, at 436–444. See *McCarthy v. CIR*, 79 TCM (CCH) 1912, 1916 (2000) ("motorcross racing activity was inherently recreational and was conducted as an activity to be shared by father and son").

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974). For an example of activity that elevated the taxpayer's social profile, see *Ford* in fn 1102.

pamphlets, and he has engaged in extensive lecturing activity, advocating and disseminating his ideas. He has made a profit from these activities in only occasional years, and the profits in those years were small in relation to the amount of the losses in all other years. The taxpayer has very sizable income from securities (dividends and capital gains) which constitutes the principal source of his livelihood. The activity of lecturing, publishing pamphlets, and disseminating his ideas is not an activity engaged in by the taxpayer for profit.

Example (3). The taxpayer, very successful in the business of retailing soft drinks, raise dogs and horses. He began raising a particular breed of dog many years ago in the belief that the breed was in danger of declining, and he has raised and sold the dogs in each year since. The taxpayer recently began raising and racing thoroughbred horses. The losses from the taxpayer's dog and horse activities have increased in magnitude over the years, and he has not made a profit on these operations during any of the last 15 years. The taxpayer generally sells the dogs only to friends, does not advertise the dogs for sale, and shows the dogs only infrequently. The taxpayer races his horses only at the "prestige" tracks at which he combines his racing activities with social and recreational activities. The horse and dog operations are conducted at a large residential property on which the taxpayer also lives, which includes substantial living quarters and attractive recreational facilities for the taxpayer and his family. Since (i) the activity of raising dogs and horses and racing the horses is of a sporting and recreational nature, (ii) the taxpayer has substantial income from his business activities of retailing soft drinks, (iii) the horse and dog operations are not conducted in a businesslike manner, and (iv) such operations have a continuous record of losses, it could be determined that the horse and dog activities of the taxpayer are not engaged in for profit.

Example (4). The taxpayer inherited a farm of 65 acres from his parents when they died 6 years ago. The taxpayer moved to the farm from his house in a small nearby town, and he operates it in the same manner as his parents operated the farm before they died. The taxpayer is employed as a skilled machine operator in a nearby factory, for which he is paid approximately $8,500 per year. The farm has not been profitable for the past 15 years because of rising costs of operating farms in general, and because of the decline in the price of the produce of this farm in particular. The taxpayer consults the local agent of the State agricultural service from time-to-time, and the suggestions of the agent have generally been followed. The manner in which the farm is operated by the taxpayer is substantially similar to the manner in which farms of similar size, and which grow similar crops in the area are operated. Many of these other farms do not make profits. The taxpayer does much of the required labor around the farm himself, such as fixing fences, planting, crops, etc. The activity of farming could be found, based on all the facts and circumstances, to be engaged in by the taxpayer for profit.

Example (5). A, an independent oil and gas operator, frequently engages in the activity of searching for oil on undeveloped and unexplored land which is not near proven fields. He does so in a manner substantially similar to that of others who engage in the same activity. The changes, based on the experience of A and others who engaged in this activity, are strong that A will not find a commercially profitable oil deposit when he drills on land not established geologically to be proven oil bearing land. However, on the rare occasions that these activities do result in discovering a well, the operator generally realizes a very large return from such activity. Thus, there is a small chance that A will make a large profit from his oil exploration activity. Under these circumstances, A is engaged in the activity of oil drilling for profit.

Example (6). C, a chemist, is employed by a large chemical company and is engaged in a wide variety of basic research projects for his employer. Although he does no work for his employer with respect to the development of new plastics, he has always been interested in such development and has outfitted a workshop in his home at his own expense which he uses to experiment in the field. He has patented several developments at his own expense but as yet has realized no income from his inventions or from such patents. C conducts his research on a regular, systematic basis, incurs fees to secure consultation on his projects from time to time, and makes extensive efforts to "market" his developments. C has devoted substantial time and expense in an effort to develop a plastic sufficiently hard, durable, and malleable that it could be used in lieu of sheet steel in many major applications, such as automobile bodies. Although there may be only a small chance that C will invent new plastics, the return from any such development would be so large that it induces C to incur the costs of his experimental work. C is sufficiently qualified by his background that there is some reasonable basis for his experimental activities. C's experimental work does not involve substantial personal or recreational aspects and is conducted in an effort to find practical applications for his work. Under these circumstances, C may be found to be engaged in the experimental activities for profit.

If a taxpayer conducts business through many entities and also conducts related business outside of those entities, the Court of Claims has held that the taxpayer may establish a "unified business enterprise" that supports finding that the outside related business has the requisite profit motive.[1109] CCA 201747006, by Brad Poston, asserts that the Court of Claims' decision undermines the separateness of S corporations from their owners and should not be followed.[1110] I do not view that to be the case; I view the "unified business enterprise" theory as merely helping establish motive. However, expect the IRS to strongly challenge the "unified business enterprise," as it did successfully in a taxpayer's very weak case decided in 2016.[1111]

Code § 183(b) allows:

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only

---

[1109] *Morton v. United States*, 98 Fed. Cl. 596 (2011). The court did not seem aware that regulations addressed how to find a profit motive under Code § 183.

[1110] The CCA opens with:

> In conference calls on 7/20/17 and 8/28/17, we discussed with your office the holding of *Peter Morton v. U.S.*, 98 Fed. Cl. 596 (2011), and its effect of excluding wholly-owned or majority owned S corporations from precedent set by *Moline Properties v. Commissioner*, 63 S.Ct. 1132 (1943). Based upon the authorities and analysis below, we conclude the Service should reject the *Morton* holding and continue to assert that *Moline Properties* is applicable to S corporations, regardless of degree of ownership.

Of course, both *Moline* and another case the CCA cited, *Deputy v. DuPont*, 308 U.S. 488 (1940), long predate the idea of an S election. However, the CCA is quite correct that one cannot simply disregard an S corporation; for example, see parts II.G.23 Taxing Entity or Individual Performing Services and II.L.5 Self-Employment Tax: Partnership with S corporation Blocker.

[1111] *Steinberger v. Commissioner*, T.C. Memo. 2016-104, rejecting a doctor's alleged business use of an airplane to travel in his business when his flying the airplane did not save the doctor any significant time over driving.

to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(References above and below to "this chapter" or "chapter 1" are to Code §§ 1-1400U-3.)

Reg. § 1.183-1(b)(1) elaborates on allowing deductions:

> *Manner and extent*. If an activity is not engaged in for profit, deductions are allowable under section 183(b) in the following order and only to the following extent:
>
> (i) Amounts allowable as deductions during the taxable year under chapter 1 of the Code without regard to whether the activity giving rise to such amounts was engaged in for profit are allowable to the full extent allowed by the relevant sections of the Code, determined after taking into account any limitations or exceptions with respect to the allowability of such amounts. For example, the allowability-of-interest expenses incurred with respect to activities not engaged in for profit is limited by the rules contained in section 163(d).
>
> (ii) Amounts otherwise allowable as deductions during the taxable year under chapter 1 of the Code, but only if such allowance does not result in an adjustment to the basis of property, determined as if the activity giving rise to such amounts was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivision (i) of this subparagraph.
>
> (iii) Amounts otherwise allowable as deductions for the taxable year under chapter 1 of the Code which result in (or if otherwise allowed would have resulted in) an adjustment to the basis of property, determined as if the activity giving rise to such deductions was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivisions (i) and (ii) of this subparagraph. Deductions falling within this subdivision include such items as depreciation, partial losses with respect to property, partially worthless debts, amortization, and amortizable bond premium.

Special rules apply to basis adjustments for deductions allowed under Reg. § 1.183-1(b)(1)(iii).[1112]

[1112] Reg. § 1.183-1(b)(2), "Rule for deductions involving basis adjustments," provides:

(i) *In general*. If deductions are allowed under subparagraph (1)(iii) of this paragraph, and such deductions are allowed with respect to more than one asset, the deduction allowed with respect to each asset shall be determined separately in accordance with the computation set forth in subdivision (ii) of this subparagraph.

(ii) *Basis adjustment fraction*. The deduction allowed under subparagraph (1)(iii) of this paragraph is computed by multiplying the amount which would have been allowed, had the activity been engaged in for profit, as a deduction with respect to each particular asset which involves a basis adjustment, by the basis adjustment fraction—

  (a) The numerator of which is the total of deductions allowable under subparagraph (1)(iii) of this paragraph, and

  (b) The denominator of which is the total of deductions which involve basis adjustments which would have been allowed with respect to the activity had the activity been engaged in for profit. The amount resulting from this computation is the deduction allowed under subparagraph (1)(iii) of this paragraph with respect to the particular asset. The basis of such asset is adjusted only to the extent of such deduction.

Code § 183(b)(2) and Reg. § 1.183-1(b)(1)(ii) provide a benefit to individuals that is not available to C corporations – deducting expenses that would be business expenses if the activity had been engaged in for profit. On the other hand, all expenses under Code § 183(b)(1) and Reg. § 1.183-1(b)(1)(i) would have been allowable to a corporation anyway, and all expenses allowable to an individual under Code § 183(b) and Reg. § 1.183-1(b)(1) would be subject to the limitations described in part II.G.3.i.ii Itemized Deductions, which might very well eliminate their benefit. Comparing the choice between C corporation and an individual (including through a partnership or S corporation):

- Both require the same profit motive to qualify under Code § 162 as a threshold inquiry.

- Code § 183 provides an additional chance for an individual to prove profit motive, which opportunity is not available to a C corporation. Whether this additional opportunity makes a difference depends on the facts and circumstances.

- Would being an entity make a difference? When testing business purpose, one would test the entity's intent[1113] rather than the individual's. When looking at an individual's business purpose, one would compare that activity to the individual's other activities. An individual who is establishing a side business may consider interposing an entity that is not disregarded between the business and the individual, so that profit motive can be tested solely by reference to the entity's activities. My sense is that C corporations are tested for profit motive only when using a side deal to shelter income from their core activity and that they are not scrutinized for profit motive for their core activity; however, Code § 162 does not draw such a distinction, so one cannot rely on that distinction as a matter of law.

- If a profit motive cannot be established:

  - o Code § 183(b)(1) and Reg. § 1.183-1(b)(1)(i) allows individuals to deduct whatever they could have deducted absent a profit motive, and C corporations have the same benefit. However, limitations on using itemized deductions may prevent these deduction from generating a tax benefit, whereas a C corporation does not have the same limits.

  - o Code § 183(b)(2) and Reg. § 1.183-1(b)(1)(ii) provide a benefit to individuals that is not available to C corporations – deducting expenses that would be business expenses if the activity had been engaged in for profit. However, limitations on using itemized deductions may prevent these deduction from generating a tax benefit.

In applying Code § 183, gross income derived from an activity not engaged in for profit includes the total of all gains from the sale, exchange, or other disposition of property, and all other gross receipts derived from such activity.[1114]

[1113] For testing a partnership's intent, see fn. 1091 in part II.G.3.i.i.(a) "Trade or Business" Under Code § 162; note that adding a service partner might complicate funding any losses. For testing an S corporation's intent, see fn. 1116; I have not looked to see the rule for Code § 162 absent Code § 183.

[1114] Reg. § 1.183-1(e), which further provides:

> Such gross income shall include, for instance, capital gains, and rents received for the use of property which is held in connection with the activity. The taxpayer may determine gross income from any activity by subtracting the cost of goods sold from the gross receipts so long as he consistently does so and follows generally accepted methods of accounting in determining such gross income.

In the case of a partnership, Code § 183(b) is applied at the partnership level and can be a helpful relief valve.[1115] Also, Code § 183 is applied at the corporate level in determining the allowable deductions of an S corporation.[1116]

II.G.3.i.i.(d). Whether Managing Investments Constitutes a Trade or Business

This part II.G.3.i.i.(d) reviews whether managing one's own investments and whether managing others' investments constitutes a trade or business, expenses of which are deductible under Code § 162. However, C corporations do not appear to be subjected to these standards,[1117] so this discussion appears to apply only to other taxpayers.

"No matter how large the estate or how continuous or extended the work required may be," managing one's own portfolio of marketable securities does not constitute a trade or business. *Higgins v. Commissioner*, 312 U.S. 212 (1941).[1118]

Congress enacted Code § 212 to provide relief for taxpayers caught by *Higgins*.[1119] In denying the taxpayer a business bad debt for loans to corporations in which the taxpayer worked full-time, *Whipple v. Commissioner*, 373 U.S. 193 (1963), stated:

> Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment,

---

[1115] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), held:

> Since the partnership is not entitled to any deductions under section 162, the activity of the partnership constitutes one "not engaged in for profit" as defined in section 183(c). We therefore turn to section 183 to determine the amount, if any, of deductions which are otherwise allowable under section 183(b). We are again faced with the question of whether the allowance provision, section 183(b), is to be applied at the partnership or partner level. For the many reasons stated above, we conclude that section 183(b) should be applied at the partnership level. See sec. 703(a); sec. 1.703-1(a), Income Tax Regs.; *Hager v. Commissioner*, *supra* at 788. Accordingly, as the partnership did not report any deductions in 1975 which are otherwise allowed without regard to whether the activity is engaged in for profit, the partnership is entitled to the deductions claimed, without inclusion in basis of the nonrecourse note in the amount of $1,400,000, but only to the extent of the gross income derived from the activity in 1975 in the amount of $679. Sec. 183(b)(2). The result of applying section 183(b)(2) is that the partnership in 1975 had income of zero; that is, it had no profit and it had no loss. Therefore, petitioner had no distributive share of income or loss from Britton Properties.[17]
>
> [17] Since petitioner's pro rata share of the partnership's income of $679 was included by respondent in his 1975 income, the result of our holding is that respondent erred in increasing petitioner's income, as reported, by $34 of partnership income but did not err in disallowing petitioner's claimed partnership loss of $15,751.

[1116] Reg. § 1.183-1(f).

[1117] See text accompanying fn 1092 in part II.G.3.i.i.(a) "Trade or Business" Under Code § 162.

[1118] See part II.G.3.i.i.(a) "Trade or Business" Under Code § 162, in which fn 1084 discusses the case's weight and continued validity.

[1119] *Whipple v. Commissioner*, 373 U.S. 193 (1963), stated:

> In response to the *Higgins* case and to give relief to *Higgins*-type taxpayers, see H.R. Rep. No. 2333, 77th Cong., 2d Sess. 46, § 23(a) was amended not by disturbing the Court's definition of "trade or business" but by following the pattern that had been established since 1916 of "[enlarging] the categories of incomes with reference to which expenses were deductible," *McDonald v. Commissioner*, 323 U.S. 57, 62; *United States v. Gilmore*, 372 U.S. 39, 45, to include expenses incurred in the production of income.

> this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation. Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debts losses arising from his own business and those actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business.

Managing investments for one's self, wife, and three children without compensation did not constitute a trade or business in *Beals v. Commissioner*, T.C. Memo. 1987-171. Although *Beals* acknowledged that being a day-trader may be a trade or business,[1120] the taxpayer's full-time efforts towards managing investments did not constitute day trading and therefore did not constitute a trade or business.[1121]

[1120] The court noted:

> On the other hand, the Court has recognized that a full-time trader of securities may be in a trade or business. *Snyder v. Commissioner*, 295 U.S. 134, 139 (1935).
>
> In *Liang v. Commissioner*, 23 T.C. 1040 (1955), we had to distinguish between an investor and a trader; we observed:
>
> > The distinction between an investment account and a trading account is that in the former, securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of the securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis. [23 T.C. at 1043.]
>
> The taxpayer's agent "never acquired any hedges; never made short sales; and never purchased any 'puts' or 'calls'." 23 T.C. at 1044. We held that the primary objective of the activity in question "was that of an investment account established to provide a reliable source of income." 23 T.C. at 1045.
>
> More recently, in *Purvis v. Commissioner*, 530 F.2d 1332 (9th Cir. 1976), *affg.* a Memorandum Opinion of this Court, the Court of Appeals for the Ninth Circuit applied the test of *Liang v. Commissioner*, *supra*, and concluded that the taxpayer was investing, not trading. The court noted:
>
> > From 1963 to 1968 petitioner engaged in only 75 sales of securities and ten short-term commodities sales. Of these, 31 involved stock which had been held for more than six months. A substantial number involved shares which petitioner admits were held as investments, or which were held for periods exceeding three years, indicating that they were investments. [530 F.2d at 1334.]

[1121] The court held:

> In the case before us, the petitioner makes no claim that he was a trader, and the evidence does not reveal any pattern of trading: his investments changed very little from year to year, and he reported only small capital transactions each year. To support his position, he relies on his investment activities. It appears that the petitioner was not a mere passive investor; he actively investigated and followed the investments made by him and his family. Nevertheless, it is well settled that the management of investments, despite the extent and scope of such activities, is not a trade or business for tax purposes. *Whipple v. Commissioner*, *supra*; *Higgins v. Commissioner*, *supra*. Consequently, we hold that the petitioner was not engaged in a trade or business during the years at issue.

Whether trading commodities was a trade or business has been the subject of attempts to tax nonresident aliens, who were taxed when the trading rose to the level of a trade or business[1122] and were not taxed when it didn't.[1123] Day-trading on margin, with annual transaction volume of

---

[1122] *Adda v. Commissioner*, 10 T.C. 273, 277 (1948), the Official Tax Court Syllabus to which said:

> Petitioner, a nonresident alien, empowered his brother, who resided in the United States, to deal in commodity futures at his own discretion through resident brokers in the United States for petitioner's account. Petitioner's brother exercised this authority in 1940 and 1941, trading in substantial amounts. *Held*, petitioner was engaged in trade or business in the United States and is taxable as a nonresident alien so engaged; *held*, further, that the petitioner is entitled to a net short term capital loss carry-over from 1940 to 1941.

The court reasoned:

> Trading in commodities for one's own account for profit may be a "trade or business" if sufficiently extensive. *Fuld v. Commissioner*, 139 Fed.(2d) 465; *Norbert H. Wiesler*, 6 T.C. 1148; *affirmed* without discussion of this point, 161 Fed.(2d) 997. The respondent determined that the petitioner was engaged in trade or business in the United States. While the number of transactions or the total amount of money involved in them has not been stated, it is apparent that many transactions were effected through different brokers, several accounts were maintained, and gains and losses in substantial amounts were realized. This evidence shows that the trading was extensive enough to amount to a trade or business, and the petitioner does not contend, nor has he shown, that the transactions were so infrequent or inconsequential as not to amount to a trade or business.

[1123] *Liang v. Commissioner*, 23 T.C. 1040 (1955), stated in its Official Tax Court Syllabus:

> Petitioner, a nonresident alien whose securities were managed primarily for investment purposes by a resident commission agent, held, on facts, not subject to tax on capital gains as not being engaged in a trade or business within the United States under section 211(b), Internal Revenue Code of 1939.

The court began its description of the case:

> Petitioner, a nonresident alien, was not present in this country in 1946 nor, apparently, at any other time after he entered into the agency agreement in 1932. He left the management of his considerable account entirely to the discretion of his agent. The latter invested petitioner's funds in stocks and securities. He never acquired any hedges; never made short sales; and never purchased "puts" or "calls." His commission in excess of a fixed salary was based on total earnings of the account, regardless of source.
>
> Purchase and sale activity in the account during 1946, the year in controversy, and during 1940, which far exceeded such activity in other years, is adequately explained by transitional changes in the industries represented by the securities immediately before and after American participation in World War II, when increased trading activity was not unusual in the routine conservation and management of investment portfolios. And, in spite of increased activity, even during the year in controversy the average holding period of the securities sold was 5.8 years. More than 90 per cent of the gross gain was derived from the sale of securities held for more than 2 years; and more than 40 per cent of the gross gain was realized from the sale of securities held for more than 5 years. The absence of frequent short-term turnover in petitioner's portfolio negatives the conclusion that these securities were sold as part of a trading operation rather than as investment activity.

In finding for the taxpayer that the taxpayer had not engaged in a trade or business, the court reasoned:

> Whether activities undertaken in connection with investments are sufficiently extensive to constitute a trade or business is a question to be decided on the particular facts. *Higgins v. Commissioner*, 312 U.S. 212. In *Fernand C. A. Adda*, 10 T.C. 273, *affirmed* per curiam (C.A. 4) 171 F.2d 457, certiorari denied 336 U.S. 952, extensive transactions in commodities which do not pay dividends and could have resulted in profit only by means of the gains on the purchases and sales were found to constitute a trade or business. For similar reasons *Commissioner v. Nubar*, (C.A. 4) 185 F.2d 584, reversing 13 T.C. 566, certiorari denied 341 U.S. 925, held that transactions in commodities and securities where the taxpayer was himself present in the United States throughout the period were sufficient to constitute the conduct of a trade or business.

more than half of the taxpayer's net worth,[1124] was held to be a trade or business for purposes of the Code § 166 bad debt rules.[1125] Averaging 15 trades per year, of which a substantial portion

---

The present situation is quite different. Petitioner never having been present in the United States, it is only through the activity of his agent that he could be held to have conducted a business. For the solution of this problem we look not solely to the year in controversy but to the entire agency and particularly to the 7 years shown by the record. These figures appearing in our findings satisfy us that the primary, if not the sole objective, was that of an investment account established to provide a reliable source of income. In fact in 4 of the 7 years the capital transactions resulted in losses rather than gains and only in the year for which respondent has determined the deficiency were the gains of any considerable consequence.

[1124] *Levin v. U.S.*, 597 F.2d 760 (Ct. Cl. 1979), found that the taxpayer:

> … devoted virtually all his working time to the purchase and sale of securities. His initial investments made during and immediately following World War II brought him substantial profits. Although he frequently purchased heavily in the stock of one company or another, he was generally active in purchases and sales of stocks of various corporations. For instance, in 1961, the year of the indebtedness note in question, he conducted 332 transactions which represented the transfer of 112,400 shares with a total value of $3,452,125.
>
> Routinely taxpayer visited the corporations in which he was interested and talked to company officers, traveling out of town for these visits when necessary. His days were frequently spent in the brokerage houses on Wall Street; he ate lunch with brokers at the Stock Exchange Club; and he attended lectures sponsored by securities analysts when the topics were of interest. He maintained ledger sheets of all his stock transactions, attended stockholders' meetings, and generally spent his time purchasing and selling securities on his own account.
>
> It was taxpayer's practice to purchase to the extent of allowable margin. He traded with four to six brokerage houses in order to disperse his large number of shares in any one corporation, as many brokers prohibited concentrated holdings in their margin accounts. In addition, this practice avoided pressure to liquidate his entire investment in a particular company to meet a single broker's margin call. Prior to the market decline in late 969 and early 1970, taxpayer was exceedingly successful in his stock transactions. In 1968, for instance, he held stock valued at nearly $8 million with a margin debt of approximately $3 million, leaving him a net worth of about $5 million. His only other source of income was $5,000 in salary for sitting on the board of directors of a small oil-producing company.

[1125] The court held:

> Although the Supreme Court has yet to find a taxpayer properly characterized as a securities "trader," it is clear such a section 166 "businessman" exists, given the proper facts. *Higgins v. Commissioner*, 312 U.S. 212 (1941); *Snyder v. Commissioner*, 295 U.S. 134 (1935); *Commissioner v. Nubar*, 185 F.2d 584 (4th Cir. 1950). By contrast the activity of a mere "invest[or] is not a trade or business." *Whipple v. Commissioner*, 373 U.S. 193, 202 (1963). Neither the code, the regulations, nor the courts have yet provided a precise definition as to when an individual taxpayer's behavior is that of a trader rather than an investor in corporate stocks. According to *Higgins*, a factual analysis in each case is required to determine if a particular taxpayer's securities activities rise to the level of "carrying on a business." 312 U.S. at 217.
>
> It has been ruled, however, that:
>
> > … [A] taxpayer who, for the purpose of making a livelihood, devotes the major portion of his time to speculating on the stock exchange may treat losses thus incurred as having been sustained in the course of a trade or business.… [*Snyder*, 295 U.S. at 139.]
>
> Establishing continuity of investment activity is not enough. The taxpayer must do more than "merely [keep] records and [collect] interest and dividends from his securities, through managerial attention for his investments." *Higgins*, 312 U.S. at 218; *Wilson v. United States*, 179 Ct.Cl. 725, 746, 376 F.2d 280, 293 (1967). In effect, a "trader" is an active investor in that he does not passively accumulate earnings, nor merely oversee his accounts, but manipulates his holdings in an attempt to produce the best possible yield. That is, the trader's profits are derived through the

were long-term investments, was not a trade or business.[1126] A "taxpayer may be a dealer as to some securities and at the same time hold other securities as a trader or investor on his own account and not for resale to customers."[1127]

Moller v. U.S., 721 F.2d 810 (Fed. Cir 1983), explained:[1128]

> … in order to be a trader, a taxpayer's activities must be directed to short-term trading, not the long-term holding of investments, and income must be principally derived from the sale of securities rather than from dividends and interest paid on those securities. In determining whether a taxpayer who manages his own investments is a trader, and thus engaged in a

---

very acts of trading—direct management of purchasing and selling. *Purvis v. Commissioner*, 530 F.2d 1332 (9th Cir. 1976); *Chiang Hsiao Liang*, 23 T.C. 1040 (1955).

Even absent a clear judicial demarcation between trader and investor, it is apparent that plaintiff taxpayer's securities activities place him close to the trader end of the spectrum. Aside from a small annual salary for sitting on the board of an oil-producing company, his entire and substantial income was derived from his trading. He devoted virtually his whole working day to his stock transactions, unlike the taxpayers in *Snyder* and *Wilson*. In contrast to the distant management of a portfolio portrayed in Higgins, judgments regarding purchases and sales were made directly by taxpayer, based on his personal investigation of the assets, operation and management of various corporations. In addition, the sheer quantity of transactions he conducted also supports a reasonable conclusion that this taxpayer's business was trading on his own account.

Defendant urges a narrowing of this issue to consideration of whether taxpayer's activities in regard to the particular stock he held in Central Railroad alone amounted to a "trade or business." While the courts do acknowledge that a trader (and even a "dealer") may hold simultaneously certain shares for investment purposes and others to trade, *e.g.*, *Bradford v. United States*, 195 Ct.Cl. 500, 444 F.2d 1133 (1971), the question here is whether taxpayer was generally "carrying on the business" of trading for his own account. It is concluded that he was.

[1126] *Purvis v. Commissioner*, 530 F.2d 1332 (9th Cir. 1976), noted:

From 1963 to 1968 petitioner engaged in only 75 sales of securities and ten short-term commodities sales. Of these, 31 involved stock which had been held for more than six months. A substantial number involved shares which petitioner admits were held as investments, or which were held for periods exceeding three years, indicating that they were investments.

[1127] *Bradford v. U.S.*, 444 F.2d 1133 (Ct. Cl. 1971).

[1128] The court analyzed the taxpayers' activity:

The Claims Court concluded that taxpayers were investors and not traders because they were primarily interested in the long-term growth potential of their stocks. We agree. Mr. Moller testified that he was looking for long-term growth and the payment of dividends. In addition, the taxpayers did not derive their income from the relatively short-term turnover of stocks, nor did they derive any significant profits through the act of trading. Interest and dividend income was over 98% of taxpayers' gross income for 1976 and 1977, and in 1976 their profit from the sale of securities was only $612, while in 1977 their sales resulted in a loss of $233.

The number of sales transactions made by the taxpayers also leads to the conclusion that they were not traders in securities. In the cases in which taxpayers have been held to be in the business of trading in securities for their own account, the number of their transactions indicated that they were engaged in market transactions on an almost daily basis. See *Levin*, 597 F.2d at 765; *Fuld v. Commissioner*, 139 F.2d 465 (2d Cir. 1943). At most, the Mollers engaged in 83 security purchase transactions and 41 sales transactions in 1976 and 76 purchase and 30 sales transactions in 1977. [footnote omitted]

Moreover, taxpayers did not "endeavor to catch the swings in the daily market movements and profit thereby on a short term basis." *Purvis*, 530 F.2d at 1334. The stocks owned by taxpayers, which they sold during 1976 and 1977, had been held for an average of over 3-1/2 and 8 years, respectively.

The Mollers were investors and not traders.

trade or business, relevant considerations are the taxpayer's investment intent, the nature of the income to be derived from the activity, and the frequency, extent, and regularity of the taxpayer's securities transactions. See *Purvis*, 530 F.2d at 1334.

King v. Commissioner, 89 T.C. 445, 458-459 (1987), explained the differences between traders, dealers, and investors:

> … a primary distinction for Federal tax purposes between a trader and a dealer in securities or commodities is that a dealer does not hold securities or commodities as capital assets if held in connection with his trade or business, where as a trader holds securities or commodities as capital assets whether or not such assets are held in connection with his trade or business.[5] A dealer falls within an exception to capital asset treatment because he deals in property held primarily for sale to customers in the ordinary course of his trade or business. A trader, on the other hand, does not have customers and is therefore not considered to fall within an exception to capital asset treatment.
>
> [5] The same capital treatment to which traders in securities are subject has also been held applicable to traders of commodity futures. *Commissioner v. Covington*, 120 F.2d 768 (5th Cir. 1941), *affg.* on this issue 42 B.T.A. 601 (1940); *Vickers v. Commissioner*, 80 T.C. 394, 405 (1983).
>
> The distinction between a "trader" and an "investor" also turns on the nature of the activity in which the taxpayer is involved. A trader seeks profit from short-term market swings and receives income principally from selling on an exchange rather than from dividends, interest, or long-term appreciation. *Groetzinger v. Commissioner*, 771 F.2d 269, 274-275 (7th Cir. 1985), *affd.* 480 U.S. __ (1987); *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983). Further, a trader will be deemed to be engaged in a trade or business if his trading is frequent and substantial. *Groetzinger v. Commissioner*, *supra* at 275; *Fuld v. Commissioner*, 139 F.2d 465 (2d Cir. 1943), *affg.* 44 B.T.A. 1268 (1941). An investor, on the other hand, makes purchases for capital appreciation and income, usually without regard to short-term developments that would influence prices on the daily market. *Groetzinger v. Commissioner*, 82 T.C. 793, 801 (1984), *affd.* 771 F.2d 269 (7th Cir. 1985), *affd.* 480 U.S. __ (1987); *Liang v. Commissioner*, 23 T.C. 1040, 1043 (1955). No matter how extensive his activities might be, an investor is never considered to be engaged in a trade or business with respect to his investment activities. *Higgins v. Commissioner*, 312 U.S. 212, 216, 218 (1941); *Groetzinger v. Commissioner*, 771 F.2d at 275.

The issue in *King* was whether interest expense relating to the taxpayer's trading was subject to the investment interest limitations of Code § 163(d) or was business interest. The court reasoned (at 459-460) [footnotes referred to below are in fn [1129]]:

[1129] Here are the footnotes that accompanied the text above:

> [6] We note that in our earlier opinion, relating to petitioner's motion for partial summary judgment, we stated that the parties were in agreement that "petitioner was a dealer in commodities within the meaning of Section 108(f)" of the Tax Reform Act of 1984 (Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630), as amended by sec. 1808(d) of the Tax Reform Act of 1986. Section 108(f), as amended, provides in relevant part "For purposes of this section, the term 'commodities dealer' means any taxpayer who - (1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B)." Sec. 1402(i)(2)(B) defines, for purposes of sec. 1402(i) a commodities dealer as "a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the

Petitioner clearly was in the trade or business of trading commodity futures during the years in issue.[6] Petitioner's trading was frequent and substantial but he traded solely for his own account during the years in issue and neither had customers nor performed services analogous to those performed by a merchant.[7] The parties appear to agree that petitioner was in the trade or business of trading commodities futures.[8]

Based on the foregoing, we determined in our earlier opinion that certain short-term capital losses claimed by petitioner were allowable. Such losses were incurred by a commodities dealer within the meaning of sec. 108(f) (see note 6 supra), in the trading of commodities and were therefore to be treated as incurred in a trade or business for purposes of sec. 108(a). The character of such losses as capital losses, however, is not affected by their treatment as losses incurred in a trade or business for purposes of sec. 108.

King also held that the purchase of gold was part of his trade or business of trading commodities futures, rejecting the IRS' contention that *Higgins* (fns 1118-1119) applied to segregate the purchase of gold from other activity.[1130]

Commodities Futures Trading Commission." A sec. 1256 contract is defined as including "any regulated futures contract." Sec. 1256(b)(1).

Petitioner was a registered member of the CME, a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, and was actively engaged in trading regulated futures contracts. Therefore, pursuant to sec. 108(f), petitioner was a commodities dealer for purposes of sec. 108 of the Tax Reform Act of 1984, as amended by sec. 1808(d) of the Tax Reform Act of 1986. This status as a commodities dealer, however, applies solely for purposes of section 108 and does not, for any other purpose, affect petitioner's status as a trader who is not a dealer. See H. Rept. 99-426, at 911 (1985).

[7] Until 1968, petitioner acted as a broker as well as trading for his own account. At that time, petitioner may have been a dealer with respect to futures contracts, but this is not relevant to the years in issue.

[8] We also note that sec. 108(a) and (b) of the Tax Reform Act of 1984, 98 Stat. 630, as amended by sec. 1808(d) of the Tax Reform Act of 1986, 100 Stat. 2817-2818, provides,

> SEC. 108(a). *General Rule*. For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions—
>
> (1) which are entered into before 1982 and form part of a straddle, and
>
> (2) to which the amendments made by title V of such Act do not apply, any loss from such disposition shall be allowed for the taxable year of the disposition if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business.
>
> (b) *Loss Incurred in a Trade or Business*. For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.

[1130] 89 T.C. at 464-465:

As we have stated, petitioner herein was clearly in the trade or business of trading commodities futures. Petitioner acquired the gold in issue pursuant to delivery on long gold futures contracts which he acquired in the regular course of his business. Petitioner also disposed of the gold pursuant to short gold futures contracts. While petitioner had not regularly held physical commodities for extended periods of time, petitioner did periodically, in the course of his business, take delivery of physical commodities. Further, petitioner took no affirmative action to set apart or distinguish this transaction from other transactions which were entered into in the normal course of his business. These factors strongly suggest that petitioner's gold transaction was part of his trade or business of trading commodity futures.

A bad debt case, *Dagres v. Commissioner*, 136 T.C. 263, 281 (2011),[1131] noted that:[1132]

> Selling one's investment expertise to others is as much a business as selling one's legal expertise or medical expertise.
>
> In cases where business promotion activities are found to rise to the level of a trade or business, a common factor for distinguishing mere investment from conduct of a trade or business has been compensation other than the normal investor's return: "income received directly for his own services rather than indirectly through the corporate enterprise". *Id.* That is, if the taxpayer receives not just a return on his own investment but compensation attributable to his services, then that fact tends to show that he is in a trade or business. Although fee, commission, or other non-investor compensation is a common element, it is not a necessary element, provided the facts support the conclusion that the taxpayer is more than a passive investor. *Farrar v. Commissioner*, T.C. Memo. 1988-385; see also *Deely v. Commissioner*, 73 T.C. at 1093. Notably, in such business promotion cases, the trade-or-business characterization applies even though the taxpayer invests his own funds in, lends funds to, or guarantees the debts of the businesses he promotes. See *Farrar v. Commissioner*, *supra*.

Lender Management, LLC v. Commissioner, T.C. Memo. 2017-246, held that Lender Management, LLC ("Lender Management") carried on a trade or business under Code § 162. Tax years 2010-2012 were at issue. Lender Management reported net losses of $462,505 and $307,760 for tax years 2010 and 2011 and net income of $376,238 and $808,302 for tax years 2012 and 2013, respectively.

> This case is not factually similar to *Higgins* in that the transaction here in issue was integrally related to transactions which were indisputably part of petitioner's trade or business, *i.e.*, the closing of the futures contracts by which the gold was acquired and disposed. In *Higgins*, the only relationship between the taxpayer's investment activities and real estate activities was that they were directed through the same office. *Higgins* does not lead us to the conclusion that the transaction here in issue should be separated out from petitioner's trade or business.
>
> We are not aware of any case which has held that a taxpayer may hold property both as a trader of commodity futures and as an investor in commodities. Past cases have held that a taxpayer may be both a trader and a dealer with respect to securities, but these cases have not dealt with the issue of whether the taxpayer therein was a trader or investor. *Kemon v. Commissioner*, *supra* at 1033; *Carl Marks & Co. v. Commissioner*, 12 T.C. 1196 (1949).

[1131] For more details about the case, see fn 996 in part II.G.3.a.iii Character of Bad Debt.

[1132] This quote followed a discussion contrasting the case from *Whipple* (see fn 1119 and accompanying text):

> However, an activity that would otherwise be a business does not necessarily lose that status because it includes an investment function. Rather, the activity of "promoting, organizing, financing, and/or dealing in corporations
>
> > … for a fee or commission or with the immediate purpose of selling the corporations at a profit in the ordinary course of that business" is a business, *Deely v. Commissioner*, 73 T.C. 1081, 1093 (1980) (citing *Whipple v. Commissioner*, 373 U.S. at 202-203), supplemented by T.C. Memo. 1981-229 [¶81,229 PH Memo TC], as is "developing …
>
> corporations as going businesses for sale to customers", *Whipple v. Commissioner*, 373 U.S. at 203. Bankers, investment bankers, financial planners, and stockbrokers all earn fees and commissions for work that includes investing or facilitating the investing of their clients' funds.[22]
>
> [22] *Cf. InverWorld, Inc. v. Commissioner*, T.C. Memo. 1996-301 (holding that the taxpayer was in a trade or business pursuant to section 864(b); distinguishing "cases [that] did not address taxpayers who managed the investments of others").

The court described certain relationships:

> During the tax years in issue Lender Management provided direct management services to three limited liability companies: Murray & Marvin Lender Investments, LLC (M&M), Lenco Investments, LLC (Lenco), and Lotis Equity, LLC (Lotis) (collectively, investment LLCs). Each of the investment LLCs elected to be treated as a partnership for Federal income tax purposes. Lender Management directed the investment and management of assets held by the investment LLCs for the benefit of their owners. The end-level owners with respect to M&M, Lenco, and Lotis were, in each case, all children, grandchildren, or great-grandchildren of Harry.

The court described certain arrangements:

> 1. ***Structure and Purpose***
>
> The investment LLCs were created in 2005 as part of a reorganization of Lender Management. The goals of the 2005 reorganization were to accommodate greater diversification of the managed investments and more flexible asset allocation at the individual investor level. As part of the restructuring Lender Management shifted from a cost-based office model to a profit-based model.
>
> Lender Management engaged a hedge fund specialist to help it restructure its affairs and its managed portfolio using a hedge fund, or "fund of funds", manager model. Pursuant to the restructuring strategy, Lender Management divided its managed portfolio into the three investment LLCs, each formed for the purpose of holding investments in a different class of assets. M&M invested in private equities, Lenco in hedge funds, and Lotis in public equities.[4] From 2005 forward, over one-half of the assets under management were invested in private equity.
>
> [4] Lotis merged into Lenco in 2010 because Lender Management determined that Lenco's hedge fund investments held enough public equities to meet the company's asset diversification goals.
>
> 2. ***Operating Agreements***
>
> Lender Management's operating agreement permitted it, without limitation, to engage in the business of managing the "Lender Family Office" and to provide management services to Lender family members, related entities, and "other third-party nonfamily members." The operating agreements for the investment LLCs designated Lender Management as the sole manager for each entity. Lender Management held the exclusive rights to direct the business and affairs of the investment LLCs.
>
> Lender Management also managed downstream entities in which M&M held a controlling interest. Investors in some of these downstream entities included persons who were not members of the Lender family. It received fees for managing these entities. For the tax years in issue between 12% and 15% of M&M's net investment portfolio consisted of these downstream entities.
>
> Members understood that they could withdraw their investments in the investment LLCs at any time, subject to liquidity constraints, if they became dissatisfied with how the investments were being managed. The operating agreements for Lenco and Lotis

provided that members could withdraw all or a portion of their capital accounts on specified dates of each year or on any other date approved by the manager. The operating agreement for M&M provided that members could withdraw all or a portion of their capital accounts with the consent of the manager in the exercise of the manager's discretion.

B. ***Compensation***

Lender Management received a profits interest in each of the investment LLCs in exchange for the services it provided to the investment LLCs and their members. These profits interests were designated "Class A" interests under the operating agreements for the investment LLCs. The class A interests were structured concurrent with Lender Management's reorganization and its shift to a profit-based office model.

Under the initial terms of the operating agreements, effective August 1, 2005, Lender Management was entitled to receive for its class A interests the following percentages: (1) from Lenco, 1% of net asset value annually, plus 5% of any increase in net asset value from the prior fiscal period; (2) from M&M, 5% of gross receipts annually, plus 2% of any increase in net asset value from the prior fiscal period; and (3) from Lotis, 2% of net asset value annually, plus 5% of net trading profits.[5] Lender Management received income from the class A interests only to the extent that the investment LLCs generated profits. Net asset value was defined as the amount by which the fair market value of the investment LLC's assets exceeded its liabilities.

[5] For Lotis, class A interests were entitled to a share of the adjusted profit as defined in the operating agreement.

As of December 31, 2010, the operating agreements for M&M and Lenco were amended to provide Lender Management with increased profits interests. The class A interests for M&M and Lenco were increased to equal the aggregate of 2.5% of net asset value, plus 25% of the increase in net asset value, annually. Similar to the initial terms of the operating agreements, Lender Management received payments for its class A interests only to the extent that M&M and Lenco generated net profits. The increased profits interests were intended to more closely align Lender Management's goal of maximizing profits with that of its clients and to create greater incentive for Lender Management and its employees to perform successfully as managers of the invested portfolios. During the tax years in issue any payments that Lender Management earned from its profits interests were to be paid separately from the payments that it would otherwise receive as a minority member of each of the investment LLCs.

C. ***Lender Management Services***

During the tax years in issue Lender Management made investment decisions and executed transactions on behalf of the investment LLCs. It operated for the purpose of earning a profit, and its main objective was to earn the highest possible return on assets under management. Lender Management provided individual investors in the investment LLCs with one-on-one investment advisory and financial planning services.

Lender Management employed five employees during each of the tax years in issue. It had a total payroll for its employees of $333,200, $311,233, and $390,554 during the tax years in issue, respectively. For tax year 2011 the payroll included a

$123,249 guaranteed payment to Keith. For tax year 2012 the payroll included a $206,417 guaranteed payment to Keith.

Lender Management's chief investment officer worked about 50 hours a week. The court described his activities:

> As CIO, Keith retained the ultimate authority to make all investment decisions on behalf of Lender Management and the investment LLCs. Most of his time was dedicated to researching and pursuing new investment opportunities and monitoring and managing existing positions. For example, he discovered a company in Israel, and Lender Management owned an interest in and participated in the management of this company.
>
> He reviewed personally approximately 150 private equity and hedge fund proposals per year on behalf of the investment LLCs. He met with and attended presentations of hedge fund managers, private equity managers, and investment bankers. Lender Management is not an active trader, but in a typical year the firm would enter into multiple new private equity deals and make one or two hedge fund trades.
>
> Lender Management arranged annual business meetings, which were for all clients in the investment LLCs. These group meetings were held so that Lender Management could review face-to-face with all of its clients the performance of their investments at least once per year. The location of the annual meeting changed each year so that no single investor was repeatedly inconvenienced by having to travel a long distance. Because of conflicts Keith had difficulty getting all of Lender Management's clients to attend these meetings. He would conduct additional face-to-face meetings with clients who were more interested in the status of their financial investments at times and locations that were convenient for them.
>
> Keith interacted directly with Lender Management's clients. He collected information from and worked with these individuals to understand their cashflow needs and their risk tolerances for investment, and Lender Management engaged in asset allocation based on these and other factors. Lender Management devised and implemented special ventures known as eligible investment options (EIOs), which allowed clients to participate in investments more directly suited to their age and risk tolerance. Keith developed and maintained a number of computer models, including a model that projected the cash needs of individual investors and a model that tracked and forecasted the cashflows associated with M&M's private equity investments.

Lender Management had other employees and outsourced certain management services:

> Lender Management interviewed accounting and investment firms to provide outsourced management services beginning in 2006. It hired Harris myCFO, a division of Harris Bank, which provided both accounting and investment advice. In 2010 two of the principals of Harris myCFO formed their own firm, Pathstone Family Office, LLC (Pathstone), and Lender Management engaged Pathstone on May 6, 2010.[7] During the tax years in issue Pathstone provided Lender Management with accounting and investment advisory services.
>
> [7] Lender Management began the process of terminating its relationship with Harris myCFO in 2009 in anticipation of its move to Pathstone. When discussing outsourced management services received by Lender Management during the tax years in issue we

refer hereinafter to Pathstone, although the record is unclear as to whether Lender Management still engaged Harris myCFO in the early months of 2010.

Pathstone's accounting professionals were based in Atlanta, Georgia. Ms. Flament spoke with the accounting professionals over the phone between three and five times per week, and they exchanged between 50 and 100 emails per week. During the tax years in issue Pathstone prepared Lender Management's partnership tax returns. Pathstone also prepared quarterly financial reports for the investment LLCs.

Keith worked at the same office buildings as Pathstone's investment professionals in Englewood Cliffs, and later Fort Lee, New Jersey. He collaborated with Pathstone's principal investment adviser in selecting new investments for the investment LLCs. He presented Pathstone's advisers with his own research on investment opportunities, and he often received their advice before acting on prospective deals. Pathstone's advisers also presented him with investment opportunities. Keith exercised ultimate authority over the investment LLCs' investments and did not always follow Pathstone's advice. Pathstone did not have the authority to move cash on behalf of Lender Management or the investment LLCs.

The court reviewed the cases discussed above:

Certain activities are not considered trades or businesses. An investor is not, by virtue of his activities undertaken to manage and monitor his own investments, engaged in a trade or business. *Whipple v. Commissioner*, 373 U.S. 193 (1963); *Higgins v. Commissioner*, 312 U.S. at 218. "No matter how large the estate or how continuous or extended the work required may be", overseeing the management of one's own investments is generally[9] regarded as the work of a mere investor. *Higgins v. Commissioner*, 312 U.S. at 218. Expenses incurred by the taxpayer in trading securities or performing other investment-related activities strictly for his own account generally may not be deducted under section 162 as expenses incurred in carrying on a trade or business. See *id.*; *Beals v. Commissioner*, T.C. Memo. 1987-171. The taxpayer's activities as an investor may produce income or profit, but profit from investment is not taken as evidence that the taxpayer is engaged in a trade or business. Any profit so derived arises from the successful conduct of the trade or business of the corporation or other venture in which the taxpayer has taken a stake, rather than from the taxpayer's own activities. *Whipple v. Commissioner*, 373 U.S. at 202.

[9] An exception to the general rule applies when the taxpayer is also an active trader of securities. See *Moller v. United States*, 721 F.2d 810 (Fed. Cir. 1983); *Liang v. Commissioner*, 23 T.C. 1040 (1955). Petitioners do not contend that Lender Management operated as a trader during the tax years in issue.

A common factor distinguishing the conduct of a trade or business from mere investment has been the receipt by the taxpayer of compensation other than the normal investor's return. *Whipple v. Commissioner*, 373 U.S. at 202-203. Compensation other than the normal investor's return is income received by the taxpayer directly for his or her services rather than indirectly through the corporate enterprise. *Id.* At 203. If the taxpayer receives not just a return on his or her own investment but compensation attributable to his or her services provided to others, then that fact tends to show that he or she is in a trade or business. *Dagres v. Commissioner*, 136 T.C. at 281-282. The trade-or-business designation may apply even though the taxpayer invests his or her own funds alongside

> those that are managed for others, provided the facts otherwise support the conclusion that the taxpayer is actively engaged in providing services to others and is not just a passive investor. *Id.* at 282, 285-286.
>
> An activity that would otherwise be a business does not necessarily lose that status because it includes an investment function. *Id.* at 281. Work that includes investing or facilitating the investing of others' funds may qualify as a trade or business. *Id.* In *Dagres* we held that "[s]elling one's investment expertise to others is as much a business as selling one's legal expertise or medical expertise." Id. Investment advisory, financial planning, and other asset management services provided to others may constitute a trade or business. See *id.*

The court discussed the heightened scrutiny of this being a family business:

> Generally transactions within a family group are subjected to heightened scrutiny. *Estate of Bongard v. Commissioner*, 124 T.C. 95, 119 (2005); *Cirelli v. Commissioner*, 82 T.C. 335, 343 (1984). Where a payment is made in the context of a family relationship, we carefully scrutinize the facts to determine whether there was a bona fide business relationship and whether the payment was not made because of the familial relationship. See *Commissioner v. Culbertson*, 337 U.S. 733, 746 (1949); *Martens v. Commissioner*, T.C Memo. 1990-42, *aff'd* without published opinion, 934 F.2d 319 (4th Cir. 1991). In *DiDonato v. Commissioner*, T.C. Memo. 2013-11, we concluded that certain payments between cousin-owned businesses were not deductible. The payments were not deductible because the record did not establish that services were actually rendered.
>
> We find that Lender Management satisfies a review under heightened scrutiny. The end-level investors in the investment LLCs during the tax years in issue were all members of the Lender family. Lender Management's CIO, Keith, is a member of the Lender family. His father Marvin was managing member and 99%-owner of Lender Management in 2010, and Keith occupied the same position in 2011 and 2012. At all relevant times only two members of the Lender family were owners of Lender Management.
>
> Separate from Lender Management, Marvin owned 11.47% of Lenco and 5.84% of M&M in 2010. Keith owned indirectly less than 4% of Lenco and 10% of M&M during the years he served as managing member.
>
> There was no requirement or understanding among members of the Lender family that Lender Management would remain manager of the assets held by the investment LLCs indefinitely. Lender Management's investment choices and related activities were driven by the needs of clients, and its clients were able to withdraw their investments if they became dissatisfied with its services. Investors in Lenco and Lotis were entitled to withdraw their capital interests for any reason at least annually. Although a complete withdrawal from M&M required the manager's approval, we are satisfied on the facts before us that there was a common understanding that Lender Management would grant such approval if any investor became unhappy with how his or her funds were being managed.
>
> Apart from what they received as returns on their respective investments, Lender Management's clients generally earned employment income. For example, Carl worked in sales for a cable communications company. Keith, like Carl, would have benefited from his membership in the investment LLCs during the tax years in issue regardless of whether

> he chose to work for Lender Management. Keith's position compensated him for the services that he provided to Lender Management, and it was his only full-time job during the tax years in issue. As managing member he was highly motivated to excel and to see Lender Management receive the benefit of the class A interests.
>
> Although each investor in the investment LLCs was in some way a member of the Lender family, Lender Management's clients did not act collectively or with a single mindset. Lender Management's clients were geographically dispersed, many did not know each other, and some were in such conflict with others that they refused to attend the same business meetings. Their needs as investors did not necessarily coincide. Lender Management did not simply make investments on behalf of the Lender family group. It provided investment advisory services and managed investments for each of its clients individually, regardless of the clients' relationship to each other or to the managing member of Lender Management.

Contrasting *Higgins*,[1133] the court said:

> Lender Management was not managing its own money. Most of the assets under management were owned by members of the Lender family that had no ownership interest in Lender Management. Lender Management managed investments and did substantially more than keeping records and collecting interest and dividends.

Contrasting *Beals*,[1134] in which the taxpayer managed investments for himself, his wife, and their children, the court noted:

> In that case there was no business relationship. By contrast Lender Management had an obligation to its clients, and it tailored its investment strategy, allocated assets, and performed other related financial services specifically to meet the needs of its clients.

The court concluded:

> There is no dispute that Lender Management provided services. The profits interests were provided in exchange for services and not because Marvin and Keith were part of the Lender family. The Lender family members that participated in the investment LLCs expected Lender Management to provide them with services similar to those of a hedge fund manager. The relationship between Lender Management and the investment LLCs was a business relationship.
>
> Respondent cites no applicable attribution rules that would require us to treat Lender Management or its managing member as owning all of the interests in the investment LLCs. Lender Management carried on its operations in a continuous and businesslike manner for the purpose of earning a profit, and it provided valuable services to clients for compensation. For the tax years in issue Lender Management was carrying on a trade or business for the purpose of section 162.

[1133] See fn 1084 in part II.G.3.i.i.(a) "Trade or Business" Under Code § 162 and text accompanying fn 1119.
[1134] See text accompanying fn 1120.

II.G.3.i.i.(e). Family Office As a Trade or Business

This part II.G.3.i.i.(e) discusses tax issues. Part II.G.3.i.i.(f) Family Office – Securities Law Issues discusses certain regulation of family offices.

Part II.G.3.i.i.(d) Whether Managing Investments Constitutes a Trade or Business teaches:

- Managing one's own investments[1135] (or the investments of one's spouse and children)[1136] does not constitute a trade or business, unless one is a day trader or something similar.[1137]

- Managing another person's investments may constitute a trade or business, whether one's compensation is expressed as a fixed payment or a profits interest.[1138]

Concerned with the unfairness of disallowing deductions for activities designed to generate profit that did not rise to the level of a trade or business,[1139] Congress enacted Code § 212 to provide individuals with an itemized deduction for investment expenses.[1140] Congress even relaxed the rules if the individual could prove that the activity generated a profit in enough years or had sufficient profit motive.[1141]

However, 2017 tax reform disallowed investment expenses through December 31, 2025.[1142] Even when deductible for regular tax, they would not be deductible for alternative minimum tax purposes.[1143]

Taxpayers may try to avoid these limitations by giving the investment manager a profits interest in a partnership through which they invest their taxable assets instead of paying an advisory fee. (The emphasis is on taxable investments, because one cannot deduct expenses incurred in managing tax-exempt investments.)[1144] Favorable precedent includes *Dagres*[1145] and *Lender Management*,[1146] both of which are described (*Lender Management* extensively) in part II.G.3.i.i.(d) Whether Managing Investments Constitutes a Trade or Business.

Subject to IRS attacks on disguised compensation,[1147] deflecting the income to the investment management firm solves the investment partnership's owners' problem, but then one needs to consider the consequences of the investment management firm's expenses. To prevent the investment management firm from having the same problem regarding miscellaneous itemized

---

[1135] See fns 1118-1121, as well as part II.G.3.i.i.(a) "Trade or Business" Under Code § 162, especially fn 1084.
[1136] See text accompanying fns 1120-1121.
[1137] See fns 1122-1132 and the accompanying text.
[1138] See fns 1131-1134 and the accompanying text.
[1139] See fn 1119 in part II.G.3.i.i.(d) Whether Managing Investments Constitutes a Trade or Business.
[1140] See part II.G.3.i.ii Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax, fn 1178 and part II.G.3.i.i.(b) Requirements for Deduction Under Code § 212.
[1141] See part II.G.3.i.i.(c) Hobby Loss Benefits of Code § 183. Despite its pejorative name, Code § 183 is a favorable provision that benefits individuals.
[1142] See Code § 67(g), cited in part II.G.3.i.ii Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.
[1143] See part II.G.3.i.ii Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.
[1144] Code § 265.
[1145] See fns 1131-1132 and the accompanying text.
[1146] See fns 1133-1134 and the accompanying and preceding text, which started shortly after fn 1132.
[1147] See fns 459-463 in part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

deductions, the investment management firm needs to be engaged in a trade or business. As described in part II.G.3.i.i.(a) "Trade or Business" Under Code § 162, this inquiry depends on a variety of circumstances, and whether the investment management firm will be able to deduct the expenses is unpredictable, unless it is owned by an unrelated third party that provides services to a variety of clients. Of course, if the investment management firm is owned by third parties and one errs on the side of a higher profits interest (so that the firm can pay its expenses), then one risks overpaying for the services.

The investment management agreement would be annually renewable, as would be the level of profits interest. The structure that makes the most sense to me varies from the cases described above. I envision a two-tier profits interest, structured as follows before the year in which the services are provided:

- The base would relate to annual operating income, excluding gain and loss from the sale of investments. The target fee would be divided by the estimated operating income to determine the percentage of operating income to be paid for the coming year.

- The parties would set targets for realized gains on all investments and unrealized gains on readily marketable investments, and the investment management firm would receive a portion of realized gains on investments based on meeting those targets.

Issuing a pure profits interest is a nontaxable event,[1148] presumably because the holder will be earning income each year as profits are received. The structure described above distributes profits to all parties out of the same pool. However, it may be desirable to distribute profits in tiers, each of which has different allocations; this is called a preferred profits interest.[1149]

If there is risk that the investment management firm may not be able to deduct its expenses, consider using a C corporation for its choice of entity. A C corporation's federal tax rate is 21%, compared to 23.8% for qualified dividends and long-term capital gains and 40.8% for other ordinary income paid to an individual in the highest federal income tax bracket. Its deductions for state income tax are not limited. Furthermore, when a C corporation receives dividends from a domestic corporation, it can exclude at least 50% of them from income. For details, see part II.E.1.g Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation. A C corporation is also more likely than an individual to be able to deduct investment expenses under Code § 162.[1150]

I'm not a fan of C corporations, because double tax generally will apply, when the earnings come out, sooner or later, making them more expensive in the long-run (depending on the time value of money) than pass-through entities. See part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities. However, if the investment management firm is spending its income on providing investment management services, then it might not accumulate much income to distribute.

Thus, a C corporation offers reduced income tax rates on investment income and deduction of none, part, or all of the investment management expenses.

[1148] See part II.M.4.f Issuing a Profits Interest to a Service Provider.
[1149] See generally part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.
[1150] See text accompanying fn 1092 in part II.G.3.i.i.(a) "Trade or Business" Under Code § 162.

Now for some caveats:

If the investment management firm is owned by family members who also own the investment partnership but is not owned in the same proportion as the investment partnership, an unexpected gift may be deemed to have been made.[1151] I expect this gift to be minimal, because the profits interest is annually renewable, but calculations under the regulations under Code § 2701 may generate gifts beyond reasonable expectations.

Furthermore, accounting for investment partnerships can be complex. A partnership needs to account for built-in gain and loss not only with respect to assets contributed to the partnership but also for assets that the partnership owns when partners come and go. See part II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships. Also, contributions of cash within two years before or after a distribution of property raises issues described in part II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner, and contributions of property within two years before or after a distributions of cash raises issues described in part II.M.3.e Exception: Disguised Sale Rules.

Given all of the issues described in this part II.G.3.i.i.(e), one might not even consider this structure unless annual investment management fees exceed $50,000.

II.G.3.i.i.(f). Family Office – Securities Law Issues

I am not a securities law expert. Below is a description of the "family office" exemption from registration under the Investment Advisers Act of 1940. The Securities & Exchange Commission (SEC) explained:[1152]

> The failure of a family office to be able to meet the conditions of the rule will not preclude the office from providing advisory services to family members either collectively or individually. Rather, the family office will need to register under the Advisers Act (unless another exemption is available) or seek an exemptive order from the Commission. A number of family offices currently are registered under the Advisers Act.

A "family office," as defined in 17 C.F.R. § 275.202(a)(11)(G)-1, is not considered an "investment adviser" for purpose of the Investment Advisers Act of 1940.[1153] Certain pre-2010 persons are automatically considered "family offices" under this rule.[1154] Being excluded from the definition of

---

[1151] See part III.B.7.c.ii Profits Interest in a Partnership in Which Transferor and Applicable Family Members Initially Hold Only a Profits Interest, which is part of part III.B.7.c Code § 2701 Interaction with Income Tax Planning and informed by part III.B.7.b Code § 2701 Overview.

[1152] Part II of RIN 3235-AK66, which is SEC Release No. IA-3220; File No. S7-25-10.

[1153] 17 C.F.R. § 275.202(a)(11)(G)-1(a).

[1154] 17 C.F.R. § 275.202(a)(11)(G)-1(c) provides:

> *Grandfathering*. A family office as defined in paragraph (a) of this section shall not exclude any person, who was not registered or required to be registered under the Act on January 1, 2010, solely because such person provides investment advice to, and was engaged before January 1, 2010 in providing investment advice to:
>
> (1) Natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who have invested with the family office before January 1, 2010 and are accredited investors, as defined in Regulation D under the Securities Act of 1933;
> (2) Any company owned exclusively and controlled by one or more family members; or
> (3) Any investment adviser registered under the Act that provides investment advice to the family office and who identifies investment opportunities to the family office, and invests in such

an "investment adviser" for purpose of the Investment Advisers Act of 1940 precludes state regulation.[1155]

Otherwise, for purposes of the family office exclusion:[1156]

> A family office is a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) that:
>
> (1) Has no clients other than family clients;[1157] provided that if a person that is not a family client becomes a client of the family office as a result of the death of a family

---

transactions on substantially the same terms as the family office invests, but does not invest in other funds advised by the family office, and whose assets as to which the family office directly or indirectly provides investment advice represents, in the aggregate, not more than 5 percent of the value of the total assets as to which the family office provides investment advice; provided that a family office that would not be a family office but for this paragraph (c) shall be deemed to be an investment adviser for purposes of paragraphs (1), (2) and (4) of section 206 of the Act.

[1155] 15 U.S.C. § 80b-3a(b) provides:

> (1) *In general*. No law of any State or political subdivision thereof requiring the registration, licensing, or qualification as an investment adviser or supervised person of an investment adviser shall apply to any person--
>
> (A) that is registered under section 80b-3 of this title as an investment adviser, or that is a supervised person of such person, except that a State may license, register, or otherwise qualify any investment adviser representative who has a place of business located within that State;
>
> (B) that is not registered under section 80b-3 of this title because that person is excepted from the definition of an investment adviser under section 80b-2(a)(11) of this title; or
>
> (C) that is not registered under section 80b-3 of this title because that person is exempt from registration as provided in subsection (b)(7) of such section, or is a supervised person of such person.
>
> (2) *Limitation*. Nothing in this subsection shall prohibit the securities commission (or any agency or office performing like functions) of any State from investigating and bringing enforcement actions with respect to fraud or deceit against an investment adviser or person associated with an investment adviser.

15 U.S.C. § 80b-2(a)(11) provides:

> "Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include … (G) any family office, as defined by rule, regulation, or order of the Commission, in accordance with the purposes of this subchapter; or (H) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

[1156] 17 C.F.R. § 275.202(a)(11)(G)-1(b).

[1157] [This footnote is not from the quoted material.] For the definition of a "family client," see text accompanying fn 1162.

member[1158] or key employee[1159] or other involuntary transfer from a family member or key employee, that person shall be deemed to be a family client for purposes of this section for one year following the completion of the transfer of legal title to the assets resulting from the involuntary event;

(2) Is wholly owned by family clients and is exclusively controlled[1160] (directly or indirectly) by one or more family members and/or family entities;[1161] and

(3) Does not hold itself out to the public as an investment adviser.

The rule does not explain what a "client" is, but it does define "family client" as:[1162]

(i) Any family member;[1163]

1158 [This footnote is not from the quoted material.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(6) provides:

> Family member means all lineal descendants (including by adoption, stepchildren, foster children, and individuals that were a minor when another family member became a legal guardian of that individual) of a common ancestor (who may be living or deceased), and such lineal descendants' spouses or spousal equivalents; provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members.

1159 [This footnote is not from the quoted material.] For the definition of a "key employee," see text accompanying fn 1167.

1160 [This footnote is not from the quoted material.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(2) provides:

> Control means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company.

Part II of RIN 3235-AK66, which is SEC Release No. IA-3220; File No. S7-25-10.

> Commenters persuaded us to expand who may own the family office from "family members" to "family clients." This change is consistent with the intent behind our proposed language (which contemplated that the family could own the family office indirectly) and more clearly allows family members to structure their ownership of the family office for tax or other reasons. We also agree with suggestions that the rule permit key employees to own a non-controlling stake in the family office to serve as part of an incentive compensation package for key employees. We remain convinced, however, that for our core policy rationale to be fulfilled - that a family office is essentially a family managing its own wealth - the family, directly or indirectly, should control the family office. Accordingly, the final rule provides that while family clients may own the family office, family members and family entities (*i.e.*, their wholly owned companies or family trusts) must control the family office.[109]
>
> 109 We note that, as proposed, we are not limiting the exclusion to a family office that is not operated for the purpose of generating a profit. We also note that some family offices may be structured such that all or a portion of family client investment gains are distributed as dividends from the family office (when family clients own the family office) and that a not-for-profit requirement would preclude this family office structure. We were persuaded by several commenters who cautioned against limiting the exclusion for family offices to those that operate on a not-for-profit basis, arguing that it would be difficult to administer and is unnecessary given the limited clientele that a family office may advise and rely on the exclusion. *See, e.g.*, AICPA Letter; Davis Polk Letter; Kozusko Letter.

1161 [This footnote is not from the quoted material.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(5) provides:

> Family entity means any of the trusts, estates, companies or other entities set forth in paragraphs (d)(4)(v), (vi), (vii), (viii), (ix), or (xi) of this section, but excluding key employees and their trusts from the definition of family client solely for purposes of this definition.

1162 17 C.F.R. § 275.202(a)(11)(G)-1(d)(4).

1163 [This footnote is not from the quoted material.] For the definition of a "family member," see text accompanying fn 1158.

(ii) Any former family member;[1164]

(iii) Any key employee;[1165]

(iv) Any former key employee, provided that upon the end of such individual's employment by the family office, the former key employee shall not receive investment advice from the family office (or invest additional assets with a family office-advised trust, foundation or entity) other than with respect to assets advised (directly or indirectly) by the family office immediately prior to the end of such individual's employment, except that a former key employee shall be permitted to receive investment advice from the family office with respect to additional investments that the former key employee was contractually obligated to make, and that relate to a family-office advised investment existing, in each case prior to the time the person became a former key employee.

(v) Any non-profit organization, charitable foundation, charitable trust (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries[1166] are other family clients and charitable or non-profit organizations), or other charitable organization, in each case for which all the funding such foundation, trust or organization holds came exclusively from one or more other family clients;

(vi) Any estate of a family member, former family member, key employee, or, subject to the condition contained in paragraph (d)(4)(iv) of this section, former key employee;

(vii) Any irrevocable trust in which one or more other family clients are the only current beneficiaries;

(viii) Any irrevocable trust funded exclusively by one or more other family clients in which other family clients and non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations are the only current beneficiaries;

(ix) Any revocable trust of which one or more other family clients are the sole grantor;

(x) Any trust of which: Each trustee or other person authorized to make decisions with respect to the trust is a key employee; and each settlor or other person who has contributed assets to the trust is a key employee or the key employee's current and/or

---

1164 [This footnote is not from the quoted material.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(7) provides:

> Former family member means a spouse, spousal equivalent, or stepchild that was a family member but is no longer a family member due to a divorce or other similar event.

1165 [This footnote is not from the quoted material.] For the definition of a "key employee," see text accompanying fn 1167.

1166 [This footnote is not from the quoted material.] Part II.A.1.c of RIN 3235-AK66, which is SEC Release No. IA-3220; File No. S7-25-10, explains:

> As suggested by commenters, the final rule disregards contingent beneficiaries of trusts, which commenters explained are often named in the event that all family members are deceased to prevent the trust from distributing assets to distant relatives or escheating to the state.[51] If the contingent beneficiary later becomes an actual beneficiary and is not a permitted current beneficiary of a family trust under the exclusion (such as a family friend), the rule's provisions concerning involuntary transfers allow for an orderly transition of investment advice regarding those assets away from the family office.
>
> 51 *See, e.g.*, Comment Letter of Arnold & Porter LLP (Nov. 11, 2010); Bessemer Letter.

former spouse or spousal equivalent who, at the time of contribution, holds a joint, community property, or other similar shared ownership interest with the key employee; or

(xi) Any company wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more other family clients; provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of "investment company" under the Investment Company Act of 1940.

The definition of "key employee" has a few components:[1167]

- A "natural person," including "any key employee's spouse or spouse equivalent[1168] who holds a joint, community property, or other similar shared ownership interest with that key employee."

- Who either:[1169]

  - Is "an executive officer,[1170] director, trustee, general partner, or person serving in a similar capacity of the family office or its affiliated family office,"[1171] or

---

[1167] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(8).

[1168] [This footnote was not in the quote.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(9) provides:

> Spousal equivalent means a cohabitant occupying a relationship generally equivalent to that of a spouse.

[1169] I wasn't quite sure of this breakdown the way that 17 C.F.R. § 275.202(a)(11)(G)-1(d)(8) reads. However, part II.A.1.f of RIN 3235-AK66, which is SEC Release No. IA-3220; File No. S7-25-10, provides:

> The final rule treats certain key employees of the family office, their estates, and certain entities through which key employees may invest as family clients so that they may receive investment advice from, and participate in investment opportunities provided by, the family office. More specifically, the final rule permits the family office to provide investment advice to any natural person (including any key employee's spouse or spousal equivalent who holds a joint, community property or other similar shared ownership interest with that key employee) who is (i) an executive officer, director, trustee, general partner, or person serving in a similar capacity at the family office or its affiliated family office or (ii) any other employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial, or administrative functions) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office or affiliated family office, provided that such employee has been performing such functions or duties for or on behalf of the family office or affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least twelve months.[79] The final rule also permits the family office to advise certain trusts of key employees, as further described below. Finally, in addition to receiving direct advice from the family office, key employees (because they are "family clients") may indirectly receive investment advice through the family office by their investment in family office-advised private funds, charitable organizations, and other family entities, as described in previous sections of this Release.
>
> [79] Rule 202(a)(11)(G)-1(d)(8).

[1170] [This footnote was not in the quote.] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(3) provides:

> Executive officer means the president, any vice president in charge of a principal business unit, division or function (such as administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the family office.

[1171] 17 C.F.R. § 275.202(a)(11)(G)-1(d)(1) provides:

- o Is an "employee of the family office or its affiliated family office[1172] (other than an employee performing solely clerical, secretarial, or administrative functions with regard to the family office) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office or affiliated family office, provided that such employee has been performing such functions and duties for or on behalf of the family office or affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months."

II.G.3.i.ii. Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax

For "itemized deductions," various limitations apply for regular tax and for alternative minimum tax. "Itemized deductions" are those not allowed in determining an adjusted gross income.[1173]

Deductions allowed in determining adjusted gross income that might be business expenses or incurred for the production of income include the following:

- "Deductions … attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee."[1174]

- Certain deductions that are reimbursed by an employer or are incurred by certain performing artists, governmental officials, elementary and secondary school teachers, or military reservists.[1175]

- Losses from the sale or exchange of property under Code §§ 161-199.[1176]

- The deductions allowed by Code §§ 161-199, by Code § 212,[1177] and by Code § 611 (relating to depletion) which are attributable to property held for the production of rents or royalties.[1178]

Affiliated family office means a family office wholly owned by family clients of another family office and that is controlled (directly or indirectly) by one or more family members of such other family office and/or family entities affiliated with such other family office and has no clients other than family clients of such other family office.

For the definition of a "family entity," see fn 1161.

[1172] See fn 1171.

[1173] Code § 63(b).

[1174] Code § 62(a)(1). This includes unreimbursed business expenses as a partner. *Cristo v. Commissioner*, T.C. Memo. 2017-239 (managing member who owned 95% of an LLC.) It also includes expenses incurred by an individual taxpayer in preparing that portion of the taxpayer's return that relates to the taxpayer's business as a sole proprietor (such as profit or loss from business (Schedule C), income or loss from rentals or royalties (Part I of Schedule E, Supplemental Income and Loss), or farm income and expenses (Schedule F)), and expenses incurred in resolving asserted tax deficiencies relating to the taxpayer's business as a sole proprietor. Rev. Rul. 92-29.

[1175] Code § 62(a)(2).

[1176] Code § 62(a)(3).

[1177] See part II.G.3.i.i.(b) Requirements for Deduction Under Code § 212.

[1178] Code § 62(a)(4).

- In the case of a life tenant of property, or an income beneficiary of property held in trust, or an heir, legatee, or devisee of an estate, the deduction for depreciation allowed by Code § 167 and the deduction allowed by Code § 611 (depletion).[1179]

- Certain contributions to qualified retirement plans[1180] or IRAs.[1181]

Code § 63(b), (e)(1) disallows an individual's itemized deductions if the individual takes the "standard deduction."

Code § 67(a) reduces an individual's "miscellaneous itemized deductions" by 2% of the adjusted gross income, but Code § 67(g) disallows these deductions entirely for an individual for any taxable year beginning after December 31, 2017 and before January 1, 2026. Code § 67(b) defines "miscellaneous itemized deductions" as itemized deductions other than:

(1) the deduction under section 163 (relating to interest),

(2) the deduction under section 164 (relating to taxes),

(3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),

(4) the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose),

(5) the deduction under section 213 (relating to medical, dental, etc., expenses),

(6) any deduction allowable for impairment-related work expenses,

(7) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),

(8) any deduction allowable in connection with personal property used in a short sale,

(9) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),

(10) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),

(11) the deduction under section 171 (relating to deduction for amortizable bond premium), and

(12) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

[1179] Code § 62(a)(5).

[1180] Code § 62(a)(6), referring to the Code § 404 deduction allowed to self-employed individuals under Code § 401(c)(1).

[1181] Code § 62(a)(7), referring to Code § 219 IRA deductions.

For any taxable year beginning after December 31, 2017 and before January 1, 2026, Code § 164(b)(6) limits an individual's deductions for state taxes to $10,000 ($5,000 for individuals who are married filing separately), but it does not apply this limit to property taxes attributable to Code § 212 trade or business (which generally would be rental real estate, if it is a trade or business).[1182] Charitable contributions that generate state tax credits are not reduced by the state tax credits that are awarded[1183] and should be considered by those who are charitably inclined as a way to pay state income taxes outside of the scope of the Code § 164(b)(6) limitation.

Among the items the alternative minimum tax disallows for noncorporate taxpayers are deductions for the following under Code § 56(b)(1)(A):

(i) for any miscellaneous itemized deduction (as defined in section 67(b)), or

(ii) for any taxes described in paragraph (1), (2), or (3) of section 164(a) or clause (ii) of section 164(b)(5)(A).

To work around the Code § 67(g) suspension of the deduction for investment expenses characterized as miscellaneous itemized deductions and the unfavorable AMT treatment after the suspension ends, see part II.G.3.i.i.(e) Family Office As a Trade or Business.

II.G.3.i.iii. Code § 172 Net Operating Loss Deduction

If net losses from business activities cause a taxpayer to have a negative taxable income, Code § 172 may allow a taxpayer to deduct a net operating loss (NOL).

2017 tax reform eliminated the NOL carryback and now provides an unlimited NOL carryforward.[1184]

However, an NOL may not offset more than 80% of taxable income.[1185]

An individual's or trust's Code § 199A deduction for qualified business income is not allowable in calculating the use of an NOL.[1186]

II.G.3.i.iv. Code § 267 Disallowance of Related-Party Deductions or Losses

Code § 267(a) disallows certain related-party deductions or losses.[1187]

1182 For more details about my comment on real estate as trade or business, see part II.E.1.e Whether Real Estate Qualifies As a Trade or Business.
1183 CCA 201105010.
1184 Code § 172(a), (b).
1185 Code § 172(a)(2).
1186 See fn 657 in part II.E.1.c.i.(b) Other Effects of Code § 199A Deduction.
1187 Code § 267(a) provides:

(1) *Deduction for losses disallowed*. No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). The preceding sentence shall not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.

(2) *Matching of deduction and payee income item in the case of expenses and interest*. If—

(A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and

Code § 267(b) applies the following relationships for subsection (a):

(1) Members of a family, as defined in subsection (c)(4);

(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(3) Two corporations which are members of the same controlled group (as defined in subsection (f));

(4) A grantor and a fiduciary of any trust;

(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

(6) A fiduciary of a trust and a beneficiary of such trust;

(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

(B) at the close of the taxable year of the taxpayer for which (but for this paragraph) the amount would be deductible under this chapter, both the taxpayer and the person to whom the payment is to be made are persons specified in any of the paragraphs of subsection (b),

then any deduction allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made (or, if later, as of the day on which it would be so allowable but for this paragraph). For purposes of this paragraph, in the case of a personal service corporation (within the meaning of section 441(i)(2)), such corporation and any employee-owner (within the meaning of section 269A(b)(2), as modified by section 441(i)(2)) shall be treated as persons specified in subsection (b).

(3) *Payments to foreign persons*.

(A) *In general*. The Secretary shall by regulations apply the matching principle of paragraph (2) in cases in which the person to whom the payment is to be made is not a United States person.

(B) *Special rule for certain foreign entities*.

(i) *In general*. Notwithstanding subparagraph (A), in the case of any item payable to a controlled foreign corporation (as defined in section 957) or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the payor with respect to such amount for any taxable year before the taxable year in which paid only to the extent that an amount attributable to such item is includible (determined without regard to properly allocable deductions and qualified deficits under section 952(c)(1)(B)) during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.

(ii) *Secretarial authority*. The Secretary may by regulation exempt transactions from the application of clause (i), including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged and in which the payment of the accrued amounts occurs within 8½ months after accrual or within such other period as the Secretary may prescribe.

(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;

(10) A corporation and a partnership if the same persons own—

(A) more than 50 percent in value of the outstanding stock of the corporation, and

(B) more than 50 percent of the capital interest, or the profits interest, in the partnership;

(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;

(12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

Grantor trusts are disregarded from their deemed owners for this purpose. See CCA 201343021.[1188]

Code § 267(c) applies the following rules in determining the ownership of stock subsection (b):

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

[1188] See fn 5519 in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation.

II.G.4. Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation

II.G.4.a. Code 179 Expense

Subject to certain limitations, a taxpayer may expense (instead of capitalizing)[1189] $1,000,000[1190] or so[1191] of qualifying property each year.

Generally, qualifying property includes certain tangible property [1192] or certain computer software,[1193] which is Code § 1245 property[1194] and is acquired by purchase for use in the active conduct of a trade or business.[1195]

However, a nongrantor trust cannot take Code § 179 expense,[1196] which is a little awkward when it holds S corporation stock.[1197]

Special rules apply to changes in interests in partnerships.[1198]

Although Code § 179 expensing may be attractive, its limitations make one want to look first to bonus depreciation.

II.G.4.b. Bonus Depreciation

Code § 168(k) bonus depreciation had been a nice complement to Code § 179 depreciation, but 2017 tax reform has made it perhaps the first choice for many taxpayers.

Bonus depreciation is a component of depreciation that provides an up-front deduction of part of qualified property and applies regular depreciation for the remaining adjusted basis in the property.[1199]

First, we will look at how powerful it is, then we'll see what property qualifies.

1189 Code § 179(a).
1190 Code § 179(b)(1).
1191 Code § 179(b)(6) provides for post-2018 increases for inflation.
1192 To which Code § 168 applies.
1193 As defined in Code § 197(e)(3)(B) and which is described in Code § 197(e)(3)(A)(i) and to which Code § 167 applies.
1194 As defined in Code § 1245(a)(3).
1195 Code § 179(d)(1), which also expressly excludes property described in Code § 50(b) (other than Code § 50(b)(2)). Generally, Code § 50(b) refers to property used (1) predominantly outside the United States, (2) predominantly to furnish lodging or in connection with the furnishing of lodging, (3) by certain tax-exempt organizations, or (4) by governmental units or foreign persons or entities.
1196 See part II.J.11.a.i Code § 179 Disallowance for Estate or Nongrantor Trust.
1197 See part II.P.1.a.ii Allocations of Income in S corporations.
1198 See part III.B.2.j.iii.(e) Allocation of Specific Items, especially fn. 5869.
1199 Code § 168(k)(1) provides:

> *Additional allowance*. In the case of any qualified property—
>
> (A) the depreciation deduction provided by section 167(a) for the taxable year in which such property is placed in service shall include an allowance equal to the applicable percentage of the adjusted basis of the qualified property, and
>
> (B) the adjusted basis of the qualified property shall be reduced by the amount of such deduction before computing the amount otherwise allowable as a depreciation deduction under this chapter for such taxable year and any subsequent taxable year.

Code § 168(k)(6) provides bonus depreciation for qualified property as follows:

(A) *In general*. Except as otherwise provided in this paragraph, the term "applicable percentage" means-

(i) in the case of property placed in service after September 27, 2017, and before January 1, 2023, 100 percent,

(ii) in the case of property placed in service after December 31, 2022, and before January 1, 2024, 80 percent,

(iii) in the case of property placed in service after December 31, 2023, and before January 1, 2025, 60 percent,

(iv) in the case of property placed in service after December 31, 2024, and before January 1, 2026, 40 percent, and

(v) in the case of property placed in service after December 31, 2025, and before January 1, 2027, 20 percent.

(B) *Rule for property with longer 20 production periods*. In the case of property described in subparagraph (B) or (C) of paragraph (2),[1200] the term "applicable percentage" means-

[1200] This is my footnote and not the statute's. Code § 168(k)(2)(B), (C) provide:

(B) Certain property having longer production periods treated as qualified property.

(i) *In general*. The term "qualified property" includes any property if such property-

(I) meets the requirements of clauses (i) and (ii) of subparagraph (A),

(II) is placed in service by the taxpayer before January 1, 2028,

(III) is acquired by the taxpayer (or acquired pursuant to a written contract entered into) before January 1, 2027,

(IV) has a recovery period of at least 10 years or is transportation property,

(V) is subject to section 263A, and

(VI) meets the requirements of clause (iii) of section 263A(f)(1)(B) (determined as if such clause also applies to property which has a long useful life (within the meaning of section 263A(f))).

(ii) *Only pre-January 1, 2027 basis eligible for additional allowance*. In the case of property which is qualified property solely by reason of clause (i) , paragraph (1) shall apply only to the extent of the adjusted basis thereof attributable to manufacture, construction, or production before January 1, 2027.

(iii) Transportation property. For purposes of this subparagraph, the term "transportation property" means tangible personal property used in the trade or business of transporting persons or property.

(iv) *Application of subparagraph*. This subparagraph shall not apply to any property which is described in subparagraph (C).

(C) *Certain aircraft*. The term "qualified property" includes property-

(i) which meets the requirements of subparagraph (A)(ii) and subclauses (II) and (III) of subparagraph (B)(i),

(ii) which is an aircraft which is not a transportation property (as defined in subparagraph (B)(iii)) other than for agricultural or firefighting purposes,

(iii) which is purchased and on which such purchaser, at the time of the contract for purchase, has made a nonrefundable deposit of the lesser of-

(i) in the case of property placed in service after September 27, 2017, and before January 1, 2024, 100 percent,

(ii) in the case of property placed in service after December 31, 2023, and before January 1, 2025, 80 percent,

(iii) in the case of property placed in service after December 31, 2024, and before January 1, 2026, 60 percent,

(iv) in the case of property placed in service after December 31, 2025, and before January 1, 2027, 40 percent, and

(v) in the case of property placed in service after December 31, 2026, and before January 1, 2028, 20 percent.

(C) *Rule for plants bearing fruits and nuts*. In the case of a specified plant described in paragraph (5), the term 'applicable percentage means-

(i) in the case of a plant which is planted or grafted after September 27, 2017, and before January 1, 2023, 100 percent,

(ii) in the case of a plant which is planted or grafted after December 31, 2022, and before January 1, 2024, 80 percent,

(iii) in the case of a plant which is planted or grafted after December 31, 2023, and before January 1, 2025, 60 percent,

(iv) in the case of a plant which is planted or grafted after December 31, 2024, and before January 1, 2026, 40 percent, and

(v) in the case of a plant which is planted or grafted after December 31, 2025, and before January 1, 2027, 20 percent.

Code § 168(k)(2)(A) defines "qualified property" to be property:

(i) [intentionally blank in statute]

(I) to which this section applies which has a recovery period of 20 years or less,

(II) which is computer software (as defined in section 167(f)(1)(B)) for which a deduction is allowable under section 167(a) without regard to this subsection,

(III) which is water utility property, or

(I) 10 percent of the cost, or
(II) $100,000, and
(iv) which has-
(I) an estimated production period exceeding 4 months, and
(II) a cost exceeding $200,000.

(IV) which is a qualified film or television production (as defined in subsection (d) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (g) of such section or this subsection, or

(V) which is a qualified live theatrical production (as defined in subsection (e) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (g) of such section or this subsection,

(ii) the original use of which begins with the taxpayer or the acquisition of which by the taxpayer meets the requirements of clause (ii) of subparagraph (E),[1201] and

(iii) which is placed in service by the taxpayer before January 1, 2027.

"Qualified property" does not include[1202] certain property used in the energy industry[1203] or property that is financed by floor plan financing indebtedness that received a special business interest deduction.[1204]

A taxpayer may elect out of Code § 168(k) bonus depreciation.[1205] If the taxpayer places property in service the first taxable year ending after September 27, 2017, the taxpayer may elect to use 50% as the applicable percentage.[1206]

II.G.4.c. Cost Segregation Studies to Accelerate Depreciation

It is not uncommon for taxpayers to separate a building's cost into tangible property with a shorter useful life and the building with a longer life.

Note that doing so would shorten the period during which the property's unadjusted basis may be used to satisfy certain limits on the Code § 199A deduction for qualified business income.[1207]

[1201] This footnote is not in the statute. Code § 168(k)(2)(E)(ii) provides:

Acquisition requirements. An acquisition of property meets the requirements of this clause if-

(I) such property was not used by the taxpayer at any time prior to such acquisition, and

(II) the acquisition of such property meets the requirements of paragraphs (2)(A), (2)(B), (2)(C), and (3) of section 179(d).

[1202] Code § 168(k)(9).

[1203] Code § 168(k)(9)(A) refers to "any property which is primarily used in a trade or business described in clause (iv) of section 163(j)(7)(A)." See text accompanying fn 1511 in part II.G.19.a Limitations on Deducting Business Interest Expense.

[1204] Code § 168(k)(9)(B) refers to "any property used in a trade or business that has had floor plan financing indebtedness (as defined in paragraph (9) of section 163(j)), if the floor plan financing interest related to such indebtedness was taken into account under paragraph (1)(C) of such section." See text accompanying fns 1521-1523 in part II.G.19.a Limitations on Deducting Business Interest Expense.

[1205] Code § 168(k)(7).

[1206] Code § 168(k)(10).

[1207] See part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income, especially part II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A.

Query whether that should even be a factor for a deduction that is scheduled to expire after December 31, 2025.[1208]

II.G.19. Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense

II.G.19.a. Limitations on Deducting Business Interest Expense

Although Code § 163(a) authorizes deducting "all interest paid or accrued within the taxable year on indebtedness," other parts of Code § 163 deviate from that general rule. Furthermore, loss limitations elsewhere in the Code may apply.[1506]

Among the many limitations within Code § 163 are:

- Deductions for investment interest cannot exceed the taxpayer's net investment income, all as described in Code § 163(d); "net investment income" here is very different in scope than the idea in part II.I 3.8% Tax on Excess Net Investment Income (NII).

- Personal interest is not deductible, except for qualified residence interest. Code § 163(h).

- Business interest deduction limitations under Code § 163(j) were greatly expanded to need to be considered by all taxpayers incurring interest expense.

For taxable years beginning after December 31, 2017, Code § 163(j)(1) provides:

> *In general*. The amount allowed as a deduction under this chapter for any taxable year for business interest shall not exceed the sum of-
>
> > (A) the business interest income of such taxpayer for such taxable year,
> >
> > (B) 30 percent of the adjusted taxable income of such taxpayer for such taxable year, plus
> >
> > (C) the floor plan financing interest of such taxpayer for such taxable year.
>
> The amount determined under subparagraph (B) shall not be less than zero.

"Business interest" means "any interest paid or accrued on indebtedness properly allocable to a trade or business."[1507] It does not include any investment interest under Code § 163(d).[1508]

After looking at carve-outs from what is a "trade or business," we will look at each element of the items that add up to the overall limitation that applies to those businesses that are not carved out.

[1208] Code § 199A(i), discussed in part II.E.1.c Code § 199A Pass-Through Deduction for Qualified Business Income.

[1506] For example, see parts II.G.3.c Basis Limitations for Deducting Partnership and S corporation Losses, II.G.3.f Passive Loss Limitations (referring to part II.K Passive Loss Rules), and II.G.3.g At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities).

[1507] Code § 163(j)(5).

[1508] Code § 163(j)(5).

After that, we will look at carryforwards of disallowed interest. Then, we wrap up with the treatment accorded partnerships.

First, small businesses are not subject to this rule.[1509] The business' average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes the taxable year cannot exceed $25,000,000, indexed for inflation, with related businesses aggregated and various other qualifications.[1510]

In applying this rule, "trade or business" does not include:[1511]

(i) the trade or business of performing services as an employee,

(ii) any electing real property trade or business,

(iii) any electing farming business, or

(iv) the trade or business of the furnishing or sale of-

(I) electrical energy, water, or sewage disposal services,

(II) gas or steam through a local distribution system, or

(III) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.

As used above, an "electing real property trade or business" is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business that elects treatment as such.[1512] Any election needs to follow IRS rules regarding timing and manner and is irrevocable.[1513] An electing

[1509] Code § 163(j)(3) provides:

> *Exemption for certain small businesses*. In the case of any taxpayer (other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)) which meets the gross receipts test of section 448(c) for any taxable year, paragraph (1) shall not apply to such taxpayer for such taxable year. In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test of section 448(c) shall be applied in the same manner as if such taxpayer were a corporation or partnership.

[1510] Code § 448(c).

[1511] Code § 163(j)(7)(A).

[1512] Code § 163(j)(7)(B). The list of businesses is from a cross-reference to Code § 469(c)(7)(C), which is further described in part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception, especially fns 2600-2602 and the accompanying text.

[1513] Code § 163(j)(7)(B). Footnote 697 of the Senate report explains:

> It is intended that any such real property trade or business, including such a trade or business conducted by a corporation or real estate investment trust, be included. Because this description of a real property trade or business refers only to the section 469(c)(7)(C) description, and not to other rules of section 469 (such as the rule of section 469(c)(2) that passive activities include rental

real property trade or business must use slower depreciation.[1514] Also, the items mentioned in clause (iv) are not eligible for bonus depreciation.[1515]

As used above, "electing farming business" means:[1516]

(i) a farming business (as defined in section 263A(e)(4)) which makes an election under this subparagraph, or

(ii) any trade or business of a specified agricultural or horticultural cooperative (as defined in Section 199A(g)(2)) with respect to which the cooperative makes an election under this subparagraph.

Again, any election needs to follow IRS rules regarding timing and manner and is irrevocable.[1517] Also, electing farming business must use slower depreciation.[1518]

Now that we have seen which businesses are carved out, let's review the components of the limitation.

In applying the Code § 163(j)(1)(A) limitation of business interest income: "Business interest income" means "the amount of interest includible in the gross income of the taxpayer for the

---

> activities or the rule of section 469(a) that a passive activity loss is limited under section 469), the other rules of section 469 are not made applicable by this reference. It is further intended that a real property operation or a real property management trade or business includes the operation or management of a lodging facility.

[1514] Code § 163(j)(10)(A), referring to Code § 168(g)(1)(F), which requires certain property to use the Code § 168(g) alternative depreciation system, that property being described in Code § 168(g)(8), which described that property as:

> *Electing real property trade or business*. The property described in this paragraph shall consist of any nonresidential real property, residential rental property, and qualified improvement property held by an electing real property trade or business (as defined in 163(j)(7)(B)).

[1515] See fn. 1203 in part II.G.4.b Bonus Depreciation.

[1516] Code § 163(j)(7)(C). Footnote 698 of the Senate report provides:

> As defined in section 263A(e)(4) (*i.e.*, farming business means the trade or business of farming and includes the trade or business of operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots)). Treas. Reg. sec. 1.263A-4(a)(4) further defines a farming business as a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples of a farming business include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. A farming business also includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products. See Treas. Reg. sec. 1.263A-4(a)(4)(i) and (ii). A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer. See Treas. Reg. sec. 1.263A-4(a)(4)(i).

[1517] Code § 163(j)(7)(C).

[1518] Code § 163(j)(10)(B), referring to Code § 168(g)(1)(G), which requires certain property to use the Code § 168(g) alternative depreciation system, that property being:

> any property with a recovery period of 10 years or more which is held by an electing farming business (as defined in section 163(j)(7)(C)).

taxable year which is properly allocable to a trade or business."[1519] It does not include any investment income under Code § 163(d).[1520]

In applying the Code § 163(j)(1)(B) limitation of 30% of the taxpayer's adjusted taxable income: Code § 163(j)(8) provides that "adjusted taxable income" is the taxpayer's taxable income:

(A) computed without regard to-

(i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business,

(ii) any business interest or business interest income,

(iii) the amount of any net operating loss deduction under section 172,

(iv) the amount of any deduction allowed under Section 199A, and

(v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion, and

(B) computed with such other adjustments as provided by the Secretary.

In applying the Code § 163(j)(1)(C) limitation the taxpayer's floor plan financing interest: "Floor plan financing interest" means "interest paid or accrued on floor plan financing indebtedness."[1521] "Floor plan financing indebtedness" means indebtedness used to finance the acquisition of motor vehicles[1522] held for sale or lease, and secured by the inventory so acquired.[1523]

If business interest exceeds the sum of the items described in Code § 163(j)(1), it is treated as business interest paid or accrued in the succeeding taxable year.[1524]

Notice 2018-28, "Initial Guidance Under Section 163(j) as Applicable to Taxable Years Beginning After December 31, 2017," includes the following:

- Notice § 4 provides that regulations will clarify that that, solely for purposes of Code § 163(j), as amended by the Act, [1525] all interest paid or accrued by a C corporation on indebtedness of that corporation will be business interest within the meaning of Code § 163(j)(5), and all

---

[1519] Code § 163(j)(6).
[1520] Code § 163(j)(6).
[1521] Code § 163(j)(9)(A).
[1522] Code § 163(j)(9)(C) provides:
Motor vehicle. The term "motor vehicle" means a motor vehicle that is any of the following:
(i) Any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road.
(ii) A boat.
(iii) Farm machinery or equipment.
[1523] Code § 163(j)(9)(B).
[1524] Code § 163(j)(2).
[1525] Referring to:
section 163(j) of the Internal Revenue Code (Code), as amended on December 22, 2017, by "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97 (the Act).

interest on indebtedness held by the corporation that is includible in that corporation's gross income will be business interest income within the meaning of Code § 163(j)(6).

- o This protection will not apply to S corporations.

- o Regulations also will address whether and to what extent interest paid, accrued, or includible in gross income by a non-corporate entity such as a partnership in which a C corporation holds an interest is properly characterized, to that corporation, as business interest within the meaning of Code § 163(j)(5) or business interest income within the meaning of Code § 163(j)(6).

- Regulations will clarify that the disallowance and carryforward of a deduction for a C corporation's business interest expense under Code § 163(j), as amended by the Act, will not affect whether or when such business interest expense reduces that corporation's earnings and profits. Notice § 6.

For partnerships:[1526]

> (i) this subsection shall be applied at the partnership level and any deduction for business interest shall be taken into account in determining the non-separately stated taxable income or loss of the partnership, and
>
> (ii) the adjusted taxable income of each partner of such partnership -
>
> > (I) shall be determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of such partnership, and
> >
> > (II) shall be increased by such partner's distributive share of such partnership's excess taxable income.

[1526] Code § 163(j)(4)(A). Further explain a term used here, Code § 163(j)(C) provides:

> *Excess taxable income*. The term "excess taxable income" means, with respect to any partnership, the amount which bears the same ratio to the partnership's adjusted taxable income as-
> (i) the excess (if any) of—
> (I) the amount determined for the partnership under paragraph (1)(B), over
> (II) the amount (if any) by which the business interest of the partnership, reduced by the floor plan financing interest, exceeds the business interest income of the partnership, bears to
> (ii) the amount determined for the partnership under paragraph (1)(B).

The Senate report explained:

> … the limit on the amount allowed as a deduction for business interest is increased by a partner's distributive share of the partnership's excess taxable income. The excess taxable income with respect to any partnership is the amount which bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of 30 percent of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership, reduced by floor plan financing interest, exceeds the business interest income of the partnership bears to 30 percent of the adjusted taxable income of the partnership. This allows a partner of a partnership to deduct additional interest expense the partner may have paid or incurred to the extent the partnership could have deducted more business interest. The Senate amendment requires that excess taxable income be allocated in the same manner as nonseparately stated income and loss.

> For purposes of clause (ii)(II), a partner's distributive share of partnership excess taxable income shall be determined in the same manner as the partner's distributive share of nonseparately stated taxable income or loss of the partnership.

Special rules apply for business interest from a partnership disallowed and carried forward.[1527]

[1527] Code § 163(j)(4)(B), "Special rules for carryforwards," provides:

> (i) *In general*. The amount of any business interest not allowed as a deduction to a partnership for any taxable year by reason of paragraph (1) for any taxable year-
>
> > (I) shall not be treated under paragraph (2) as business interest paid or accrued by the partnership in the succeeding taxable year, and
> >
> > (II) shall, subject to clause (ii), be treated as excess business interest which is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership.
>
> (ii) *Treatment of excess business interest allocated to partners*. If a partner is allocated any excess business interest from a partnership under clause (i) for any taxable year-
>
> > (I) such excess business interest shall be treated as business interest paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, but only to the extent of such excess taxable income, and
> >
> > (II) any portion of such excess business interest remaining after the application of subclause (I) shall, subject to the limitations of subclause (I), be treated as business interest paid or accrued in succeeding taxable years.
>
> For purposes of applying this paragraph, excess taxable income allocated to a partner from a partnership for any taxable year shall not be taken into account under paragraph (1)(A) with respect to any business interest other than excess business interest from the partnership until all such excess business interest for such taxable year and all preceding taxable years has been treated as paid or accrued under clause (ii).
>
> (iii) *Basis adjustments*.
>
> > (I) *In general*. The adjusted basis of a partner in a partnership interest shall be reduced (but not below zero) by the amount of excess business interest allocated to the partner under clause (i)(II).
> >
> > (II) *Special rule for dispositions*. If a partner disposes of a partnership interest, the adjusted basis of the partner in the partnership interest shall be increased immediately before the disposition by the amount of the excess (if any) of the amount of the basis reduction under subclause (I) over the portion of any excess business interest allocated to the partner under clause (i)(II) which has previously been treated under clause (ii) as business interest paid or accrued by the partner. The preceding sentence shall also apply to transfers of the partnership interest (including by reason of death) in a transaction in which gain is not recognized in whole or in part. No deduction shall be allowed to the transferor or transferee under this chapter for any excess business interest resulting in a basis increase under this subclause.

The Senate report explained:

> … any business interest that is not allowed as a deduction to the partnership for the taxable year is allocated to each partner in the same manner as nonseparately stated taxable income or loss of the partnership. The partner may deduct its share of the partnership's excess business interest in any future year, but only against excess taxable income attributed to the partner by the partnership the activities of which gave rise to the excess business interest carryforward. Any such deduction requires a corresponding reduction in excess taxable income. Additionally, when excess business interest is allocated to a partner, the partner's basis in its partnership interest is reduced (but not below zero) by the amount of such allocation, even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. However, the partner's deduction in a future year for interest carried forward does not reduce the partner's basis in the partnership interest. In the event the partner disposes of a partnership interest the basis of which has been so reduced,

S corporations apply similar rules.[1528]

Notice 2018-28, § 7, "Business Interest Income and Floor Plan Financing of Partnerships, Partners, S corporations, and S corporation Shareholders," provides [all one paragraph, but I broke up for ease of reading]:

> Section 163(j)(4) requires that the annual limitation on the deduction for business interest expense be applied at the partnership level and that any deduction for business interest be taken into account in determining the non-separately stated taxable income or loss of the partnership.
>
> Although section 163(j)(4) is applied at the partnership level with respect to the partnership's indebtedness, section 163(j) may also be applied at the partner level in certain circumstances.
>
> The Treasury Department and the IRS intend to issue regulations providing that, for purposes of calculating a partner's annual deduction for business interest under section 163(j)(1), a partner cannot include the partner's share of the partnership's business interest income for the taxable year except to the extent of the partner's share of the excess of (i) the partnership's business interest income over (ii) the partnership's business interest expense (not including floor plan financing).
>
> Additionally, the Treasury Department and the IRS intend to issue regulations providing that a partner cannot include such partner's share of the partnership's floor plan financing interest in determining the partner's annual business interest expense deduction limitation under section 163(j).
>
> Such regulations are intended to prevent the double counting of business interest income and floor plan financing interest for purposes of the deduction afforded by section 163(j) and are consistent with general principles of Chapter 1 of the Code.
>
> Similar rules will apply to any S corporation and its shareholders.

II.G.19.b. When Debt Is Recharacterized as Equity

Sometimes difficulty arises in determining whether payment obligations constitute debt or equity. For example:

- Once a C corporation becomes profitable, its owners cannot extract their original investment without paying tax.[1529]

---

the partner's basis in such interest shall be increased, immediately before such disposition, by the amount that any such basis reductions exceed any amount of excess interest expense that has been treated as paid by the partner (*i.e.*, excess interest expense that has been deducted by the partner against excess taxable income of the same partnership). This special rule does not apply to S corporations and their shareholders.

[1528] Code § 163(j)(4)(D) provides:
Application to S corporations. Rules similar to the rules of subparagraphs (A) and (C) shall apply with respect to any S corporation and its shareholders.

[1529] Code § 316.

- Perhaps one owner contributes capital and the other labor, and they want their entity to be taxed as an S corporation. Because an S corporation cannot have two classes of stock,[1530] they need to characterize as the debt the disproportionate contribution of the owner who contributes the capital.[1531]

- Sometimes a family member will loan to another to start a business without wanting to receive an equity interest.[1532]

Congress authorized the promulgation of regulations to distinguish debt from equity generally,[1533] but the effort proved unsuccessful until 2016,[1534] and what was issued in 2016 focused on foreign entities.[1535] Accordingly, one needs to look to court cases. The Tax Court has described the state of the law as follows:[1536]

> A "singular defined set of standards" capable of being uniformly applied in debt-versus-equity inquiries remains elusive. See *Segel v. Commissioner*, 89 T.C. 816, 826-828 (1987). In differentiating between loans and capital investments, "It is not always easy to tell which are which, for securities can take many forms, and it is hazardous to try to find moulds into which all arrangements can certainly be poured." *Jewel Tea Co., Inc. v. United States*, 90 F.2d 451, 453 (2d Cir. 1937).
>
> Notwithstanding the difficulty in distinguishing between debt instruments and equity instruments, the focus of a debt-versus-equity inquiry generally narrows to whether there

---

1530 See part II.A.2.i Single Class of Stock Rules.

1531 Safe harbors for debt issued by an S corporation are provided by Code § 1361(c)(5) and Reg. § 1.1361-1(l)(5).

1532 For complexity that might arise when families invest in businesses with ownership interests other than straight pro rata ownership, see parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

1533 Code § 385.

1534 T.D. 7920 (1983).

1535 See text accompanying fn. 1551.

1536 *Pepsico Puerto Rico, Inc. v. Commissioner*, T.C. Memo. 2012-269. The quote from the case does not include footnotes. *Rutter v. Commissioner*, T.C. Memo. 2017-174, which was also quoted in fns. 984 and 987 in part II.G.3.a.ii Bad Debt Loss – Must be Bona Fide Debt, summarized the Ninth Circuit's position:

> That court has identified 11 nonexclusive factors to determine whether an advance of funds gives rise to bona fide debt as opposed to an equity investment. See *Hardman*, 827 F.2d at 1411-1412 (citing *Bauer*, 748 F.2d at 1368); *Bell v. Commissioner*, __ F. App'x __, 2017 WL 2963547 (9th Cir. July 12, 2017) (reaffirming 11-factor test), *aff'g* T.C. Memo. 2015-111. Those factors are: (1) the labels on the documents evidencing the alleged indebtedness; (2) the presence or absence of a maturity date; (3) the source of payment; (4) the right of the alleged lender to enforce payment; (5) whether the alleged lender participates in management of the alleged borrower; (6) whether the alleged lender's status is equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) the adequacy of the alleged borrower's capitalization; (9) if the advances are made by shareholders, whether the advances are made ratably to their shareholdings; (10) whether interest is paid out of "dividend money"; and (11) the alleged borrower's ability to obtain loans from outside lenders. *Hardman*, 827 F.2d at 1411-1412.

As mentioned in fn 987, *Povolny Group, Inc. v. Commissioner*, T.C. Memo. 2018-37, had a similar result to *Rutter*, only the lender was a related corporation, so the payment to the related corporation was a dividend from the payor to the shareholder, followed by a contribution to capital from the shareholder to the recipient. For dividend treatment, see fn 3992 in part II.Q.7.a.iv Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303.

was an intent to create a debt with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship. *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968); *Litton Bus. Sys., Inc. v. Commissioner*, 61 T.C. 367, 377 (1973). The key to this determination is primarily the taxpayer's actual intent, evinced by the particular circumstances of the transfer. *A. R. Lantz Co. v. United States*, 424 F.2d 1330, 1333 (9th Cir. 1970); see also *United States v. Uneco, Inc. (In re Uneco, Inc.)*, 532 F.2d at 1209 (in resolving debt-equity questions, both objective and subjective evidence of a taxpayer's intent are considered and given weight in the light of the particular circumstances of a case).

Various Courts of Appeals have identified and considered certain factors in *re Uneco, Inc.)*, 532 F.2d at 1208 (10 factors); *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972) (13 factors);[1537] *Fin Hay Realty Co. v. United States*, 398 F.2d at 697 (16 factors). This Court has articulated a list of 13 factors germane to such an analysis: (1) names or labels given to the instruments; (2) presence or absence of a fixed maturity date; (3) source of payments; (4) right to enforce payments; (5) participation in management as a result of the advances; (6) status of the advances in relation to regular corporate creditors; (7) intent of the parties; (8) identity of interest between creditor and stockholder; (9) "thinness" of capital structure in relation to debt; (10) ability of the corporation to obtain credit from outside sources; (11) use to which advances were put; (12) failure of debtor to repay; and (13) risk involved in making advances. *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980).

Regarding "thinness" of capital structure in relation to debt, the court reasoned:

The purpose of examining the debt-to-equity ratio in characterizing an advance is to determine whether a corporation is so thinly capitalized that repayment would be unlikely. *CMA Consol., Inc. v. Commissioner*, T.C. Memo. 2005-16. In such a circumstance, the advance would be indicative of venture capital rather than a loan. *Bauer v. Commissioner*, 748 F.2d 1365, 1369 (9th Cir. 1984); see also *Hubert Enters., Inc. v. Commissioner*, 125 T.C. 72, 96-97 (2005), *aff'd in part*, *vacated in part* and *remanded on other grounds* 230 Fed. Appx. 526 (6th Cir. 2007).[1538]

[1537] After this case was decided, in affirming a Tax Court decision, *DF Systems, Inc. v. Commissioner*, 112 A.F.T.R.2d 2013-7331 (5th Cir. 12/10/2013), in an unpublished *per curiam* opinion, quoted the *Mixon* factors as follows in finding a lack of bona fide debt:

(1) the names given to the certificates evidencing the indebtedness; (2) [t]he presence or absence of a fixed maturity date; (3) [t]he source of payments; (4) [t]he right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement.

[1538] The court's footnote 75 here stated:

Respondent relies on Fifth Circuit precedent which recognizes that thin capitalization is "very strong evidence" of a capital investment where: (1) the debt-to-equity ratio was initially high; (2) the parties understood that it would likely go higher; and (3) substantial portions of these funds were used for the purchase of capital assets and for meeting expenses needed to commence operations. See *Estate of Mixon*, 464 F.2d at 408 (citing *United States v. Henderson*, 375 F.2d 36, 40

The court then noted how the taxpayer's debt-to-equity ratio compared to the industry's debt-to-equity ratio,[1539] accepting the taxpayer's expert's conclusion that the instrument was equity for U.S. income tax purposes. It also said the law focuses on the willingness of unrelated lenders to make a loan on the same terms or similar terms.[1540]

In another case, "The absence of an unconditional right to demand payment is practically conclusive that an advance is an equity investment rather than a loan for which an advancing taxpayer might be entitled to claim a deduction for a bad debt loss."[1541] "The salient fact of this case is the lack of written evidence demonstrating that there was a valid and enforceable obligation to repay on the part of any of the companies at issue that received advances from Mr. Sensenig through CLCL."[1542] "The three companies at issue were objectively risky debtors, and an unrelated prospective lender would probably have concluded that they would likely be unable to repay any proposed loan."[1543] Although an advance may be properly characterized as

---

> (5th Cir. 1967)). Respondent contends that petitioners cannot satisfy this standard; he submits that, in particular, petitioners have not conclusively demonstrated that PGI used advances to purchase capital assets or to meet expenses needed to commence operations.
>
> However, neither this Court nor the Court of Appeals for the Second Circuit has embraced this more nuanced test for thin capitalization in a debt-versus-equity analysis. See, *e.g.*, *Nassau Lens Co. v. Commissioner*, 308 F.2d 39, 47 (2d Cir. 1962), remanding 35 T.C. 268 (1960); *Kraft Foods Co. v. Commissioner*, 232 F.2d at 127; *Hubert Enters., Inc. v. Commissioner*, 125 T.C. 72, 96 (2005); *Anchor Nat'l Life Ins. Co. v. Commissioner*, 93 T.C. 382, 401 n.16 (1989); *Recklitis v. Commissioner*, 91 T.C. 874, 903-905 (1988). Indeed, the Second Circuit has stated that the isolated debt-to-equity ratio is of "great importance in determining whether an ambiguous instrument is a debt or an equity interest." *Kraft Foods Co. v. Commissioner*, 232 F.2d at 127. Moreover, the other elements in the Fifth Circuit standard are subsumed within our larger inquiry. Accordingly, we approach the "thin capitalization" factor without addressing the additional Fifth Circuit elements.

[1539] Citing *Recklitis v. Commissioner*, 91 T.C. 874, 904 (1988).

[1540] Citing *Segel v. Commissioner*, 89 T.C. at 832, which in turn was citing *Scriptomatic, Inc. v. United States*, 555 F.2d 364, 368 (3d Cir. 1977), and *Fin Hay Realty Co. v. United States*, 398 F.2d at 697).

[1541] *Sensenig v. Commissioner*, T.C. Memo. 2017-1, supporting its statement as follows:

> Secs. 166(a), 385; *Fischer v. United States*, 441 F.Supp. at 37 (*Fin Hay* factor 7); *Scriptomatic Inc. v. United States*, 397 F.Supp. 753, 759 (E.D. Pa. 1975). Thus, courts have found the lack of any formality to be inimical to a contention that a loan exists when there is no provision for interest, no enforceable obligation to repay the funds advanced, no maturity date, and no provision for superiority. *Fischer*, 441 F.Supp. at 37; see also *PepsiCo Puerto Rico, Inc. v. Commissioner*, T.C. Memo. 2012-269 (finding that a definite maturity date for payment, without reservation or condition, is a fundamental characteristic of a debt and that if a financial instrument does not provide any means to ensure payment of interest, it is a strong indication of an equity interest).

Because the case was appealable to the Third Circuit, the case relied heavily on *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3rd Cir. 1968).

[1542] *Sensenig v. Commissioner*, T.C. Memo. 2017-1, supporting its statement as follows:

> (*Fin Hay* factor 11.) There is no written evidence of an enforceable obligation between CLCL and any of the companies at issue, much less a provision for a fixed maturity date or a fixed rate of interest. (*Fin Hay* factors 10 and 13.)

[1543] *Sensenig v. Commissioner*, T.C. Memo. 2017-1, further stated:

> Mr. Sensenig emphasized that, with respect to the advances at issue here, he generated no formal written financial projections and that he did not know what those projections would be. He was satisfied to go with the "gut feel of everybody involved". He considered business plans a waste of time and emphasized the importance of being able to "turn on a dime" on the basis of the facts of the moment, unconstrained by any formal plan. We think an unrelated lender would have considered this approach too cavalier.

a loan, the substance needs to support that conclusion.[1544] The Third Circuit affirmed, rebuking the taxpayers' arguments that loans can be documented other than promissory notes: "The Tax Court noted that the purported loans were not evidenced by promissory notes, but it went on to conclude that, the handful of journal entries aside, the purported loans bore no other objective indicia of loans and the economic realities of the transactions suggested that they were intended as equity investments instead."[1545]

The Second and Fifth Circuits have spoken in a high profile debt vs. equity case involving partnerships in the foreign arena.[1546]

If a debt instrument with a term of more than five years from issuance original issue discount that exceeds the AFR by more than 5%, the excess may be reclassified as a dividend.[1547] Straight debt the term of which was an unknown length between 3 and 9 years was not equity even though its length might be extended to up to 15 years after issuance.[1548]

[1544] *Sensenig v. Commissioner*, T.C. Memo. 2017-1, further stated:

> To the same effect, an advance may have the economic substance of a loan where the funds are advanced with a reasonable expectation of repayment regardless of the success of the venture or are placed at the risk of the business. *Steiner v. Commissioner*, T.C. Memo. 1981-212. Mr. Sensenig's expectation of repayment to CLCL, however, was completely dependent on the future financial success of the companies (which were not successful). See *Scriptomatic, Inc.*, 397 F.Supp. at 764 (holding advances were not debt where repayment "can only be reasonably assured by the chance of profits or from the liquidation of the business"). Repayment of any amount advanced by CLCL to one of the companies was not anticipated until the project had been "completed". Moreover, as to WSC, any expectation of repayment was even more remote, given that CLCL's interest was necessarily subordinate to the interest of WSC's prior mortgage lender. (*Fin Hay* factor 8.)
>
> Also at odds with a conclusion that this was a genuine loan transaction is Mr. Sensenig's not charging any loan origination fees for the advances and his lack of interest in obtaining third-party audits, financial statements, or credit reports for the companies he had chosen to invest in.
>
> CLCL's advances simply do not have the appearance of loans. We believe that no reasonable third-party lender would have extended money to these companies when none of the objective attributes which denote a bona fide loan are present, including a written promise of repayment, a repayment schedule, and security for the loan.
>
> The transfers simply did not give rise to a reasonable expectation or enforceable obligation of repayment. For these reasons, we find that the relationship between Mr. Sensenig and CLCL on the one hand and the three companies on the other was not that of creditor and debtor, and we conclude that Mr. Sensenig's advances of CLCL funds were in substance equity and that the IRS properly disallowed the deduction for tax year 2005.

[1545] *Sensenig v. Commissioner*, 121 A.F.T.R.2d 2018-505 (1/23/2018), citing *Geftman v. Commissioner*, 154 F.3d 61, 68 (3d Cir. 1998). The Supreme Court denied cert. to *Sensenig* 6/4/2018.

[1546] Chiand and Du, "The Debt-Equity Debate in the *Castle Harbour* Case," *Practical Tax Strategies* (April 2013), analyzing *TIFD III-E, Inc. v. United States*, 342 F.Supp.2d 94 (D. Conn. 2004), *rev'd* 459 F.3d 220, 231 (2d Cir. 2006), *on remand* 660 F.Supp.2d 367, 395 (D. Conn. 2009), *rev'd* 666 F.3d 836 (2d Cir. 2012). See fn. 4254 for the Fifth Circuit's analysis. Note that 2015 changes to Code §§ 704(e) and 761(b) would affect the analysis.

[1547] Code § 163(e)(5), (i).

[1548] Letter Ruling 201405005. This ruling involved a stock redemption followed by stock being issued to key employees and included number of representations.

Although payments made within two years of a partner investing in a partnership generally are presumed to be disguised sales, payments of not more than 150% of the AFR are not presumed to be disguised sales.[1549]

See Schneider, "Is Debt vs. Equity Different in a Partnership?" *Taxes* (CCH (3/2015).[1550]

On April 8, 2016, the government issued proposed regulations under Code § 385, providing certain guidelines for recharacterizing debt as equity.[1551] Final regulations were issued October 21, 2016 as T.D. 9790. The final regulations and their preamble are lengthy. In response to comments, the final regulations narrowed the entities to which they apply, as part III of the preamble explains:

> Changes to the overall scope of the regulations:
>
> - *Exclusion of foreign issuers*. The final regulations reserve on all aspects of their application to foreign issuers; as a result, the final regulations do not apply to foreign issuers.
> - *Exclusion of S corporations and non-controlled RICs and REITs*. S corporations and non-controlled regulated investment companies (RICs) and real estate investment trusts (REITs) are exempt from all aspects of the final regulations.
> - *Removal of general bifurcation rule*. The final regulations do not include a general bifurcation rule. The Treasury Department and the IRS will continue to study this issue.
>
> Significant changes to the documentation requirements in § 1.385-2:
>
> - *Extension of period required for timely preparation*. The final regulations eliminate the proposed regulations' 30-day timely preparation requirement, and instead treat documentation and financial analysis as timely prepared if it is prepared by the time that the issuer's federal income tax return is filed (taking into account all applicable extensions).
> - *Rebuttable presumption based on compliance with documentation requirements*. The final regulations provide that, if an expanded group is otherwise generally compliant with the documentation requirements, then a rebuttable presumption, rather than per se recharacterization as stock, applies in the event of a documentation failure with respect to a purported debt instrument.
> - *Delayed implementation*. The final regulations apply only to debt instruments issued on or after January 1, 2018.
>
> Significant changes to the rules regarding distributions of debt instruments and similar transactions under § 1.385-3:

[1549] Reg. § 1.707-4(a)(3)(ii).
[1550] Saved as Thompson Coburn LLP doc. no. 6544618.
[1551] REG-108060-15, Fed. Reg. Vol. 81, No. 68, p. 20911.

- *Exclusion of debt instruments issued by regulated financial groups and insurance entities*. The final and temporary regulations do not apply to debt instruments issued by certain specified financial entities, financial groups, and insurance companies that are subject to a specified degree of regulatory oversight regarding their capital structure.

- Treatment of cash management arrangements and other short-term debt instruments. The final and temporary regulations generally exclude from the scope of § 1.385-3 deposits pursuant to a cash management arrangement as well as certain advances that finance short-term liquidity needs.

- *Limiting certain "*cascading*" recharacterizations*. The final and temporary regulations narrow the application of the funding rule by preventing, in certain circumstances, the so-called "cascading" consequence of recharacterizing a debt instrument as stock.

- *Expanded earnings and profits exception*. The final and temporary regulations expand the earnings and profits exception to include all the earnings and profits of a corporation that were accumulated while it was a member of the same expanded group and after the day that the proposed regulations were issued.

- *Expanded access to $50 million exception*. The final and temporary regulations remove the "cliff effect" of the threshold exception under the proposed regulations, so that all taxpayers can exclude the first $50 million of indebtedness that otherwise would be recharacterized.

- *Credit for certain capital contributions*. The final and temporary regulations provide an exception pursuant to which certain contributions of property are "netted" against distributions and transactions with similar economic effect.

- *Exception for equity compensation*. The final and temporary regulations provide an exception for the acquisition of stock delivered to employees, directors, and independent contractors as consideration for the provision of services.

- *Expansion of 90-day delay for recharacterization*. The 90-day delay provided in the proposed regulations for debt instruments issued on or after April 4, 2016, but prior to the publication of final regulations, is expanded so that any debt instrument that is subject to recharacterization but that is issued on or before October 21, 2016, will not be recharacterized until immediately after October 21, 2016.

Notice 2017-36, part II, described the documentation requirements and postponed their applicability until 2019:

> The Documentation Regulations in § 1.385-2 have two principal purposes. The first is to provide guidance regarding the documentation and other information that must be prepared, maintained, and provided to be used in the determination of whether an instrument subject to the Documentation Regulations will be treated as indebtedness for federal tax purposes. The second is to establish certain operating rules, presumptions, and factors to be taken into account in the making of any such determination. The Documentation Regulations, once applicable, implement these purposes by generally requiring taxpayers to prepare and maintain documentation that evidences specified "indebtedness factors" with respect to purported debt instruments subject to the

> regulations. Thus, compliance with the Documentation Regulations does not establish that an interest is indebtedness; it serves only to satisfy the minimum documentation for the determination to be made under general federal tax principles.
>
> ….
>
> In response to the concern that taxpayers have continued to raise with the application of the Documentation Regulations to interests issued on or after January 1, 2018, and in light of further actions concerning the final and temporary regulations under section 385 in connection with the review of those regulations, the Treasury Department and the IRS have determined that these concerns warrant a delay in the application of the Documentation Regulations by 12 months. Accordingly, the Treasury Department and the IRS intend to amend the Documentation Regulations to apply only to interests issued or deemed issued on or after January 1, 2019. Pending the issuance of those regulations, taxpayers may rely on the delay in application of the Documentation Regulations set forth in this notice.

Key to much of this is multinational entities documenting loans properly.[1552] Also, transfers between related companies 36 months before or after a loan generally are deemed to be a repayment of debt rather transactions affecting equity.[1553]

The final regulations under Code § 385 do not recharacterize debt issued by a partnership as equity; instead, they treat a partnership as an aggregate and test as if the partners had made the loan or investment.[1554]

[1552] See Connors, de Marigny, and Rodgers, "The Final § 385 Regulations," *TM Memorandum* (BNA) 2/20/2017, saved as Thompson Coburn doc. no. 6515888.

[1553] Reg. § 1.385-3(b)(3)(iii)(A).

[1554] See part 3, "Aggregate Treatment of Partnerships," of section Part V, "Comments and Changes to § 1.385-3—Certain Distributions of Debt Instruments and Similar Transactions," of the preamble to T.D. 9790 (10/21/2016).

II.I.8. Application of 3.8% Tax to Business Income

II.I.8.a. General Application of 3.8% Tax to Business Income

Gross income from interest,[1916] dividends, annuities, royalties,[1917] and rents is excluded from NII if it is derived in the ordinary course of a trade or business that is not a passive activity;[1918] however, any item of gross income from the investment of working capital will be treated as not derived in the ordinary course of a trade or business.[1919] Gain from the sale of an asset is

---

[1916] Self-charged interest is treated as business income. Reg. § 1.1411-4(g)(5) provides:

> Gross income from interest (within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section) that is received by the taxpayer from a nonpassive activity of such taxpayer, solely for purposes of section 1411, is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5. The amount of interest income that is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5, and thus excluded from the calculation of net investment income, under this paragraph (g)(5) is limited to the amount that would have been considered passive activity gross income under the rules of § 1.469-7 if the payor was a passive activity of the taxpayer. For purposes of this rule, the term nonpassive activity does not include a trade or business described in § 1.1411-5(a)(2). However, this rule does not apply to the extent the corresponding deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

As described in fn. 1919, other than self-charged interest described above, interest income generally will constitute NII, even if it is fully business-related, unless the business is in the nature of a bank, etc.

[1917] See part II.K.1.f Royalty as a Trade or Business. If licensing royalties does not rise to the level of a trade or business, consider obtaining a preferred profits interest in lieu of royalty income (if the owner of the property being provided is active in the business) or a structure such as described in part II.E Recommended Structure for Entities (with some extra share of profits allocated to the person who contributed the property).

[1918] Reg. § 1.1411-4(b), which provides:

> Gross income described in paragraph (a)(1)(i) of this section is excluded from net investment income if it is derived in the ordinary course of a trade or business not described in § 1.1411-5….

[1919] Reg. § 1.1411-6(a), which also provides:

> In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See § 1.1411-4(f) for rules regarding properly allocable deductions with respect to an investment of working capital…

Reg. § 1.469-2T(c)(3)(ii) treats only the following as gross income derived in the ordinary course of a trade or business:

> (A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;
> (B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;
> (C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;
> (D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);
> (E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);
> (F) Amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and
> (G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

excluded from NII if it is derived in the ordinary course of a trade or business that is not a passive activity;[1920] however, any net gain that is attributable to the investment of working capital will be treated as not derived in the ordinary course of a trade or business.[1921] Other gross income from a trade or business is NII if it a passive activity.[1922]

Passive income is subject to the NII tax, and Code § 469 and the regulations thereunder determine whether a trade or business is passive.[1923]

Income from a trade or business of trading in financial instruments[1924] or commodities[1925] is also subject to NII tax.[1926] This rule applies to traders – not to dealers or investors.[1927]

[1920] Reg. § 1.1411-4(a)(1)(iii).

[1921] Reg. § 1.1411-6(a), which also provides:

> In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See ... § 1.1411-7 for rules relating to the adjustment to net gain on the disposition of interests in a partnership or S corporation.

It also provides an example showing how strict this rule is: The taxpayer uses an interest-bearing checking account at a local bank to make daily deposits of the restaurant's cash receipts and to pay the restaurant's recurring ordinary and necessary business expenses. The account's average daily balance is approximately $2,500, but at any given time the balance may be significantly more or less than this amount, depending on the business' short-term cash flow needs. Any interest the account generates constitutes NII.

[1922] Reg. § 1.1411-4(c).

[1923] Reg. § 1.1411-5(b)(1)(ii).

[1924] Reg. § 1.1411-5(c)(1) provides:

> *Definition of financial instruments*. For purposes of section 1411 and the regulations thereunder, the term financial instruments includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives, or any evidence of an interest in any of the items described in this paragraph (c)(1). An evidence of an interest in any of the items described in this paragraph (c)(1) includes, but is not limited to, short positions or partial units in any of the items described in this paragraph (c)(1).

[1925] Reg. § 1.1411-5(c)(2) provides:

> *Definition of commodities*. For purposes of section 1411 and the regulations thereunder, the term commodities refers to items described in section 475(e)(2).

[1926] Code § 1411(c)(2)(B); Reg. § 1.1411-5(a)(2).

[1927] The final regulations adopted the proposed regulations. The preamble to the latter, REG-130507-11, provides:

> **C. Trading in Financial Instruments or Commodities**
>
> **i. Distinguishing Between Dealers, Traders, and Investors**
>
> Determining whether trading in financial instruments or commodities rises to the level of a section 162 trade or business is a question of fact. *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941); *Estate of Yaeger v. Comm'r*, 889 F.2d 29, 33 (2d Cir. 1989). In general, section 475(c)(1) provides that the term dealer in securities means a taxpayer who (A) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (B) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. In contrast, a trader seeks profit from short-term market swings and receives income principally from selling on an exchange rather than from dividends, interest, or long-term appreciation. *Groetzinger v. Comm'r*, 771 F.2d 269, 274-275 (7th Cir. 1985), *aff'd* 480 U.S. 23 (1987); *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983). A person will be a trader, and therefore engaged in a section 162 trade or business, if his or her trading is frequent and substantial, which has been rephrased as "frequent, regular, and continuous."

This tax favors (by excluding) trade or business income from partnerships and S corporations in which the taxpayer significantly or materially participates, which for many taxpayers simply means work for more than 100 hours in a year.[1928] Although a partnership's income from a trade or business generally would be subject to self-employment tax, whereas an S corporation income from a trade or business is not,[1929] one should consider that exit strategies[1930] and basis step-up issues[1931] tend to favor partnerships over S corporations. One might consider combining a partnership for the business operations themselves with an S corporation to block self-employment income from passing through to the ultimate owners.[1932]

II.I.8.a.i. Passive Activity Recharacterization Rules

Various passive activity recharacterization rules also provide NII exclusions for trade or business activity:

- Significant participation activities (more than 100 hours of participation).[1933]
- Certain rental activities.[1934]
- To the extent that any gain from a trade or business is recharacterized as "not from a passive activity" by reason of certain rules relating to the disposition of substantially appreciated

---

Boatner v. Comm'r, T.C. Memo. 1997-379, *aff'd* in unpublished opinion 164 F.3d 629 (9th Cir. 1998).

An investor is a person who purchases and sells securities with the principal purpose of realizing investment income in the form of interest, dividends, and gains from appreciation in value over a relatively long period of time (that is, long-term appreciation). The management of one's own investments is not considered a section 162 trade or business no matter how extensive or substantial the investments might be. See *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941); *King v. Comm'r*, 89 T.C. 445 (1987). Therefore, an investor is not considered to be engaged in a section 162 trade or business of investing.

For purposes of section 1411(c)(2)(B), in order to determine whether gross income is derived from a section 162 trade or business of trading in financial instruments or commodities, the gross income must be derived from an activity that would constitute trading for purposes of chapter 1. Therefore, a person that is a trader in commodities or a trader in financial instruments is engaged in a trade or business for purposes of section 1411(c)(2)(B). The Treasury Department and the IRS emphasize that the proposed regulations do not change the state of the law with respect to classification of traders, dealers, or investors for purposes of chapter 1.

[1928] See part II.K.1.a Counting Work as Participation, being careful to consider part II.K.1.a.v What Does Not Count as Participation. Other than work as a mere investor, almost any type of work appears to qualify towards material participation for purposes of the Code § 1411. For the more-than-100 hours rule, see fn. 1933.

[1929] See part II.L.1 FICA: Corporation.

[1930] See part II.Q Exiting from or Dividing a Business. However, when considering a Code § 736 redemption, see part II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411. Also see part II.G.14 Limitations on the Use of Installment Sales, but note that the suggestion in that part about forming a partnership to hold property that is to be sold would not work with an S corporation, because a partnership is not eligible to hold stock in an S corporation.

[1931] See part II.H.2 Basis Step-Up Issues.

[1932] See part II.L.5 Self-Employment Tax: Partnership with S corporation Blocker.

[1933] Reg. § 1.1411-5(b)(2)(i), referring to Reg. § 1.469-2T(f)(2), which is described in fn. 2648 of part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

[1934] Reg. § 1.1411-5(b)(2)(i), referring to Reg. § 1.469-2(f)(5) or 1.469-2(f)(6), which are described in fns. 2634 and 2595, respectively, within part II.K.1.e Rental Activities.

property formerly used in nonpassive activity[1935] and is not from the disposition of an interest in property that was held for investment for more than 50% of the period during which the taxpayer held that interest in property in nonpassive activities,[1936] such trade or business is a nonpassive activity solely with respect to such recharacterized gain.[1937]

- To the extent that any income or gain from a trade or business is recharacterized as a nonpassive activity and is further characterized as portfolio income under certain provisions, then such trade or business constitutes a passive activity solely with respect to such recharacterized income or gain.[1938] The relevant portfolio income provision is either:

  - o the rental of nondepreciable property, equity-financed lending activities, and royalty income from passthrough entities,[1939] or

  - o the disposition of an interest in property that was held for investment for more than 50% of the period during which the taxpayer held that interest in property in nonpassive activities.[1940]

II.I.8.a.ii. Passive Activity Grouping Rules

Regarding how the Code § 469 grouping rules interact with classifying income under Code § 469, the preamble explains:[1941]

> Section 1.469-4 provides rules for defining an activity for purposes of applying the passive activity loss rules of section 469 (grouping rules). The grouping rules will apply in determining the scope of a taxpayer's trade or business in order to determine whether such trade or business is a passive activity for purposes of section 1411(c)(2)(A). However, a proper grouping under § 1.469-4(d)(1) (grouping rental activities with other trade or business activities) will not convert gross income from rents into other gross income derived from a trade or business described in proposed § 1.1411-5(a)(1).

For example, if a partner in a partnership participates in one trade or business for more than 500 hours and another trade or business for only 50 hours and the individual groups both activities

[1935] Reg. § 1.469-2(c)(2)(iii), which provides, generally:

> If an interest in property used in an activity is substantially appreciated at the time of its disposition, any gain from the disposition shall be treated as not from a passive activity unless the interest in property was used in a passive activity for either:
>
> (1) 20 percent of the period during which the taxpayer held the interest in property; or
>
> (2) The entire 24-month period ending on the date of the disposition.

An interest in property is substantially appreciated if the fair market value of the interest in property exceeds 120% of the adjusted basis of the interest. Reg. § 1.469-2(c)(2)(iii)(C).

[1936] Reg. § 1.469-2(c)(2)(iii)(F).

[1937] Reg. § 1.1411-5(b)(2)(i).

[1938] Reg. § 1.1411-5(b)(2)(iii).

[1939] Reg. § 1.1411-5(b)(2)(iii) refers to Reg. § 1.469-2T(f)(10), which refers to Reg. § 1.469-2(f)(10). Sutton & Howell-Smith, *Federal Income Taxation of Passive Activities* (WG&L), ¶ 7.01[2][b] Recharacterized Items, refers to Reg. § 1.469-2(f)(10) as the rental of nondepreciable property (¶ 10.05 of the treatise), equity-financed lending activities (¶ 7.03 of the treatise), and royalty income from passthrough entities (¶ 13.05 of the treatise).

[1940] Reg. § 1.469-2(c)(2)(iii)(F).

[1941] Part 6.B.1.(b)(4) of the preamble.

as one activity in a way that qualifies both trades or businesses as nonpassive, business income from both trades or businesses is excluded from NII.[1942]

For more information about the Code § 469 grouping rules, including regrouping as a result of the NII tax, see part II.K.1.b Grouping Activities.

II.I.8.a.iii. Qualifying Self-Charged Interest or Rent Is Not NII

Certain self-charged interest[1943] or rent[1944] received from a business are automatically deemed nonpassive trade or business income if the borrower/tenant is a nonpassive trade or business; however, self-charged interest is excluded only to the extent it is self-charged.[1945]

Note that the taxpayer must materially participate, satisfying the more-than-500-hours or similar rules,[1946] to satisfy the self-rental exception of footnote 1944:

[1942] Reg. § 1.1411-5(b)(3), Example (2).

[1943] Reg. § 1.1411-4(g)(5) provides:

> Treatment of self-charged interest income. Gross income from interest (within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section) that is received by the taxpayer from a nonpassive activity of such taxpayer, solely for purposes of section 1411, is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5. The amount of interest income that is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5, and thus excluded from the calculation of net investment income, under this paragraph (g)(5) is limited to the amount that would have been considered passive activity gross income under the rules of § 1.469-7 if the payor was a passive activity of the taxpayer. For purposes of this rule, the term nonpassive activity does not include a trade or business described in § 1.1411-5(a)(2). However, this rule does not apply to the extent the corresponding deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

[1944] Reg. § 1.1411-4(f)(6)(i) provides:

> Gross income from rents. To the extent that gross rental income described in paragraph (a)(1)(i) of this section is treated as not derived from a passive activity by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), such gross rental income is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section.

See fn. 1984 regarding the interaction of Reg. § 1.469-2(f)(6) with the 3.8% tax on net investment income. See part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity for an explanation of Reg. § 1.469-2(f)(6).

See fn. 2595 for the text of Reg. § 1.469-2(f)(6).

[1945] Reg. § 1.469-7 (treatment of self-charged items of interest income and deduction), which applies "in the case of a lending transaction (including guaranteed payments for the use of capital under section 707(c)) between a taxpayer and a passthrough entity in which the taxpayer owns a direct or indirect interest, or between certain passthrough entities." Reg. § 1.469-7(a)(1). See parts II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S corporation, II.I.8.d Partnership Structuring in Light of the 3.8% Tax on Net Investment Income, and II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736 regarding the interaction of partnership tax rules with the passive loss rules and rules governing NII.

[1946] See part II.K.1.a.ii Material Participation.

- Although significant participation (more than 100 hours) suffices for other business income,[1947] it does not for the self-rental exception. If this contrast in treatment (between material participation and significant participation) is significant (particularly if the property is about be sold)[1948] and avoiding the NII tax on the rental income becomes important, consider using the structure depicted in part II.E.6 Recommended Partnership Structure – Flowchart, [1949] perhaps migrating as depicted in part II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

- Material participation requires ownership.[1950]

If self-charged rental is excluded from NII, gain on the sale of the rental property is also excluded.[1951]

II.I.8.a.iv. Determination of Trade or Business Status, Passive Activity Status, or Trading Status of Pass-Through Entities

If an individual, estate, or trust owns or engages in a trade or business,[1952] the determination of whether such gross income is derived in a trade or business is made at the owner's level.[1953]

If an individual, estate, or trust owns an interest in a trade or business through a partnership or S corporation:[1954]

- whether gross income is a passive trade or business activity is determined at the owner level; and

---

1947 See part II.I.8.a.i Passive Activity Recharacterization Rules. If at all practical, an owner should materially participate instead of significantly participate. See part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

1948 See fn. 1951

1949 This structure often is ideal; see part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons. However, it might need to be unwound by subjecting the real estate to a long-term business lease and distributing the real estate to the client's beneficiaries not active in the business, to try to disentangle the active from the inactive beneficiaries. Note, however, that splitting up an entity taxed as a partnership generally can be done on a tax-free basis; see part II.Q.8 Exiting From or Dividing a Partnership, especially part II.Q.8.b.i Distribution of Property by a Partnership.

1950 See fn. 2594 and part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

1951 Reg. § 1.1411-4(f)(6)(ii) provides:

> Gain or loss from the disposition of property. To the extent that gain or loss resulting from the disposition of property is treated as nonpassive gain or loss by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), then such gain or loss is deemed to be derived from property used in the ordinary course of a trade or business within the meaning of paragraph (d)(4)(i) of this section.

See fns. 1984 and 2596 regarding Reg. § 1.469-2(f)(6).

1952 Directly or indirectly through ownership of an interest in an entity that is disregarded as an entity separate from its owner under the check-the-box rules of Reg. § 301.7701-3.

1953 Reg. § 1.1411-4(b)(1).

1954 Reg. § 1.1411-4(b)(2).

- whether gross income is derived in trade or business of a trader trading in financial instruments or commodities[1955] is determined at the entity level.

II.I.8.a.v. Working Capital Is NII

II.I.8.a.v.(a). Policy of Working Capital as NII

The tax applies to interest, dividends, etc. whether inside or outside an entity, and arguments that such income was derived from working capital used to generate active business income will not help any.[1956] The preamble to the proposed regulations explains:[1957]

> Section 1411(c)(3) provides that a rule similar to the rule of section 469(e)(1)(B) applies for purposes of section 1411 (the working capital rule). Section 469(e)(1)(B) provides that, for purposes of determining whether income is treated as from a passive activity, any income or gain attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business.
>
> The term working capital is not defined in either section 469 or section 1411, but it generally refers to capital set aside for use in and the future needs of a trade or business. Because the capital may not be necessary for the immediate conduct of the trade or business, the amounts are often invested by businesses in income-producing liquid assets such as savings accounts, certificates of deposit, money market accounts, short-term government and commercial bonds, and other similar investments. These investment assets will usually produce portfolio-type income, such as interest. Under section 469(e)(1)(B), portfolio-type income generated by working capital is not derived in the ordinary course of a trade or business, and therefore, it is not treated as passive income. Under section 1411(c)(3), gross income from and net gain attributable to the investment of working capital is not derived in the ordinary course of a trade or business, and therefore such gross income and net gain is subject to section 1411.
>
> A taxpayer may take into account the properly allocable deductions (related to losses or deductions properly allocable to the investment of such working capital) in determining net investment income. See part 5.E of this preamble regarding properly allocable deductions.

The preamble to the final regulations simply mentions:[1958]

> Section 1411(c)(3) provides that income on the investment of working capital is not treated as derived from a trade or business for purposes of section 1411(c)(1) and is subject to tax under section 1411. Section 1.1411-6 of the final regulations provides guidance on working capital under section 1411(c)(3).

[1955] Reg. § 1.1411-5(c) discusses financial instruments and commodities.
[1956] Code § 1411(c)(3) provides that any income, gain, or loss which is attributable to an investment of working capital is deemed not to be derived in the ordinary course of a trade or business in applying this rule.
[1957] Part 7 of the preamble.
[1958] T.D. 9644.

Of course, if the taxpayer does not materially participate in the business, generally all of the business' income will be NII, so the working capital exception would be moot.[1959]

II.I.8.a.v.(b). What Is Working Capital

Reg. § 1.1411-6(a) provides:[1960]

> *General rule*. For purposes of section 1411, any item of gross income from the investment of working capital will be treated as not derived in the ordinary course of a trade or business, and any net gain that is attributable to the investment of working capital will be treated as not derived in the ordinary course of a trade or business. In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See § 1.1411-4(f) for rules regarding properly allocable deductions with respect to an investment of working capital and § 1.1411-7 for rules relating to the adjustment to net gain on the disposition of interests in a partnership or S corporation.

Reg. § 1.1411-6(b) provides an example holding that cash used in daily operations constitute

> working capital under § 1.469-2T(c)(3)(ii) and, pursuant to paragraph (a) of this section, the interest generated by this working capital will not be treated as derived in the ordinary course of S's restaurant business. Accordingly, the interest income derived by S from its checking and savings accounts … constitutes gross income from interest under § 1.1411-4(a)(1)(i).

To place context on this reference to Reg. § 1.469-2T(c)(3)(ii), Reg. § 1.469-2T(c)(3)(i) excludes from passive activity gross income items of portfolio income and further provides:

> For purposes of the preceding sentence, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of paragraph (c)(3)(ii) of this section), that is attributable to—
>
> (A) Interest (including amounts treated as interest under paragraph (e)(2)(ii) of this section, relating to certain payments to partners for the use of capital); annuities; royalties (including fees and other payments for the use of intangible property); dividends on C corporation stock; and income (including dividends) from a real estate investment trust (within the meaning of section 856), regulated investment company (within the meaning of section 851), real estate mortgage investment conduit (within the meaning of section 860D), common trust fund (within the meaning of section 584), controlled foreign corporation (within the meaning of section 957), qualified electing fund (within the meaning of section 1295(a)), or cooperative (within the meaning of section 1381(a));

[1959] Reg. § 1.1411-5(b)(3), Example (5).

[1960] Reg. § 1.1411-6(b) provides an example holding that cash used in daily operations constitute working capital under § 1.469-2T(c)(3)(ii) and, pursuant to paragraph (a) of this section, the interest generated by this working capital will not be treated as derived in the ordinary course of S's restaurant business. Accordingly, the interest income derived by S from its checking and savings accounts … constitutes gross income from interest under § 1.1411-4(a)(1)(i).

(B) Dividends on S corporation stock (within the meaning of section 1368(c)(2));

(C) The disposition of property that produces income of a type described in paragraph (c)(3)(i)(A) of this section; and

(D) The disposition of property held for investment (within the meaning of section 163(d)).

Reg. § 1.469-2T(c)(3)(ii) provides:

> *Gross income derived in the ordinary course of a trade or business*. Solely for purposes of paragraph (c)(3)(i) of this section, gross income derived in the ordinary course of a trade or business includes only—

(A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;

(B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;

(C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;

(D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);

(E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);

(F) Amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and

(G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

As to (G) above, it has been suggested that the IRS has informally indicated its intention to broaden the definition of mineral royalty income derived in a trade or business, but taxpayers should request a ruling to receive a proper determination.[1961] The same author said that several private letter rulings held that "float revenue, as a substitute for service fees, is derived in the ordinary course of a trade or business."[1962]

[1961] Sutton & Howell-Smith, ¶ 12.03[3][a] Royalties, *Federal Income Taxation of Passive Activities* (WG&L).
[1962] Sutton & Howell-Smith, ¶ 2.02[1][f][vii] Other income identified by the Commissioner, *Federal Income Taxation of Passive Activities* (WG&L), pointing to Letter Rulings 199924020, 199924022, and 199924023.

II.I.8.a.vi. What is a "Trade or Business"?

The preamble to the final regulations discuss what is a "trade or business" for purposes of the 3.8% tax:[1963]

> Several commentators requested guidance concerning the meaning of "trade or business." Commentators suggested that the regulations include references to relevant case law and administrative guidance. A commentator requested that the regulations expand upon existing guidance by including bright-line examples of what constitutes a trade or business to aid taxpayers in determining if income is derived in the ordinary course of a trade or business and thus is excluded from net investment income.
>
> As noted in part 6.A. of the preamble to the proposed regulations, the rules under section 162 have long existed as guidance for determining the existence of a trade or business and are applied in many circumstances. Whether an activity constitutes a trade or business for purposes of section 162 is generally a factual question. For example, in Higgins v. Commissioner, 312 U.S. 212 (1941), the Supreme Court stated that the determination of "whether the activities of a taxpayer are 'carrying on a trade or business' requires an examination of the facts in each case." 312 U.S. at 217. Except for certain clarifications made in response to the proposed regulations, further guidance concerning the definition of trade or business is beyond the scope of these regulations.
>
> In response to these commentators, § 1.1411-1(d) of the final regulations provides that the term trade or business, when used in section 1411 and the final regulations, describes a trade or business within the meaning of section 162. The section 162 reference incorporates case law and administrative guidance applicable to section 162.
>
> One commentator noted that determining whether income is earned in a section 162 trade or business under a separate entity approach, as reflected in proposed § 1.1411-4(b), will yield unexpected results that are inconsistent with section 162. For purposes of determining whether income is earned under section 162, the commentator noted that § 1.183-1(d) provides that activities are determined and their section 162 trade or business status is evaluated by aggregating undertakings in any reasonable manner determined by the taxpayer.
>
> The Treasury Department and the IRS do not believe that the determination of a trade or business under section 162 mandates the use of the definition of "activity" within the meaning of § 1.183-1(d). Section 183 disallows expenses in excess of income attributable to activities not engaged in for profit. Section 1.183-1(a) provides that section 162 and section 212 activities are not subject to section 183 limitations. The definition of activity within § 1.183-1(d) allows taxpayers latitude to combine different activities into a single activity to establish that the taxpayer is engaged in an activity for profit, and thus is not subject to the section 183 limitation. However, once the taxpayer determines that section 183 is not applicable, the taxpayer then must determine whether the activity is a section 162 trade or business or a section 212 for-profit activity. Furthermore, different definitions of "activity" can be found in sections 465 and 469. Therefore, the Treasury Department and the IRS do not believe that determining whether a trade or business exists

[1963] T.D. 9644.

using the activity determinations of Code provisions unrelated to section 162 is appropriate.

For further analysis, see part II.G.3.i.i.(a) "Trade or Business" Under Code § 162.

II.I.8.a.vii. Former Passive Activities – NII Implications

The preamble to the final regulations addressed former passive activities:[1964]

> The final regulations clarify, for section 1411 purposes, the treatment of income, deductions, gains, losses, and the use of suspended losses from former passive activities. The Treasury Department and the IRS considered three alternatives. One approach is the complete disallowance of all suspended losses once the activity is no longer a passive activity (in other words, becomes a former passive activity or a nonpassive activity). The rationale behind this approach is that the income from the activity would not be includable in net investment income, thus the suspended losses become irrelevant. Another approach is the unrestricted allowance of all suspended losses in the year in which they are allowed by section 469(f), regardless of whether the nonpassive income is included in net investment income. The rationale behind this approach is that the losses were generated during a period when the activity was a passive activity, and if such losses were allowed in full, they would have potentially reduced net investment income, and therefore the losses should continue to retain their character as net investment income deductions. The third approach is a hybrid approach that allows suspended losses from former passive activities in calculation of net investment income (as properly allocable deductions under section 1411(c)(1)(B) or in section 1411(c)(1)(A)(iii) in the case of losses) but only to the extent of the nonpassive income from such former passive activity that is included in net investment income in that year. The final regulations adopt this hybrid approach.
>
> For example, in the case of a former passive trade or business activity with suspended losses of $10,000 that generates $3,000 of net nonpassive income, section 469(c)(1)(A) allows $3,000 of the $10,000 suspended loss to offset the nonpassive income in the current year. Since the gross nonpassive income is not included in section 1411(c)(1)(A)(ii) (or in section 1411(c)(1)(A)(iii) in the case of gains from the

[1964] T.D. 9644. For general issues regarding former passive activities, see part II.K.1.j Former Passive Activities. The preamble describes the interaction of these rules with Code § 1411:

> If a taxpayer materially participates in a former passive trade or business activity, the gross income produced by that activity (and associated section 1411(c)(1)(B) properly allocable deductions) in the current year generally would not be net investment income because the activity is no longer a trade or business that is a passive activity within the meaning of section 469. However, in the case of rental income not derived in the ordinary course of a trade or business, a classification of the rental income as nonpassive for purposes of section 469 will not result automatically in the exclusion of such rental income and associated deductions from net investment income. Furthermore, it is possible that a section 469 former passive activity may still generate net investment income on its disposition to the extent the gain is included in section 1411(c)(1)(A)(iii) and not entirely excluded by, for example, section 1411(c)(4).
>
> Suspended losses that are allowed by reason of section 469(f)(1)(A) or (C) may constitute properly allocable deductions under section 1411(c)(1)(B) and § 1.1411-4(f)(2) (to the extent those losses would be described in section 62(a)(1) or 62(a)(4)) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) and § 1.1411-4(d) (to the extent those losses would be described in section 62(a)(3) in the year they are allowed, depending on the underlying character and origin of such losses). The treatment of excess suspended losses of a former passive activity upon a fully taxable disposition is discussed in the next section of this preamble.

disposition of property in such trade or business), none of the deductions and losses associated with such income are properly allocable deductions under section 1411(c)(1)(B) (or in section 1411(c)(1)(A)(iii) in the case of losses from the disposition of property in such trade or business). Thus, under the facts of this example, the final regulations provide that the $3,000 is not a properly allocable deduction (or a loss included in section 1411(c)(1)(A)(iii)). However, to the extent that the remaining suspended passive loss deduction of $7,000 is allowed by section 469(f)(1)(C) to offset other net passive activity income (which is included in net investment income by reason of section 1411(c)(1)(A) less deductions allowed by section 1411(c)(1)(B)), such amounts are considered properly allocable deductions under section 1411(c)(1)(B), or as a loss included in section 1411(c)(1)(A)(iii), as appropriate.

Reg. § 1.1411-4(g)(8) provides the details described above. For more information on former passive activities, see part II.K.1.j Former Passive Activities.

II.I.8.b. 3.8% Tax Does Not Apply to Gain on Sale of Active Business Assets

Net gain from the disposition of property does not include gain or loss attributable to property held in a nonpassive[1965] trade or business.[1966]

However, this exception does not apply to the gain or loss attributable to the disposition of investments of working capital.[1967]

Although a partnership interest or S corporation stock generally is not property held in a trade or business qualifying for the exclusion,[1968] the portion of the sale proceeds attributable to business assets does qualify.[1969]

If an individual, estate, or trust owns or engages in a trade or business directly (or indirectly through a disregarded entity), the determination of whether net gain is attributable to property held in a trade or business is made at the individual, estate, or trust level.[1970] If an individual, estate, or trust that owns an interest in a passthrough entity such as a partnership or S corporation and that entity is engaged in a trade or business, the determination of whether net gain is attributable to (i) a passive activity is made at the owner level; and (ii) the trade or business of a trader trading in financial instruments or commodities is made at the entity level.[1971]

[1965] By "nonpassive" I mean not described in Reg. § 1.1411-5. See part II.I.8 Application of 3.8% Tax to Business Income, especially fn. 1923.
[1966] Reg. §§ 1.1411-4(a)(1)(iii), 1.1411-4(d)(4)(i)(A).
[1967] Reg. § 1.1411-4(d)(4)(i)(A). See Reg. § 1.1411-6 regarding working capital, which is described in part II.I.8.a.v Working Capital Is NII.
[1968] Reg. § 1.1411-4(d)(4)(i)(B)(1).
[1969] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S corporation.
[1970] Reg. § 1.1411-4(d)(4)(i)(B)(2).
[1971] Reg. § 1.1411-4(d)(4)(i)(B)(3).

II.I.8.c. Application of 3.8% Tax to Rental Income

As mentioned above, rental income is NII unless it is self-rental[1972] or not only is from a trade or business but also nonpassive.[1973]

Because the self-rental exception is relatively straightforward, this part II.I.8.c focuses on whether the rental not only is from a trade or business but also is nonpassive.

II.I.8.c.i. If Not Self-Rental, Most Rental Income Is *Per Se* Passive Income and Therefore NII

Generally, rental constitutes passive income, even if it constitutes a trade or business in which the taxpayer materially participates.[1974] The NII rules elaborate on exceptions to this general rule. For example, short-term equipment leasing income is not NII,[1975] if the taxpayer materially participates.[1976]

[1972] See fn. 1944.

[1973] See fn. 1918. Note that *Erbs v. Commissioner*, T.C. Summary Opinion 2001-85, held that the material participation rules "govern whether a trade or business is passive and do not address the more fundamental question of whether an activity constitutes a trade or business." See generally "¶L-1103, Regular activity in business is required for being engaged in a trade or business—trade or business expenses," Fed. Tax. Coord.2d. See also Bittker & Lokken, "¶47.3, Property Used in a Trade or Business," *Federal Taxation of Income, Estates, and Gifts*; "¶L-1115, Renting and/or managing rental real estate as a trade or business," *Fed. Tax. Coord.2d*.

[1974] See part II.K.1.e Rental Activities.

[1975] Reg. § 1.1411-5(b)(3), Example (3) provides:

> *Application of the rental activity exceptions*. B, an unmarried individual, is a partner in PRS, which is engaged in an equipment leasing activity. The average period of customer use of the equipment is seven days or less (and therefore meets the exception in § 1.469-1T(e)(3)(ii)(A)). B materially participates in the equipment leasing activity (within the meaning of § 1.469-5T(a)). The equipment leasing activity constitutes a trade or business. In Year 1, B has modified adjusted gross income (as defined in § 1.1411-2(c)) of $300,000, all of which is derived from PRS. All of the income from PRS is derived in the ordinary course of the equipment leasing activity, and all of PRS's property is held in the equipment leasing activity. Of B's allocable share of income from PRS, $275,000 constitutes gross income from rents (within the meaning of § 1.1411-4(a)(1)(i)). While $275,000 of the gross income from the equipment leasing activity meets the definition of rents in § 1.1411-4(a)(1)(i), the activity meets one of the exceptions to rental activity in § 1.469-1T(e)(3)(ii) and B materially participates in the activity. Therefore, the trade or business is not a passive activity with respect to B for purposes of paragraph (b)(1)(ii) of this section. Because the rents are derived in the ordinary course of a trade or business not described in paragraph (a) of this section, the ordinary course of a trade or business exception in § 1.1411-4(b) applies, and the rents are not described in § 1.1411-4(a)(1)(i). Furthermore, because the equipment leasing trade or business is not a trade or business described in paragraph (a)(1) or (a)(2) of this section, the $25,000 of other gross income is not net investment income under § 1.1411-4(a)(1)(ii). However, the $25,000 of other gross income may be net investment income by reason of section 1411(c)(3) and § 1.1411-6 if it is attributable to PRS's working capital. Finally, gain or loss from the sale of the property held in the equipment leasing activity will not be subject to § 1.1411-4(a)(1)(iii) because, although it is attributable to a trade or business, it is not a trade or business to which the section 1411 tax applies.

[1976] Reg. § 1.1411-5(b)(3), Example (4) provides:

> Application of section 469 and other gross income under §1.1411-4(a)(1)(ii). Same facts as Example 3, except B does not materially participate in the equipment leasing trade or business and therefore the trade or business is a passive activity with respect to B for purposes of

II.I.8.c.ii. Real Estate Classified as Nonpassive for Real Estate Professionals

The general rule that rental is per se passive does not apply to certain real estate professionals.[1977] Therefore, if a real estate professional who meets this exceptions engages in a real estate trade or business, the rental income would not constitute NII.

Although the final regulations declined to provide broad relief for real estate professionals, the preamble informs us:[1978]

> The final regulations do, however, provide a safe harbor test for certain real estate professionals in § 1.1411-4(g)(7). The safe harbor test provides that, if a real estate professional (within the meaning of section 469(c)(7)) participates in a rental real estate activity for more than 500 hours per year, the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. Alternatively, if the taxpayer has participated in a rental real estate activity for more than 500 hours per year in five of the last ten taxable years (one or more of which may be taxable years prior to the effective date of section 1411), then the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. The safe harbor test also provides that, if the hour requirements are met, the real property is considered as used in a trade or business for purposes of calculating net gain under section 1411(c)(1)(A)(iii). The Treasury Department and the IRS recognize that some real estate professionals with substantial rental activities may derive such rental income in the ordinary course of a trade or business, even though they fail to satisfy the 500 hour requirement in the safe harbor test. As a result, the final regulations specifically provide that such failure will not preclude a taxpayer from establishing that such gross rental income and gain or loss from the disposition of real property, as applicable, is not included in net investment income.

Thus, the annual threshold is reduced from more than 750 hours under the passive loss rules to more than 500 hours.[1979]

> paragraph (b)(1)(ii) of this section. Accordingly, the $275,000 of gross income from rents is described in § 1.1411-4(a)(1)(i) because the rents are derived from a trade or business that is a passive activity with respect to B. Furthermore, the $25,000 of other gross income from the equipment leasing trade or business is described in § 1.1411-4(a)(1)(ii) because the gross income is derived from a trade or business described in paragraph (a)(1) of this section. Finally, gain or loss from the sale of the property used in the equipment leasing trade or business is subject to § 1.1411-4(a)(1)(iii) because the trade or business is a passive activity with respect to B, as described in paragraph (b)(1)(ii) of this section.

[1977] See fns. 2586-2601.

[1978] T.D. 9655.

[1979] Reg. § 1.1411-4(g)(7) provides:

> (7) *Treatment of certain real estate professionals*
>
> (i) *Safe Harbor*. In the case of a real estate professional (as defined in section 469(c)(7)(B)) that participates in a rental real estate activity for more than 500 hours during such year, or has participated in such real estate activities for more than 500 hours in any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year, then—
>
> (A) Such gross rental income from that rental activity is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section; and

Also, Reg. § 1.1411-4(g)(7)(ii)(B) does not require that each rental activity owned by the real estate professional be a trade or business. On June 16, 2014, I informally confirmed with a drafter of the regulation that, if a real estate professional groups activities so that real estate trade or business undertakings are grouped with real estate undertakings that are not trade or business undertakings, the latter nevertheless receive treatment as not constituting NII. For example, suppose a real estate professional actively manages several real estate properties that are trade or business undertakings and also owns several properties rented using triple-net leases. If the professional groups all of those undertakings as a single activity, income from the triple-net leases does not constitute NII.

See also part II.G.25 Real Estate Dealer vs. Investor.

II.I.8.c.iii. Rental as a Trade or Business

If rental activity is nonpassive under special exceptions or by reason of the taxpayer being a real estate professional, the taxpayer would apply the concepts below in conjunction with the rules of part II.I.8.a General Application of 3.8% Tax to Business Income.

Grouping passive activities will not convert gross income from rents into other gross income derived from a trade or business. [1980]

The preamble to the final regulations explains how the IRS views rental as a trade or business (emphasis added):[1981]

> The Treasury Department and the IRS received multiple comments regarding the determination of a trade or business within the context of rental real estate. Specifically, commentators stated that <u>Example 1</u> of proposed § 1.1411-5(b)(2) is inconsistent with existing case law regarding the definition of a trade or business of rental real estate. Commentators cited cases such as <u>Fackler v. Commissioner</u>, 45 BTA 708 (1941), *aff'd*,

---

> (B) Gain or loss resulting from the disposition of property used in such rental real estate activity is deemed to be derived from property used in the ordinary course of a trade or business within the meaning of paragraph (d)(4)(i) of this section.
>
> (ii) *Definitions*—
>
> (A) *Participation*. For purposes of establishing participation under this paragraph (g)(7), any participation in the activity that would count towards establishing material participation under section 469 shall be considered.
>
> (B) *Rental real estate activity*. The term rental real estate activity used in this paragraph (g)(7) is a rental activity within the meaning of § 1.469-1T(e)(3). An election to treat all rental real estate as a single rental activity under §1.469-9(g) also applies for purposes of this paragraph (g)(7). However, any rental real estate that the taxpayer grouped with a trade or business activity under § 1.469-4(d)(1)(i)(A) or (d)(1)(i)(C) is not a rental real estate activity.
>
> (iii) *Effect of safe harbor*. The inability of a real estate professional to satisfy the safe harbor in this paragraph (g)(7) does not preclude such taxpayer from establishing that such gross rental income and gain or loss from the disposition of property, as applicable, is not included in net investment income under any other provision of section 1411.

[1980] Part 6.B.1.(b)(4) of the preamble explains:

> … a proper grouping under § 1.469-4(d)(1) (grouping rental activities with other trade or business activities) will not convert gross income from rents into other gross income derived from a trade or business described in proposed § 1.1411-5(a)(1).

[1981] T.D. 9655.

133 F.2d 509 (6th Cir. 1943); Hazard v. Commissioner, 7 T.C. 372 (1946); and Lagreide v. Commissioner, 23 T.C. 508 (1954), for the proposition that the activities of a single property can rise to the level of a trade or business.

The Treasury Department and the IRS agree with commentators that, in certain circumstances, the rental of a single property may require regular and continuous involvement such that the rental activity is a trade or business within the meaning of Section 162. However, the Treasury Department and the IRS do not believe that the rental of a single piece of property rises to the level of a trade or business in every case as a matter of law. For example, § 1.212-1(h) provides that the rental of real property is an example of a for-profit activity under section 212 and not a trade or business.[1982]

Within the scope of a section 162 determination regarding a rental activity, key factual elements that may be relevant include, but are not limited to, the type of property (commercial real property versus a residential condominium versus personal property), the number of properties rented, the day-to-day involvement of the owner or its agent, and the type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease). Therefore, due to the large number of factual combinations that exist in determining whether a rental activity rises to the level of a section 162 trade or business, bright-line definitions are impractical and would be imprecise. The same is true wherever the section 162 trade or business standard is used and is not unique to section 1411. The Treasury Department and the IRS decline to provide guidance on the meaning of trade or business solely within the context of section 1411. However, the Treasury Department and the IRS have modified Example 1 in § 1.1411-5(b)(3) to explicitly state that the rental property in question is not a trade or business under applicable section 162 standards.

In cases where other Code provisions use a trade or business standard that is the same or substantially similar to the section 162 standard adopted in these final regulations, the IRS will closely scrutinize situations where taxpayers take the position that an activity is a trade or business for purposes of section 1411, but not a trade or business for such other provisions. For example, if a taxpayer takes the position that a certain rental activity is a trade or business for purposes of section 1411, the IRS will take into account the facts and circumstances surrounding the taxpayer's determination of a trade or business for other purposes, such as whether the taxpayer complies with any information reporting requirements for the rental activity imposed by section 6041.

The example cited above is as follows (emphasis added):[1983]

Rental activity. A, an unmarried individual, rents a commercial building to B for $50,000 in Year 1. A is not involved in the activity of the commercial building on a regular and continuous basis, therefore, A's rental activity does not involve the conduct of a trade or

---

[1982] This comment in the preamble seems to take out of context Reg. § 1.212-1(h), the full text of which is:

Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. However, ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held by the taxpayer as rental property are deductible even though such property was formerly held by the taxpayer for use as a home.

That regulation does not say that rental is not a trade or business (although it appears in a regulation designed for activities that do not constitute trades or businesses. Rather, that regulation points out that property formerly held for personal use can later be used for the production or collection of income.

[1983] Reg. § 1.1411-5(b)(3), Example 1.

business, and under section 469(c)(2), A's rental activity is a passive activity. Because paragraph (b)(1)(i) of this section is not satisfied, A's rental income of $50,000 is not derived from a trade or business described in paragraph (b)(1) of this section. However, A's rental income of $50,000 still constitutes gross income from rents within the meaning of § 1.1411-4(a)(1)(i) because rents are included in the determination of net investment income under § 1.1411-4(a)(1)(i) whether or not derived from a trade or business described in paragraph (b)(1) of this section.

The preamble explains how the final regulations relaxed the rules for nonpassive rental to one's business:[1984]

> With regard to grouping and recharacterizations, commentators recommended that the final regulations clarify that determining whether income is net investment income should be based solely on its recharacterized or grouped status as nonpassive under section 469 and the regulations thereunder. Although the Treasury Department and the IRS recognize the administrative simplicity of this rule, the Treasury Department and the IRS believe that this rule is too broad as it would 'deem' certain items to be derived in a trade or business when it is unlikely that a section 162 trade or business is present. For example, see §§ 1.469-1T(e)(3)(ii)(D) (rental of property incidental to an investment activity) and 1.469-2T(f)(3) (rental of nondepreciable property). Therefore, the final regulations do not adopt this broad approach.
>
> Another option advanced by some commentators is a special rule for self-charged rents similar to § 1.469-7 pertaining to self-charged interest. However, a proposed rule for self-charged rents would be more complex than the rule for self-charged interest because the amount of the net investment income exclusion must take into account the deductions allowed (depreciation, taxes, interest, etc.) that are not present in self-charged interest. A self-charged rent rule would have to exclude from gross income rents in the same way as self-charged interest, and would also exclude a share of the deductions attributable to earning the income. In addition, a rule based on § 1.469-7 would cover only rents within the context of section 1411(c)(1)(A)(i) and would not provide relief from the inclusion of the gain upon the sale of the property from net investment income. Accordingly, the final regulations do not adopt this recommendation.
>
> However, the Treasury Department and the IRS appreciate the concerns raised by the commentators. Therefore, the final regulations provide special rules for self-charged rental income. The final regulations provide that, in the case of rental income that is treated as nonpassive by reason of § 1.469-2(f)(6) (which generally recharacterizes what otherwise would be passive rental income from a taxpayer's property as nonpassive when the taxpayer rents the property for use in an activity in which the taxpayer materially participates) or because the rental activity is properly grouped with a trade or business

[1984] T.D. 9655. Reg. §1.1411-4(g)(6)(i):

> To the extent that gross rental income described in paragraph (a)(1)(i) of this section is treated as not derived from a passive activity by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), such gross rental income is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section.

For what is a rental activity under Reg. § 1.469-2(f)(6), see part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity. No relief is provided for self-charged royalties. Consider the structure described in part II.E Recommended Structure for Entities.

activity under § 1.469-4(d)(1) and the grouped activity is a nonpassive activity, the gross rental income is deemed to be derived in the ordinary course of a trade or business. Furthermore, in both of these instances, the final regulations provide that any gain or loss from the assets associated with that rental activity that are treated as nonpassive gain or loss will also be treated as gain or loss attributable to the disposition of property held in a nonpassive trade or business.

It has been suggested that multiple rental properties in which the taxpayer invests considerable and regular effort should meet the standard of trade or business, even when an agent is engaged to carry out some of the responsibility to manage and maintain the properties.[1985] However, one of three inherited properties leased to chain stores on triple-net-leases did not constitute a trade or business;[1986] same with an inherited residential property in which the tenant was also inherited.[1987] It has been further suggested that the Board of Tax Appeals and Tax Court have

---

[1985] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013), also appearing in the *TM Real Estate Journal* (April 3, 2013). Footnote 76 of that articles asserts:

> The fact that services were performed by agents was not detrimental in attaining trade or business status in the following cases: *Reiner v. U.S.*, 222 F.2d 770 (7th Cir. 1955); *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953); *Post v. Commissioner*, 26 T.C. 1055 (1956). See, however, *Chicago Title & Trust Co. v. U.S.*, 209 F.2d 773 (7th Cir. 1954), where the operation of 25 rental properties managed by real estate firms was considered an investment, rather than a trade or business, of the taxpayer as he was not sufficiently engaged in the operation.

[1986] *Union National Bank of Troy v. U.S.*, 195 F.Supp. 382 (N.D. NY 1961), held:

> The record discloses that Louis Gross, the deceased taxpayer, was the distinguished Bank President of the Union National Bank in that city since 1939. It was there he gave his full energy and talent every business day from that time until his death. His one-third interest in 316 River Street came to him under his father's will upon the termination of a trust for his mother, May 29, 1946. This property was a substantial one in the business section of Troy. Like two others he similarly acquired by inheritance, it was subject to net lease of the entire property to chain stores. The lease on 316 River Street was dated March 15, 1930 and executed by his father for twenty years, to expire April 30, 1952, the lessee being F. W. Woolworth Company. The lease was a net lease, and there was no obligation at all on Gross and his family to maintain or repair. Taxes, water rents, ordinary assessments, were all the obligations of the lessee. It is undisputed in the record that Gross did not to any extent, directly or indirectly through agents, have anything at all to do with the management and operation of the property. His passive contact was to receive his share of the rents as paid. The extension of the lease was arranged by his cousin through a broker, and I am content to find that the taxpayer played no active part in the arrangement of such extension. A most significant factor in the record is that the income of Gross for all rented properties in 1953 was $7,887.49; in 1954 $3,594.06, as compared to his declared net income for those years of $80,213.92 and $81,264.06. It would crush reason to conclude in view of these facts that the rental of property was his trade or business. The government concedes in its brief that the taxpayer was not heavily involved in real estate in Troy outside of the inherited properties.

[1987] *Grier v. U.S.*, 120 F.Supp. 395 (D. Conn. 1954), *aff'd* per curiam, 218 F2d 603 (2d Cir. 1955), in which the trial court held:

> In this case the activities with relation to this single dwelling, although of long duration, were minimal in nature. Activity to rent and re-rent was not required. No employees were regularly engaged for maintenance or repair.
>
> Lacking the broader activity stressed in *Rogers v. U. S.*, D.C. Conn. 1946, 69 F.Supp. 8, and *Pinchot v. C.I. R.*, *Gilford v. C. I. R.* and *Fackler v. C. I. R.*, *supra*, the real estate in this case appears to partake more of the nature of property held for investment than property used in a trade or business. The property in this case, although used for the production of income should not be considered as used in the taxpayer's trade or business.

found the mere rental of real property sufficient to constitute a trade or business but that contrary decisions in various appeals courts would suggest that jurisdiction may be an important factor.[1988] The article that made these comments offers excellent planning tips.[1989] Additional clues regarding when rental is a trade or business might be found in the rules governing tax-free split-

---

[1988] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013), also appearing in the *TM Real Estate Journal* (April 3, 2013). Footnotes 77-79 cited *Fackler v. Commissioner*, 45 B.T.A. 708, 714 (1941); *Hazard v. Commissioner*, 7 T.C. 372 (1946) (former residence rented for three years prior to sale) (real estate, even a single property in appropriate circumstances, devoted to rental purposes constitutes property used in a trade or business); *Fegan v. Commissioner*, 71 T.C. 791 (1979); *Lagriede v. Commissioner*, 23 T.C. 508 (1954); *Curphey v. Commissioner*, 73 T.C. 766 (1980) (noting that the ownership and management of such properties would not necessarily, as a matter of law, constitute a trade or business, referring to *Grier v. U.S.*, 218 F.2d 603 (2d Cir. 1955), *aff'g* 120 F. Supp. 395 (D. Conn. 1954)); 561 T.M., "Capital Assets," V.D. The latter included a reference to FSA 200120036 (for purposes of the earned income credit, rental was a trade or business when the taxpayer leased the building to the corporation with continuity and regularity, and the taxpayer's primary purpose for engaging in the rental activity was for profit). Also cited by the "Capital Assets" treatise as favoring trade or business treatment when the taxpayer only holds a single parcel of real property for rent were *Post v. Commissioner*, 26 T.C. 1055 (1956), *acq.*, 1958-1 C.B. 5 (rental of a building managed by an agent was a trade or business); *Campbell v. Commissioner*, 5 T.C. 272 (1945), *acq*., 1947-1 C.B. 1 (inherited property was placed for sale or rent immediately upon being inherited); *Ohio County & Ind. Agr. Soc., Del. County Fair v. Commissioner*, 43 T.C.M. 1126 (1982) (rental property held to constitute a trade or business for Code § 513 purposes); *Crawford v. Commissioner*, 16 T.C. 678, 680-681 (1951), *acq.*, 1951-2 C.B. 2. The "Capital Assets" treatise also mentioned that the standard tends to higher for inherited property that is sold before being operated as a business. All parentheticals above in this footnote describing cases are based on these secondary sources' summaries and not the result of my reading the cases themselves. *Central States, Southeast and Southwest Areas Pension Fund v. Messina Products, LLC*, 2013 WL 466196 (7th Cir. 2013), held that rental to one's own trade or business itself constituted a trade or business for pension withdrawal liability purposes (not a tax case); the court stated that its determination was based on general "trade or business" principles as required by *Commissioner v. Groetzinger*, 480 U.S. 23 (1987). "Simply upgrading his homes with the desire to make a profit on a sale at some time in the future is not sufficient to meet the regular-and-continuous-activity test for a trade or business." *Ohana v. Commissioner*, T.C. Memo. 2014-83, which also rejected an alleged conversion from personal to business use:

> We use five factors to determine whether an individual has converted his personal residence into property held for the production of income:
>
> - the length of time the house was occupied by the individual as his home before placing it on the market for sale;
> - whether the individual permanently abandoned all further personal use of the house;
> - the character of the property;
> - offers to rent; and
> - offers to sell.
>
> *Grant v. Commissioner*, 84 T.C. 809, 825 (1985), *aff'd without published opinion*, 800 F.2d 260 (4th Cir. 1986); *Bolaris v. Commissioner*, 81 T.C. 840 (1983), *aff'd in part, rev'd in part on another issue*, 776 F.2d 1428, 1433 (9th Cir. 1985).

[1989] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013) , also appearing in the *TM Real Estate Journal* (April 3, 2013). For additional cases and commentary, see Kehl, "Passive Losses and Tax on Net Investment Income," *T.M. Real Estate Journal* (BNA), Vol. 29, No. 06 (6/5/2013).

ups/spin-offs.[1990] Equipment rental appears to have much easier standards in qualifying as a trade or business.[1991]

Combining all of the ideas above:

- The IRS considers:
    - The type of property (commercial real property versus a residential condominium versus personal property),
    - The number of properties rented, the day-to-day involvement of the owner or its agent, and
    - The type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease).
- The IRS believes that rental of a single property may require regular and continuous involvement to constitute a trade or business, and an example in its regulations requires such participation when an individual leases a commercial property to another person. The fairest view is that, for a single property, it depends.[1992]

[1990] See part II.Q.7.f.iii Active Business Requirement for Code § 355.

[1991] See fns. 2817-2818 in part II.L.2.a.ii Rental Exception to SE Tax, discussing cases in the unrelated business income area (regarding qualified retirement plans, etc.) that apply a very low threshold of activity for treating leasing tangible personal property as a trade or business, using statutory language similar to that used in determining whether income is subject to self-employment tax. I am unaware of any authority addressing the issue of leasing tangible personal property as a trade or business outside of this arena.

[1992] In analyzing the existence of a trade or business under Code § 108, Letter Ruling 9840026 reasoned:

> The rental of even a single property may constitute a trade or business under various provisions of the Code. See, *e.g.*, *Hazard v. Commissioner*, 7 T.C. 372 (1946), *acq.*, 1946-2 C.B. 3 (section 117 of the 1939 Code); *Post v. Commissioner*, 26 T.C. 1055 (1956), *acq.*, 1958-2 C.B. 7 (same); *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953) (same); *Schwarcz v. Commissioner*, 24 T.C. 733 (1955), *acq.*, 1956-1 C.B. 5 (section 122 of the 1939 Code); *Elek v. Commissioner*, 30 T.C. 731 (1958), *acq.*, 1958-2 C.B. 5 (same); *Fegan v. Commissioner*, 71 T.C. 791 (1979), *aff'd*, 81-1 USTC ¶ 9436 (10th Cir. 1981) (section 482); *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940) (section 302 of 1926 Act); *Flint v. Stone Tracy Co.*, 220 U.S. 107, 171 (1911) (Corporation Tax). However, the ownership and rental of property does not always constitute a trade or business. See *Neill v. Commissioner*, 46 B.T.A. 197 (1942); Rev. Rul. 73-522, 1973-2 C.B. 226. The issue of whether the rental of property is a trade or business of a taxpayer is ultimately one of fact in which the scope of a taxpayer's activities, either personally or through agents, in connection with the property, are so extensive as to rise to the stature of a trade or business. *Bauer v. United States*, 168 F.Supp. 539, 541 (Ct. C1. 1958); *Schwarcz v. Commissioner*, 24 T.C. 733 (1955); See *Higgins v. Commissioner*, 312 U.S. 212 (1941) (management of taxpayer's own investment portfolio not a business).
>
> In Rev. Rul. 73-522, 1973-2 C.B. 226, the Service held that rental of real property under a "net lease" does not render the lessor engaged in a trade or business with respect to such property for purposes of section 871 of the Code. Section 871 provides special rules for taxation of a nonresident alien engaged in a trade or business in the United States. Under the facts of the ruling, the taxpayer owned rental property situated in the United States that was subject to long-term leases providing for monthly payments by the lessee of real estate taxes, operating expenses, ground rent, repairs, interest and principal on existing mortgages, and insurance in connection with the leased property. See also *Neill v. Commissioner*, 46 B.T.A. 197 (1942).

Thus, in planning rental activities:

1. First consider the extent to which the rental income qualifies as self-charged rental that is excluded from NII.

2. If the self-charged rental rules do not provide sufficient protection (or if the rental is not self-charged), consider moving away from triple-net leases and moving towards leases in which the landlord provides significant services, such as insider and outside maintenance, repairs, etc., even if the tenant ultimately bears the burden of the expenses. However, as noted in the discussion of Reg. § 1.1411-4(g)(7)(ii)(B) in part II.I.8.c.ii Real Estate Classified as Nonpassive for Real Estate Professionals, a real estate professional might not need to take this step if the professional has enough activity that does constitute a trade or business.

3. Consider that the self-charged rules might not always apply in the same way in the future as they do today. Even if the law does not change, owner, consider that ownership of the business or ownership of the rental property might change in a way that makes the self-charged rental rules no longer apply. Because grouping elections are difficult to change, consider making grouping elections with these possible ownership changes in mind. Also, grouping elections can affect whether rental is considered self-charged.

4. Finally, consider contributing the property to the partnership and receiving a preferred profit return in lieu of rent, as well as a special allocation of any gain on the sale of the property. See part II.E Recommended Structure for Entities.

If the tax savings are significant enough, one might want to avoid the uncertainty of the rental issue and instead place the business operations and the rented property in the same umbrella.[1993]

See also part II.G.25 Real Estate Dealer vs. Investor.

II.I.8.d. Partnership Structuring in Light of the 3.8% Tax on Net Investment Income

II.I.8.d.i. Interest for Use of Capital Compared with Distributive Share

Based on the principles described in this part II.I.8.d:

For operating businesses, a distributive share provides better tax treatment than a guaranteed payment of interest, if the partner is a limited partner in a partnership and materially participates.

Note, however, that, for taxpayers with modest incomes, NII tax does not apply, and self-employment (SE) tax looms large, because SE tax is at a high rate all the way up to the taxable wage base and applies to SE earnings regardless of the taxpayer's overall adjusted gross income.[1994]

For more on Rev. Rul. 73-522 and related cases regarding whether nonresident aliens holding U.S. real estate are engaging in a trade or business, see part II.E.1.e.ii Real Estate As a Trade or Business under the Effectively Connected Income (ECI) Rules.

[1993] See part II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

[1994] For self-employment tax rates and strategies, see part II.L Self-Employment Tax (FICA), especially part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax, as well as part II.Q.1.d.iii Timeline for FICA and Income Taxation of Deferred Compensation, especially fn. 3536, the latter for rates.

For high income taxpayers, SE tax might be better than NII tax, because they can deduct 1.45% of the 2.9% or 3.8% Medicare tax.

II.I.8.d.ii. Overview of Interaction between Code § 1411 and Code §§ 707(c) and 736

The preamble to 2013 proposed regulations explain their concerns regarding certain compensation and exit strategies:[1995]

> Section 731(a) treats gain from distributions as gain from the sale or exchange of a partnership interest. In general, the section 1411 treatment of gain to a partner under section 731 is governed by the rules of section 1411(c)(1)(A)(iii). Such gain is thus generally treated as net investment income for purposes of section 1411 (other than as determined under section 1411(c)(4)). However, certain partnership payments to partners are treated as not from the sale or exchange of a partnership interest. These payments include section 707(c) guaranteed payments for services or the use of capital and certain section 736 distributions to a partner in liquidation of that partner's partnership interest. Because these payments are not treated as from the sale or exchange of a partnership interest, their treatment under section 1411 may differ from the general rule of section 1411(c)(1)(A)(iii). The proposed regulations therefore provide rules for the section 1411 treatment of these payments.

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

II.I.8.d.iii. Treatment of Code § 707(c) Guaranteed Payments under Code § 1411

Regarding guaranteed payments, the preamble to the 2013 proposed regulations explains:[1996]

> Section 707(c) provides that a partnership payment to a partner is a "guaranteed payment" if the payment is made for services or the use of the capital, and the payment amount does not depend on partnership income. Section 1.707-1(c) provides that guaranteed payments to a partner for services are considered as made to a person who is not a partner, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, section 162(a) (relating to trade or business expenses). Section 1.704-1(b)(2)(iv)(o) provides that guaranteed payments are not part of a partner's distributive share for purposes of section 704(b).
>
> The proposed regulations' treatment of section 707(c) guaranteed payments under section 1411 depends on whether the partner receives the payment for services or the use of capital. The proposed regulations exclude all section 707(c) payments received for services from net investment income, regardless of whether these payments are subject to self-employment tax, because payments for services are not included in net investment income.
>
> The Treasury Department and the IRS believe that guaranteed payments for the use of capital share many of the characteristics of substitute interest, and therefore should be included as net investment income. This treatment is consistent with existing guidance

[1995] REG-130843-13, which would apply "to taxable years beginning after December 31, 2013. However, taxpayers may apply this section to taxable years beginning after December 31, 2012 in accordance with § 1.1411-1(f).
[1996] REG-130843-13.

> under section 707(c) and other sections of the Code in which guaranteed payments for the use of capital are treated as interest. See, for example, §§ 1.263A-9(c)(2)(iii) and 1.469-2(e)(2)(ii).

Prop. Reg. § 1.1411-4(g)(10) provides the above rules.[1997]

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

For the self-employment consequences of guaranteed payments for services, see parts II.L.3 Self-Employment Tax: General Partner or Sole Proprietor and II.L.4 Self-Employment Tax Exclusion for Limited Partner.

II.I.8.d.iv. Treatment of Code § 736 Redemption Payments under Code § 1411

Regarding payments to a retiring partner,[1998] the preamble to the 2013 proposed regulations explains certain general ideas:[1999]

> Section 736 applies to payments made by a partnership to a retiring partner or to a deceased partner's successor in interest in liquidation of the partner's entire interest in the partnership. Section 736 does not apply to distributions made to a continuing partner, distributions made in the course of liquidating a partnership entirely, or to payments received from persons other than the partnership in exchange for the partner's interest. Section 736 categorizes liquidating distributions based on the nature of the payment as in consideration for either the partner's share of partnership property or the partner's share of partnership income. Section 736(b) generally treats a payment in exchange for the retiring partner's share of partnership property as a distribution governed by section 731. Section 736(a) treats payments in exchange for past services or use of capital as either distributive share or a guaranteed payment. Section 736(a) payments also include

---

[1997] The proposed regulation provides:

> Treatment of section 707(c) guaranteed payments. Net investment income does not include section 707(c) payments received for services. Except to the extent provided in paragraph (g)(11)(iii)(A) of this section, section 707(c) payments received for the use of capital are net investment income within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section.

However, I do not believe that the last sentence of the quote above ends the story; I believe that it merely suggests under what category payments for the use of capital would be tested. Prop. Reg. § 1.1411-4(g)(11)(iii)(A), described further below, applies to Code § 736(a)(2) payments for Code § 751(c) unrealized receivables and for goodwill and states that those payments are included in NII under the sale-of-business category. Prop. Reg. § 1.1411-4(g)(11)(iii)(B) coordinates with (A) and characterizes payments other than for unrealized receivables and goodwill as for services or interest. To me, this reference to treatment as NII under these buckets means merely that one tests these items under those buckets – not that they will automatically be NII; otherwise, the sale of an active business under Code § 736 would be treated less favorably than the sale of a partnership interest other than to the partnership or the sale of an interest in a sole proprietorship or S corporation, and the spirit of the preamble to the proposed regulations is to provide parity to partnership redemptions – not to place them at a disadvantage. Fn. 2002 clarifies that the Code § 1411(c)(4) exclusion from NII on the sale of a partnership interest would apply.

The self-charged interest rules apply to Code § 707(c) payments. Reg. § 1.469-7(a)(1). I believe that the "better" reading is that they apply to treat Code § 707(c) guaranteed payments for the use of capital as interest subject to the self-charged interest exclusion from NII . See fn. 1945.

[1998] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[1999] REG-130843-13.

payments to retiring general partners of service partnerships in exchange for unrealized receivables (other than receivables described in the flush language of section 751(c)) or for goodwill (other than payments for goodwill provided for in the partnership agreement) (collectively, "Section 736(a) Property").

Because the application of section 1411 depends on the underlying nature of the payment received, the section 736 categorization controls whether a liquidating distribution is treated as net investment income for purposes of section 1411. Thus, the treatment of the payment for purposes of section 1411 differs depending on whether the distribution is a section 736(b) distribution in exchange for partnership property or a section 736(a) distribution in exchange for past services, use of capital, or Section 736(a) Property. Among section 736(a) payments, the proposed regulations further differentiate the treatment of payments depending on: (i) whether or not the payment amounts are determined with regard to the income of the partnership and (ii) whether the payment relates to Section 736(a) Property or relates to services or use of capital.

Section 1.469-2(e)(2)(iii) contains rules pertaining to whether section 736 liquidating distributions paid to a partner will be treated as income or loss from a passive activity. Where payments to a retiring partner are made over a period of years, the composition of the assets and the status of the partner as passive or nonpassive may change. Section 1.469-2(e)(2)(iii) contains rules on the extent to which those payments are classified as passive or nonpassive for purposes of section 469. The proposed regulations generally align the section 1411 characterization of section 736 payments with the treatment of the payments as passive or nonpassive under § 1.469-2(e)(2)(iii).

These rules regarding Code § 736 payments do not apply to distributions from qualified retirement plans or self-employment earnings.[2000]

Regarding Code § 736(b) payments for partnership property, the preamble to the 2013 proposed regulations explains certain general ideas:[2001]

Section 736(b) payments to retiring partners in exchange for partnership property (other than payments to retiring general partners of service partnerships in exchange for Section 736(a) Property) are governed by the rules generally applicable to partnership distributions. Thus, gain or loss recognized on these distributions is treated as gain or loss from the sale or exchange of the distributee partner's partnership interest under section 731(a).

The proposed regulations provide that section 736(b) payments will be taken into account as net investment income for section 1411 purposes under section 1411(c)(1)(A)(iii) as net gain or loss from the disposition of property. If the retiring partner materially

[2000] Prop. Reg. § 1.1411-4(g)(11)(i) provides:

In general. The treatment of payments received by a retiring partner or a deceased partner's successor in interest described in section 736 is determined under the rules of this paragraph (g)(11). Section 736 payments are not distributions from a plan or arrangement described in section 1411(c)(5) and § 1.1411-8 [qualified retirement plans, etc.]. To the extent that any portion of a section 736 payment is taken into account in computing a taxpayer's net earnings from self-employment (within the meaning of § 1.1411-9), then such amount is not taken into account in computing net investment income by reason of section 1411(c)(6) and § 1.1411-9.

[2001] REG-130843-13.

> participates in a partnership trade or business, then the retiring partner must also apply § 1.1411-7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4).[2002] Gain or loss relating to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) regardless of whether the payments are classified as capital gain or ordinary income (for example, by reason of section 751).
>
> In the case of section 736(b) payments that are paid over multiple years, the proposed regulations provide that the characterization of gain or loss as passive or nonpassive is determined for all payments as though all payments were made at the time that the liquidation of the exiting partner's interest commenced and is not retested annually. The proposed regulations thus adopt for section 1411 purposes the section 469 treatment of section 736(b) payments paid over multiple years as set forth in § 1.469-2(e)(2)(iii)(A).

Thus, Code § 736(b) payments are treated as sales of partnership interests,[2003] and Code § 736(b) payments are treated as an installment sale in the year of disposition for Code § 1411 purposes[2004] even though for income tax purposes each year's payment stands alone.[2005]

Regarding Code § 736(a) payments for partnership goodwill, etc., the preamble to the 2013 proposed regulations explains certain general ideas:[2006]

> As described in part 2.B.i., section 736 provides for several different categories of liquidating distributions under section 736(a). Payments received under section 736(a) may be an amount determined with regard to the income of the partnership taxable as distributive share under section 736(a)(1) or a fixed amount taxable as a guaranteed payment under section 736(a)(2). The categorization of the payment as distributive share or guaranteed payment will govern the treatment of the payment for purposes of section 1411.
>
> The determination of whether section 736(a) payments received over multiple years are characterized as passive or nonpassive depends on whether the payments are received in exchange for Section 736(a) Property. With respect to section 736(a)(1) payments in exchange for Section 736(a) Property, § 1.469-2(e)(2)(iii)(B) provides a special rule that computes a percentage of passive income that would result if the partnership sold the

---

[2002] This sentence is key to interpreting Prop. Reg. § 1.1411-4(g)(11)(iii). One might construe Prop. Reg. § 1.1411-4(g)(11)(iii)(A) as making certain payments per se NII; this sentence instead provides the correct context – Prop. Reg. § 1.1411-4(g)(11)(iii)(A) merely described under which bucket to categorize the payment if it is NII, and then apply the Code § 1411(c)(4) exclusion from gain on sale after placing the item in the bucket.

[2003] Prop. Reg. § 1.1411-4(g)(ii)(iv) provides:

> Gain or loss attributable to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) and paragraphs (a)(1)(iii) and (d) of this section as gain or loss from the disposition of a partnership interest.

[2004] Prop. Reg. § 1.1411-4(g)(ii)(iv) provides:

> A taxpayer who elects under § 1.736-1(b)(6) must apply the principles that are applied to installment sales in § 1.1411-7(d).

[2005] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736, especially fns. 4544 and 4571 and the accompanying text.

[2006] REG-130843-13.

retiring partner's entire share of Section 736(a) Property at the time that the liquidation of the partner's interest commenced. The percentage of passive income is then applied to each payment received. See § 1.469-2(e)(2)(iii)(B)(1). These rules apply to section 736(a)(1) and section 736(a)(2) payments for Section 736(a) Property. The proposed regulations adopt this treatment as set forth in section 469 for purposes of section 1411.

When Code § 736(a) payments for partnership goodwill, etc. are taxable as a distributive share, the preamble to the 2013 proposed regulations explains:[2007]

> Section 736(a)(1) provides that if the amount of a liquidating distribution (other than a payment for partnership property described in section 736(b)) is determined with regard to the partnership's income, then the payment is treated as a distributive share of income to the retiring partner. For purposes of section 1411, the items of income, gain, loss, and deduction attributable to the distributive share are taken into account in computing net investment income under section 1411(c)(1) in a manner consistent with the item's chapter 1 character and treatment. For example, if the partner's distributive share includes income from a trade or business not described in section 1411(c)(2), that income will be excluded from net investment income. However, if the distributive share includes, for example, interest income from working capital, then that income is net investment income.
>
> The proposed regulations treat section 736(a)(1) payments unrelated to Section 736(a) Property as characterized annually as passive or nonpassive by applying the general rules of section 469 to each payment in the year received. To the extent that any payment under section 736(a)(1) is characterized as passive income under the principles of section 469, that payment also will be characterized as passive income for purposes of section 1411.

Thus, the 2013 proposed regulations treat Code § 736(a)(1) payments consistent with their character for regular income tax purposes, including their character under the passive loss rules.[2008] If a retiring partner receives a distributive share of the partnership's income in exchange for that partner's shares of the partnership's unrealized receivables and the partner materially participated in the partnership's trade or business before retiring, the distributive share is not NII.[2009] However, payments that exceeded the partner's shares of the partnership's unrealized receivables needed to be tested annually to determine whether the distributive share of operating income and deductions would be NII, presumably because the payments (described as an incentive to retire early) were not for the partnership's underlying assets;[2010] note that a retired partner generally would not be materially participating, although it is possible that the retired

---

[2007] REG-130843-13.

[2008] Prop. Reg. § 1.1411-4(g)(11)(ii)(A) provides:

> General rule. In the case of a payment described in section 736(a)(1) as a distributive share of partnership income, the items of income, gain, loss, and deduction attributable to such distributive share are taken into account in computing net investment income in section 1411(c) in a manner consistent with the item's character and treatment for chapter 1 purposes. See § 1.469-2(e)(2)(iii) for rules concerning the item's character and treatment for chapter 1.

See part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736. Fn. 2002 points out that the Code § 1411(c)(4) exclusion from NII on the sale of a partnership interest would apply.

[2009] Prop. Reg. § 1.1411-4(g)(11)(ii)(B), Example (1). However, the example did not exclude the income if it was from financial instruments and commodities.

[2010] Prop. Reg. § 1.1411-4(g)(11)(ii)(B), Example (2).

partner might still have some time remaining under the rule that looks to participation in 5 of the past 10 years[2011] or if the activity were a personal service activity in which the taxpayer materially participated for any 3 years.[2012]

When Code § 736(a) payments for partnership goodwill, etc. are taxable as guaranteed payments, the preamble to the 2013 proposed regulations explains:[2013]

> Section 736(a)(2) provides that if the amount of a liquidating distribution (other than a payment for partnership property described in section 736(b)) is determined without regard to the partnership's income, then the payment is treated as a guaranteed payment as described in section 707(c). Payments under section 736(a)(2) might be in exchange for services, use of capital, or Section 736(a) Property. The section 1411 treatment of guaranteed payments for services or the use of capital follows the general rules for guaranteed payments set forth in part 2.A of this preamble. Thus, section 736(a)(2) payments for services are not included as net investment income, and section 736(a)(2) payments for the use of capital are included as net investment income.
>
> Section 736(a)(2) payments in exchange for Section 736 Property are treated as gain or loss from the disposition of a partnership interest, which is generally included in net investment income under section 1411(c)(1)(A)(iii). If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply § 1.1411-7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4). To the extent that section 736(a)(2) payments exceed the fair market value of Section 736(a) Property, the proposed regulations provide that the excess will be treated as either interest income or as income in exchange for services, in a manner consistent with the treatment under § 1.469-2(e)(2)(iii).

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

When Code § 736 payments are taxable as guaranteed payments or considered attributable to the sale of the partnership's underlying assets, the preamble to the 2013 proposed regulations explains:[2014]

> The proposed regulations provide that section 1411(c)(4) applies to section 736(a)(2) and section 736(b) payments. Thus, the inclusion of these payments as net investment income may be limited if the retiring partner materially participated in all or a portion of the partnership's trade or business. The extent of any limitation is determined under the rules of § 1.1411-7.
>
> The proposed regulations provide that, when section 736 payments are made over multiple years, the characterization of gain or loss as passive or nonpassive and the values of the partnership assets are computed for all payments as though all payments were

[2011] See part II.K.1.a.ii Material Participation.
[2012] See part II.K.1.a.ii Material Participation, including fn. 2469, referring to activity that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or is a trade or business in which capital is not a material income-producing factor.
[2013] REG-130843-13.
[2014] REG-130843-13.

made at the time that the liquidation of the exiting partner's interest commenced, similar to the treatment in § 1.469-2(e)(2)(iii)(A).

If a partner's net investment income is reduced pursuant to section 1411(c)(4), then the difference between the amount of gain recognized for chapter 1 and the amount includable in net investment income after the application of section 1411(c)(4) is treated as an addition to basis, in a manner similar to an installment sale for purposes of calculating the partner's net investment income attributable to these payments.

To the extent that a guaranteed payment redeeming a partner's interest is allocable to the partnership's unrealized receivables[2015] and goodwill,[2016] for NII purposes it is treated as gain from the disposition of a partnership interest.[2017] To the extent that a guaranteed payment redeeming a partner's interest is not allocable to the partnership's unrealized receivables and goodwill, for NII purposes it is treated as payment for services[2018] or the payment of interest consistent with its characterization under the passive loss rules.[2019]

To summarize testing regarding the passive or nonpassive character of income from trade or business activities:

- Code § 736(a)(2) guaranteed payments and Code § 736(b) payments are tested at the time of the disposition, even though for regular income tax purposes they are treated as separate payments each year.

- Code § 736((a)(1) payments are tested annually, which might be a disadvantage to a partner who no longer participates in the business, subject to certain favorable rules regarding prior participation.[2020]

II.I.8.e. NII Components of Gain on the Sale of an Interest in a Partnership or S corporation

Part 8 of the preamble to the 2012 proposed regulations describes how Code § 1411 approaches the sale of an interest in a partnership or S corporation:

In most cases, an interest in a partnership or S corporation is not property held in a trade or business. Therefore, gain or loss from the sale of a partnership interest or S corporation

---

[2015] Within the meaning of Code § 751(c).
[2016] As described and calculated in Reg. § 1.469-2(e)(2)(iii)(B). See part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736, especially fn. 2585.
[2017] Prop. Reg. § 1.1411-4(g)(11)(iii)(A).
[2018] Because this characterization is only for NII purposes (see fn. 1860), presumably it has no effect on the favorable treatment for self-employment tax of payments described in part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.
[2019] Prop. Reg. § 1.1411-4(g)(11)(iii)(B), referring to Reg. § 1.469-2(e)(2)(ii); see part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736. The provision cross-references Reg. § 1.1411-4(g)(9), which provides that losses allowed in computing taxable income by reason of Code § 469(g) (disposition of an entire interest in a passive activity) are taken into account in computing net gain under Reg. § 1.1411-4 (d) or as properly allocable deductions under Reg. § 1.1411-4(f), as applicable, in the same manner as such losses are taken into account in computing taxable income under Code § 63. Code § 469(g), the rule governing the disposition of a passive activity, is described in part II.K.1.i Complete Disposition of Passive Activity. Note that part or all of a self-charged interest component may be excluded from NII. See fn. 1945.
[2020] For the favorable rules regarding prior participation, see text accompanying fns. 2011-2012.

stock will be subject to section 1411(c)(1)(A)(iii). See also section 731(a) and section 1368(b)(2) (providing that the gain recognized when cash is distributed in excess of the adjusted basis of, as applicable, a partner's interest in a partnership or a shareholder's stock in an S corporation is treated as gain from the sale or exchange of such partnership interest or S corporation stock).

Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or S corporation, gain from such disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be so taken into account by the transferor under section 1411(c)(1)(A)(iii) if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest. Section 1411(c)(4)(B) applies a similar rule to a loss from a disposition.

For purposes of section 1411, Congress intended section 1411(c)(4) to put a transferor of an interest in a partnership or S corporation in a similar position as if the partnership or S corporation had disposed of all of its properties and the accompanying gain or loss from the disposition of such properties passed through to its owners (including the transferor). However, the gain or loss upon the sale of an interest in the entity and a sale of the entity's underlying properties will not always match. First, there may be disparities between the transferor's adjusted basis in the partnership interest or S corporation stock and the transferor's share of the entity's adjusted basis in the underlying properties. See Example 2 of proposed § 1.1411-7(e). Second, the sales price of the interest may not reflect the proportionate share of the underlying properties' fair market value with respect to the interest sold.

In order to achieve parity between an interest sale and an asset sale, section 1411(c)(4) must be applied on a property-by-property basis, which requires a determination of how the property was held in order to determine whether the gain or loss to the transferor from the hypothetical disposition of such property would have been gain or loss subject to section 1411(c)(1)(A)(iii). As described in proposed § 1.1411-4(a)(1)(iii) and proposed § 1.1411-4(d), section 1411(c)(1)(A)(iii) applies if the property disposed of is either not held in a trade or business, or held in a trade or business described in proposed § 1.1411-5. In other words, under the proposed regulations, the exception in section 1411(c)(4) is only applicable where the property is held in a trade or business not described in section 1411(c)(2). See JCT 2011 Explanation, at 364, fn. 976 (and accompanying text); Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act" (JCX-18-10) (Mar. 21, 2010), at 135 fn. 286 (and accompanying text) (JCT 2010 Explanation). This means that the exception in section 1411(c)(4) does not apply where (1) there is no trade or business, (2) the trade or business is a passive activity (within the meaning of proposed § 1.1411-5(a)(1)) with respect to the transferor, or (3) where the partnership or the S corporation is in the trade or business of trading in financial instruments or commodities (within the meaning of proposed § 1.1411-5(a)(2)), because in these cases there would be no change in the amount of net gain determined under proposed § 1.1411-4(a)(1)(iii) upon an asset sale under section 1411(c)(4). For example, if the transferor is passive with respect to the entity's trade or business, the application of the deemed asset sale rule under section 1411(c)(4), as described in part 8.A of this preamble, would not adjust the transferor's section 1411(c)(1)(A)(iii) gain on the disposition of the interest….

Getting into the details, Reg. § 1.1411-4(a)(1)(iii) taxes as net investment income:

> Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property, except to the extent excluded by the exception described in paragraph (d)(4)(i)(A) of this section for gain or loss attributable to property held in a trade or business not described in § 1.1411-5.

Reg. § 1.1411-4(d)(4)(i)(A) provides:

> Net gain does not include gain or loss attributable to property (other than property from the investment of working capital (as described in § 1.1411-6)) held in a trade or business not described in § 1.1411-5.

Reg. § 1.1411-4(d)(4)(i)(B)(1) provides:

> A partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock is generally gain described in paragraph (a)(1)(iii) of this section. However, net gain does not include certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations as provided in § 1.1411-7.

Reg. § 1.1411-5(a) provides:

> *In general*. A trade or business is described in this section if such trade or business involves the conduct of a trade or business, and such trade or business is either--
>
> (1) A passive activity (within the meaning of paragraph (b) of this section) with respect to the taxpayer; or
>
> (2) The trade or business of a trader trading in financial instruments (as defined in paragraph (c)(1) of this section) or commodities (as defined in paragraph (c)(2) of this section).

For whether assets are used in a business, see part II.I.8.a.v Working Capital Is NII (as describing Reg. § 1.1411-6). However, ultimately part II.I.8.a.v.(b) What Is Working Capital provides an additional exclusion under Reg. § 1.1411-7, which needs to be addressed anyway, as described in Reg. § 1.1411-4(d)(4)(i)(B)(1) above.

The preamble to the final regulations explains:[2021]

> In the case of the disposition of an interest in a partnership or an S corporation, section 1411(c)(4) provides that gain or loss from such disposition is taken into account for purposes of section 1411(c)(1)(A)(iii) only to the extent of the net gain or net loss that would be so taken into account by the transferor if all property of the partnership or S corporation were sold at fair market value immediately before the disposition of such interest. Section 1.1411-7 of the final regulations is reserved for guidance under section 1411(c)(4). However, regulations are being proposed contemporaneously with

[2021] T.D. 9655

these final regulations that address the application of section 1411(c)(4) to dispositions of interests in partnerships or S corporations.

The preamble to the 2013 proposed regulations summarized these rules:[2022]

9. Calculation of Gain or Loss Attributable to the Disposition of Certain Interests in Partnerships and S corporations

Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or of stock in an S corporation (either, a "Passthrough Entity"), gain from the disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be taken into account by the transferor if the Passthrough Entity sold all of its property for fair market value immediately before the disposition of the interest. Section 1411(c)(4)(B) provides a similar rule for losses from dispositions.

The 2012 Proposed Regulations required that a transferor of a partnership interest or S corporation stock first compute its gain (or loss) from the disposition of the interest in the Passthrough Entity to which section 1411(c)(4) may apply, and then reduce that gain (or loss) by the amount of non-passive gain (or loss) that would have been allocated to the transferor upon a hypothetical sale of all of the Passthrough Entity's assets for fair market value immediately before the transfer. The Treasury Department and the IRS received several comments questioning this approach based on the commentators' reading of section 1411(c)(4) to include gain/loss from the disposition of a partnership interest or S corporation stock only to the extent of the transferor's share of gain/loss from the Passthrough Entity's passive assets.

The 2013 Final Regulations do not provide rules regarding the calculation of net gain from the disposition of an interest in a Passthrough Entity to which section 1411(c)(4) may apply. After considering the comments received, the Treasury Department and the IRS have withdrawn the 2012 Proposed Regulations implementing section 1411(c)(4) and are issuing this notice of proposed rulemaking to propose revised rules for the implementation of section 1411(c)(4) adopting the commentators' suggestion. Accordingly, the 2013 Final Regulations reserve on this issue.

Proposed § 1.1411-7(b) provides a calculation to determine how much of the gain or loss that is recognized for chapter 1 purposes is attributable to property owned, directly or indirectly, by the Passthrough Entity that, if sold, would give rise to net gain within the meaning of section 1411(c)(1)(A)(iii) ("Section 1411 Property"). Section 1411 Property is any property owned by, or held through, the Passthrough Entity that, if sold, would result in net gain or loss allocable to the partner or shareholder that is includable in determining the partner or shareholder's net investment income under § 1.1411-4(a)(1)(iii). This definition recognizes that the items of property inside the Passthrough Entity that constitute Section 1411 Property might vary among transferors because a transferor may or may not be "passive" with respect to the property.

Proposed § 1.1411-7(c) provides an optional simplified reporting method that qualified transferors may use in lieu of the calculation described in proposed § 1.1411-7(b). Proposed § 1.1411-7(d) contains additional rules that apply when a transferor disposes of its interest in the Passthrough Entity in a deferred recognition transaction to which

[2022] REG-130843-13.

6833577

> section 1411 applies. Proposed § 1.1411-7(f) provides rules for adjusting the amount of gain or loss computed under this paragraph for transferors subject to basis adjustments required by § 1.1411-10(d). Proposed § 1.1411-7(g) provides rules for information disclosures by a Passthrough Entity to transferors and for information reporting by individuals, trusts, and estates.

Net gain constituting NII does not include gain or loss attributable to property (other than property from the investment of working capital)[2023] held in a nonpassive trade or business.[2024]

Thus, to determine whether net gain is from property held in a trade or business:[2025]

1. A partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock is generally NII. However, net gain constituting NII does not include certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations that is attributable to their business assets, to the extent provided in Reg. § 1.1411-7.

2. In the case of an individual, estate, or trust that owns or engages in a trade or business,[2026] the determination of whether net gain that is ordinarily NII is attributable to property held in a trade or business is made at the individual, estate, or trust level.[2027]

3. In the case of an individual, estate, or trust that owns an interest in a partnership or an S corporation, and that entity is engaged in a trade or business, the determination of whether net gain that is ordinarily NII from such entity is:[2028]

    - from a passive trade or business activity is determined at the owner level; and

    - derived in trade or business of a trader trading in financial instruments or commodities[2029] is determined at the entity level.

See also part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

The preamble to the final regulations explains how Code § 469(g) (the rule governing the disposition of a passive activity, which is described in part II.K.1.i Complete Disposition of Passive Activity) interacts with the 3.8% tax:[2030]

> Section 469(g)(1) provides, in relevant part, that if all gain or loss realized on a disposition is recognized, the excess of any loss from that activity for such taxable year (determined

[2023] As described in Reg. § 1.1411-6.
[2024] Reg. § 1.1411-4(d)(4)(i)(A).
[2025] Reg. § 1.1411-4(d)(4)(i)(B).
[2026] Whether directly or indirectly through ownership of an interest in an entity that is disregarded under the check-the-box rules under Reg. § 301.7701-3.
[2027] Reg. § 1.1411-4(d)(4)(i)(B)(3).
[2028] Reg. § 1.1411-4(d)(4)(i)(B)(3).
[2029] Reg. § 1.1411-5(c) discusses financial instruments and commodities.
[2030] T.D. 9655. Reg. § 1.1411-4(g)(9) provides:
> *Treatment of section 469(g)(1) losses*. Losses allowed in computing taxable income by reason of section 469(g) are taken into account in computing net gain under paragraph (d) of this section or

after the application of section 469(b)), over any net income or gain for that taxable year from all other passive activities (determined after the application of section 469(b)), shall be treated as a loss which is not from a passive activity. The preamble to the proposed regulations requested comments on "whether the losses triggered under section 469(g)(1) upon the disposition should be taken into account in determining the taxpayer's net gain on the disposition of the activity under section 1411(c)(1)(A)(iii) or whether the losses should be considered properly allocable deductions to gross income and net gain described in section 1411(c)(1)(A)(i) through (iii)." Because section 469(g)(1) provides that the allowed loss is treated as a loss "which is not from a passive activity," there is a question whether this language prevents the allowed losses from being treated as "properly allocable deductions" from passive activities for purposes of section 1411.

Commentators recommended that losses allowed under section 469(g) be taken into account in computing net gain under section 1411(c)(1)(A)(iii), and that any net loss in section 1411(c)(1)(A)(iii) resulting from the use of such losses should be treated as a properly allocable deduction under section 1411(c)(1)(B). One commentator suggested that, to the extent a taxpayer has a net loss under section 1411(c)(1)(A)(iii) that is attributable to the allowed loss under section 469(g), the excess section 469(g) loss should continue to be suspended and carried forward to offset future gain resulting from the disposition of other passive assets subject to inclusion in section 1411(c)(1)(A)(iii).

The final regulations provide that section 469(g) losses, which are treated as losses from a nonpassive activity, are taken into account for net investment income purposes in the same manner in which they are taken into account for chapter 1 purposes. As discussed in the context of section 469(f), section 469 does not alter the character or nature of the suspended passive loss. If the suspended losses allowed as a current year deduction by reason of section 469(g)(1) are attributable to operating deductions in excess of operating income, such suspended losses retain that character as, in most cases, deductions described in section 62(a)(1) or 62(a)(4). However, to the extent the suspended losses are comprised of losses originating from the disposition of property (such as ordinary section 1231 losses or capital losses), those losses also retain their character when they are ultimately allowed by section 469. Therefore, losses that are allowed by reason of section 469(g) may constitute properly allocable deductions under section 1411(c)(1)(B) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) in the year they are allowed, depending on the underlying character and origin of such losses. The recommendations proposed by the commentators depart from the general operating principles in chapter 1 and add additional complexity. Therefore, the final regulations do not adopt the positions advanced by commentators that section 469(g)(1) suspended losses should offset the gain first, then be allowed as a properly allocable deduction or that it should continue to be suspended and carried forward.

Furthermore, section 469(g)(1) losses that are allowed by reason of a fully taxable disposition of a former passive activity are also fully taken into account for net investment income. As a result of the ordering rules in sections 469(f)(1) and (g)(1), any nonpassive gain realized on the disposition that causes passive losses to be allowed would be excluded from net investment income under the general former passive activity rules

---

as properly allocable deductions under paragraph (f) of this section, as applicable, in the same manner as such losses are taken into account in computing taxable income (as defined in section 63).

See Reg. § 1.1411-4(g)(8)(iii), Example (2).

discussed in part 5.E.iv of this preamble. However, to the extent that any of the nonpassive gain is included in net investment income (for example, a portion of the gain remaining after the application of section 1411(c)(4)), the final regulations allow the same amount of suspended losses described in section 469(f)(1)(A) to be included in net investment income to offset the gain. The section 469(g)(1) losses allowed by reason of the disposition of the former passive activity are allowed in full because they relate to a period of time when the activity was a passive activity and represent true economic losses from a passive activity that do not materially differ from other section 469(g)(1) losses from non-former passive activities.

Losses allowed in computing taxable income by reason of Code § 469(g) are taken into account in computing net gain or as properly allocable deductions in the same manner as such losses are taken into account in computing Code § 63 taxable income.[2031]

I do not plan to analyze here the methods of calculating gain excluded from NII under the 2013 proposed regulations. If any reader would like to alert me to planning opportunities, I would be happy to review those ideas.

II.I.8.f. Summary of Business Activity Not Subject to 3.8% Tax

This part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax hits some of the highlights of part II.I.8 Application of 3.8% Tax to Business Income but is not intended to be comprehensive. Also consider part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, especially part II.K.3.b Maximizing Flexibility to Avoid NOLs and Use Losses in the Best Year.

If a trade or business is not a long-term rental activity, then the activity is not NII if:

- During the taxable year, the owner spends more than 100 hours in the business' daily operations (a significant participation activity),[2032]
- The activity is a personal service activity, and the individual materially participated in the activity for any 3 taxable years (whether or not consecutive) preceding the taxable year,[2033] or
- For either the current year or any five out of the past ten years, the owner spent more than 500 hours in the business' daily operations (a material participation activity).[2034]

[2031] Reg. § 1.1411-4(f)(9).
[2032] See parts II.I.8.a.i Passive Activity Recharacterization Rules, II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, II.K.1.a.vi Proving Participation, and II.K.1.a.v What Does Not Count as Participation.
[2033] See part II.K.1.a.ii Material Participation, including fn. 2469, referring to activity that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or is a trade or business in which capital is not a material income-producing factor.
[2034] See parts II.I.8.a General Application of 3.8% Tax to Business Income and II.K.1.a Counting Work as Participation.

Note, however, that significant participation activities may be aggregated to constitute material participation, moving one from a significant participation paradigm to a material participation paradigm, so be sure you know which paradigm applies.[2035]

The significant participation activity exception covers many situations but is not a panacea:

- Various credits arising from significant participation activities might be suspended.[2036]

- From an income tax perspective, consider that losses from a significant participation activity offset regular income only in certain situations.[2037]

- The self-charged rental and interest exception described below apply only if the recipient materially participates in the payer activity. For example, if a taxpayer rents real estate to an S corporation in which the taxpayer materially participates, then the rental meets the self-charged rental exception. If the taxpayer's participation in the S corporation is "significant" but not "material" (see text accompanying fn. 2035 above), then the S corporation's income is nonpassive but the rental activity is passive investment income (subject to exclusions for real estate professionals).

- If a taxpayer works for more than 500 hours for five years, the activity continues to be nonpassive under the 5-out-of-the-last-10-years rule. Working for more than 100 hours but not more than 500 hours does not trigger the 5-out-of-the-last-10-years rule. The same idea also applies to the 3-year personal service activity rule.

Rental income and part or all of interest income paid to an owner of a business in which the landlord or lender, respectively, materially participate is not NII.[2038]

Rental not protected by the self-rental exception is not NII under either of the following situations:

- The taxpayer is a real estate professional and the rental activity rises to the level of being a trade or business or is not a trade or business but is grouped with a rental trade business.[2039]

- Any gain from the property's sale is included in the taxpayer's income for the taxable year, the property's rental began less than 12 months before the property was sold, and the taxpayer materially participated or significantly participated for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the property's value.[2040]

See also part II.G.25 Real Estate Dealer vs. Investor.

[2035] See fns. 2466-2467 and accompanying text, found in part II.K.1.a.ii Material Participation.
[2036] See part II.K.1.h.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.
[2037] See part II.K.1.a Counting Work as Participation.
[2038] See part II.I.8.a.iii Qualifying Self-Charged Interest or Rent.
[2039] See parts II.I.8.c.ii Real Estate Classified as Nonpassive for Real Estate Professionals and II.I.8.c.iii Rental as a Trade or Business.
[2040] For details and nuances, see fn. 2634 in part II.K.1.e Rental Activities.

II.I.8.g. Structuring Businesses in Response to 3.8% Tax

What might be an ideal structure for a new business entity is described in part II.E Recommended Structure for Entities.

When structuring to avoid this 3.8% tax, be careful to avoid triggering another 3.8% tax: FICA (self-employment tax). Part II.L Self-Employment Tax (FICA) describes these rules, with specific structures illustrated in parts II.L.5 Self-Employment Tax: Partnership with S corporation Blocker and II.L.6 SE Tax N/A to Nongrantor Trust; see also part II.E Recommended Structure for Entities. If one has to choose between the 3.8% tax on net investment income and self-employment tax, consider not only the thresholds for applying them but also the fact that the employer's 1.45% share is deductible against business income,[2041] whereas none of the 3.8% tax on net investment income is deductible.

Structuring a trust to characterize its income as nonpassive income might not be quite as easy as one might think. See part II.K.2.b Participation by an Estate or Nongrantor Trust. For other considerations regarding trusts and net investment income tax, see part II.J.3.a Who Is Best Taxed on Gross Income, especially the text accompanying fns. 2068-2072.

Note that participation by an ESBT is based on its trustee's actions, whereas participation by a QSST is based on its beneficiary's actions:

- Although switching to a QSST might facilitate participation regarding the S corporation's income, it might complicate qualifying for the self-rental exception that avoids the 3.8% tax on rental income. The self-rental exception requires the landlord to materially participate in the tenant's business.[2042] Material participation in the tenant's business includes owning an interest in the tenant's business.[2043] Suppose a nongrantor trust owns the real estate and the S corporation stock. If and to the extent that the QSST election is made, the beneficiary, not the trust, is deemed to own the stock. A solution might be to place most of the stock into a QSST, keeping some in an ESBT. The portion that is in the ESBT would qualify that trust for the self-rental exception. The governing regulations[2044] do not impose a minimum ownership requirement, so it appears that any ownership of stock by the ESBT would suffice; I leave it to the reader to decide whether leaving more than a peppercorn is advisable.

- A trust that has only one current beneficiary might be able to switch back and forth every 36 months. See part III.A.3.e.iv Flexible Trust Design.

See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income if the business has enough potential for ups and downs in its taxable income that planning for a potential significant loss becomes important.

Also, one might consider selling S corporation stock to a QSST that a third party (perhaps the client's parent) creates for the client. For a discussion of how this avoids income tax on the sale but also might require the equivalent of paying for the stock twice, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs. After the note is repaid (or 36 months, whichever occurs last),

---

[2041] Code § 164(f)(1).
[2042] See part II.I.8.a.iii Qualifying Self-Charged Interest or Rent Is Not NII, especially fn. 1950, and part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity, especially fn. 2594-2595.
[2043] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.
[2044] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

perhaps part or all of the trust would be switched to an ESBT, as discussed in part III.A.3.e.iv Flexible Trust Design.

II.I.9. Elections or Timing Strategies to Consider to Minimize the 3.8% Tax on NII

Elections to consider to minimize the tax apply to:[2045]

- Regrouping passive activities.[2046]

- Pre-2013 installment sales that might generate net investment income in 2013 and later years.

- Controlled foreign corporation and qualified electing fund stock.

- Married taxpayers, in which one spouse is a nonresident alien. Nonresident aliens are not subject to the tax.[2047]

Because the tax applies only if modified adjusted gross income (MAGI) exceeds various thresholds, consider accelerating next year's income or deferring the current year's income so that either this year or next year has MAGI below the threshold. For example:

- Accelerate or defer retirement plan distributions or change the mix between Roth and traditional IRA distributions, to the extent permitted without violating the rules requiring minimum distributions to be taken.[2048] Even though retirement plan distributions are not NII, income from distributions increases MAGI.

- Time capital gains and losses which might include, if spreading out the gain will keep MAGI below the threshold, engaging in installment sales.[2049]

II.J. Fiduciary Income Taxation

Generally, a "trust" is:[2050]

[2045] Nadeau and Ellis, "The Net Investment Income Tax: Elections to Start Thinking About Now," *T.M. Memorandum* (BNA), Vol. 54, No. 07 (4/8/2013). This article's Appendix contains a handy chart.
[2046] See parts II.K.1.b.ii Grouping Activities – General Rules and II.K.1.b.iv Regrouping Activities Transitioning into 3.8% Tax on Net Investment Income.
[2047] Code § 1411(e)(1).
[2048] Code §§ 401(a)(9), 403(b)(10), 408(a)(6), 408(b)(3).
[2049] Code § 453, which is subject to Code §§ 453A and 453B.
[2050] Reg. § 301.7701-4(a), which further provides:

> Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

> an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.

A life estate might create a relationship that rises to the level of a trust.[2051]

However, a mere agency agreement does not constitute a trust.[2052] Nor does a court-supervised guardianship or conservatorship for a minor or other incapacitated person.[2053]

See also part II.D Special Purpose Trusts.

This part II.J tends to focus on estates and nongrantor trusts and often refers to such entities when referring to trust. In many ways, estates are taxed as nongrantor trusts that are not required to distributed all of their income, so a reference to such a trust tends to apply to an estate as well; however, as with anything in these materials, a tax professional should apply independent judgment to any such inference.

For a focus on grantor trusts, see part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust, especially parts III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment and III.B.2.h How to Make a Trust a Grantor Trust.

That a beneficiary provided consideration for the trust's establishment does not prevent the trust from being classified as such. *Hanover Bank v. Commissioner*, 40 T.C. 532 (1963), *acq.* 1964-2 C.B. 5, which further held:

> There does not appear to be any ambiguity in the agreement concerning the creation of the trust and, in fact, all the parties to that agreement, including Frances, have long treated the agreement as creating a valid trust. Petitioners Strong reported as trust income in 1953 and 1954 most of the amounts paid to them by the trustee. Long-standing interpretations should be given consideration and will not lightly be set aside even when there is ambiguity in the instrument, *Babette B. Israel*, 11 T.C. 1064 (1948). Furthermore, the Supreme Court of New York previously construed the agreement as creating a valid trust and the material parts of that judgment are set forth in our Findings of Fact. Judicial constructions by State courts are conclusive as to the legal extent and character of the interests created under such an agreement, *Louise Savage Knapp Trust A*, 46 B.T.A. 846 (1942).
>
> The situation here is distinguishable from cases such as *Lyeth v. Hoey*, 305 U.S. 188, and *Chase National Bank et al., Executors*, 40 B.T.A. 44 (1939). In each of those cases the taxpayer threatened to take contrary to a will and in each case compromised his claims. The Courts determined that the property received in compromise was the substitute for an inheritance. In the instant case, Frances did not contest the disposition and the amounts she received were not in compromise of any claim she may have had.

[2051] Taxpayers sought that conclusion in fn. 5052 (found in part III.A.3.e.i QSSTs) to confirm treatment as a QSST.

[2052] Rev. Rul. 76-265 held:

> In the instant case, the bank trustee will not take title to the property for the purpose of protecting or conserving it for beneficiaries, but will be acting as an agent of the United States and in that capacity will receive moneys, hold assets, and make payments on behalf of the United States for the purposes of constructing public buildings and satisfying the obligation of the United States to holders of the participating certificates.
>
> Accordingly, the arrangement is not a trust for Federal income tax purposes, but is a security arrangement with the bank trustee acting as an agent on behalf of the United States.

Letter Ruling 200227012 followed Rev. Rul. 76-265.

[2053] Reg. § 1.6012-3(b)(3).

II.J.1. Trust's Income Less Deductions and Exemptions Is Split Between Trust and Beneficiaries

Our fiduciary income tax system, generally computes taxable income as if the trust were an entity, then allocates taxable income between the trust and its beneficiaries.[2054]

A trust, all of the accounting income of which is required to be distributed currently to one or more noncharitable beneficiaries, deducts the lesser of its accounting income or distributable net income (DNI).[2055] It also deducts any other amounts of DNI that are "properly paid or credited or required to be distributed" for the taxable year.[2056] Thus, a mandatory income feature is simply a proxy for other distributions, without the requirement that the distribution be made during the year or within 65 days thereafter.[2057] The beneficiary includes in income the amount of the trust's deduction for DNI.[2058]

The above is a simplistic explanation. Among omissions are the treatment of tax-exempt income, the separate share rule,[2059] and charitable deductions.[2060]

II.J.2. Tactical Planning Shortly After Yearend to Save Income Tax for Year That Ended

Code § 663(b) allows distributions in the first 65 days of the taxable year to count as distributions in the current or prior year's tax return.

Thus, the trustee can count distributions from January 1, 2016 through and including March 5, 2016 as 2015 or 2016 distributions or a combination thereof.

[2054] Technically, the trust allocates distributable net income to the trust and beneficiaries, then takes into account other items in computing the trust's taxable income. The text in the body is a convenient way to describe the system to clients.

[2055] Code § 651 and Code § 661(a)(1), (c). Code § 643(a) defines DNI, and Code § 643(b) defines accounting income. For more on accounting income, see part II.J.8.c.i Capital Gain Allocated to Income Under State Law, which generally covers the area of accounting income, with extra attention paid to capital gains.

[2056] Code § 661(a)(2), (c). A beneficiary's use of a residence generally should not constitute a deemed distribution unless the trust is a foreign trust and the beneficiary is a US person. For the latter rule, see Code § 643(i). For various cases analyzing the former issue, see *DuPont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976), *aff'd* 574 F.2d 1332 (5th Cir. 1978); *Commissioner v. Plant*, 76 F.2d 8 (2nd Cir. 1935); TAM 8341005 (following *Plant* - real property taxes and the cost of the caretaker were carrying costs allocable to corpus, and income used to pay those expenses were not deemed distributed to the beneficiary who used the house; the beneficiary paid for electricity, heating and personal expenses); *Commissioner v. Lewis*, 141 F.2d 221 (3rd Cir. 1944) (carrying charges and depreciation were chargeable to trust accounting income under local law and deductible in computing amounts taxable to the mandatory income beneficiaries). *Moreell v. U.S.*, 221 F.Supp. 864 (W.D. Pa. 1963), is a sloppy, confusing, unreasoned opinion involving a mandatory income trust that was partly a grantor trust. I have not read but have seen cited *Fuller v. Commissioner*, 9 T.C. 1069 (1947), *aff'd* 171 F.2d 704 (3rd Cir. 1948); *Prince v. Commissioner*, 35 T.C. 974, 978 (1961).

[2057] Part II.J.2 Tactical Planning Shortly After Yearend describes the 65-day rule.

[2058] Code §§ 651, 652.

[2059] See part II.J.9.a Separate Share Rule.

[2060] As described in part II.J.4.c Charitable Distributions, Code § 642(c) generally governs charitable deductions. Among other issues, see part II.Q.7.c S corporations Owned by a Trust Benefitting Charity, which also covers how a trust's income from business or certain other activities affects the charitable deduction.

When in doubt, distribute more rather than less (if distributions are appropriate).[2061] The tax return, including extensions, will determine how much of the distribution counts as a distribution for the year just ended or for the year in which the distribution is made, but the distribution needs to be made within the 65-day period.

This tactic can carry out capital gains, without regard to any prior year election regarding distributing capital gains.[2062]

II.J.3. Strategic Fiduciary Income Tax Planning

Planning for fiduciary income tax is a matter of comparing taxation at the trust level, beneficiary level, or deemed owner level, including the following issues:

- Who is best taxed on gross income?[2063]
- Who benefits most from deductions?[2064]
- Consider not only the effect of federal tax but also state and local income tax.[2065]
- Does the method of shifting the incidence of taxation undermine any material purpose of the trust?
- Do decisions made for the current taxable year affect taxation in future years?
- How much flexibility does a trustee have for currently irrevocable trusts, and can this flexibility be enhanced?
- How should one draft to provide more flexibility?

For distributing capital gain, see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

Also note that beneficiaries who are trustees can reduce income subject to the net investment income tax by taking reasonable trustee fees; however, this strategy is not a good idea if the trust has any significant tax-exempt income (because the deduction would be disallowed to the extent allocable to tax-exempt income,[2066] but the entire fee income would still be recognized) or if and to the extent the deduction would offset income (such as qualified dividends or long-term capital gain) taxable at a lower rate. For other aspects of the NII tax, see parts II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles and II.I.9 Elections or Timing Strategies to Consider to Minimize the 3.8% Tax on NII.

[2061] See part II.J.3 Strategic Fiduciary Income Tax Planning for tax and nontax issues to consider in deciding whether to make distributions.
[2062] See part II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.
[2063] See parts II.J.3.a Who Is Best Taxed on Gross Income and II.J.3.b Effect of Kiddie Tax on Rates.
[2064] See part II.J.3.d Who Benefits Most from Deductions.
[2065] See part II.J.3.e State and Local Income Tax.
[2066] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 2332.

II.J.3.a. Who Is Best Taxed on Gross Income

Increased adjusted gross income (AGI) might cause a beneficiary to lose tax benefits, effectively increasing the beneficiary's marginal income tax rate. Therefore, even if the trust and beneficiary have the same nominal rate, the beneficiary might have a higher effective tax rate. Increased beneficiary AGI can cause the following tax detriments:

- Reduction in Particular Itemized Deductions. Itemized deductions such as medical expenses and casualty losses are reduced as AGI increases.

- Phase Out of AMT Exemption. The alternative minimum tax exemption is phased out and eventually eliminated once income exceeds certain limits.

- Net Investment Income (NII) Tax.

    - Once an individual's income exceeds certain thresholds, NII tax applies.[2067] Although a trust's income quickly becomes subject to the NII tax, the threshold for an individual is much higher.

    - NII tax applies to passive income.[2068] The trustee of a nongrantor trust might not be a suitable person to participate sufficiently to avoid the income being characterized as passive, and the rules governing whether a trustee's work constitutes participation are challenging to apply.[2069] If the trust is a grantor trust, the deemed owner's work is what counts while that person is the deemed owner,[2070] although the trustee's work might be important to set the stage for future nonpassive treatment.[2071] For a nongrantor trust, beneficiary's participation should count for depreciation but does not count for other items of business income.[2072]

    - If the beneficiary is charitably inclined, the trust and beneficiary can avoid NII tax by the trust instead of the beneficiary making charitable contributions.[2073]

[2067] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[2068] See part II.I.8 Application of 3.8% Tax to Business Income.
[2069] See part II.K.2.b Participation by an Estate or Nongrantor Trust.
[2070] See part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, especially fn. 1902.
[2071] The trust will cease to be a grantor trust when the deemed owner dies, if the grantor trust powers are not turned off before then. If a QSST sells its S corporation stock, the sale is taxed to the trust rather than to the beneficiary. Consider having the trustee work in the business to try to establish participation, looking toward those events. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax), II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets, and II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S corporations in Light of the 3.8% Tax.
[2072] See part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary; Interaction with Special Depreciation Rules.
[2073] Individuals cannot deduct charitable contributions against NII (the charitable deduction is not listed in part II.I.6 Deductions Against NII), but trusts can. See part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, especially fn. 1908.

If the trust has business income, consider planning opportunities described in part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

Also, consider whether the trust or the beneficiary has capital loss (or, less likely but still possible, net operating loss) carryovers against which to offset trust income.

II.J.3.b. Effect of Kiddie Tax on Rates

Code § 1(g) requires the tax of certain children, including certain students who have not attained age 24 as of the close of such calendar year, to compute their income tax based on their parents' rates.

However, no comparable rule applies to computing children's 3.8% net investment income tax.[2074]

Thus, shifting income to children subject to the kiddie tax can still result in tax savings.

Code § 1(j)(4) provides special rules relating to the kiddie tax for any taxable year beginning after December 31, 2017, and before January 1, 2026. Unearned income is taxable based on trust tax brackets.

II.J.3.c. Who Is Benefits the Most from Losses

See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income if the business has enough potential for ups and downs in its taxable income that planning for a potential significant loss becomes important.

II.J.3.d. Who Benefits Most from Deductions

Consider that generally the fiduciary income tax system allows nongrantor trusts[2075] to net deductions against income before allocating income to beneficiaries. Thus, incurring expenses at the trust level provides benefits similar to trapping income inside trusts described in part II.J.3.a Who Is Best Taxed on Gross Income. However, depreciation deductions may pass through directly to beneficiaries, and trusts cannot use Code § 179 to expense assets but instead need to rely on bonus depreciation.[2076]

Note that miscellaneous itemized deductions are disallowed for any taxable year beginning after December 31, 2017 and before January 1, 2026.[2077] However, favorable treatment is provided deductions for costs which are paid or incurred in connection with the administration of the estate

[2074] For thresholds, see part II.I.3 Tax Based on NII in Excess of Thresholds.
[2075] Reg. § 1.67-2T(g)(1) prevents grantor trusts from netting deductions.
[2076] Depreciation and similar deductions are an exception to this rule. See part II.J.11.a Depreciation Advantages and Disadvantages.
[2077] See part II.G.3.i.ii Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax.

or trust and which would not have been incurred if the property were not held in such trust or estate.[2078] Unfortunately, this favorable treatment does not apply to grantor trusts.[2079]

For any taxable year beginning after December 31, 2017 and before January 1, 2026, Code § 164(b)(6) limits an individual's (and a trust's, which are the same as an individual's except as provided otherwise) deductions for state taxes to $10,000 ($5,000 for individuals who are married filing separately), but it does not apply this limit to property taxes attributable to a Code § 212 trade or business (which generally would be rental real estate, if it is a trade or business).[2080] Suppose an individual is the beneficiary of a nongrantor trust that pays $10,000 in state taxes, and the individual pays $10,000 in state taxes. The individual and trust would deduct a total of $20,000 of state taxes. However, if the trust were a grantor trust, then only one $10,000 amount – the individual's – would apply. Splitting income among multiple trusts may generate more entities with up to $10,000 state income tax deductions, but beware part II.J.9.c Multiple Trusts Created for Tax Avoidance.

Charitable deductions often produce more benefit to a trust than to an individual.[2081]

Certain losses from the sale of small business stock[2082] are not available to nongrantor trusts,[2083] so grantor trust planning might be considered for that asset. Similarly, depreciation deductions allocated to the remaindermen of a nongrantor trust that is included in the grantor's or beneficiary's estate reduce the basis step-up; presumably this rule would not apply to a grantor trust.[2084]

II.J.3.e. State and Local Income Tax

II.J.3.e.i. Residence Generally

Consider whether income trapped inside a trust might be taxed at a lower state and local income tax rate (or entirely exempt from such tax) than income reported on a beneficiary's income tax return.

Generally, states do not tax nonbusiness income earned by a nonresident trust. Some high income-tax states fail to tax income earned by trusts set up by their residents that are administered

---

[2078] Code § 67(e)(1), which regulations narrow the definition more than one might have otherwise thought. Some people have suggested that Code § 67(g) limitations may apply to Code § 67(e). However, Code § 67(e)(1) provides that its deductions "shall be treated as allowable in arriving at adjusted gross income," and Code § 63(d)(1) provides:

> For purposes of this subtitle, the term "itemized deductions" means the deductions allowable under this chapter other than … the deductions allowable in arriving at adjusted gross income ….

Thus, Code § 67(e)(1) deductions are not itemized deductions and cannot be characterized under Code § 67(b) as miscellaneous itemized deduction that would have been allowed under Code § 67(a) but for Code § 67(g).

[2079] Code § 67(c)(1), which Reg. § 1.67-2T(e)(3) applies to grantor trusts.

[2080] Income taxes attributable to a trade or business remain subject to the $10,000 limit. For more details about my comment on real estate as a trade or business, see part II.E.1.e Whether Real Estate Qualifies As a Trade or Business.

[2081] See part II.J.4.c Charitable Distributions, text accompanying fns 2120-2127.

[2082] See part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244.

[2083] See part II.J.11.b Code § 1244 Treatment Not Available for Trusts.

[2084] See part II.H.2.d Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate.

in other jurisdictions, which has led to the creation of incomplete gift nongrantor trusts to cause capital gain from investments to avoid state income tax.[2085]

Consider whether:

- The trustee could have minimized tax by moving the trust.

- By changing residence, the trustee has subjected the trust to income tax. Sometimes a trustee moves, doesn't realize that the move subjects the trust to fiduciary income tax, fails to file, then makes the trust liable for not only tax but also interest and penalties.

Consider preparing and updating a contacts list for the trust to see what contacts the trust has with which states and whether that can generate state income tax liability or whether contacts can be changed to reduce or eliminate state income tax.

Before making a Code § 645 election to treat a revocable trust as an estate, consider whether that will subject the trust (and trusts created upon its funding) to state income tax.[2086]

If a state that imposes income tax follows the federal rules, exercising a general power of appointment might shift the grantor.[2087] If such a shift is undesirable, see part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

II.J.3.e.ii. Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence

A state might ignore a trust's existence while the trust is a grantor trust.[2088] On the other hand, some states do not recognize grantor trust status of irrevocable trusts.[2089]

[2085] "Incomplete nongrantor" is abbreviated ING, so one often hears of DING (Delaware ING) or NING (Nevada ING) trusts, even though the strategy is available for trusts established in other states (including Missouri). Private letter rulings approving such trusts treat certain trustees as adverse for income tax but not gift tax purposes without explaining how those conditions can coexist.
Now I have some silly comments to add spice to your day:
- Suppose your DING also has some asset protection features. It might be a bankruptcy avoidance trust (BAT). Being a DING-BAT, it was referred to frequently on the TV series, "All in the Family."
- Suppose you have a Missouri ING, and to the extent the grantor allocates GST exemption at death it terminates in favor of a perpetual trust. This MING Dynasty Trust might be appropriate to hold 13th century Chinese artifacts.

[2086] See fn. 2253, found in part II.J.7 Code § 645 Election to Treat a Revocable Trust as an Estate.

[2087] Reg. § 1.671-2(e)(5). Connecticut Ruling 2005-2 held:
> The residency status of an appointive trust created by the exercise of a power of appointment that is not a general power of appointment is to be determined by the residency of the donor of the power of appointment. The residency status of an appointive trust created by the exercise of a general power of appointment is to be determined by the residency of the donee of the power of appointment.

By "donor," the ruling was referring to the settlor. The ruling is my doc. no. 6517233.

[2088] For example, in defining what is a trust, Illinois disregards the existence of a grantor trust. 35 ILCS 5/1501(a)(20)(D) and 86 Ill. Admin. Code § 100.3020(a)(4) refer to grantor trusts under Code §§ 671-678.

[2089] Nenno, 869 T.M. II.A. states:

Given that clients often retire to jurisdictions that are not subject to income tax, keeping the trusts as grantor trusts until the clients move to those jurisdiction might mean that the state in which the trust was created will not treat the trust as a resident trust, because for income tax purposes the trust was deemed not to exist until the grantor was not a resident.

See also part II.J.15.b QSSTs and State Income Tax Issues.

II.J.3.f. Consider Trust Purposes

If shifting the incidence of taxation requires making distributions, consider whether distributions are appropriate. Consider whether distributions undermine the following nonexclusive list of concerns:

- Supplemental needs trusts designed to protect the flow of governmental benefits
- Protection from tort creditors
- Protection from business creditors
- Protection from spouses or ex-spouses
- Otherwise keeping funds inside the family
- Poor spending habits
- Inability to handle money
- Discouraging undue influence
- Funding addictive behavior

As noted above, if a trust is treated as a grantor trust for federal and for state income-tax purposes, all income (including accumulated ordinary income and capital gains) is taxed to the trustor, making planning difficult if not impossible while that status continues. Nevertheless, where the federal and state grantor-trust rules are not identical, it might be possible to structure a trust to be a grantor trust for federal purposes but to be a nongrantor trust for state purposes and to arrange matters so that the trust is not subject to that state's tax. For instance, Pennsylvania and Tennessee don't have grantor-trust rules for irrevocable trusts; Arkansas, the District of Columbia, Louisiana, and Montana tax the grantor only in limited circumstances;[21] and Massachusetts classifies a trust as a grantor trust based on §§ 671–678 only, so that a trust that falls under § 679 will be a grantor trust for federal but not for state purposes. Unfortunately, a number of those states tax individuals based on federal taxable income,[22] which captures all federal grantor-trust income,[23] making the foregoing planning option unavailable.

[21] Ark. Inc. Tax Reg. § 4.26-51-102; D.C. Code §§ 47-1809.08–47-1809.09; La. Rev. Stat. Ann. § 47:187; Mont. Code Ann. § 15-30-2151(5).

[22] § 63.

[23] § 671.

Instructions to Pennsylvania's fiduciary income tax returns explain that they respect the grantor trust rules only for revocable trusts.

- Protecting from estate tax
- Other spendthrift concerns

II.J.3.g. Effect on Future Years

The first time a distribution of principal is made from principal without referring to or actually distributing capital gain proceeds, the trustee is essentially electing for that year and all future years whether such distributions will carry out capital gains.[2090]

Causing a trust to be taxed to the grantor can be turned on or off by the presence or absence of a swap power or other powers.[2091]

However, turning off the powers that make a trust deemed owned by one or more beneficiaries is more challenging.[2092] If one wants flexibility in turning on or off beneficiary grantor trust treatment, consider using QSST strategies (which can cause difficulty splitting up trust assets if more than one person is a remainderman).[2093]

II.J.3.h. Drafting for Flexibility in Trust Income Taxation

When drafting using an ascertainable standard for distributions ("support" in my documents),[2094] one can give the trustee the flexibility to consider or ignore the beneficiary's other resources. If the trustee has a legal duty to support one or more beneficiaries, consider using "reasonable

---

[2090] See part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

[2091] See part III.B.2.h How to Make a Trust a Grantor Trust.

[2092] See generally part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

[2093] See parts III.A.3.e.vi QSST (including part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts) and III.A.3.e.iv Flexible Trust Design.

[2094] See Reg. §§ 1.674(b)-1(b)(5)(i) (grantor trust income tax rules), 20.2041-1(c)(2) (exception to estate tax general power of appointment) and 25.2511-1(g)(2) (gift tax ascertainable standard – reproduced in fn. 2293).

Some documents include a statement that the trustee's determination is conclusive and binding on all parties. Reg. §§ 1.674(b)-1(b)(5)(i) and 25.2511-1(g)(2) take the position that such language undermines the ascertainable standard exception, but Reg. § 20.2041-1(c)(2) is silent on the issue. Those regulations were promulgated before the Uniform Trust Code ("UTC"), section 814(s) of which provides:

> Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms as "absolute", "sole", or "uncontrolled", the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

UTC §§ 1002(b), 1008(a)(1) (see also the sections to which the Comments to Section 103(8) refer) provide similar references to good faith and the beneficiaries' interests in determining whether a trustee is liable. Thus, the assumption that "conclusive and binding" language makes the trustee's discretion unreviewable might be incorrect. I would not use such language in connection with trying to establish an ascertainable standard, but generally I would not urge reformation of an irrevocable trust merely for using that language. *Jennings v. Smith*, 161 F2d 74 (2nd Cir. 1947), upheld as not causing estate inclusion an ascertainable standard that included some language about the trustee's "absolution discretion."

support and comfort”[2095] to emphasize that distributions are more than just the minimum that is required to discharge a support obligation.[2096]

I also like to include standards that are not ascertainable (“welfare” in my documents). To avoid the IRS alleging adverse estate/gift tax consequences, the trustee either cannot have been appointed by the beneficiary or was appointed by the beneficiary but is not a related or subordinate party (as defined in Code § 672(c))[2097] with respect to the beneficiary.[2098]

When drafting, consider including an annually lapsing withdrawal right to make the trust deemed owned in part by the beneficiary;[2099] one twist on the power would be giving the trustee or a trust protector the power to turn off the power for a year (or range of years) before the year starts, allowing the power to be turned off if creditors are hovering. Absent such a provision, one might convert a trust to a partial beneficiary grantor trust by exercising one of the standards described above with respect to the lesser of $5,000 or 5% of the trust’s assets and giving the beneficiary the power to withdraw the declared amount or portion.[2100] In either case, such treatment generally has a permanent effect.[2101]

If locking in the beneficiary as the deemed owner is unattractive, the trust can dump its assets in an S corporation, make a QSST election when taxing the beneficiary is attractive,[2102] and convert to an ESBT when trapping income in the trust (primarily when the trust is not subject to state income tax but the beneficiary is) is more attractive.[2103] However, planning using S corporations involves additional long-term planning.[2104]

Also, to promote flexibility in including capital gains in distributable net income that the trustee can elect to carry out to the beneficiaries, consider using flexible language regarding allocating receipts between income and principal.[2105]

[2095] As defined in Reg. §§ 25.2511-1(g)(2) and 1.674(b)-1(b)(5)(i).
[2096] Generally, a legal support obligation encompasses a much more narrow view of support than does what is permitted for an ascertainable standard, but one would want to check state law to verify. Also, if a trust makes distributions for items encompassed by a support obligation, query whether the trust has a claim against the person who has the support obligation. Finally, state laws prohibiting trustees from discharging their legal obligations, as well as any such prohibitions in the trust instrument itself, should reinforce the idea of the trust having a claim against the beneficiary. Nevertheless, many estate planners prefer to have other mechanisms for getting distributions to dependent children.
[2097] See Rev. Rul. 66-160 (director of a corporation is not an “employee” under Code § 672(c)); Letter Rulings 9842007 and 9841014.
[2098] For the latter, see fn. 5674.
[2099] See part III.B.2.i.vi.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.
[2100] See part II.J.4.f Making Trust a Partial Grantor Trust as to a Beneficiary.
[2101] For flexibility regarding beneficiary grantor trust status, see fn. 2093.
[2102] See part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs, which is part of the larger part III.A.3.e QSSTs and ESBTs.
[2103] See parts III.A.3.e.ii.(c) When ESBT Income Taxation Might Help and III.A.3.e.iv Flexible Trust Design When Holding S corporation Stock.
[2104] See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made).
[2105] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 2290.

II.J.3.i. Planning for Excess Losses

Generally, an estate or nongrantor trust cannot pass losses (other than depreciation)[2106] to beneficiaries except in the year of termination. Also consider the points made in part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good in light of planning a trust's and its beneficiaries' income and losses.

If the trust is not terminating by the end of the calendar year, consider accelerating income (perhaps selling appreciated assets, among other items) or deferring deductions if and to the extent that the trust's deductions otherwise would exceed its income.

On the final termination of an estate or a nongrantor trust, it can pass to its beneficiaries a net operating loss carryover under Code § 172, a capital loss carryover under Code § 1212, or for the last taxable year of the estate or trust deductions (other than the exemption and charitable deduction) in excess of gross income for such year, all to the extent provided in regulations:[2107]

- These carryovers and excess deductions are allocated among the beneficiaries succeeding to the property proportionately according to the share of each in the burden of the loss or deductions, which can include those receiving specific bequests that are abated.[2108] A person who qualified as a beneficiary succeeding to the property with respect to one amount and does not qualify with respect to another amount is a beneficiary succeeding to the property as to the amount with respect to which the beneficiary qualifies.[2109]

- However, other than the NOL and capital loss carryover, excess deductions on termination are miscellaneous itemized deductions in the hands of the beneficiaries, which means they will not receive any tax benefit for them until 2026. See parts II.G.3.i.ii Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax and II.J.3.d Who Benefits Most from Deductions. Consider recognizing gain that can be offset by these deductions before distributing assets (essentially obtaining a free basis step-up) or retaining taxable income-producing assets, the income from which can be offset by those deductions instead of being taxable to the beneficiaries (if they had been distributed to the beneficiaries). Related party sales or an election to recognize gain on distribution[2110] are ways to recognize gain while keeping assets within the family.

[2106] See part II.J.11.a.ii.(b) Beneficiary's Ability to Deduct Depreciation That Generates Net Loss.
[2107] Code § 642(h); Reg. § 1.642(h)-2.
[2108] Reg. § 1.642(h)-4, which concludes with an example:

> A decedent's will leaves $100,000 to A, and the residue of his estate equally to B and C. His estate is sufficient to pay only $90,000 to A, and nothing to B and C. There is an excess of deductions over gross income for the last taxable year of the estate or trust of $5,000, and a capital loss carryover of $15,000, to both of which section 642(h) applies. A is a beneficiary succeeding to the property of the estate to the extent of $10,000, and since the total of the excess of deductions and the loss carryover is $20,000, A is entitled to the benefit of one half of each item, and the remaining half is divided equally between B and C.

[2109] Reg. § 1.642(h)-4.
[2110] See part II.J.8.d.i Distribution in Kind - Generally. The election to recognize gain on distribution may have unexpected results, so read that part carefully.

A trust will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).[2111]

II.J.9. Separate Share Rule; Trust Divisions

II.J.9.a. Separate Share Rule

In addition to its significance for fiduciary income tax purposes, the separate share rule can be critically important for determining a trust's eligibility for QSST treatment[2347] and for certain nonqualified deferred compensation plans.[2348]

"A separate share comes into existence upon the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate economic interest exists,"[2349] which really

---

[2111] Reg. § 1.641(b)-3(b), incorporated by reference by Reg. § 1.642(h)-1(a).

[2347] See part III.A.3.e.i.(a) QSSTs Generally, especially fns. 5063-5065.

[2348] Reg. § 1.404(a)-12(b)(3).

[2349] Reg. § 1.663(c)-2(a), which applies to trusts other than qualified revocable trusts within the meaning of Code § 645(b)(1). For estates and such qualified trusts:

> The applicability of the separate share rule provided by section 663(c) to estates and qualified revocable trusts within the meaning of section 645(b)(1) will generally depend upon whether the governing instrument and applicable local law create separate economic interests in one beneficiary or class of beneficiaries of such estate or trust. Ordinarily, a separate share exists if the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries.

Reg. §§ 1.663(c)-3(c) and 1.663(c)-4(c) discuss this economic interest:

> A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is separate and independent from another share in which one or more beneficiaries have an interest. Likewise, the same person may be a beneficiary of more than one separate share.

Reg. § 1.663(c)-3(b) explains how rights to distributions need to be separated:

> Separate share treatment will not be applied to a trust or portion of a trust subject to a power to:
>
> (1) Distribute, apportion, or accumulate income, or
>
> (2) Distribute corpus
>
> to or for one or more beneficiaries within a group or class of beneficiaries, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing instrument) so that substantially separate and independent shares exist.

Reg. § 1.663(c)-3(d) explains that remote possibilities of distributions outside the separate share's targeted beneficiaries will not ruin separate share treatment:

> Separate share treatment may be given to a trust or portion of a trust otherwise qualifying under this section if the trust or portion of a trust is subject to a power to pay out to a beneficiary of a share (of such trust or portion) an amount of corpus in excess of his proportionate share of the corpus of the trust if the possibility of exercise of the power is remote. For example, if the trust is subject to a power to invade the entire corpus for the health, education, support, or maintenance of A, separate share treatment is applied if exercise of the power requires consideration of A's other income which is so substantial as to make the possibility of exercise of the power remote. If instead it appears that A and B have separate shares in a trust, subject to a power to invade the entire corpus for the comfort, pleasure, desire, or happiness of A, separate share treatment shall not be applied.

means that "distributions of the trust are to be made in substantially the same manner as if separate trusts had been created."[2350] If a trust (or estate) has separate and independent shares, such treatment "must prevail in all taxable years of the trust (or estate) unless an event occurs as a result of which the terms of the trust instrument and the requirements of proper administration require different treatment."[2351] This rule applies "even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust (or estate), and even though no physical segregation of assets is made or required."[2352] Special rules apply to specific bequests, trusts with Code § 645 elections, and elective shares;[2353] also see part III.A.3.d Special Fiduciary Income Tax Issues Regarding Bequeathing S corporation Stock and Partnership Interests.

If different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts for the sole purpose of determining the amount of distributable net

---

However, such remoteness is not permitted for a QSST. See part III.A.3.e.i.(a) QSSTs Generally, fn. 5063.

[2350] Reg. § 1.663(c)-3(a), which explains:

> Thus, if an instrument directs a trustee to divide the testator's residuary estate into separate shares (which under applicable law do not constitute separate trusts) for each of the testator's children and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income, or to do both, separate shares will exist under section 663(c). In determining whether separate shares exist, it is immaterial whether the principal and any accumulated income of each share is ultimately distributable to the beneficiary of such share, to his descendants, to his appointees under a general or special power of appointment, or to any other beneficiaries (including a charitable organization) designated to receive his share of the trust and accumulated income upon termination of the beneficiary's interest in the share. Thus, a separate share may exist if the instrument provides that upon the death of the beneficiary of the share, the share will be added to the shares of the other beneficiaries of the trust.

[2351] Reg. § 1.663(c)-1(d).

[2352] Reg. § 1.663(c)-1(c).

[2353] Reg. § 1.663(c)-4(a) provides:

> Separate shares include, for example, the income on bequeathed property if the recipient of the specific bequest is entitled to such income and a surviving spouse's elective share that under local law is entitled to income and appreciation or depreciation. Furthermore, a qualified revocable trust for which an election is made under section 645 is always a separate share of the estate and may itself contain two or more separate shares. Conversely, a gift or bequest of a specific sum of money or of property as defined in section 663(a)(1) is not a separate share.

Reg. § 1.663(c)-4(b) provides:

> Notwithstanding the provisions of paragraph (a) of this section, a surviving spouse's elective share that under local law is determined as of the date of the decedent's death and is not entitled to income or any appreciation or depreciation is a separate share. Similarly, notwithstanding the provisions of paragraph (a) of this section, a pecuniary formula bequest that, under the terms of the governing instrument or applicable local law, is not entitled to income or to share in appreciation or depreciation constitutes a separate share if the governing instrument does not provide that it is to be paid or credited in more than three installments.

income (DNI) allocable to the respective beneficiaries under Code §§ 661 and 662.[2354] Any separate share's DNI is computed as if each share constituted a separate trust or estate:[2355]

- Gross income includible in DNI that is fiduciary accounting income "is allocated among the separate shares in accordance with the amount of income that each share is entitled to under the terms of the governing instrument or applicable local law."[2356]

- Gross income includible in DNI that is income in respect of a decedent under Code § 691(a) and is not fiduciary accounting income "is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts."[2357]

- Gross income includible in DNI "that is not attributable to cash received by the estate or trust (for example, original issue discount, a distributive share of partnership tax items, and the pro rata share of an S corporation's tax items) … is allocated among the separate shares in the same proportion as [fiduciary accounting] income from the same source would be allocated under the terms of the governing instrument or applicable local law."[2358]

[2354] Reg. § 1.663(c)-1(a). Reg. § 1.663(c)-1(b) elaborates:

> The separate share rule does not permit the treatment of separate shares as separate trusts (or estates) for any purpose other than the application of distributable net income. It does not, for instance, permit the treatment of separate shares as separate trusts (or estates) for purposes of:
> (1) The filing of returns and payment of tax,
> (2) The deduction of personal exemption under section 642(b), and
> (3) The allowance to beneficiaries succeeding to the trust (or estate) property of excess deductions and unused net operating loss and capital loss carryovers on termination of the trust (or estate) under section 642(h).

[2355] Reg. § 1.663(c)-2(b)(1), which further provides:

> Accordingly, each separate share shall calculate its distributable net income based upon its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses.

[2356] Reg. § 1.663(c)-2(b)(2).

[2357] Reg. § 1.663(c)-2(b)(3). Reg. § 1.663(c)-5, Example (9), provides:

> The will of Testator, who dies in 2000, directs the executor to divide the residue of the estate equally between Testator's two children, A and B. The will directs the executor to fund A's share first with the proceeds of Testator's individual retirement account. The date of death value of the estate after the payment of debts, expenses, and estate taxes is $9,000,000. During 2000, the $900,000 balance in Testator's individual retirement account is distributed to the estate. The entire $900,000 is allocated to corpus under applicable local law. This amount is income in respect of a decedent within the meaning of section 691(a). The estate has two separate shares, one for the benefit of A and one for the benefit of B. If any distributions are made to either A or B during the year, then, for purposes of determining the distributable net income for each separate share, the $900,000 of income in respect of a decedent must be allocated to A's share.

The Example is troubling, in that the allocation of the IRA does not have economic effect under the actual facts. However, if the residue is less than $1.8 million, then A gets $900,000 and B gets the balance, which would be less than what A received. The fact that the estate was more than that does not change the possible economic effect, because one never knew how large the IRA or the estate would be.

[2358] Reg. § 1.663(c)-2(b)(4).

- "Any deduction or any loss which is applicable solely to one separate share of the trust or estate is not available to any other share of the same trust or estate."[2359] It is unclear whether (a) this merely keeps the deduction within its share to offset its share's income but allows a net loss from a separate share might lower the trust's and therefore the other shares' tax liability, or (b) it completely prevents the loss generated by one share from reducing the amount included in the income of the other shares' beneficiaries.[2360] I believe that the former is the better view,[2361] although when taking that position one might attach IRS Form 8275-R

[2359] Reg. § 1.663(c)-2(b)(5).

[2360] Although the above allocations govern the allocation of DNI, Code §§ 661 and 662 govern how much income the trust can deduct and consequently include in a beneficiary's income. That amount is the lesser of DNI or the sum of income required to be distributed for a taxable year and any other amounts properly paid or credited or required to be distributed for such taxable year. Code § 661(a). These amounts are allocated to the beneficiaries and included in their income. Code § 662(a).

However, because the only mechanism for a beneficiary to deduct a loss is either depreciation deductions (see part II.J.11.a.ii.(b) Beneficiary's Ability to Deduct Depreciation That Generates Net Loss) or loss on termination (Code § 642(h)), a beneficiary cannot deduct a loss and the trust cannot carry over a loss other than one generated by a business (Code § 642(d)) or a capital loss (Code § 1212). Thus, if a separate share has a net loss, the beneficiary(ies) will not deduct that loss. See part II.J.3.i Planning for Excess Losses.

Consider the following scenario: Trust has $10,000 of taxable interest income, allocated to share A, and $10,000 of state income tax liability, attributable to taxes on the prior year's municipal bond interest earned by share B earned before the bonds were sold at no gain or loss. The trust distributes $10,000 to A and $10,000 to B, each out of her own share. The trust's taxable income, ignoring exemptions, is zero. Applying Reg. § 1.663(c)-2(b)(5) to disallow the state income tax deduction would result in A including $10,000 in income and the trust having a $10,000 loss ($10,000 interest income minus the $20,000 sum of the $10,000 income distribution deduction and the $10,000 state income tax liability). Which is correct: zero taxable income for everyone, or $10,000 taxable income to A and the trust has a $10,000 loss that benefits nobody? In other words, does the trust's overall DNI of zero control, or do A's DNI of $10,000 and B's DNI of negative $10,000 control?

Consider another scenario: share A has $10,000 of dividends and $10,000 of capital gain through a partnership that distributes $20,000 as a distribution of operating income (and not a distribution in partial liquidation), and share B has no dividends and $10,000 of capital loss through a partnership that distributes $20,000 of cash as a distribution of the prior year's operating income. On Form 1041, Schedule D, the capital gain and loss offset. We know that the separate share rule prevents B from reporting any of A's income. However, does the separate share rule tax $20,000 ($10,000 of dividends and $10,000 of capital gain) or $10,000 (dividends only, because capital gains were offset by capital loss) to A? If the former, what mechanism is there for preserving the $10,000 capital loss allocated to B? Nowhere do the Instructions for Schedule D (Form 1041) address this issue; even if one allocated share B's capital loss to the trust instead of to the beneficiaries, neither the tax return nor the Capital Loss Carryover Worksheet in the Instructions provides a mechanism that prevents netting the beneficiaries' capital gain against the trust's capital loss in a manner that would generate a capital loss carryover for share B.

[2361] Yu, "Deductions in a Proposed Calculation and Allocation of Distributable Net Income to the Separate Shares of a Trust or Estate," 5 Pitt. Tax Rev. 123 (2008) (saved as my document no. 6167169), reviews the two approaches to resolve the issue raised in fn. 2360 and the accompanying text and states that the view I adopted is the better approach. Footnote 93 in Yu's article cited F. Ladson Boyle & Jonathan G. Blattmachr, *Blattmachr on Income Taxation of Estates and Trusts* (15th ed. 2008), as saying on pages 3-104 to 3-105 the following about Reg. § 1.663(c)-2(b)(5):

> Notwithstanding this rule [that any deduction or loss that is applicable solely to one separate share is not available to any other share], when a net loss in one share results in the DNI of an entire trust being less than the potential DNI of a different share (computed as though it was a separate trust), the DNI of the share with net income should not exceed the DNI of the trust. The effect of limiting the DNI of the profitable, second share to the trust's DNI is to give the second share the benefit of the net loss in the first share.

because on its face that position appears to contradict Reg. § 1.663(c)-2(b)(5).[2362] If one or more separate shares benefit from the overall ceiling of tax liability, then the trustee should consider making an equitable adjustment to compensate the share that generated the loss for the benefit that the other share(s) received – especially because that loss is probably reflected in lower tax basis of assets held by the share that generated the loss. If one is doing an interim division of a trust, holding some back in the general residue but opening up a separate account within a trust to represent a separate share for each beneficiary or group of beneficiaries, one might consider raising this issue and clarifying the approach to be taken if one share generates a loss.

In making the above allocations to separate shares, "the fiduciary must use a reasonable and equitable method to make the allocations, calculations, and valuations…."[2363] For example, a principal distribution from one share that is disproportionately larger than a principal distribution from another share should affect the relative allocation of income between those shares.[2364]

However, the amount the trust deducts[2365] and the amount each separate share includes in income[2366] is the lesser of the DNI allocated to[2367] or the amount actually distributed to that separate share.

The charitable deduction reduces the amount allocable to DNI.[2368] After separate shares are determined, the charitable deduction reduces the amount of DNI allocated to each separate

---

Informal email conversations with Lad and Jonathan in April 2015 confirmed that they had not changed their view on this issue.

Reg. § 1.663(c)-1(a) explains the philosophy of the separate share rules, applying them to an example, and concludes, "In the absence of a separate share rule B would be taxed on income which is accumulated for A. The division of distributable net income into separate shares will limit the tax liability of B." Yu's preferred approach that I adopted does not cause any income to be shifted from one beneficiary to another; it merely limits the estate's deduction consistent with the overall DNI limitation of Code § 661(a).

[2362] Such an explanation is saved as my document no. 6149985.

[2363] Reg. § 1.663(c)-2(c).

[2364] Reg. § 1.663(c)-5, Example (3) provides:

> The facts are the same as in Example 2, except that in 2000 the executor makes the payment to partially fund the children's trust but makes no payment to the surviving spouse. The fiduciary must use a reasonable and equitable method to allocate income and expenses to the trust's share. Therefore, depending on when the distribution is made to the trust, it may no longer be reasonable or equitable to determine the distributable net income for the trust's share by allocating to it 40% of the estate's income and expenses for the year. The computation of the distributable net income for the trust's share should take into consideration that after the partial distribution the relative size of the trust's separate share is reduced and the relative size of the spouse's separate share is increased.

T.D. 8849 added this example December 27, 1999, presumably superseding the approach taken in Letter Ruling 9644057, which ruling approved disproportionate distributions of principal without changing the distribution of income.

[2365] Code § 661(a).

[2366] Code § 662(a).

[2367] Code § 663(c) allocates DNI and therefore is a factor the determining, rather than the sole determinant of, the amount deducted by the trust or estate and included in the beneficiary's income.

[2368] Code § 663(a)(2) and Reg. § 1.663(a)-2, the former which is incorporated by reference into Reg. § 1.661(a)-1. For the charitable fiduciary income tax deduction, see part II.J.4.c Charitable Distributions.

share.[2369] Furthermore, generally the charitable deduction proportionately reduces the other deductions allocable to each share.[2370]

If a beneficiary dies, to the extent that this part II.J.9.a does not apply, see part II.J.6 Income Allocation on Death of a Beneficiary.

II.J.9.b. Trust Divisions

See part II.J.18 Trust Mergers and Divisions; Decanting.

II.J.9.c. Multiple Trusts Created for Tax Avoidance

For purposes of the fiduciary income tax rules under Code §§ 641-692, under Treasury regulations, two or more trusts are treated as one trust if:[2371]

> (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and
>
> (2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.
>
> For purposes of the preceding sentence, a husband and wife shall be treated as 1 person.

1984 Committee Reports for HR 98-432, P.L.98-369, provide:

> For example, the committee expects that the Treasury regulations would treat the trusts in the following example as one trust: A establishes, with the principal purpose for the avoidance of Federal income tax, trust 1 for the benefit of his sister S1, his brother B1, and his brother B2; trust 2 for the benefit of his sister S2, his brother B1, and his brother B2; trust 3 for the benefit of his sister S1, his sister S2, and his brother B1; and trust 4 for the benefit of his sister S1, his sister S2, and his brother B2. Under each trust instrument, the trustee is given discretion to pay any current or accumulated income to any one or more of the beneficiaries.
>
> Where there are substantial independent purposes, and tax purposes are not a principal purpose of the existence of separate trusts, the trusts will not be aggregated. The following is an example where separate trusts will not be aggregated under the committee bill: X establishes two irrevocable trusts for the benefit of X's son and daughter. Son is

---

[2369] Reg. § 1.663(c)-5, Example (11) provides:

> The will of Testator, who dies in 2000, provides that after the payment of specific bequests of money, the residue of the estate is to be divided equally among the Testator's three children, A, B, and C. The will also provides that during the period of administration one-half of the income from the residue is to be paid to a designated charitable organization. After the specific bequests of money are paid, the estate initially has three equal separate shares. One share is for the benefit of the charitable organization and A, another share is for the benefit of the charitable organization and B, and the last share is for the benefit of the charitable organization and C. During the period of administration, payments of income to the charitable organization are deductible by the estate to the extent provided in section 642(c) and are not subject to the distribution provisions of sections 661 and 662.

[2370] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 2336.

[2371] Code § 643(f).

the income beneficiary of the first trust and the trustee (Bank of P) is required to pay all income currently to son for life. Daughter is the remainder beneficiary. X's daughter is an income beneficiary of the second trust and the trust instrument permits the trustee (Bank of D) to accumulate or to pay income, in its discretion, to daughter for her education, support and maintenance. The trustee also may pay income or corpus to son for his medical expenses. Daughter is the remainder beneficiary and will receive the trust corpus upon son's death.

However, no relevant Treasury regulations existed before 2018, so one wondered whether the provision is effective. Nevertheless, at least one taxpayer was concerned enough to include it in a private letter ruling request that focused on a trust division and received a favorable ruling (which is not surprising, considering that the trusts has different primary beneficiaries).[2372]

Proposed regulations regarding the multiple trust rule were issued in conjunction with proposed regulations interpreting Code § 199A, which has its own multiple trust rule.[2373] The preamble, REG-107892-18 (8/16/2018), explains:

> **VII. Proposed § 1.643(f)-1: Anti-avoidance Rules for Multiple Trusts**
>
> As described in section VI.B of the Explanation of Provisions, under Section 199A, the threshold amount is determined at the trust level without taking into account any distribution deductions. Therefore, taxpayers could circumvent the threshold amount by dividing assets among multiple trusts, each of which would claim its own threshold amount. This result is inappropriate and inconsistent with the purpose of Section 199A and general trust principles.
>
> To address this and other concerns regarding the abusive use of multiple trusts, proposed § 1.643(f)-1 confirms the applicability of section 643(f). As noted in part II of the Background, section 643(f) permits the Secretary to prescribe regulations to prevent taxpayers from establishing multiple non-grantor trusts or contributing additional capital to multiple existing non-grantor trusts in order to avoid Federal income tax. Proposed § 1.643(f)-1 provides that, in the case in which two or more trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and a principal purpose for establishing such trusts or contributing additional cash or other property to such trusts is the avoidance of Federal income tax, then such trusts will be treated as a single trust for Federal income tax purposes. For purposes of applying this rule, spouses are treated as only one person and, accordingly, multiple trusts established for a principal purpose of avoiding Federal income tax may be treated as a single trust even in cases where separate trusts are established or funded independently by each spouse. Proposed § 1.643(f)-1 further provides examples to illustrate specific situations in which multiple trusts will or will not be treated as a single trust under this rule, including a situation where multiple trusts are created with a principal purpose of avoiding the limitations of Section 199A. The application of proposed § 1.643(f)-1, however, is not limited to avoidance of the limitations under Section 199A and proposed §§ 1.199A-1 through 1.199A-6.

[2372] Letter Ruling 199912034.

[2373] Prop. Reg. § 1.199A-6(d)(3)(v), which is reproduced in part II.E.1.f Trusts/Estates and the Code § 199A Deduction.

> The rule in proposed § 1.643(f)-1 would apply to any arrangement involving multiple trusts entered into or modified on or after August 16, 2018. In the case of any arrangement involving multiple trusts entered into or modified before August 16, 2018, the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) will be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f). Pending the publication of final regulations, the position of the Treasury Department and the IRS is that the rule in proposed § 1.643(f)-1 generally reflects the intent of Congress regarding the arrangements involving multiple trusts that are appropriately subject to treatment under section 643(f).

Prop. Reg. § 1.643(f)-1(a), "General rule," provides:

> For purposes of subchapter J of chapter 1 of Title 26 of the United States Code, two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax. For purposes of applying this rule, spouses will be treated as one person.

Thus, Prop. Reg. § 1.643(f)-1(a) seems to say that the multiple trust rule does not apply to trusts that:

- Do not have substantially the same grantor or grantors, or
- Do not have substantially the same primary beneficiary or beneficiaries, or
- Do not have the avoidance of Federal income tax as a principal purpose for establishing those trusts or for contributing additional cash or other property to those trusts.

Unfortunately, the Examples in Prop. Reg. § 1.643(f)-1(c) seem to take a narrow view to these exceptions and to actually combine the above three bullet points into a single tax-avoidance test.

Prop. Reg. § 1.643(f)-1(b), "A principal purpose," provides:

> A principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of these separate trusts.

Prop. Reg. § 1.643(f)-1(c), Example (1) provides:

> (i) A owns and operates a pizzeria and several gas stations. A's annual income from these businesses and other sources exceeds the threshold amount in Section 199A(e)(2), and the W-2 wages properly allocable to these businesses are not sufficient for A to maximize the deduction allowable under Section 199A. A reads an article in a magazine that suggests that taxpayers can avoid the W-2 wage limitation of Section 199A by contributing portions of their family businesses to multiple identical trusts established for family members. Based on this advice, in 2018, A establishes three irrevocable, non-grantor trusts: Trust 1 for the benefit of A's sister, B, and A's brothers, C and D; Trust 2 for the benefit of A's second sister, E, and for C and D; and Trust 3 for the benefit of E. Under each trust instrument, the trustee is given discretion

to pay any current or accumulated income to any one or more of the beneficiaries. The trust agreements otherwise have nearly identical terms. But for the enactment of Section 199A and A's desire to avoid the W-2 wage limitation of that provision, A would not have created or funded such trusts. A names A's oldest son, F, as the trustee for each trust. A forms a family limited partnership, and contributes the ownership interests in the pizzeria and gas stations to the partnership in exchange for a 50-percent general partner interest and a 50-percent limited partner interest. A later contributes to each trust a 15% limited partner interest. Under the partnership agreement, the trustee does not have any power or discretion to manage the partnership or any of its businesses on behalf of the trusts, or to dispose of the limited partnership interests without the approval of the general partner. Each of the trusts claims the Section 199A deduction on its Form 1041 in full based on the amount of qualified business income (QBI) allocable to that trust from the limited partnership, as if such trust was not subject to the wage limitation in Section 199A(b)(2)(B).

(ii) Under these facts, for Federal income tax purposes under this section, Trust 1, Trust 2, and Trust 3 would be aggregated and treated as a single trust.

Although Trust 1 and Trust 3 have different beneficiaries, Example (1) seems to view the contemporaneous funding of Trusts 1, 2, and 3 as requiring them to be viewed as a single trust, given that Trust 2 has the same beneficiaries as Trust 1 and Trust 3. This seems consistent with the first example in the legislative history.

Prop. Reg. § 1.643(f)-1(c), Example (2) provides:

(i) X establishes two irrevocable trusts: one for the benefit of X's son, G, and the other for X's daughter, H. G is the income beneficiary of the first trust and the trustee is required to apply all income currently to G for G's life. H is the remainder beneficiary of the first trust. H is an income beneficiary of the second trust and the trust instrument permits the trustee to accumulate or to pay income, in its discretion, to H for H's education, support, and maintenance. The trustee also may pay income or corpus for G's medical expenses. H is the remainder beneficiary of the second trust and will receive the trust corpus upon G's death.

(ii) Under these facts, there are significant non-tax differences between the substantive terms of the two trusts, so tax avoidance will not be presumed to be a principal purpose for the establishment or funding of the separate trusts. Accordingly, in the absence of other facts or circumstances that would indicate that a principal purpose for creating the two separate trusts was income tax avoidance, the two trusts will not be aggregated and treated as a single trust for Federal income tax purposes under this section.

In Example (2), the first clause in part (ii), "there are significant non-tax differences between the substantive terms of the two trusts," should end the analysis and conclude directly, "the two trusts will not be aggregated and treated as a single trust." Instead, Example (2) seems to take the position that having different terms is merely an indication of no income tax avoidance motive. Example (2) suggests that trusts created for different beneficiaries with different terms can be combined if "a principal purpose for creating the two separate trusts was income tax avoidance." This appears contrary to Code § 643(f), which requires that not only must "a principal purpose of such trusts is the avoidance of the tax imposed by this chapter," but also "such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries." Thus, the implication in Example (2) that trusts created for different beneficiaries with different terms can be combined if "a principal purpose for creating the two separate trusts was income tax avoidance" seems incorrect. However, the second example in the legislative history does seem to conflate the tests somewhat, which may have led the government to this interpretation that contradicts the statute's literal language. Furthermore, I am assuming that having different terms means that they have primary beneficiaries who are not substantially the same; however, if that assumption is incorrect, then the fact that the trusts in Example (2) benefit the same people might mean that they have substantially the same primary beneficiaries and therefore Example (2) may be correct.

Although the preamble comments on the effective date, Prop. Reg. § 1.643(f)-1(b) provides:

> *Effective/applicability date*. The provisions of this section apply to taxable years ending after August 16, 2018.

What is the effect of violating the rule? Suppose parents create a separate trust for each of their five children, where each child is the sole beneficiary who may or must receive distributions. Code § 643(f) would not try to combine them. Suppose they create a sixth trust that sprinkles among all five children and that the avoidance of Federal income tax was a principal purpose for establishing the sixth trust. Are all six trusts combined? Are the tax attributes of the sixth trust allocated to the five other trusts? We need better guidance.

II.J.10. Consider Extending Returns for Year of Death and Shortly Thereafter

If an estate tax audit results in higher values and therefore higher basis, the related fiduciary income tax return might need to be amended to take advantage of higher basis to reduce gain on sale of assets or increase depreciation deduction.

II.J.11. Trust Business Income Tax Nuances

II.J.11.a. Depreciation Advantages and Disadvantages

II.J.11.a.i. Code § 179 Disallowance for Estate or Nongrantor Trust

Code § 179 allows businesses to expense depreciable personal property within certain limits, which limits have become much more generous in recent years.[2374] However, a trust cannot deduct this special Code § 179 expense that flows through on its K-1 from a partnership or S corporation.[2375] The business entity does not reduce its basis in, and may depreciate, this

[2374] See Stevens, "Section 179's Special Pass-Through Entity Rules," *Business Entities* (WG&L) (July/August 2010).
[2375] Code § 179(d)(4).

depreciable property to the extent that this deduction is disallowed.[2376] Presumably, this complexity would be avoided by using a grantor trust.[2377]

However, don't overlook the possibility of bonus depreciation, which under the 2017 tax reform law allows 100% deduction for most tangible personal property placed in service after September 27, 2017 and before January 1, 2023. See part II.G.4.b Bonus Depreciation.

II.J.11.a.ii. Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses)

II.J.11.a.ii.(a). Separate Reporting of Depreciation Deductions Allocable to Beneficiary

When a depreciation deduction of a trust is allocable to its beneficiaries, and where such deductions if separately taken into account by the trust would result in an income tax liability for the trust different from that which would result if the trust did not take such deductions into account separately, then the partnership's depreciation must be separately reported on the K-1 that the trust receives; a similar rule applies to depreciation allocated between a life tenant and the remaindermen or between an estate and its beneficiaries.[2378]

The allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each;[2379] however, if the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve is apportioned between the income beneficiaries and the trustee on the basis of the trust income (in

---

[2376] Reg. § 1.179-1(f)(3). Because the regulation specifically refers to S corporations, presumably this regulation overrides the general rule that all S corporation shareholders are taxed the same; the only way to give effect to this regulation would appear to make a special allocation of depreciation expense (including bonus depreciation – see part II.G.4 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation) to the trust or estate. Presumably, an S corporation or partnership would allocate the asset's inside basis, depreciation expense, and other tax attributes to the trust, including not reducing the basis of the trust's interest in the business until depreciation expense is incurred.

[2377] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, especially fn. 5521, for the proposition that the grantor of a grantor trust is deemed to own directly any asset owned by that trust.

[2378] Rev. Rul. 74-71. See 2017 Form 1041, Schedule K-1, line 9, "directly apportioned deductions." Code § 167(d) provides:

> *Life tenants and beneficiaries of trusts and estates*. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

For an elaboration on rules governing estates, see *Estate of Nissen v. Commissioner*, 345 F2d 230 (4th Cir. 1965), *rev'g* 41 T.C. 522 (1964); *Lamkin v. U.S.*, 533 F.2d 303 (5th Cir. 1976).

[2379] Code § 642(e) provides:

> An estate or trust shall be allowed the deduction for depreciation and depletion only to the extent not allowable to beneficiaries under sections 167(d) and 611(b) .

excess of the income set aside for the reserve) allocable to each,[2380] and the trust agreement may not override this rule.[2381] No effect is given to any allocation of the depreciation deduction which gives any beneficiary a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument.[2382] I am unaware of any guidance how to allocate in a sprinkle trust; presumably, those beneficiaries who tend to receive distributions would be the ones entitled to the depreciation deductions.

If a trust holds mortgaged property and the trustee charges payments of mortgage principal against trust income in determining the amount to be distributed to the trust's beneficiaries, depreciation must be allocated to the trust, by multiplying the total allowable depreciation by a fraction, the numerator of which is the amount of income accumulated and the denominator of which is the total trust income computed under Code § 643(b).[2383]

Rev. Rul. 74-530 clarifies that the trust calculates deductions and then apportions them [note, however, that Code § 167(h) then is now Code § 167(d)]:

> For purposes of section 167(h) and section 611(b) of the Code the allowable deductions described therein are the depreciation and depletion deductions attributable to properties owned by an estate or a trust. The computation of the allowable deductions is made by the estate or trust in its capacity as a separate taxable person under section 7701.
>
> Accordingly, before apportioning the deduction for depreciation under section 167(h) of the Code and the deduction for depletion under section 611(b), such deductions first must be computed by the estate or trust based on the properties it holds in its capacity as a separate taxable person.
>
> Furthermore, it is possible under section 167(h) and section 611(b) of the Code to allocate depreciation and depletion deductions between an estate and its heirs, legatees, and devisees or between a trust and its beneficiaries in amounts that are greater than their pro rata shares of the income of the estate or income of the trust. This is so because although the depreciation and depletion deductions are apportioned on the basis of the income of the estate or income of the trust allocable to each of the parties (without regard to any depreciation or depletion allocable to them), they are not limited by the amount of such income.

Thus, generally limitations on losses, such as basis and at-risk limitations,[2384] would be applied first at the trust level. However, that does not end the analysis regarding how a beneficiary deducts these directly apportioned deductions; see part II.J.11.a.ii.(b) Beneficiary's Ability to Deduct Depreciation That Generates Net Loss.

[2380] Reg. § 1.167(h)-1(b), incorporated by reference by Reg. § 1.642(e)-1, the latter of which (not yet amended to reflect changes made by P.L. 101-508, P.L. 97-34, P.L. 94-455) provides:

> An estate or trust is allowed the deductions for depreciation and depletion, but only to the extent the deductions are not apportioned to beneficiaries under sections 167(h) and 611(b). For purposes of sections 167(h) and 611(b), the term "beneficiaries" includes charitable beneficiaries. See the regulations under those sections.

[2381] *Dusek v. Commissioner*, 376 F.2d 410 (10th Cir. 1967).

[2382] Reg. § 1.167(h)-1(b).

[2383] Rev. Rul. 90-82.

[2384] See part II.G.3 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner.

For an in-depth discussion of allocating depreciation, see Lawson, "Tax Planning for Rental Real Estate Owned by a Trust," *Estate Planning Journal* (Vol. 40, No. 9, Sept. 2013), and Ransome, "Allocating Partnership Depreciation Between Trusts and Beneficiaries," *The Tax Adviser* (7/1/2007), the latter saved as Thompson Coburn LLP doc. no. 6682178.

II.J.11.a.ii.(b). Beneficiary's Ability to Deduct Depreciation That Generates Net Loss

Although the depreciation and depletion deductions are apportioned on the basis of the income of the estate or income of the trust allocable to each of the parties (without regard to any depreciation or depletion allocable to them), they are not limited by the amount of such income.[2385]

Therefore, a fiduciary might be able to allocate depreciation and depletion deductions between an estate and its heirs, legatees, and devisees or between a trust and its beneficiaries in amounts that are greater than their pro rata shares of the income of the estate or income of the trust.[2386]

For application of the Code § 469 passive loss rules to depreciation and depletion deductions, see part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary.

II.J.11.a.ii.(c). Trust vs. Separately Recognized Business Entity Holding Depreciable Property

If the trust holds depreciable property through a partnership, the trustee might not be making any decision regarding depreciation reserve, if the trustee is counting on the partnership to make any appropriate reserve.[2387] In that case, presumably the depreciation deduction would be allocated solely to the beneficiaries who do or may receive current distributions. Furthermore, passing the deductions through to any beneficiaries who participate in the business would simplify any passive loss issues (if and to the extent that the passive loss rules do not supersede this part II.J.11.a.ii),[2388] because the rules for determining an individual's participation are more well-defined and easier to apply than determining a trust's participation.[2389]

If a trust holds depreciable property through an S corporation, consider the following:

- If a nongrantor trust is permitted to hold the stock without making an ESBT or a QSST election,[2390] then see the discussion above regarding partnerships.

[2385] Rev. Rul. 74-530, reproduced in part II.J.11.a.ii.(a) Separate Reporting of Depreciation Deductions Allocable to Beneficiary.

[2386] Rev. Rul. 74-530, reproduced in part II.J.11.a.ii.(a) Separate Reporting of Depreciation Deductions Allocable to Beneficiary.

[2387] Query whether the aggregate theory of partnership taxation affects this analysis any.

[2388] See part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary.

[2389] See part II.K.2.b Participation by an Estate or Nongrantor Trust.

[2390] See parts III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S corporation and III.A.3.e QSSTs and ESBTs.

- If and to the extent an ESBT is a nongrantor trust, the depreciation deductions are trapped inside the trust.[2391] (This is a bad result if the trust is included in a person's estate.)[2392]

- If and to the extent the trust is grantor trust deemed owned by the grantor or the beneficiary (the latter including QSSTs), the deemed owner (including the deemed owner of an ESBT)[2393] would be allocated the depreciation deductions, because the grantor trust rules supersede everything.

II.J.11.b. Code § 1244 Treatment Not Available for Trusts

Individuals may deduct as an ordinary a loss incurred on the first $50,000 or $100,000 on the sale of small business corporation stock under Code § 1244.[2394]

Trusts and estates are not entitled to this treatment.[2395]

Note that, for S corporations, trusts can deduct losses as the S corporation incurs them if they have sufficient basis,[2396] so that the S corporation's ordinary losses will provide current annual benefit to the trust, and the trust's basis in the stock would be correspondingly reduced, which reduces the chance of the trust having a capital loss on disposition of the S corporation stock. Therefore, this issue is much more of concern for trusts owning C corporation stock than for trusts owning S corporation stock.

2391 See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, which generally traps in a trust all items on an S corporation's K-1. Reg. § 1.641(c)-1 does not expressly discuss the depreciation issue, the only authority being Reg. § 1.641(c)-1(d)(2)(i):

> (i) *In general*. The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. [then discusses ESBT elections for a partial year]

The second sentence tends to suggest applying this part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses) would apply to S corporation K-1 items. However, in requiring breaking out separately stated items, Code § 1366(a)(1)(A) cross-references Code § 702(a)(4), (6), but depreciation deductions under this this part II.J.11.a.ii would fall under Code § 702(a)(7) by reason of Reg. § 1.702-1(a)(8)(ii). On the other hand, fiduciary income tax return form instructions refer to items under this part II.J.11.a.ii from a pass-through; by not specifying the type of pass-through, do these instructions suggest that S corporation items would fall under this part II.J.11.a.ii? Ultimately, the issue appears decided in favor of trapping these deductions in the trust by the language at the end of Code § 641(c)(2)(C), "…no item described in this paragraph shall be apportioned to any beneficiary," which per Code § 641(c)(2)(C)(i) includes any item described in Code § 1366.

2392 See part II.H.2.d Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate.

2393 Reg. § 1.641(c)-1(c).

2394 Part II.Q.7.l Special Provisions for Loss on the Sale of Stock in a Corporation.

2395 Code § 1244(d)(4).

2396 See part II.G.3.c.i Basis Limitations for S corporation Owners.

II.J.12. Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act

Articles by Dobris (1979)[2397] and Blattmachr (1984)[2398] seem to be the leading authority in this area. In exercising tax elections, trustees may have these duties:[2399]

(1) the duty to minimize the overall tax burden on the estate and its beneficiaries;

(2) the duty of impartiality; and

(3) the duty to abstain from self-dealing.

Harris Trust & Sav. Bank v. MacLean, 542 N.E.2d 943 (1st Dist. Ill. 1989), involved a common situation: Trust recognizes big capital gain and pays federal and state capital gain tax. Both taxes are charged to principal. However, the income beneficiaries benefitted the following year by deducting the state capital gain tax. The court held that the trustee could not reduce the beneficiaries' income account by the tax benefit they received, because a trustee should be able to make an equitable adjustment only for inequities resulting from a trustee's discretionary decisions.[2400] The court viewed the tax benefit from the deduction of state income taxes to be

[2397] "Equitable Adjustments in Postmortem Income Tax Planning: An Unremitting Diet of Warms," 65 *Iowa L. Rev.* 103 (1979), saved as Thompson Coburn doc. no. 6174776.

[2398] "The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey," *18th University of Miami (Heckerling) Estate Planning Institute ¶ 1400* (1984).

[2399] *Estate of Rappaport*, 467 N.Y.S.2d 814 (N.Y. 1983), citing Carrico and Bondurant, "Equitable Adjustments: A Survey and Analysis of Precedents and Practice," 36 The Tax Lawyer, 545–6. Earlier the opinion discussed with approval Dobris, "Limits on the Doctrine of Equitable Adjustment in Sophisticated Post-mortem Tax Planning," 66 Iowa L. Rev., 273, 297–8. When administrative expenses are not needed to be deducted on an estate tax return to save estate tax, consider deducting them for income tax purposes. *Matter of Ettinger*, 564 N.Y.S.2d 691 (1990). When fiduciaries have conflicts of interest in exercising tax elections, a court may resolve the issue. *Matter of Estate of Spear*, 553 N.Y.S.2d 985 (1990).

[2400] The court reasoned and held:

> The question of whether a trustee is required to make an equitable adjustment between the trust's income and principal accounts where inequitable consequences result from the mandatory application of tax laws is one of first impression in Illinois. Several courts in other jurisdictions have addressed this issue. Some courts have suggested that an equitable adjustment should only be applied in response to a trustee's election or discretionary decision (*In re Dick's Estate* (1961), 29 Misc.2d 648, 218 N.Y.S.2d 182; *In re Kent's Estate* (1964), 23 Fla. Supp. 133), while one court has approved an adjustment to correct inequities not caused by any discretionary decision of the trustees (*Rice Estate* (1956), 8 Pa. D & C 2d 379) and another has rejected a distinction between discretionary decisions and mandatory applications (*In re Holloway's Estate* (1972), 68 Misc.2d 361, 327 N.Y.S.2d 865).
>
> We believe the better view is that equitable adjustments should be applied only in response to inequities resulting from a trustee's discretionary decisions which favor one beneficiary or class of beneficiaries over another. We agree with the trustees' position that the common law doctrine of equitable adjustments should only be employed in such circumstances because this concept is grounded in the fiduciary duty of a trustee not to be partial in making decisions or elections impacting on successive beneficiaries. (See *In re Warms' Estate* (Surr. Ct. 1955), 140 N.Y.S.2d 169; *In re Bixby's Estate* (1956), 140 Cal.App.2d 326, 295 P.2d 68.) The fiduciary should not be required to cure the inequities resulting from the application of mandatory tax laws; rather, any corrective action is more properly left for the legislature. *In re Dick's Estate*, 29 Misc.2d 648, 218 N.Y.S.2d 182; accord *In re Kent's Estate*, 23 Fla. Supp. 133.

I have been told that a Massachusetts court reached the same result.

very small compared to the sales proceeds that benefitted the principal beneficiaries, even though the benefit was probably hundreds of thousands of dollars. Blattmachr had indicated mixed results on this issue before this case was decided.[2401]

The Uniform Principal & Income Act, which has not been enacted in Illinois,[2402] takes the following approach:[2403]

Section 506. Adjustments Between Principal And Income Because Of Taxes.

(a) A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

(1) elections and decisions, other than those described in subsection (b), that the fiduciary makes from time to time regarding tax matters;

(2) an income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from the estate or trust; or

(3) the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary.

(b) If the amount of an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.

[2401] See fn. 2398, ¶ 1403.3 Corpus Expenses Benefit Income and Not Corpus but Not as a Result of Fiduciary Election, fns. 30-33. A leading case he cited, *In re Holloway's Estate*, 68 Misc.2d 361, 327 N.Y.S.2d 865 (1972), held:

> It is this court's considered opinion, however, that the *Dick* case rationale lacks the requisite equitable approach. As one writer observed: "Sections of the 1954 Code dealing with estate and trusts yield other examples directly contrary to both estate and trust law and common sense. For example, subchapter J, part I, was apparently drawn by tax lawyers not entirely familiar with trust concepts or fiduciary accounting principles. *The fiduciary and the court must be free in such cases to repair the damage by equitable adjustment*" (Browning, Problems of Fiduciary Accounting, 36 N.Y.U.L.Rev. 931, p. 953 [1961]). (Italics supplied.)

[2402] However, 760 ILCS 15/3(b)(2) allows a trustee to reallocate receipts "if the trustee in the trustee's discretion determines that application of the provisions of this Act would result in a substantial inequity to either the income beneficiaries or the remaindermen, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as those entitled to principal." The statute enacting the quoted provision was included in 1991 Ill. Legis. Serv. P.A. 87-714 (S.B. 717) (WEST).

[2403] http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008).

The official Comments include:

> **Discretionary adjustments**. Section 506(a) permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; (2) a distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who receive the income of any obligation to pay income tax on the income; or (3) a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain. See generally Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).
>
> Section 506(a)(3) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the retention of cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders.

See also part II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation.

Settlement of an ambiguous provision allocating capital gain tax between income and principal should not carry with it any gift, GST, or income tax consequences (except, of course, to the extent that they modify cash distributions that carry out DNI).[2404] Similarly, when a trust erroneously reported capital gain as taxable to the beneficiary instead of to the trust, reimbursing the beneficiary for tax paid on the capital gain did not have gift, estate, or GST tax consequences.[2405]

[2404] Letter Ruling 201528024, addressing construction of a provision directing the trustee to collect all the income and out of such income pay or provide for "all proper taxes."

[2405] Letter Ruling 201735005, involving a QSST that sold its S corporation stock. Fir the income tax consequences of such a transaction, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). in the ruling:

> On or about Date 2, Trustee sold Trust's share of stock in Corporation in a transaction that resulted in capital gain to Trust for federal and state tax purposes. Pursuant to State law, the capital gains should have been allocated to Trust principal and all income taxes due on the capital gains were required to be paid from Trust principal. However, Trustee in connection with Trust's Form 1041, U.S. Fiduciary Income Tax Return, erroneously issued Daughter a K-1, Beneficiary's Share of Income, Deductions, Credits, Etc., which treated the capital gain as a taxable distribution to Daughter for both federal and state tax purposes. As a result of receiving the K-1 Daughter reported the entire amount of the capital gain on her individual Federal and state income tax returns which she jointly filed with Spouse. The errors on the Schedules K-1 were in Year 1. Trustee distributed $A

When an estate deducted administrative expenses on its income tax return and reimbursed the principal for the income tax saved, the estate was allowed an estate tax deduction for the increased residue passing to charity (even though post-mortem actions normally do not affect the charitable deduction).[2406]

---

to Daughter in Year 2 as a partial reimbursement for the income taxes erroneously paid by Daughter and Spouse. Daughter did not waive the right of recovery with respect to the erroneous payment of income taxes in Year 1.

Trustee prepared a draft of its first accounting as Trustee on Date 3. Upon receipt of the draft accounting, Daughter became aware that she was due an additional reimbursement from Trustee for the income taxes paid by Daughter and Spouse in connection with the sale of S Corporation stock.

On or about Date 4, Trustee filed a Petition for Adjudication with Court seeking judicial approval of its first intermediate accounting (Accounting) from Date 5 to Date 6. On Date 7, Daughter, through her counsel, filed an objection (Objection) to the Accounting alleging that it failed to provide for the additional reimbursement to Daughter from Trust for state income taxes in the amount of $B, together with interest on the unreimbursed taxes at a specified rate, and reimbursement of Daughter's attorney's fees incurred in connection with the Accounting and Objection.

On Date 8, Court entered an order (Order) ruling that the statute of limitations remains open for Daughter to object to any and all matters disclosed in the Accounting; and that the Accounting fails to provide for an additional reimbursement from Trust to Daughter for the unreimbursed taxes, interest and attorney's fees associated with the Accounting and Objection. Trustee intends, in accordance with the Order, to reimburse Daughter for the amount of the unreimbursed taxes, interest, and attorney's fees due for the erroneous payment of income taxes by Daughter and Spouse in Year 1.

The ruling held:

1. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust does not constitute a constructive addition by Daughter and Spouse to Trust under § 26.2601-1(b)(1)(v)(C).
2. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust and the subsequent reimbursement to them of the income taxes paid, together with interest and attorney's fees, does not cause any portion of Trust to become subject to chapter 13.
3. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with the taxable income of Trust does not constitute a gift to Trust for federal gift tax purposes where Daughter and Spouse have a right of recovery from Trust, they have exercised their rights, and Trustee, in fact, has previously reimbursed Daughter and Spouse a portion of the income taxes, and will further reimburse Daughter and Spouse the balance of income taxes together with, interest and attorney's fees.
4. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust does not cause any portion of Trust to be includible in Daughter's gross estate.

[2406] Rev. Rul. 78-445, reasoning:

In *Estate of Britenstool v. Commissioner*, 46 T.C. 711 (1966), *acq*. and *nonacq.*, page 3, this Bulletin, the decedent bequeathed a remainder interest in the residuary trust to charity. The court, in effect, concluded that a reimbursement paid pursuant to section 11-1.2(A) of the Estates, Powers and Trusts Law (which actually codified the New York case law relied upon by the court) should be included in determining the amount passing to charity for purposes of section 2055(a).

The court determined that the purpose of such reimbursement (under section 11-1.2(A)) is to ensure that the amount passing to the residuary legatees in accordance with the decedent's will is not diminished by the additional estate tax payable as a result of the estate's election under section 642(g). To accomplish this, the statute requires a reimbursement, which effectively limits the amount of estate tax charged against the residue to the tax that would have been due had the

II.J.13. Applying 3.8% Tax to Trusts Owning Businesses Other than S corporations If the Beneficiary is Active But the Trustee Is Not

A nongrantor trust's NII passes through to beneficiaries as NII.

For a nongrantor trust, the determination of whether business income is passive and therefore constitutes NII is made at the trust level.

If the beneficiary is active but the trustee is not, considering doing the following:

1. The trust contributes its interest in the partnership or sole proprietorship into one or more S corporations.

2. The trust converts into a trust eligible to be subjected to a QSST election.

3. The beneficiary makes a QSST election.

For cautions in applying this strategy, see part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

---

administration expenses been deducted from the federal gross estate. The reimbursement is not properly characterized as an additional gift to the residuary legatees from the income recipient. Rather, the reimbursement ensures that the residuary legatees receive the amount they are otherwise entitled to receive under the terms of the decedent's will. The Service's acquiescence in Britenstool related to this issue.

Similarly, in the instant case, for purposes of section 2055(a), the value of the charitable deduction should be computed based on a residue of $825x, and not $800x. In accordance with the court's decision in Britenstool, $825x represents the amount passing to the residuary trust from D, under the terms of D's will. The $25x reimbursement, which was paid pursuant to state law, merely ensured that this $825x amount would not be diminished as a result of the executor's section 642(g) election.

Reg. § 20.2055-3(b)(2)-(4) provide:

(2) *Effect of transmission expenses*. For purposes of determining the charitable deduction, the value of the charitable share shall be reduced by the amount of the estate transmission expenses paid from the charitable share.

(3) *Effect of management expenses attributable to the charitable share*. For purposes of determining the charitable deduction, the value of the charitable share shall not be reduced by the amount of the estate management expenses attributable to and paid from the charitable share. Pursuant to section 2056(b)(9), however, the amount of the allowable charitable deduction shall be reduced by the amount of any such management expenses that are deducted under section 2053 on the decedent's federal estate tax return.

(4) Effect of management expenses not attributable to the charitable share. For purposes of determining the charitable deduction, the value of the charitable share shall be reduced by the amount of the estate management expenses paid from the charitable share but attributable to a property interest not included in the charitable share.

II.J.14. Application of 3.8% NII Tax to ESBTs

Electing small business trusts (ESBTs)[2407] are separated into S and non-S portions[2408] and subjected to the NII tax as follows:[2409]

1. The S portion and non-S portion computes each portion's undistributed net investment income as separate trusts[2410] and then combine these amounts to calculate the ESBT's undistributed net investment income.

2. The ESBT calculates the non-S portion's-adjusted gross income,[2411] increased or decreased by the S portion's net income or net loss, after taking into account all the S portion's deductions, carryovers, and loss limitations, as a single item of ordinary income (or ordinary loss).

3. The ESBT will pay tax on the lesser of (a) the ESBT's total undistributed net investment income, or (b) the excess of the ESBT's adjusted gross income[2412] over the dollar amount at which the highest fiduciary income tax bracket begins.

Beyond the 3.8% tax on NII, consider parts II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, particularly noting the IRS' position on NOLs incurred by an ESBT when the S corporation stock it owns generates losses.[2413]

II.J.15. QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items

II.J.15.a. QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax)

The preamble to the 2013 proposed regulations for net investment income tax generally explains the regular income tax treatment of sales involving QSSTs when discussing how the proposed regulations would treat the sales for net investment income tax purposes:[2414]

> H. Qualified subchapter S trusts (QSSTs)
>
> The preamble to the 2012 Proposed Regulations requested comments on whether special coordination rules are necessary to address dispositions of stock in an S corporation held

---

[2407] See part III.A.3.e.ii ESBTs.

[2408] Reg. § 1.1411-3(c)(1) provides:

> The S portion and non-S portion (as defined in § 1.641(c)-1(b)(2) and (3), respectively) of a trust that has made an ESBT election under section 1361(e)(3) and § 1.1361-1(m)(2) are treated as separate trusts for purposes of the computation of undistributed net investment income in the manner described in paragraph (e) of this section, but are treated as a single trust for purposes of determining the amount subject to tax under section 1411. If a grantor or another person is treated as the owner of a portion of the ESBT, the items of income and deduction attributable to the grantor portion (as defined in § 1.641(c)-1(b)(1)) are included in the grantor's calculation of net investment income and are not included in the ESBT's computation of tax described in paragraph (c)(1)(ii) of this section.

[2409] Reg. § 1.1411-3(c)(2). Reg. § 1.1411-3(c)(3) provides an example.

[2410] In the manner described in Reg. § 1.1361-3(e).

[2411] As defined in Reg. § 1.1361-3-(a)(1)(ii)(B)(1).

[2412] As calculated under Reg. § 1.1361-3(c)(2)(ii).

[2413] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 5116.

[2414] REG-130843-13.

by a QSST. Specifically, the request for comments deals with the application of section 1411(c)(4) to the existing QSST stock disposition mechanics in § 1.1361-1(j)(8).

In general, if an income beneficiary of a trust that meets the QSST requirements under section 1361(d)(3) makes a QSST election, the income beneficiary is treated as the section 678 owner with respect to the S corporation stock held by the trust. Section 1.1361-1(j)(8), however, provides that the trust, rather than the income beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of the disposition of the stock by the QSST. Section 1361(d)(1)(C) and the last sentence of § 1.1361-1(j)(8) provide that, solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST is treated as a disposition by the income beneficiary. However, in this special case, the QSST beneficiary, for chapter 1 purposes, does not have any passive activity gain from the disposition. Therefore, the entire suspended loss (to the extent not allowed by reason of the beneficiary's other passive net income in the disposition year) is a section 469(g)(1) loss, and is considered a loss from a nonpassive activity.

For purposes of section 1411, the inclusion of the operating income or loss of an S corporation in the beneficiary's net investment income is determined in a manner consistent with the treatment of a QSST beneficiary in chapter 1 (as explained in the preceding paragraph), which includes the determination of whether the S corporation is a passive activity of the beneficiary under section 469. However, because gain or loss resulting from the sale of S corporation stock by the QSST will be reported by the QSST and taxed to the trust by reason of § 1.1361-1(j)(8), it is not clear whether the beneficiary's section 469 status with respect to the S corporation is attributed to the trust.

One commentator recommended that the disposition of S corporation stock by a QSST should be treated as a disposition of the stock by the income beneficiary for purposes of determining material participation for purposes of section 1411. In addition, the commentator recommended that the final regulations confirm that the special rule stated in the last sentence of § 1.1361-1(j)(8) applies for purposes of section 1411 as it does for section 469 and 465.

After consideration of the comments, these proposed regulations provide that, in the case of a QSST, the application of section 1411(c)(4) is made at the trust level.

This treatment is consistent with the chapter 1 treatment of the QSST by reason of § 1.1361-1(j)(8). However, these proposed regulations do not provide any special computational rules for QSSTs within the context of section 1411(c)(4) for two reasons.

First, the treatment of the stock sale as passive or nonpassive income is determined under section 469, which involves the issue of whether there is material participation by the trust. As discussed in part 4.F of the preamble to the 2013 Final Regulations, the Treasury Department and the IRS believe that the issue of material participation by estates and trusts, including QSSTs, is more appropriately addressed under section 469.

Additionally, one commentator noted that the IRS has addressed the treatment of certain asset sales as the functional equivalent of stock sales for purposes of § 1.1361-1(j)(8) in a limited number of private letter rulings. In these cases, the private letter rulings held that gain from the sale of assets, which was followed by a liquidation, would be taxed at the trust level under § 1.1361-1(j)(8) rather than being taxed at the beneficiary level. The

> commentator recommended that an asset sale followed by a liquidation, within the context of § 1.1361-1(j)(8), should have a similar result under section 1411(c)(4). Similar to the issue of material participation by QSSTs discussed in the preceding paragraph, the Treasury Department and the IRS believe that the issue of whether an asset sale (deemed or actual) is the equivalent of a stock sale for purpose of the QSST rules should be addressed under the § 1.1361-1(j) QSST regulations, rather than in § 1.1411-7. However, the Treasury Department and the IRS believe that proposed § 1.1411-7(a)(4)(i), which provides that asset sales followed by a liquidation is a disposition of S corporation stock for purposes of section 1411(c)(4), address the commentator's QSST issue.
>
> Second, with respect to the section 1411 treatment of the disposition by the beneficiary by reason of section 1361(d)(1)(C) and the last sentence of § 1.1361-1(j)(8), the Treasury Department and the IRS believe that the general administrative principles enumerated in § 1.1411-1(a), when combined with the general treatment of section 469(g) losses within § 1.1411-4, provide an adequate framework for the treatment of QSSTs beneficiaries without the need for a special computational rule within § 1.1411-7.

Code § 469(g), the rule governing the disposition of a passive activity, is described in part II.K.1.i Complete Disposition of Passive Activity

For more information on the taxation of QSSTs, see parts III.A.3.e.i QSSTs [2415] and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

For planning issues relating to the dispositions described in this part II.J.15.a, see part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

II.J.15.b. QSSTs and State Income Tax Issues

As a grantor trust with respect to S corporation items, the trust is not subjected to state income tax on those items; instead, the beneficiary is.

A state might even treat the trust as not existing while it is a grantor trust, providing the opportunity to treat the trust as a nonresident trust if the grantor moves to another state (for example, a state with no income tax).[2416] Thus, if a QSST holds only S corporation stock, then the QSST election might allow the trust's residency to be determined at a later, perhaps more favorable date.[2417]

[2415] Particularly the text accompanying fns. 5070-5072, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale. For additional planning issues, see parts II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI). See also part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs, especially part III.A.3.e.v.(b) Implementation and, within that, the paragraph that includes a reference to fn. 5166.

[2416] See part II.J.3.e.ii Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence.

[2417] Illinois Schedule K-1-P, which partnerships and S corporations use to report K-1 income includible in their owners' income, has a separate line, line 9b, which was "expanded to allow grantor trusts and other federally disregarded entities to identify the taxpayer that will report the income or loss shown on the Schedule K-1-P…." See Illinois Dept. of Rev. Info. Bulletin, No. FY 2013-09, 01/01/2013. That line was also on 2014 returns.

Some trust agreements provide that any S corporation will be held in a separate QSST, leaving the original trust undisturbed as to any provisions that might be consistent with QSST status. This approach would appear to maximize the possibility of the delayed residence determination described above.

Of course, one would also want to consider the other factors mentioned in part II.J.3 Strategic Fiduciary Income Tax Planning rather than focusing exclusively on this issue.

II.J.16. Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets

Consider the following:

- The sale of ownership of a business entity is allocated to principal. Assuming the business interest is a capital asset, any capital gain is included in DNI only if certain exceptions are satisfied[2418] and any ordinary income[2419] is automatically included in DNI.[2420]

- A flow-through entity might sell its assets, or a sale of S corporation stock might be taxed to the shareholders as a sale of the entity's assets followed by the corporation liquidating.[2421] Generally, assets used in business activities do not constitute capital assets, so capital gain from their sale is included in DNI without needing to apply the special rules for gain from the sale of a capital asset,[2422] and of course any ordinary income generated by depreciation recapture is included in DNI as well. Goodwill is a capital asset unless it has been subject to any amortization.[2423] Because this gain/income is included in DNI, the allocation of such gains to principal does not cause any particular limits to be placed on shifting them to beneficiaries if they are properly paid, credited, or required to be distributed.[2424] However, if and to the extent that they are not paid or credited during the year or within 65 days thereafter[2425] and are not required to distributed, consider whether they can be allocated to income if the trust is a mandatory income trust.[2426]

- State and local income taxes are not deductible in determining alternative minimum tax (AMT).[2427] Often the best way to prevent these items from triggering AMT is to pay them in the year in which the income that generated them is recognized. Given that a state might allow one to use the prior year's income tax as a safe harbor or might not require estimated

---

[2418] See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).
[2419] For example, the sale of a partnership interest might generate ordinary income from the sale of "hot assets" – see part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest.
[2420] Code § 643(a).
[2421] See parts II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items and II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.
[2422] See part II.J.8.a Capital Gain Constitutes DNI Unless Excluded.
[2423] See fns. 3482-3486.
[2424] Code § 661(a)(1), (c).
[2425] See part II.J.2 Tactical Planning Shortly After Yearend.
[2426] See parts II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation and II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act.
[2427] Code § 56(b)(1)(A)(ii).

tax payments at all, one might easily overlook the need to pay state income tax in the year of the sale (or other major income recognition event).

Although items on a K-1 from an S corporation generally are taxed the beneficiary as if the QSST were a grantor trust, gain from sale of the stock and gain from the sale or deemed sale of the corporation's assets (even if reported on a K-1) are taxed to the trust, not as part of the grantor trust portion.[2428] However, if the beneficiary's federal and state/local income taxation (including the 3.8% tax net investment income) are more favorable than the trust's and a distribution form the trust would not frustrate the trust's objectives, consider using the ideas in the bullet points above to shift taxation on any items otherwise taxable to the trust. It is not unusual for an income tax preparer to be unfamiliar with the QSST rules regarding taxation of the sale or deemed sale of the corporation's assets and not to plan for the correct taxation, so be sensitive to this issue up front and also consider reallocating principal to income if the trust is a mandatory income trust.[2429] Although one might initially view the election to tax a stock sale as a sale of the business' assets (followed by liquidation) as merely substituting gain on the sale of assets for gain on the sale of stock, note that state income taxation might also generate surprising results; see part II.H.8.a.ii State Income Tax Disconnect.

For an ESBT, consider allocating administrative expenses and state income taxes to the S portion as much as is reasonable to do.[2430] Allocating administrative expenses to the non-S portion might create a loss that is not deductible unless the trust is terminating,[2431] making an allocation to the S portion even more desirable. In addition to that concern, allocating state income tax to the non-S portion might generate a large alternative minimum tax bill,[2432] which would not be owed if allocated to the S portion and paid in the year of sale.

If the trust is a QSST or if the trust is a grantor trust that would be converted to an ESBT shortly before the sale, consider making the trustee active in the business to maximize opportunities to avoid the 3.8% tax on net investment income and, in the case of a grantor trust, converting it to an ESBT far enough in advance of the sale for the trustee to accumulate sufficient hours of participation. See generally part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S corporations in Light of the 3.8% Tax.

[2428] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). For more information on the taxation of QSSTs, see parts III.A.3.e.i QSSTs (particularly the text accompanying fns. 5070-5072, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale) and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs. If the corporation actually sells its assets without adopting a plan of liquidation, I am unsure of the result.

[2429] See part II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S corporation. In a QSST, one might be able to allocate principal to income to make up for expenses ordinarily allocated to principal that were allocated to income as an adjustment needed due to cash flow issues; see text accompanying fns. 5059-5062 in part III.A.3.e.i.(a) QSSTs Generally. For form language that might facilitate this allocation, see fn. 2290, found in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

[2430] For ESBT tax issues, see parts II.J.14 Application of 3.8% NII Tax to ESBTs and III.A.3.e.ii.(b) ESBT Income Taxation - Overview, the latter especially including fns. 5118-5119.

[2431] Code § 642(h). See part II.J.3.i Planning for Excess Losses.

[2432] Code § 56(b)(1)(A)(ii).

If the trustee mistakenly taxes the sale to the beneficiary, reimbursing the beneficiary should not generate any transfer tax consequences.[2433]

II.J.17. Planning for Grantor and Nongrantor Trusts Holding Stock in S corporations in Light of the 3.8% Tax

This part II.J.17 assumes that avoiding NII characterization is the most important objective. Before making that assumption, see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good.[2434]

Making income from operations and gain on sale be nonpassive income is the key to avoiding NII characterization:

- Generally, income from a trade or business is exempt from the 3.8% tax if it is nonpassive income.[2435]

- Gain on the sale of assets used in a nonpassive trade or business (or from the part of the sale of a partnership interest or S corporation stock allocable to such assets) is exempt from the 3.8% tax.[2436]

- The taxpayer needs to sufficiently participate in a business to make it nonpassive.[2437]

Consider the following:

- In an ESBT, the trust is the taxpayer.

- In a QSST, for normal operations, the beneficiary, as deemed owner under the grantor trust rules, is the taxpayer.

- In a QSST, when the business is sold, generally the trust will be the taxpayer.[2438]

- In a grantor trust, the deemed owner is the taxpayer, but the deemed owner might turn off the grantor trust powers before selling the business, generally making the trust the taxpayer, whether the trust is an ESBT or a QSST (or the business is taxed as partnership).

Thus, even when a trust is taxable to the grantor or beneficiary under the grantor trust rules, one might consider establishing the trustee's material participation at least a year before the business might be sold;[2439] whether this would count given the trust's being disregarded for income tax purposes has never been addressed, but, with rules regarding trust material participation so

[2433] See part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act, especially fn. 2405.

[2434] Particularly note the IRS' position on NOLs incurred by an electing small business trust (ESBT) when the S corporation stock it owns generates losses part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 5116.

[2435] See part II.I.8 Application of 3.8% Tax to Business Income.

[2436] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S corporation.

[2437] See part II.K.1.a Counting Work as Participation.

[2438] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).

[2439] See part II.K.2.b Participation by an Estate or Nongrantor Trust.

uncertain, these extra precautions might be worthwhile if the tax at risk is significant enough. This might require jumping through extra hoops if the entity was formed as a state law corporation, because a traditional corporate structure does not lend itself to the type of participation the IRS seeks.[2440]

For more discussion of QSSTs and ESBTs, see generally part III.A.3.e QSSTs and ESBTs, which compares and contrasts those types of trusts and discusses strategies for switching back and forth.

II.J.18. Trust Mergers and Divisions; Decanting

If a trust is divided so that each trust has the same beneficial interests but different assets and trustees, the division itself will not carry out income from one trust to the other.[2441] If one trust later distributes to another trust as a conduit to make distributions to the beneficiaries, the distribution will carry out DNI; however, if the distribution is just to shift funds between with the trusts without the shift being related to distributions, the shift does not carry DNI.[2442]

Whether a trust division shifts the grantor does not affect whether the division constitutes a distribution that carries out DNI.[2443] For what decanting is, see Uniform Trust Decanting Act, found at http://www.uniformlaws.org/Act.aspx?title=Trust Decanting, with the drafting committee's work found at http://www.uniformlaws.org/Committee.aspx?title=Trust%20Decanting; R.S.Mo. § 456.4-419, found at http://www.moga.mo.gov/mostatutes/stathtml/45600404191.html. The Uniform Trust Decanting Act authorizes amending a trust without transferring assets.[2444]

[2440] See part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.

[2441] Letter Ruling 201642028. For a similar result for decanting, see part II.J.4.i Modifying Trust to Make More Income Tax Efficient.

[2442] Letter Ruling 201642028.

[2443] T.D. 8831 (8/6/1999), provides:

> Commenters also questioned a provision in the proposed regulations that treated a distribution from one trust to another trust that is a beneficiary of the first trust as a gratuitous transfer, with the result that the first trust was a grantor of the second trust. Under the temporary regulations, if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally is treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, such person is treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Code. (These rules do not affect the determination of whether or not the gratuitous transfer from the transferor trust is a distribution subject to sections 651 or 661.)

See parts II.D.3 Trust as Grantor of a Trust and III.B.2.h.i Who Is the Grantor, the latter including fns. 5598-5601.

[2444] Uniform Trust Decanting Act § 2(23)(A), authorizes amending a trust without transferring assets. The official Comments state:

> Thus the authorized fiduciary may exercise the decanting power by modifying the first trust, in which case the "second trust" is merely the modified first trust. The decanting instrument can, when appropriate, merely identify the specific provisions in the first trust that are to be modified and set forth the modified provisions, much like an amendment to a revocable trust. If the decanting power is exercised by modifying the terms of the first trust, the trustee could either treat the second trust as a new trust or treat the second trust as a continuation of the first trust. If the second trust is treated as a continuation of the first trust, there should be no need to transfer or retitle the trust property. Further, subject to future tax guidance, if the second trust is a continuation of the first trust, there may be no need to treat the first trust as having terminated for income tax purposes and no need to obtain a new tax identification number.

ACTEC comments on decanting (http://www.actec.org/resources/comments-on-transfers-by-a-trustee) proposed a revenue ruling saying no new tax ID but do not cite authority for that conclusion. However, they mentioned that Letter Ruling 200607015 treated a decanted trust as a continuation of the original trust. On the other hand, they also referred to Letter Ruling 200736002, which involved a trust division and also treated the division as being a continuation and not a distribution, but the three successor trusts were treated as different trusts from each other, which means that at least two trusts needed to get new tax IDs. So I don't know how much to read into whether being considered a continuation trust would require a tax ID.

For a trust merger, Letter Ruling 200552009 stated:

> We also conclude that because § 1001 does not apply to the proposed division of merged Trust 4, under § 1015, the tax basis that the New Trusts have in the assets of the New Trusts immediately after the division will be the same as the tax basis of the merged Trust 4 in such assets immediately before the division. The tax basis of the historic assets in the New Trusts immediately after the division will be the same as the tax basis that the merged Trust 4 had in those assets immediately before the division. We further conclude that each asset transferred by the merged Trust 4 to the New Trusts will have the same holding period in the hands of the New Trusts immediately after the division that it had in the hands of the merged Trust 4 immediately before the division. Each historic asset of the New Trusts will have the same holding period immediately after the division that it had immediately before the division.
>
> We additionally conclude that in each of the mergers of the Family Trusts into Trust 4, the merged Trust 4 will succeed to and take into account any net operating loss carry forward (NOLCF), net capital loss, and other tax attributes, including passive activity losses and credit carryforwards, of the merging Family Trusts. Each asset transferred by the merging Family Trusts to the merged Trust 4 will have the same tax attributes immediately after the merger that it had immediately before the merger. Each historic asset of the merged Trust 4 will have the same tax attributes immediately after the merger that it had immediately before the merger. All NOLCFs, net capital losses, and other tax attributes, including passive activity losses and credit carryforwards, of the merging Family Trusts immediately before the mergers will survive and remain available to the merged Trust 4 after the mergers and no limitation will be imposed as a result of the proposed mergers on the merged Trust 4 's use of such tax attributes.
>
> Finally, we conclude that on the division of the merged Trust 4 into New Trusts, each of the New Trusts will succeed to and take into account c of any net operating loss carry forward (NOLCF), net capital loss, and other tax attributes, including passive activity losses and credit carryforwards, of the divided merged Trust 4. Each asset transferred by the divided merged Trust 4 to the New Trusts will have the same tax attributes immediately after the division that it had immediately before the division. Each historic asset of the New Trusts will have the same tax attributes immediately after the division that it had immediately before the division. All NOLCFs, net capital losses, and other tax attributes, including passive activity losses and credit carryforwards, of the divided merged Trust 4 immediately before the division will survive and remain available to the divided New Trusts after the division and no limitation will be imposed as a result of the proposed division on the New Trusts' use of such tax attributes.

II.K.2. Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business

II.K.2.a. Overview of Passive Loss Rules Applied to Trusts or Estates

A trust or estate participating might be important not only to prevent the passive loss rules from suspending a loss but also to prevent the 3.8% tax on net investment income from applying to the trust's business income. For details on the net investment income tax, see part II.I 3.8% Tax on Excess Net Investment Income (NII), especially part II.I.8 Application of 3.8% Tax to Business Income. See also parts II.J.13 Applying 3.8% Tax to Trusts Owning Businesses Other than

S corporations If the Beneficiary is Active But the Trustee Is Not, II.J.14 Application of 3.8% NII Tax to ESBTs, and II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S corporations in Light of the 3.8% Tax.

Grantor trusts are taxed to their deemed owners and generally are not cover further in this part II.K.2. Further below are discussions of current law and how to plan for estates and nongrantor trusts in light of it.[2684] Here is an overview of regulatory developments:

From when the Code § 469 passive loss rules were enacted until when the Code § 1411 tax on net investment income (NII) was enacted, the application of the passive loss rules to estates and nongrantor trusts generally was ignored. This idea was ignored because the issues were those of timing of deductions, estates and nongrantor trusts with excess deductions could not use them, and the suspending passive losses until sales occurred generally was favorable. However, the NII tax changed the paradigm, causing taxpayers to ask the government for guidance, to which the government responded by asked for comments on what those rules should look like.

Before discussing the comments, one needs to provide context to the government's general approach. The proposed regulations under Code § 1411 initially addressed the general application of the passive loss rules (not yet focusing on trusts) in a manner biased in favor of the government: the proposed regulations would have left taxpayers with income that was nonpassive for Code § 469 but passive for Code § 1411. This approach was inconsistent with the scant legislative history of Code § 1411, and pressure was applied (in a process in which I was not involved) that caused the final regulations to back away from that approach and simply apply Code § 469 (with certain pro-taxpayer exceptions) and let the Code § 1411 consequences fall where they may.

My understanding is that the government will be looking at comments on trust participation as purely Code § 469 issues and let the Code § 1411 consequences fall where they may. It has been suggested that Code § 469 comments that tend to favor characterizing income as nonpassive in the hands of an estate, nongrantor trust, or beneficiary would be an unwarranted boon for taxpayers. However, my understanding is that the government is concerned about what might if it adopts regulations with Code § 1411 in mind, Code § 1411 later gets repealed, and the government has shot itself in the foot under Code § 469 by making it difficult to characterize income as nonpassive. Thus, regulations under Code § 1411, not Code § 469, would be the appropriate place to address any concerns the government might have about the impact of Code § 469 regulations on Code § 1411.

Making fair rules for how trusts can materially participate will be a complex task. Fiduciary arrangements can be grantor trusts (in which case the trust is disregarded and the deemed owner is taxed), estates, or nongrantor trusts. Trustees can be individuals or entities. A trust might have one trustee or multiple trustees. Each trustee might have different skills or knowledge of the beneficiaries' needs, leading to slicing and dicing of trustees' authority and duties. Furthermore, the level of fiduciary duties varies according to state law and the document that created the trust.

Here is a description of comments by certain major groups, all of which I participated in varying degrees:

[2684] Part II.K.2.b Participation by an Estate or Nongrantor Trust.

- AICPA comments were first.[2685] They pointed to taxpayer-friendly case law.

- The ABA's Section on Taxation submitted highly technical comments, which, among other matters, explored the relationship between the passive loss and the fiduciary income tax system.[2686]

- The American College of Trust & Estate Counsel (ACTEC), whose task force I chaired, focused on the fiduciary nature of a trust and explored how the government might handle the evolving roles of trustees.[2687]

ACTEC proposed that work in a business activity be considered work attributable to a trust in determining its material participation if performed by a person who is a qualifying fiduciary. To qualify under ACTEC's proposal, the person must hold a substantial related fiduciary power and personally owe fiduciary duties to the beneficiaries with respect to the power.

One set of comments (not mentioned above) suggested varying the rules depending on who serves (and perhaps how many people serve) as trustee. Considering those factors would punish trusts that do not conform to those comments' ideas of how trusts should be administered. In contrast, ACTEC's comments treat all trustees and trust arrangements the same, focusing on whether fiduciary duties are owed with respect to the work that is performed.

ACTEC's comments mention what little law there is and recommend changes to the law. When one needs a logical framework for trusts that have more than one trustee, when distributions are made to a beneficiary, or when my planning suggestions do not work out or were not followed, ACTEC's comments would form the basis for a well-reasoned argument about how the passive loss rules should be applied.

[2685] Thompson Coburn LLP document number 6252341 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicUrc/OGHGu+qSyFQIHlSrV/Yyi63VldeR&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.

[2686] Thompson Coburn LLP document number 6252340 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicikIVHHCCawA0JoSeWnL+iQcx1y1EIbsot+x1JadeV10=&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.

[2687] Thompson Coburn LLP document number 6252339 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicxjC0od0egqdZH1P8mlbZQ43UvnjYGixP&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.

II.K.2.b. Participation by an Estate or Nongrantor Trust

II.K.2.b.i. Participation by a Nongrantor Trust: Authority

Regulations do not address participation by a nongrantor trust.[2688] The legislative history provides:[2689]

> An estate or trust is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if an executor or fiduciary, in his capacity as such, is so participating.

The legislative history does not state that this is the exclusive test for how fiduciaries may participate. For planning purposes, one should consider assuming that is the exclusive test, because the IRS takes that position. For reporting purposes, however,

"Fiduciary" means a "guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person."[2690] The term "applies to persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators. A fiduciary is a person who holds in trust an estate to which another has a beneficial interest, or receives and controls income of another" and also includes a "committee or guardian of the property of an incompetent person."[2691] A mere agent is not a fiduciary; for example, an "agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary" under this definition.[2692]

The IRS has litigated whether one should test based only on actions directly by the trustee or whether actions by others, such as an agent, should be considered.

In *Mattie K. Carter Trust v. United States*,[2693] the IRS argued that "material participation" should be based on the trustee's actions alone. However, the court agreed with the taxpayer that it should be tested by whoever participates on behalf of the trust, which in this case included two people to whom the trustee delegated functions: (1) a full-time ranch manager whose actions were subject to the trustee's approval, and (2) a beneficiary who supervised the manager and general ranch operations.

[2688] Note that participation of the activity of the deemed owner of a grantor trust would be a matter if that individual's personal participation. Thus, for example, this discussion in this section would not apply to a revocable trust. The rules for the Code § 1411 tax on passive business income expressly recognize this treatment of grantor trusts; see fn. 1902.
[2689] Committee Reports for Senate Bill 99-313, P.L. 99-514. A footnote in the legislative history provides that one looks to the participation of the deemed owner of a grantor trust rather than to the trust's participation.
[2690] Code § 7701(a)(6), which applies to Code § 469 where not otherwise distinctly expressed or manifestly incompatible with that section's intent.
[2691] Reg. § 301.7701-6(b)(1).
[2692] Reg. § 301.7701-6(b)(2).
[2693] 256 F.Supp.2d 536 (N.D. Tex. 2003).

TAM 200733023 rejected the taxpayer's reliance on *Mattie Carter* and asserted:

> What is apparent from the line of authority in this area is that a fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. Although Trust represents that Special Trustees were heavily involved in the operational and management decisions of Business, Special Trustees — like the banks in Revenue Ruling 82-177 and *Anderson* — were ultimately powerless to commit Trust to any course of action or control Trust property without the express consent of Trustees. The contract between Trust and Special Trustees is explicit on this point, and Trust itself has acknowledged that Trustees retained final decision-making authority with regard to all facets of Business. The services performed by Special Trustees appear to be indistinguishable from those that would be expected of other non-fiduciary business personnel. If advisors, consultants, or general employees can be classified as fiduciaries simply by attaching different labels to them, the material participation requirement of § 469 as applied to trusts would be meaningless.

Letter Ruling 201029014 involved a trust that owned a partnership interest. The partnership interest was the sole owner of another entity, which in turn was the sole owner of the ultimate subsidiary. The ruling held that the trust may materially participate in the subsidiary's activities if the trustee is involved in the operations of the subsidiary's activities on a regular, continuous, and substantial basis. The ruling failed to mention the *Mattie K. Carter Trust* case or to address whether any formalities were needed to establish participation as the trustee rather than participation as an individual.

The IRS' Audit Technique Guide discusses the topic as follows:[2694]

> **Trusts Material Participation**
>
> If a business activity is owned by a trust, the examiner will need to determine if the material participation standard is met in order for losses to be fully deductible. Businesses may be conducted via Schedules C or Form, partnerships, S corporations or LLCs.
>
> The IRC § 469(h) requires regular, continuous and substantial participation in the operations of the business to meet material participation and for losses to be fully deductible. There is no guidance in the regulations at this time for material participation of trusts and estates.[2695]
>
> As an administrative proxy, we look to the seven tests in Reg. § 1.469-5T(a) for material participation, and generally will not raise an issue if the trustee meets one of the tests. However, as a technical matter the tests apply to individuals, not to a trust or trustee. Thus, as a legal matter, the trustee must prove he works on a regular basis in operations, on a continuous basis, and on a substantial basis in operations, i.e. rise to the requirements of IRC § 469(h).

[2694] Chapter 6, found by starting with http://www.irs.gov/pub/irs-mssp/pal.pdf or http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-6-Entity-Issues. The footnotes in the excerpt below are direct copies from the IRS' audit guide, although the footnote numbers have been changed from footnote numbers 15-19 to those used below.

[2695] Note that Reg. § 1.469-5T(g) is "Reserved".

Grantor Trusts: Since tax law does not recognize a grantor trust as a separate taxable entity, the examiner should ignore the trust entirely and look to the grantor (individual taxpayer) to determine material participation.

Qualified Subchapter S Trust[2696] **(QSST):** The QSSTs are generally grantor trusts in which the grantor is frequently a parent and the beneficiary is a child. The examiner should look to the beneficiary (child) to determine material participation.

Exceptions: There are two major exceptions to the passive loss rules:

1. Partnerships which are traders in stocks and bonds;[2697] and,

2. Working interests in oil and gas activities.[2698] Losses or income from these activities are excepted from the passive loss limitations and are not entered on Form 8582.

Issue Identification: Does the trustee materially participate in the following:

- Schedule C or F activities with losses.

- Partnership or S corporation with losses.

- Entity with an EIN and address a long distance from the trust or trustee.

- Entity in which the trust is a limited partner or the ownership percentage is low.

Examination Techniques:

- Secure the trust instrument or will and read it.

- Determine who the trustee is and what his other responsibilities are. If the trustee is a busy bank officer or attorney, material participation may be questionable in businesses or entities in which the trust owns an interest.

Documents to Request:

- Trust instrument or will including any amendments and codicils.

- Copies of Schedule K-1s from related entities.

- Detailed description of business activities conducted on Schedule C or F or by any partnerships, or S corporations.

[2696] See IRC § 1361(d) where the beneficiary elects to be treated as the owner of the trust for purposes of IRC § 678.
[2697] Reg. § 1.469-1T(e)(6).
[2698] IRC § 469(c)(3), Reg. § 1.469-1T(e)(4)(v).

- Explanation of the duties and responsibilities of the trustee for each business, whether conducted as a Schedule C, partnership or S corporation.

- Completion of the log at the end of Chapter 4 for any activity in which material participation is questioned.

Supporting Law:

- The **Senate Report**[2699] clearly provides that an estate or trust would be treated as materially participating if the executor or fiduciary/trustee materially participates.

- **Reg. § 1.469-1T(b)(2)** Passive loss rules apply to trusts other than trusts described in IRC § 671 (grantor trusts). Also see Rev. Rul. 85-13, 1986-1 CB 184.

- **QSSTs:** The General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation, Note 33, page 242, explains, "Similarly, in the case of a qualified electing Subchapter S trust (§ 1361(d)(1)(B)) that is treated as a grantor trust (i.e., the beneficiary is treated as the owner for tax purposes), the material participation of the beneficiary is relevant to the determination of whether the S corporation's activity is a passive activity with respect to the beneficiary."

In its April 5, 2013 comments to the proposed regulations under Code § 1411, the American Bar Association's Section on Taxation said:[2700]

> Because of the uncertainty of current law under chapter 1, we recommend that the Service issue guidance regarding material participation for a trust or estate for purposes of section 1411. We recommend that this guidance be issued as a new proposed regulation package rather than including these rules in these final Regulations.
>
> In this regard, we recommend that the new proposed regulation package would provide that material participation by a trust or estate can be accomplished through meeting at least one of three tests:
>
>> (a) The fiduciary materially participates under the standards that apply to individuals under previously promulgated Regulations.[2701]
>>
>> (b) The fiduciary, based on all of the facts and circumstances, participates in the activity on a regular, continuous and substantial basis during the year.[2702]

[2699] S. Rep. No. 313, 99th Cong., 2d Sess., Reprinted in 1986-3 C.B. (Vol. 3) 1, at 735.
[2700] The footnotes below use my numbering rather than the numbering used in the report. The report is at http://www.regulations.gov/contentStreamer?objectId=090000648127f7c2&disposition=attachment&contentType=pdf.
[2701] See Temp. Reg. § 1.469-5T(a)(1)-(5).
[2702] See Temp. Reg. § 1.469-5T(a)(7).

> (c) The fiduciary participates in the activity on a regular, continuous, and substantial basis, either directly or through employees or contractors whose services are directly related to the conduct of the activity.[2703]

It explained its recommendations as follows:

> The recommended alternative tests for material participation by a trust take into account the hybrid nature of a trust by allowing it to qualify based on the actions of the fiduciary (individual tests) and also those employed by the fiduciary in certain circumstances (similar to a closely held C corporation). When considering the efforts of the fiduciary, any time spent working on the activity should be considered towards meeting the material participation requirements regardless of whether the fiduciary is working on the activity as a fiduciary or in another role, for instance as an officer or an individual investor. If there are multiple fiduciaries, time spent by the fiduciaries could be aggregated for purposes of determining material participation.
>
> Applying only the standards for an individual to be a material participant in an activity would ignore the obvious differences between individuals and trusts. In what is apparently the only court case to address the issue to date, the court in *Mattie K. Carter Trust*[2704] found the trust to be analogous to a closely held C corporation and concluded that "the material participation of the Carter Trust in the ranch operations should be determined by reference to the persons who conducted the business of the ranch on Carter Trust's behalf, including [the trustee]." The Service took the position that when determining active and passive activities under section 469, only the activities of the fiduciary are to be considered when meeting the standard of regular, continuous, and substantial participation. The taxpayer argued that the participation of the trust's other employees and agents also should be included since the trust could only participate in an activity through its fiduciaries, agents and employees much like a corporation.
>
> The court held for the taxpayer, finding that a trust was most analogous to a corporation and that the acts of its agents would be deemed acts of the taxpayer. Based on the activities of the trust through its trustee, fiduciaries, employees, and agents, the material participation requirement was satisfied. The Court noted that it had studied the "snippet" of legislative history purporting to provide insight on how Congress intended section 469 to apply to a trust's participation in a business, including the Senate Finance Committee Report and the footnote in the Joint Committee on Taxation's Explanation, but did not find it helpful.
>
> In private rulings, the Service has taken the position that it is appropriate in the trust context to look only to the activities of the fiduciary to determine material participation.[2705]

[2703] Based upon Temp. Reg. § 1.469-1T(g) (rules for C corporations). This regulation was in turn based on I.R.C. § 469(c)(7)(C).

[2704] *Mattie K. Carter Trust v. U.S.*, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

[2705] In TAM 200733023 (Aug. 17, 2007), the Service took the position that a trust satisfies the material participation test only if the fiduciaries (i.e., the trustee or trustees) are involved in the operations of the trust's business activities on a regular, continuous, and substantial basis. See also PLR 201029014 (July 23, 2010). A person "required to hold and conserve the property, or the proceeds of the sale thereof, for future distribution" to others is a trustee. Rev. Rul. 61-102; see also Rev. Rul. 74-273. So is a person with "certain discretionary powers of administration and management with regard to the property ….[who] could vote at any stockholders' meeting; approve or oppose any reorganization or refinancing proposal;

> The IRS Audit Technique Guide for Passive Activity Loss (the "ATG"), addresses material participation by trusts. The ATG states that the Service will generally not raise an issue if the trustee meets one of the material participation tests included in Regulation section 1.469-5T(a). We view this position as too restrictive given the hybrid nature of trusts and estates.[2706]
>
> The approach outlined above would maintain the approach outlined in private rulings requiring material participation by the fiduciary, but would also allow certain trusts which meet the requirements to be treated analogous to a closely held C corporation and apply similar standards to qualify for active treatment.

Although neither the Audit Technique Guide nor the above comments focus on whether the trustee's participation is in the trustee's fiduciary capacity, TAM 201317010 did focus on that issue, finding no material participation:

> Notwithstanding the decision in *Mattie K. Carter*, the Service believes that the standard annunciated in the legislative history is the proper standard to apply to trusts for purposes of § 469(h). Thus, the sole means for Trust A and Trust B to establish material participation in the relevant activities of Company X and Company Y is if the fiduciaries, in their capacities as fiduciaries, are involved in the operations of the relevant activities of Company X and Company Y on a regular, continuous, and substantial basis.
>
> A fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. *United States v. Anderson*, 132 F.2d 98 (9th Cir. 1942). Although the Trusts represent that A was involved in the day-to-day operations and management decisions of Company X and Company Y, A's powers as Special Trustee were restricted by Article XI of the trust agreements. As Special Trustee, A lacked the power to commit Trust A and Trust B to any course of action or control trust property beyond selling or voting the stock of Company X or Company Y. The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.

---

invest earnings in government obligations; retain counsel; exercise or sell conversion or subscription rights; hold the property in its own name or in a street name; and petition the court with respect to any other disposition concerning the property it considered to be in the best interest of the unknown owner." Rev. Rul. 69-300. A bank was not a fiduciary when it held an estate's money during litigation over the estate, paid interest, but performed no administrative duties for the estate. Rev. Rul. 82-177.

[2706] TAM 200733023 (Aug. 17, 2007).

Because this issue has a big impact on the 3.8% tax on net investment income,[2707] the Treasury Department and IRS are considering whether issue formal guidance at some point, even though they did not issue guidance when they finalized the regulations they issued in December 2012.[2708]

Meanwhile, the Tax Court held that, when a nongrantor trust created its own LLC to manage a business and the trustees themselves were paid by the LLC for managing the business, the trust was able to count the trustees' participation.[2709] However, rather than simply disregarding the LLC (which was a disregarded entity for income tax purposes) and holding that the trustees were working for the trust (for income tax purposes), instead the court focused on the trustee's duty to the trust when working for the LLC.[2710] That focus might open the door for an attack on the

---

[2707] See part II.I 3.8% Tax on Excess Net Investment Income (NII), particularly part II.I.8 Application of 3.8% Tax to Business Income.

[2708] The preamble to the final regulations issued in T.D. 9644 stated:

> F. Material participation of estates & trusts
>
> Several commentators noted that the enactment of section 1411 has created an additional and compelling reason for the need to determine how an estate or a trust materially participates in an activity. An estate's or a trust's income or gain from a trade or business activity in which the entity materially participates does not constitute income from a passive activity under section 469 or section 1411. One commentator noted that, in the case of estates or trusts that have not incurred losses from a passive activity, those estates and trusts previously have not had to characterize either losses or income under section 469.
>
> Commentators stated that the legislative history of section 469 suggests that only a fiduciary's participation should control in determining whether an estate or a trust materially participates in a trade or business activity. In certain situations, case law has concluded that the participation of beneficiaries and employees also should be considered. One commentator noted that case law and IRS guidance conflict, leaving taxpayers with uncertainty in determining the material participation of a trust.
>
> A number of commentators requested that the Treasury Department and the IRS provide guidance on material participation of estates and trusts. However, the commentators acknowledged that guidance on material participation would apply under both sections 469 and 1411, and consequently suggested the initiation of a guidance project to propose the rules for which § 1.469-5T(g) has been reserved.
>
> The Treasury Department and the IRS believe that the commentators have raised valid concerns. The Treasury Department and the IRS considered whether the scope of these regulations should be broadened to include guidance on material participation of estates and trusts. The Treasury Department and the IRS, however, believe that this guidance would be addressed more appropriately in the section 469 regulations. Further, because the issues inherent in drafting administrable rules under section 469 regarding the material participation of estates and trusts are very complex, the Treasury Department and the IRS believe that addressing material participation of trusts and estates at this time would significantly delay the finalization of these regulations. However, the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date. The Treasury Department and the IRS welcome any comments concerning this issue, including recommendations on the scope of any such guidance and on specific approaches to the issue.

[2709] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014). The petition, reply, and briefs are at http://tcinstitute.com/rv/ff0012e61ef3812cbb3202812343b05e2fbe2da8/p=3879220. CCA 201244017 had taken the position that a trust cannot be a real estate professional.

[2710] The court said:

> Even if the activities of the trust's non-trustee employees should be disregarded,[15] the activities of the trustees--including their activities as employees of Holiday Enterprises, LLC--should be considered in determining whether the trust materially participated in its real-estate operations. The trustees were required by Michigan statutory law to administer the trust solely in the interests of the

premise of TAM 201317010 that a trustee who acts as an individual is not also serving as a trustee.

Since then, the AICPA,[2711] ABA Section on Taxation,[2712] and ACTEC[2713] have made formal comments to the government.

II.K.2.b.ii. Participation by a Nongrantor Trust: Planning Issues

Some have suggested that the trustee's participation in the business will cause the trust to be taxed as a business entity. For trusts created for traditional estate planning purposes, that concern is not justified. See part II.K.2.b.iii Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity.[2714]

Consider giving a beneficiary who participates in the activity a role as a trustee, whose authority is limited to acting on behalf of the trust with respect to investments that need to be tested under

---

trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary. Mich. Comp. Laws sec. 700.7302 (2001) (before amendment by 2009 Mich. Pub. Acts No. 46); see also *In re Estate of Butterfield*, 341 N.W.2d 453, 459 (Mich. 1983) (construing Mich. Comp. Laws sec. 700.813 (1979), a statute in effect from 1979 to 2000 that was a similarly-worded predecessor to Mich. Comp. Laws sec. 700.7302). Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. *Cf. In re Estate of Butterfield*, 341 N.W.2d at 457 ("Trustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny [i.e., duties imposed on trustees by Michigan courts] under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy."). Therefore their activities as employees of Holiday Enterprises, LLC, should be considered in determining whether the trust materially participated in its real-estate operations.[16]

[15]We need not and do not decide whether the activities of the trust's non-trustee employees should be disregarded.

[16]We need not consider the effect of sec. 469(c)(7)(D)(ii), which provides that for purposes of sec. 469(c)(7)(B) personal services performed as an employee are generally not treated as performed in real-property trades or businesses. This rule has no application to the resolution of this case because, as we explain *infra*, the IRS has confined its challenges to the trust's qualification for sec. 469(c)(7) treatment to two challenges: (1) that trusts are categorically barred from sec. 469(c)(7) treatment, and (2) the trust did not materially participate in real-property trades or businesses. Thus, we need not, and do not, determine how many hours of personal services were performed by the trust in real-property trades or businesses. We also note that the IRS does not cite sec. 469(c)(7)(D)(ii) in its brief.

[2711] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicUrc/OGHGu+qSyFQIHlSrV/Yyi63VldeR&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[2712] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicikIVHHCCawA0JoSeWnL+iQcx1y1EIbsot+x1JadeV10=&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[2713] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicxjC0od0egqdZH1P8mlbZQ43UvnjYGixP&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[2714] Particularly fn. 2732.

the passive activity rules. Depending on the state, one might be able to use a nonjudicial settlement agreement to not only add a special trustee for this purpose but also protect the trustee from liability.[2715] Note that the legislative history refers to ***an*** executor or fiduciary, not ***the*** executor or fiduciary, implying that material participation by any one co-trustee will cause a trust to be treated as materially participating in an activity.

At first glance, it might seem an easy matter simply to designate as a special trustee an employee of the business. Note, however, that the special trustee must be participating on behalf of the trust and not merely on his or her own behalf. The trustee's work on behalf of the trust as an investor in an activity is not treated as participation in the activity unless the trustee is directly involved – on behalf of the trust - in the day-to-day management or operations of the activity.[2716] Consider these issues:

- What activities would an owner of that entity typically perform?
- Does the company want the individual to be protecting the trust's interests rather than the company's?[2717]
- As an active participant in running the business, the trust might have fiduciary duties to the other owners that it might not have as a passive owner. The trust might already have duties to other owners if the trust has a controlling interest, but being active in the business would tend to strengthen these duties to others. If the business entity is an LLC, these duties to other owners might be more easily reduced than perhaps for other types of entities, depending on applicable state law.
- Because the trustee is participating on behalf of the trust rather than for his or her own benefit, should the trust be compensated for the trustee's services and then pay the trustee itself, rather than the trustee receiving compensation directly from the company? If so, then the trustee needs to consider whether the trustee is an employee or independent contractor (generally the latter) and the related employment taxes and insurance.
- Because the trust itself is participating in a trade or business, it might subject itself to Form 1099 filing requirements for payments it makes.
- A very significant purpose of using a business entity is to protect its owners from liability. However, to the extent that the trust is directly involved in the business activity, it would subject itself to liability for the trustee's actions or omissions as the trust's agent. The trust may form an LLC that it wholly owns to provide those services and have the trustees

[2715] Section 111 of the Uniform Trust Code, found at www.uniformlaws.org/shared/docs/trust_code/utc_final_rev2010.pdf; RSMo § 456.1-111. Subsection 4 authorizes a nonjudicial settlement agreement to interpret the terms of the trust, approve a trustee's report/accounting, direct a trustee to refrain from performing a particular act, grant a trustee any necessary or desirable power, accept a trustee's resignation, appoint a trustee, determine a trustee's compensation, transfer a trust's principal place of administration, and resolve the liability of a trustee for an action relating to the trust.

[2716] See part II.K.1.a.v What Does Not Count as Participation.

[2717] See part III.A.4.c.iv Advising Clients about the UPAIA § 505 Change and UFIPA § 506 regarding the trustee's fiduciary duties to beneficiaries when the trustee is active in the business.

provide those services through the LLC;[2718] if run in a financially responsible manner, the LLC might shield the trust from liability for managing the business.

Additionally, consider the trust's legal rights as an owner. If the entity is a corporation, to what course of action could a trustee commit a trust with respect to stock the trust owns other than voting it and selling it? Note that the trustee's actions as an investor do not count in determining material participation.[2719]

Generally, under corporate law a shareholder cannot act on behalf of a corporation. All the shareholders can do is elect directors. Directors then make strategic decisions (often not more than 100 or 500 hours' worth) and delegate the daily running to the officers (who are by definition employees). So generally a trust as a shareholder in a corporation has no authority to participate in the business' affairs. TAM 201317010 does not seem to understand this inherent limitation and appears geared toward businesses that are wholly owned by trusts.

Given that the IRS is reading the legislative history in a manner that makes it difficult for a trust to materially participate in its role as a shareholder, one might consider the following if the entity is an S corporation:

- Many states have "close corporation" statutes or other statutes that allow shareholders to directly run a corporation, much like an LLC is run by its members.[2720] They also have built-in buy-sell provisions, some of which might protect a corporation's S election (once in place).

- Consider an LLC or limited partnership taxed as an S corporation,[2721] with an operating agreement or partnership agreement that has distributions following S corporation single-class-of-stock rules rather than capital accounts, and either a limited liability partnership registration in place to protect the general partner (making the partnership an LLLP)[2722] or having the limited partnership do business through an LLC subsidiary. Generally, for an existing corporation, a merger into the new entity (LLLP or the LP's LLC subsidiary) would be required.[2723]

2718 *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014).

2719 See part II.K.1.a.v What Does Not Count as Participation.

2720 See fn 968 and accompanying text regarding close corporation statutes as providing protection against creditors. Such statutes are in the minority. Of the states that do not have close corporation statutes, almost all of them have buried in their corporate law provisions allowing the shareholders to bypass the board of directors and directly run part or all of the business. A chart of states in an article co-authored with Richard Barnes was published March/April 2015 in *Probate & Property*, which is reproduced at http://www.thompsoncoburn.com/Images/Newsletters/6131013_1.pdf; links supporting this chart were prepared by a summer associate in 2014 and are found in my firm's internal document number 5977514, which is reproduced at http://www.thompsoncoburn.com/Images/Newsletters/5977514_7.pdf.

2721 As described in part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election, certain regulations might lead one to believe that an S election does not shield LLC owners from self-employment tax; however, those regulations appear to be obsolete. For those who are concerned about those regulations, a limited partnership would be the preferred state law entity, to obtain the self-employment tax exclusion available to limited partners, which is described in part II.L.4 Self-Employment Tax Exclusion for Limited Partner.

2722 See parts II.C.11 Limited Partnership and II.C.12 Limited Liability Partnership Registration.

2723 See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

In either case, if all the S corporation stock the trust has is old-and-cold nonvoting stock, do a Code § 1036 tax-free swap for voting stock, giving enough voting stock to constitute adequate and full consideration (using a formula transfer). The holder of the voting stock would file a gift tax return adequately disclosing the transaction as a non-gift.

Also, consider having the entity pay the trust for services rendered managing the business, issuing IRS Form 1099-MISC to the trust.[2724] The trust would report the management income and expense on Schedule C or C-EZ.[2725] Trusts do not pay self-employment tax. After taking a reasonable profit on the payment, the trust would compensate the trustee for services rendered. Unlike most trusts, because the trust is now engaging in a trade or business, the trust would issue IRS Form 1099-MISC to the trustee for those services, and the trustee would report the income in his/her Form 1040, Schedule C, and pay self-employment tax;[2726] however, the IRS did not object when a trust formed its own LLC (disregarded for income tax purposes) to manage the

---

[2724] For Thompson Coburn LLP personnel – see document number 5879530.

[2725] For an ESBT, management fee income is not part of the S portion, because it is not a K-1 item. Reg. § 1.641(c)-1(d)(1), (2). The same answer applies to QSSTs. Reg. § 1.1361-1(j)(7), (8).

[2726] Generally, nonprofessional trustees do not pay self-employment tax. Rev. Rul. 58-5, reproduced in large part in fn. 1912, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles. However, the Rev. Rul. modifies that position when the trustees carry on a trade or business:

> *Example (1). Executor who receives a flat fee for administering the estate*. A, a nonprofessional fiduciary, receives a flat $10,000 for administering the estate of B. B's gross estate is valued at $150,000 and includes a trade or business which A manages for the period of time required to distribute the assets of the estate. Under the laws of the State in which B's estate is probated, an executor is entitled to a five percent commission based upon the value of the assets distributed. Since A distributed the entire estate worth $150,000 he would have been entitled to $7,500 executor's commissions, based upon the statutory five percent allowance. Inasmuch as A, pursuant to court order, actually received $10,000 instead of $7,500 in commissions, the excess, or $2,500, is regarded as being attributable to the operation of the trade or business of the estate. A must therefore treat this $2,500 as earnings from self-employment. The remaining $7,500 is regarded as being attributable to the normal fiduciary duties of marshalling the assets of the estate and should not be treated as trade or business income. On the other hand, if A's total fee for administering the estate was equal to or less than $7,500 (the statutory executor's allowance in this case), and if nothing was said in the court order with respect to allocation of the fee, the entire fee would be regarded as being attributable to A's fiduciary activities and no part of the fee would be treated as trade or business income to A.
>
> *Example (2). Executrix who receives a special fee for handling the estate's business*. C, the sole executrix of the estate of her husband, operates a drugstore belonging to the estate, pending dissolution of the estate. As her commission for handling the estate, C receives, pursuant to court order, $5,125 (based upon a percentage of the value of the assets distributed) and $500, in addition, for the operation of the drugstore. Under these circumstances, only the $500 commission for the operation of the drugstore constitutes earnings from self-employment. The $5,125 commission, based upon the value of the assets distributed is not related to the operation of the trade or business, and, accordingly, does not constitute earnings from self-employment.
>
> *Example (3). Coexecutor who does not participate in the operation of the estate's business*. D and E are coexecutors of an estate which includes a trade or business. D is totally unfamiliar with the operation of the business and leaves the entire management of the business to E. Under these circumstances, D, who does not participate in the operation of the business, cannot be treated as being in a trade or business. The fees received by D do not constitute net earnings from self-employment. E, however, actively participates in the operation of the business and the compensation received by him for the management of the estate's trade or business constitutes net earnings from self-employment.

business, which LLC reported on Forms W-2 (instead of Form 1099-MISC) compensation that the LLC paid the trustees.[2727]

Does changing the individual's participation from being a direct employee to serving as a trustee affect that person's material participation as an individual? No – although the IRS takes the position that work a trustee's work as an individual does not count as participation by the trust, work done as a trustee apparently counts towards the trustee's participation as an individual.[2728] Consider, however, any impact on employee benefits.

Finally, to avoid the 3.8% tax on net investment income, consider converting an ESBT into one or more QSSTs[2729] if the beneficiary works for the business (or could do so in any capacity for more than 100 hours per year)[2730] and a QSST's mandatory income requirement does not do violence to the estate planning goals. However, the trustee's participation will become important again if the stock or business assets are sold.[2731] See part III.A.3.e.iv Flexible Trust Design When Holding S corporation Stock.

II.K.2.b.iii. Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity, But Be Wary If Multiple Grantors

If the beneficiaries are associates in a joint enterprise for the conduct of business for profit, then the trust might be characterized as a business entity. See part II.D.1 Trust as a Business Entity.

However, if the beneficiaries did not create the trust, the trust will not be considered a business entity merely because the trustee engages in business operations.[2732]

[2727] *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (2014). The court did not mention this nuance, but the facts described somewhere in the petition, reply, and briefs mentioned that Forms W-2 were issued; see http://tcinstitute.com/rv/ff0012e61ef3812cbb3202812343b05e2fbe2da8/p=3879220.

[2728] See fn. 2457 in part II.K.1.a.ii Material Participation.

[2729] See part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSST.

[2730] Because a QSST is a grantor trust deemed owned by the beneficiary, the beneficiary's participation, not the trustee's, is what counts. See text accompanying fns. 1902-1903. Although normally participating in owner-type activities is required to avoid the passive loss rules, regulations governing the 3.8% tax do not mention this issue and therefore do not appear to impose that requirement for avoiding the 3.8% tax. See part II.K.1.a.v What Does Not Count as Participation. For more planning tips involving how to meet the participation requirements and qualify for an exclusion from the 3.8% tax, see part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

[2731] See part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S corporations in Light of the 3.8% Tax. This is important only for net investment income tax purposes, as a complete disposition of a passive activity removes the passive loss restrictions for that activity. Code § 469(g).

[2732] I am unaware of any case addressing this issue after the adoption of Reg. § 301.7701-4(a). The regulation's preamble, T.D. 8697, provides:

> The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts and business entities, although restated, are not changed by these regulations.

The last major pre-1997 case, *Bedell Trust v. Commissioner*, 86 T.C. 1207 (1986), *acq*. 1987-2 C.B. 1, held:

> We cannot find, where one person has created an entity, unilaterally distributed interests in it to others, and then restricted their ability to transfer their interests, that there exists "a voluntary association of individuals for convenience and profit", which characteristic is the very essence of an association. *Blair v. Wilson Syndicate Trust*, 39 F.2d 43, 46 (5th Cir. 1930)….

II.K.2.b.iv. Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary; Interaction with Special Depreciation Rules

Generally, income retains its character when flowing from a nongrantor trust to a beneficiary.[2733] Therefore, income's character as passive or nonpassive at the trust level also controls at the beneficiary's level.

In support of this, note that private letter rulings have held that passive rental income earned by a pooled income fund was passive income in the hands of its beneficiaries.[2734]

In grouping passive activities, a beneficiary's beneficial interest in a trust's ownership of an activity cannot be grouped; all grouping is done at the trust level.[2735]

Regarding applying the passive loss rules to the beneficiary's share of directly apportionable deductions (such as depreciation, depletion, and amortization), the IRS instructs taxpayers:[2736]

> Any directly apportionable deduction, such as depreciation, is treated by the beneficiary as having been incurred in the same activity as incurred by the estate or trust. However, the character of such deduction may be determined as if the beneficiary incurred the deduction directly.
>
> To assist the beneficiary in figuring any applicable passive activity loss limitations, also attach a separate schedule showing the beneficiary's share of directly apportionable

---

> We conclude that the beneficiaries, who neither created nor contributed to the trust, whose interests in the trust are not transferable, and only a few of whom participate in the trust affairs, are not associates and their trust is not an association.

The court further commented:

> We understand that the Government regarded this case as a test case in respect of testamentary trusts and trusts engaged in the conduct of a business, and that high levels in the IRS were active in pressing the matter. It is difficult to imagine a more unsuitable vehicle than this case for any such purpose, and we think it regrettable that extensive misguided efforts were exerted to such a fruitless end in this litigation.

[2733] See fn. 1911, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, and fns. 2343-2344, found in part II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It.

[2734] Letter Rulings 200608002 and 200608003 held:

> … the rental of land and buildings by the Fund to X will be a passive activity under § 469(c). Because the excess of aggregate income from all passive activities over the aggregate losses from all passive activities will enter into the computation of DNI, then the characterization rule of § 662(b) will apply. Thus, if the Fund's gross income in any year from rental of the land and buildings exceeds its losses (including a ratable portion of the Fund's indirect expenses) in that year from rental of the land and buildings, amounts distributed from the Fund that are includible in the gross income of an income beneficiary for that year will be income to that beneficiary from a passive activity, within the meaning of § 469, in the same proportion as the Fund's net income from that rental that enters into the computation of the Fund's DNI for that year bears to the Fund's entire DNI for that year.

Letter Ruling 8806065 took a similar position.

[2735] See fn. 2537.

[2736] 2013 Form 1041 Instructions, page 38, explaining how to prepare line 9 of Schedule K-1 issued to the beneficiaries. The instructions also refer to depletion and amortization. See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

> deductions derived from each trade or business, rental real estate, and other rental activity.

However, some commentators suggest that depreciation deductions flow through to the beneficiaries separately only to the extent allowed after applying the passive loss rules at the trust level.[2737] The best reconciliation I can come up with is the following example: Suppose the trust has $100 rental income before depreciation and $60 depreciation, for $40 net income; therefore, the depreciation is fully deductible under the passive loss rules applied at the trust level. The rental income and depreciation deductions are separately stated on the trust's K-1s to beneficiaries.

On the other hand, a source that CPAs often use for tax preparation states:[2738]

> When net passive income less depreciation results in a net passive loss, a PAL limitation applies at either the trust or beneficiary level, or both. If the depreciation is required to be distributed to the beneficiary, the PAL limitation occurs at the beneficiary level. If a depreciation reserve is required and maintained by the fiduciary and the depreciation allocated to the trust exceeds the passive income, the PAL limitation occurs at the trust level. If a depreciation reserve is not required and the fiduciary does not distribute all fiduciary accounting income, the PAL limitations occur at both the trust and beneficiary level if the allocated depreciation exceeds the income at both the trust and beneficiary levels.

It appears that more than one approach might be defensible. Consider the strategic consequences:

- If the beneficiary can deduct the depreciation currently, then separately applying the passive loss rules based on the beneficiary's participation seems beneficial. However, if the deduction does not offset net investment income, query whether it would have been better to deferred the deduction until it can be deducted against NII.

- If the beneficiary cannot deduct the depreciation currently, consider the effect of suspending the passive losses. When can one credit the beneficiary for a disposition of the passive activity, freeing that activity's losses from suspension?[2739] If the trust sells the asset, incurs gain because depreciation reduced the trust's basis in the property, and the gain is trapped inside the trust, then the depreciation deductions (suspended or not) do not offset the gain.[2740]

[2737] Sutton & Howell-Smith, ¶ 15.03 Application of Passive Loss Limitations at the Entity Level, *Federal Income Taxation of Passive Activities* (WG&L) (referring to the position the AICPA took in the late 1980s); Schmolka, "Passive Activity Losses, Trusts, and Estates: The Regulations (If I Were King)," *N.Y.U. Tax Law Review*, vol. 58, p. 191 (2005).

[2738] Key Issue 7E: Reporting Passive Activity Information to a Beneficiary, *1041 Deskbook* (PPC) (2015). See also Key Issue 7D: Passive Loss Limitations Generally Determined at the Entity Level, *1041 Deskbook* (PPC) (2015).

[2739] Code § 469(g). For more about Code § 469(g), see fn. 2448.

[2740] For further discussion of mismatches along these lines, see Abbin (WTAS), § 811 Real Estate Investment Passive Activity Concerns, *Income Taxation of Fiduciaries and Beneficiaries* (2013), arguing that passive loss rules limit the extent to which a trust passes depreciation deductions to the beneficiaries.

II.K.2.b.v. Electing Small Business Trusts (ESBTs) and the Passive Loss Rules

Electing small business trusts have a special tax regime that divides the trust into a grantor trust portion, a nongrantor trust S corporation portion, and a nongrantor trust non-S corporation portion.[2741]

I am unaware of any guidance directly addressing how the passive loss rules interact with these separate portions.

I believe that all portions should be combined in determining whether income or loss is active or passive. The grouping rules[2742] allow an individual and a C corporation that the individual owns to combine their participation even though they are separate taxpayers.[2743]

Because the nongrantor S corporation portion and the nongrantor non-S corporation portion are taxed as separate trusts for all income tax purpose other than administratively,[2744] they would not aggregate their income and loss in determining allowable passive losses and then disaggregate their income and loss in determining taxable income. Given uncertainty regarding how ESBTs treat net operating losses (NOLs),[2745] it's a good thing that this separate treatment applies.

II.K.2.c. Participation When Grantor Trusts Are Involved; Effect of Toggling

Because grantor trusts are ignored for income tax purposes,[2746] the deemed owner's work is what counts. Complications arise with Qualified Subchapter S Trusts.[2747]

A grantor can count her work in a business for only that part of the year in which she is treated as owning an interest in the business.[2748] If, when grantor trust status terminates, she has not yet worked sufficient hours in the current year (and does not qualify for participation based on participation in prior years),[2749] then consider making sure she keeps at least some ownership in the business after turning off grantor trust status, so that she can count the hours she works later that year. If necessary, the trustee might divide the trust and leave a small portion of the trust as a grantor trust.

II.K.2.d. Effect of Death of an Individual or Termination of Trust on Suspended Losses

If an interest in the activity is transferred by reason of the death of the taxpayer, losses generally are allowed to the extent such losses are greater than the excess (if any) of the basis of such property in the hands of the transferee, over the adjusted basis of such property immediately before the death of the taxpayer, but any losses to the extent of that excess are not allowed as a deduction for any taxable year.[2750] Let's turn this recitation of the Code's rule into common sense:

[2741] See part III.A.3.e.ii.(b) ESBT Income Taxation.
[2742] See part II.K.1.b Grouping Activities.
[2743] Reg. § 1.469-4(a), (d)(5)(ii).
[2744] See part III.A.3.e.ii.(b) ESBT Income Taxation, especially fn. 5110.
[2745] See fn. 5116.
[2746] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
[2747] See part II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items.
[2748] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.
[2749] See part II.K.1.a Counting Work as Participation in Business under the Passive Loss Rules, especially part II.K.1.a.ii Material Participation.
[2750] Code § 469(g)(2), reproduced in part II.K.1.i Complete Disposition of Passive Activity.

Suspended losses reduce basis, but without the person incurring the losses receiving a benefit from that lost basis. If the owner disposes of the interest during life in a taxable disposition, the suspended losses are allowed, and the tax system has broken even. If the owner dies holding the interest, then the question is what it takes to get the basis restored on account of the suspended losses. To the extent that there is a basis step-up, the suspended losses have not caused a tax detriment, so those losses do not need to be taken to make up for lost basis; therefore, the losses are disallowed to that extent. However, if the suspended losses exceed the basis step-up, then the excess losses should be allowed.

The corollary is that losses are allowed on the decedent's final income tax return to the extent that the transferee does not receive a basis step-up at death, which would make beneficiary grantor trusts[2751] (including QSSTs),[2752] particularly attractive; in fact, substantial triggered losses can generate a net operating loss carryback, generating income tax refunds.[2753] That also might apply to irrevocable grantor trusts taxed to the settlor[2754] - "might" because the statute requires that the interest be "transferred by reason of the death of the taxpayer;" arguably the grantor's death would qualify, but for trust deemed owned by settlor legally the transfer to the trust preceded the deemed owner's death. So, in the latter case, the trust might consider selling the interest to an otherwise identical nongrantor trust – triggering the losses and increasing the basis – to make sure that the benefits of the losses offset their detriment (in that the losses reduced basis).

Code § 469(j)(12) provides that, when an estate or trust terminates, any passive losses suspended under Code § 469 will be permanently disallowed, but, to inject some fairness, added to the basis of the partnership interest.

Suppose an estate is terminating, using fractional pick-and-choose funding. At first, a Code § 469(j)(12) basis increase in the partnership interest might not appear to generate a Code § 743 basis step-up because, lacking a pecuniary aspect, there is no sale or exchange, and therefore the transfer is not "by sale or exchange or upon the death of a partner." Perhaps the termination of the estate might be attributed to the partner's death? This seems uncertain, however, because the suspended passive losses generating the Code § 469(j)(12) basis increase necessarily occurred post-mortem. On the other hand, a trust's or estate's distribution of a partnership interest probably does trigger Code § 743 basis adjustments, so a Code § 743 adjustment seems to be available after all.[2755] For more thoughts on planning for Code § 469(j)(12) and evaluating its impact, see Sutton & Howell-Smith, ¶15.07. Treatment of Suspended Passive Losses Upon Distribution of Activity by an Estate or Trust, *Federal Income Taxation of Passive Activities* (WG&L).

II.K.3. NOL vs. Suspended Passive Loss - Being Passive Can Be Good

II.K.3.a. Why Being Passive Can Be Good

Particularly when significant business interests are passed to the next generation, being passive can have good results, if the business has a significant net loss.

[2751] See part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.
[2752] See part III.A.3.e QSSTs and ESBTs.
[2753] FSA 200106018.
[2754] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
[2755] See part II.Q.8.e.ii.(b) Distribution of Partnership Interests.

Suppose the taxpayer has a relatively modest income, other than what the business generates. Deducting a net loss will offset income in the lower tax brackets. This is especially true if the loss is so large that it generates a net operating loss (NOL) carryover under Code § 172. Another concern is the IRS' position on NOLs incurred by an electing small business trust (ESBT) when the S corporation stock it owns generates losses.[2756]

However, in profitable years, the business income might be taxed in the highest tax bracket. The owner might save more taxes by offsetting the income in a later, high-tax-bracket year, than by deducting the loss in the lower tax brackets.

If and to the extent that the loss is passive and the taxpayer does not have passive income against which to offset it, the loss is suspended and carried forward.[2757] Thus, instead of offsetting income in lower brackets in the year in which the loss is generated, it offsets income in a later year that would otherwise push the taxpayer into a higher bracket.

Furthermore, after 2017 tax reform, NOLs may offset only up to 80% of taxable income,[2758] whereas suspended passive losses can offset 100% of any income from that activity or passive income from any other activity.

Being passive does cause income to constitute net investment income (NII)[2759] subject to the 3.8% tax on net investment income.[2760] However, for taxpayers who have income below the NII thresholds,[2761] that impact might be small or none. If the NII tax impact is significant, compare (a) the possible income tax savings if income and loss years tend to fluctuate significantly, to (b) the extra cost of NII tax; I am not suggesting that being passive will usually be better – merely that one should consider it when planning. Furthermore, suspended passive losses that offset passive income will also offset income that generally would otherwise be subject to the NII tax.

II.K.3.b. Maximizing Flexibility to Avoid NOLs and Use Losses in the Best Year

One might increase planning flexibility in the planning described in part II.K.3.a Why Being Passive Can Be Good by engaging in significant participation (more than 100 hours)[2762] rather than material participation (more than 500 hours).[2763] If suspending the loss becomes important and one sees the loss coming (or perhaps is experiencing losses and expects them next year), one might cut back one's work.

Material participation might be difficult to impossible to turn off:

- One might have worked too many hours in the year before one realizes that being passive is desirable.

[2756] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 5116.
[2757] See the introduction to part II.K.1 Passive Loss Rules Generally.
[2758] See part II.G.3.i.iii Code § 172 Net Operating Loss Deduction.
[2759] See part II.I.8 Application of 3.8% Tax to Business Income.
[2760] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[2761] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[2762] See part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, especially fns. 2650-2653.
[2763] See part II.K.1.a.ii Material Participation. Although more than 500 hours (see fn. 2462) is usually what people consider, it is not the only way to materially participate.

- One might have worked too many hours in a prior year to turn it off.
    - An individual is deemed to materially participate if the individual materially participated in the activity (determined without regard to this sentence) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year.[2764]
    - An individual is deemed to materially participate if the activity is a personal service activity, and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year.[2765]

Suppose an activity is passive when it generates losses and active when it generates income. The suspended passive losses offset active income from the same activity,[2766] and the active income avoids the 3.8% NII tax.[2767]

Furthermore:

- After 2017 tax reform, net operating losses (NOLs) offset only 80% of taxable income,[2768] whereas suspended passive losses can offset 100% of taxable income when released.

- Suspended passive losses may help generate a better Code § 199A deduction, because they appear to allow wages and UBIA to be used when released, whereas NOLs do not carry wages and UBIA with them.[2769]

If one is leaning toward using significant participation instead of material participation, consider:

- Not being able to turn off material participation might be good, if the taxpayer stops working in the business and continues to generate business income.

- Part II.K.1.h.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.

2764 See part II.K.1.a.ii Material Participation, especially fn. 2468.
2765 See part II.K.1.a.ii Material Participation, especially fn. 2469.
2766 See part II.K.1.j Former Passive Activities.
2767 See part II.I.8 Application of 3.8% Tax to Business Income.
2768 See part II.G.3.i.iii Code § 172 Net Operating Loss Deduction.
2769 See part II.E.1.c.vii Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

II.L.2.a.ii. Rental Exception to SE Tax

Income from real estate and from personal property leased with the real estate generally is not subject to SE tax, unless such rentals constitute certain types of farm activities[2804] or are received in the course of a trade or business as a real estate dealer.[2805]

Farm activities generate significant controversy as to what is rent and what constitutes payment for services[2806] or income from growing crops, raising livestock, etc. Payments under USDA's Conservation Reserve Program are subject to self-employment tax according to the Tax Court and IRS, but not according to the Eighth Circuit.[2807] Instead of conducting operations on one's

---

[2804] Code § 1402(a)(1) provides that the rental exception:

> shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity.

See Reg. § 1.1402(a)-4(b) and *Mizell v. Commissioner*, T.C. Memo. 1995-571 (broadly construing arrangement).

[2805] Code § 1402(a)(1); Reg § 1.1402(a)-4. See Chief Counsel Advice 200816030 (Code § 761(f) active participation does not override exclusion of rental income from self-employment tax).

[2806] In reversing the Tax Court, *McNamara v. Commissioner*, 236 F.3d 410 (8th Cir. 2000), *non-acq.* AOD CC-2003-003 (10/22/2003). said:

> What is missing from both the Commissioner's and the Tax Court's analyses is any mention of a nexus between the rents received by Taxpayers and the arrangement that requires the landlords' material participation. We believe this omission overlooks section 1402(a)(1)'s requirement that rents be derived under such an arrangement. That is to say, the mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received by the landowner into self-employment income. It is only where the payment of those rents comprise part of such an arrangement that such rents can be said to derive from the arrangement.
>
> Rents that are consistent with market rates very strongly suggest that the rental arrangement stands on its own as an independent transaction and cannot be said to be part of an arrangement for participation in agricultural production. Although the Commissioner is correct that, unlike other provisions in the Code, section 1402(a)(1) contains no explicit safe-harbor provision for fair market value transactions, we conclude that this is the practical effect of the derived under language.
>
> At this point, the only evidence in the record is that the rents in question were at or below market rates. However, we believe the Commissioner is entitled to an opportunity to show a connection between those rents and the production arrangement it identified.

[2807] Payments under USDA's Conservation Reserve Program are subject to self-employment tax according to the Tax Court, *Morehouse v. Commissioner*, 140 T.C. 350 (unanimous reviewed decision), but not according to the Eighth Circuit, 114 A.F.T.R.2d 2014-6287 (2014); the IRS agrees with the Tax Court, A.O.D. 2015-002, IRB No. 2015-41. The *Morehouse* Tax Court opinion relied on *Timber Co. v. Commissioner*, 64 T.C. 700, 709-711 (1975), *aff'd without published opinion*, 552 F.2d 368 (5th Cir. 1977); *Webster Corp. v. Commissioner*, 25 T.C. 55, 61 (1955), *aff'd*, 240 F.2d 164 (2nd Cir. 1957); *Harding v. Commissioner*, T.C. Memo. 1970-179; and Rev. Rul. 60-32. The *Morehouse* Tax Court opinion cited *Johnson v. Commissioner*, 60 T.C. 829, 833 as holding that exception for rentals from real estate must be narrowly construed. Rev. Rul. 65-149, cited with approval in the *Morehouse* Eighth Circuit opinion, held that grain storage fees for delaying in selling grain one produced constitute income from farming and therefore net earnings from self-employment, but grain storage fees paid for the storage of a landlord's farms and paying SE tax on all of the income, one may lease the farm to one's own S corporation for fair rental without paying SE tax on that rental, have the S corporation run operations and not pay SE tax on the operations, and simply take reasonable compensations for one's services to the S corporation – an arrangement that the Tax Court approved in a 2017 reviewed case.[2808]

---

share of a crop paid to the landlord as rental income are excluded from net earnings from self-employment as rental income.

In a split opinion, the Eighth Circuit held [footnotes omitted]:

> [T]he record discloses that the government, whether by contractual right or otherwise, physically inspected the CRP properties nearly as often as Morehouse did. These entries, coupled with the significant tilling, seeding, fertilizing, and weed control work required by the CRP contracts reveal the government likely had more physical possession for its own land conservation uses than Morehouse did. Accordingly, we hold the 2006 and 2007 CRP payments were consideration paid [by the government] for use [and occupancy] of [Morehouse's] property and thus constituted rentals from real estate fully within the meaning of § 1402(a)(1).

Both the majority and dissent cited *Wuebker v. Commissioner*, 205 F.3d 897, 903-904 (6th Cir. 2000) and mentioned Notice 2006-108, without paying deference to the latter because the IRS never issued the promised Revenue Ruling (perhaps concluding that its position was not necessarily a consensus view). For a discussion of such payments generally and a brief overview of cases, see Malloy, Langstraat, and Wilkinson, "Conservation Reserve Program Payments and Self-Employment Tax: Farmers vs. Non-Farmers," *TAXES - The Tax Magazine* (8/2015).

A.O.D. 2015-002, IRB No. 2015-41, nonacquiesced to the Eighth Circuit's opinion, stating:

> We disagree with the Eighth Circuit's characterization of the revenue rulings as establishing a line of demarcation on the self-employment tax treatment of conservation reserve payments paid to farmers and nonfarmers. We also disagree with the Eighth Circuit's holding that the CRP payments were consideration paid by the government for use and occupancy of Morehouse's property and thus constituted rentals from real estate excluded from self-employment tax under section 1402(a)(1).
>
> The Eighth Circuit misinterprets Rev. Rul. 60-32 and Rev. Rul. 65-149 when it states that the rulings establish the position that CRP payments made to non-farmers constitute rentals from real estate and are excluded from the self-employment tax. *Morehouse*, 769 F.3d at 621….
>
> We recognize the precedential effect of the decision in *Morehouse* to cases appealable to the Eighth Circuit. Accordingly, we will follow *Morehouse* within the Eighth Circuit only with respect to cases in which the CRP payments at issue were both (1) paid to an individual who was not engaged in farming prior to or during the period of enrollment of his or her land in CRP and (2) paid prior to January 1, 2008 (i.e., the effective date of the 2008 amendment to section 1402(a)(1)). We will continue to litigate the IRS position in the Eighth Circuit in cases not having these specific facts. We will also continue to litigate the IRS position in all cases in other circuits.

[2808] *Martin v. Commissioner*, 149 T.C. No. 12 (9/27/2017). The Official Tax Court Syllabus (which syllabus is not precedential, but of course the text of the case is) summarized the case:

> Ps owned a farm, renting a portion of the land to wholly owned S corporation C. C contracted with unrelated entity S to raise chickens according to S' exacting specifications. Ps followed S' specific instructions to build structures designed only to raise S' chickens. C paid Ps wages for their labor and rent for the use of the farm and structures. R asserts that the rent is subject to self employment tax pursuant to sec. 1402(a)(1).
>
> *Held*: The facts of the instant case are not materially distinguishable from the facts of *McNamara v. Commissioner*, T.C. Memo. 1999-333, *rev'd*, 236 F.3d 410 (8th Cir. 2000). The U.S. Court of Appeals for the Eighth Circuit in *McNamara* also reversed *Hennen v. Commissioner*, T.C. Memo. 1999-306, and *Bot v. Commissioner*, T.C. Memo. 1999-256. In the light of the reversals by the Court of Appeals for the Eighth Circuit, the Court reconsiders its holdings.
>
> *Held*, further, Ps established that the rent received was at or below fair market value. R failed to show a sufficient nexus between the rental income and petitioners' obligations to participate in the production or management of the production of agricultural commodities. Therefore, the rent Ps received pursuant to the lease is not includible in their net self-employment income. To the extent

Citing an Eighth Circuit case[2809] that it decided to find persuasive in any jurisdiction, the Tax Court[2810] held:

> Regardless of a taxpayer's material participation, if the rental income is shown to be less than or equal to market value for rent, the income is presumed to be unrelated to any employment agreement. *Id*. At that point, the burden of production shifts to the Commissioner to show a nexus between the rent and the taxpayer's obligation to materially participate. Such a showing would render the lease and employment agreements part and parcel of a larger "arrangement". *Id*.

However, the Tax Court cautioned that rent payments tied to production may be recharacterized as SE income,[2811] so one should consider avoiding such an arrangement when renting to one's own S corporation.

Regulations clarify the distinction between a real estate investor and dealer:[2812]

> In general, an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales is a real-estate dealer. On the other hand, an individual who merely holds real estate for investment or speculation and receives rentals therefrom is not considered a real-estate dealer. Where a real-estate dealer holds real estate for investment or speculation in addition to real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, only the rentals from the real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, and the deductions attributable thereto, are included in determining net earnings from self-employment; the rentals from the real estate held for investment or speculation, and the deductions attributable thereto, are excluded.

See also part II.G.25 Real Estate Dealer vs. Investor.

McNamara v. Commissioner, T.C. Memo. 1999-333, *Hennen v. Commissioner*, T.C. Memo. 1999-306, and *Bot v. Commissioner*, T.C. Memo. 1999-256, are inconsistent with this holding, they are not followed.

[2809] See *McNamara* in fn. 2806.

[2810] *Martin*, fn. 2808.

[2811] *Martin*, fn. 2808, noted:

> This Court has previously evaluated the nexus between the rental income and the taxpayer's production arrangement. See, *e.g.*, *Bot v. Commissioner*, 118 T.C. 138 (finding value-added payments reported as rental income includible in net self-employment income where the payments were directly related to the volume of corn acquired and delivered by taxpayers); *Solvie v. Commissioner*, T.C. Memo. 2004-55 (same when rent payments were tied directly to the number of pigs raised). But see *Johnson v. Commissioner*, T.C. Memo. 2004-56 (finding an insufficient nexus). But despite petitioners' presentation and the Court's previous application of the well-reasoned nexus requirement in *Solvie* and *Johnson*, respondent did not brief this issue.

[2812] Reg. § 1.1402(a)-4(a). *Pool v. Commissioner*, T.C. Memo. 2014-3 (see fn. 1300), set forth factors deciding whether the taxpayer is a real estate dealer and held that the taxpayer had the burden of proof of disproving the IRS findings in this area. When real estate is used in a business, see part II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business; within that part, if property is bought for use in a trade or business but never placed in service, see text accompanying fns. 1213-1214.

Apartments that include the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc. fall within the rental real estate exception.[2813] However, payments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, or payments for the use or occupancy of space in parking lots, warehouses, or storage garages, do not qualify for this exception;[2814] neither does a university providing athletic facilities to third parties when not being used for university purposes.[2815] The real estate rental exception is narrowly construed.[2816]

How about leasing equipment or other tangible personal property not connected with real estate? Renting personal property on a short-term basis is self-employment income.[2817] Although I am unaware of any cases subjecting to self-employment tax the long-term rental of personal property, cases interpreting the tax on unrelated business income in the tax-exempt area clearly view long-term rental as a trade or business;[2818] and the rental exception for the unrelated business income

---

[2813] Reg. § 1.1402(a)-4(c)(2). This regulation is similar to Reg. § 1.512(b)-1(c)(5); interpreting the latter regulation, Letter Ruling 201422027 ruled that, when local law required apartments to provide parking for tenants, extra charges for a carport constituted rental income (excluded from UBTI) because the carports were characteristic of the real property, pointing out that no services, such as a security guard, were provided and covered spots were charged only a minimal monthly amount in the set rental rate. However, the ruling held that the apartment complex providing coin-operated washers and dryers on-site for use of tenants without in-home laundry was an extra service not within the rental exclusion, because tenants could use commercial laundry and cleaning establishments off-site; the ruling did not mention whether the apartment provided any services in connection with the washers and dryers.

[2814] Reg. § 1.1402(a)-4(c)(2); Rev. Ruls. 57-108 (vacation rentals involved too many services to be excluded from SE income) and 83-139 (discussing when trailer park rentals do or do not qualify for the exclusion form SE income).

[2815] See fn. 3871 in part II.Q.6.d.i UBTI Related to a Partnership or Sole Proprietorship, which applies by analogy to SE income, as described in fns. 2819-2821 in this part II.L.2.a.ii.

[2816] *Johnson v. Commissioner*, 60 T.C. 829 (1973), denying the rental exclusion for boat sheds as part of a marina business in which the taxpayer provided many services included in the rental of the boat sheds.

[2817] *Stevenson v. Commissioner*, T.C. Memo. 1989-357, pointing out, "His work in buying, assembling, storing, renting, selling, repairing and maintaining the portable signs required him to devote a substantial amount of time on a regular and continuous basis."

[2818] Rev. Rul. 69-278 (owner of buildings also leased trucks to tenants, but the truck leases were not tied in any way to the real estate leases; truck leases did not qualify for rental exception even though the lessees were responsible for fueling, maintaining, and insuring the trucks); Rev. Rul. 60-206 (rent from long-term leases of railroad tank cars was a trade or business, even though the lessee was fully responsible for the cars' operation and maintenance of their cars, as well as replacement in case of destruction or loss); Rev. Rul. 78-144 (long-term lease of heavy machinery was a trade or business even though the lessee must provide insurance, pay any taxes, and make and pay for all repairs except those involving defects in the machine parts or workmanship; the taxpayer's only work was to find a lessee, arrange for the lease, and receive, record, and deposit the rents; did not qualify for the exception to unrelated business income tax for all work being done by volunteers because labor was not a material income-producing factor in the business); *Cooper Tire & Rubber Co. Employees' Retirement Fund v. Commissioner*, 36 T.C. 96, *aff'd* 306 F.2d 20 (6th Cir. 1962) (retirement plan's one-time purchase of twenty tire manufacturing machines and one press and long-term lease of them to the plan's employer was a business even though the plan's only activity was to lease the machinery, collect the rentals and make monthly payments on the bank note and the transaction appeared to have been done merely to avoid restriction against loans from the plan to the company). See also part II.Q.6.d Unrelated Business Income.

tax is similar to that for SE tax,[2819] and the Tax Court has noted similarities between income subject to SE tax and unrelated business income tax.[2820] The 2013 Instructions to Form 1040, Schedule E generally take that position as well.[2821]

II.M.4.f. Issuing a Profits Interest to a Service Provider

II.M.4.f.i. Overview of Profits Interest; Contrast with Code § 409A

Issuing a profits interest usually makes more sense than issuing stock to the employee, in that a service provider usually is interested more in sharing the fruits of the business' future success than in buying its existing assets. Awarding a profits interest is also less expensive, because it does not require buying any of the business' current value.

[2819] Compare Code § 1402(a)(1) (there shall be excluded rentals from real estate and from personal property leased with the real estate… unless such rentals are received in the course of a trade or business as a real estate dealer) with Code § 512(b)(3) (there shall be excluded all rents from real property … and all rents from personal property ... leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service). Neither statute exempts rents from personal property that is not leased with real estate.

[2820] *Cokes v. Commissioner*, 91 T.C. 222, 234, in subjecting passive business income to SE tax, noted:

> We note that the concept that the character of trade or business income is retained in the partner's hands is not unique to the self-employment taxes area. The unrelated business income tax provisions (sec. 511 et seq.) generally provide that a tax-exempt organization's distributive share of a partnership's unrelated trade or business income is subject to the unrelated trade or business income tax. Sec. 512(c). The report of the House Ways and Means Committee on the bill enacting the unrelated business income tax, reads as follows (H. Rept. 2319, 81st Cong., 2d Sess. 111-112 (1950), 1950-2 C.B. 460):
>
>> In the event an organization to which Supplement U [the predecessor of sec. 511 et seq.] applies is a member of a partnership which is regularly engaged in a trade or business which is unrelated to the functions and purposes of the organization, the organization would include, in computing its unrelated business net income, so much of its share (whether or not distributed) of the partnership gross income as is derived from that unrelated business and its share of the deductions attributable thereto, and make the necessary adjustments for the exceptions and limitations which have been discussed above. For example, if an exempt educational institution is a silent partner in a partnership which runs a barrel factory and such institution also holds stock in a pottery manufacturing corporation, it would include in its unrelated business income its share of the barrel factory income, but not its proportionate share of any dividends received by the partnership from the pottery corporation. If the taxable year of the organization is different from that of the partnership, the amounts to be so included or deducted in computing the unrelated business net income are to be based upon the income and deductions of the partnership for any taxable year of the partnership ending within or with the taxable year of the organization.
>
> The example in the committee report explains that the unrelated business income tax provisions draw essentially the same line as that drawn in the self-employment tax provisions. Interestingly, both statutes were enacted by the 81st Congress.

[2821] From page E-4 of the Instructions:

> **Personal property**. Do not use Schedule E to report income and expenses from the rental of personal property, such as equipment or vehicles. Instead, use Schedule C or C-EZ if you are in the business of renting personal property. You are in the business of renting personal property if the primary purpose for renting the property is income or profit and you are involved in the rental activity with continuity and regularity.
>
> If your rental of personal property is not a business, see the instructions for Form 1040, lines 21 and 36, to find out how to report the income and expenses.

Code § 409A does not apply to the issuance of a profits interest.[3100] The profits interest could turn into golden handcuffs that avoid the strict rules on timing that Code § 409A imposes. For example, a partnership distributes enough of the service partner's share of profits to pay the service partner's income taxes. The rest of the service partner's share of profits is accumulated in the service partner's capital account and may be subject to any timing rules the parties choose. Because the service partner has already paid income tax on this accumulated income, this deferral does not offend the principles of Code § 409A, which are concerned about the timing of taxation. For more on Code § 409A, see part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

Profits interests have Code § 2701 consequences for family-controlled businesses, so the transferor either prepares to be treated as making a gift of the capital account that would ordinarily be associated with the profits interest or retains preferred payments that help reduce the impact

---

[3100] Notice 2005-1, Q&A 7 (third sentence). For a general discussion of the broader topic, see, The Proper Tax Treatment of the Transfer of a Compensatory Partnership Interest and also Finding the Right Balance: A Critical Analysis of the Major Proposals to Reform the Taxation of Carried Interests in Private Equity, both in *Tax Lawyer*, Vol. 62, No. 1 (Fall 2008). This Notice continued to apply under section III.G of the preamble to the final regulations under Code § 409A and still applies under the final regulations pursuant to Section 4 of Notice 2007-86. Reg. § 1.409A-1(b)(7) has the following text: Arrangements between partnerships and partners. [Reserved.] The preamble to the final regulations, T.D. 9321, provides:

> (G.) Arrangements Between Partnerships and Partners
>
> The proposed regulations did not address the application of section 409A to arrangements between partnerships and partners, and these final regulations also do not address such arrangements. The statute and the legislative history of section 409A do not specifically address arrangements between partnerships and partners providing services to a partnership and do not explicitly exclude such arrangements from the application of section 409A. Commentators raised a number of issues, relating both to the scope of the arrangements subject to section 409A and the coordination of the provisions of subchapter K and section 409A with respect to those arrangements that are subject to section 409A. The Treasury Department and the IRS are continuing to analyze the issues raised in this area. Notice 2005-1, Q&A-7 provides interim guidance regarding the application of section 409A to arrangements between partnerships and partners. Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A-7 and sections II.E. and VI.E. of the preamble to the proposed regulations.
>
> Notice 2005-1, Q&A-7 provided that until further guidance is issued for purposes of section 409A, taxpayers may treat the issuance of a partnership interest (including a profits interest) or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock. For this purpose, taxpayers may apply the principles applicable to stock options or stock appreciation rights under these final regulations, as effective and applicable, to equivalent rights with respect to partnership interests.
>
> Taxpayers also may continue to rely upon the explanation in the preamble to the proposed regulations regarding the application of section 409A to guaranteed payments for services described in section 707(c). As stated in that preamble, until further guidance is issued, section 409A will apply to guaranteed payments described in section 707(c) (and rights to receive such guaranteed payments in the future), only in cases where the guaranteed payment is for services and the partner providing services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the guaranteed payment or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.

of Code § 2701. For a discussion of how Code § 2701 might apply, see III.B.7.c Code § 2701 Interaction with Income Tax Planning.

Also, receiving a profits interest causes the service provider to be taxed as a partner for all of that person's compensation, because bona fide members of a partnership are not employees for tax purposes.[3101]

II.M.4.f.ii. Tax Effects of Profits Interests

Below we discuss that issuing a profits interest generally does not have a tax consequence.

Then we discuss that certain sales of compensatory partnership interests are recharacterized from long-term to short-term capital gains.

II.M.4.f.ii.(a). Tax Effects of Issuing a Profits Interest

Reg. § 1.721-1(b)(1) provides (highlighting added):

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. To the extent that an interest in capital representing compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under section 691.

Under Rev. Proc. 93-27, if a person receives a profits interest[3102] for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner,

---

[3101] See note 466. For self-employment tax on guaranteed payments, see text accompanying notes 2838-2839.

[3102] Under the Rev. Proc., a profits interest is a partnership interest other than a capital interest. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest. For the rules on revaluing partnership assets and adjusting capital accounts when that occurs, see part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts), especially fn. 450.
See also *Mark IV Pictures, Inc. v. Commissioner*, T.C. Memo. 1990-571, which held:

> Deciding whether a partner's interest in a partnership is a capital interest, rather than a mere profits interest, turns on whether that partner has the right to receive a share of the partnership's assets

generally the IRS will not treat the receipt of such an interest as a taxable event for the partner or the partnership. However, that rule does not apply:

(1) If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;

(2) If within two years of receipt, the partner disposes of the profits interest; or

(3) If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Code § 7704(b).

If Rev. Proc. 93-27 applies, the profits interest is treated as a capital asset when the service provider sells it.

Rev. Proc. 2001-43 applies Rev. Proc. 93-27 to the grant of a partnership profits interest that is substantially nonvested for the provision of services to or for the benefit of the partnership. Under Section 4 of Rev. Proc. 2001-43, the service provider will be treated as receiving the interest on the date of its grant, and a Code § 83(b) election will not be required, if:

> .01 The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;
>
> .02 Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and
>
> .03 All other conditions of Rev. Proc. 93-27 are satisfied.

> upon a hypothetical winding up and liquidation immediately following acquisition of the interest, rather than the mere right to share in future partnership earnings or profits. Here, a fair reading of paragraphs 2.4 and 9.2 of the Articles indicates that the general partners had the *right to receive* a specified share of the partnerships' liquidation proceeds (assets). Thus, even if no partnership proceeds remained to be distributed to the general partners after distributing the liquidating proceeds in accordance with section 545.42, they nevertheless had the *right to receive* a share of the partnerships' assets.
>
> Based on the foregoing, we conclude that the general partners received a capital interest in their respective limited partnerships. See sec. 1.721-1(b)(1), Income Tax Regs.

Reg. § 1.721-1(b)(1) provides:

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services….

If Rev. Proc. 2001-43 does not apply to the grant of a substantially nonvested partnership profits interest and if case law[3103] does not provide otherwise, then the service provider recognizes ordinary income (and the partnership is deemed to have paid compensation) when the profits interest vests. The holding period for a later sale of the profits interest would be based on the date of vesting, rather than the date of grant.

The IRS has proposed regulations[3104] that would change these rules for profits interests, effective only when the regulations are finalized. Under the proposed regulations, a service provider would be required to recognize income upon receipt of a vested profits interest. A Code § 83(b) election would be required to treat a substantially nonvested profits interest as if it were vested. At any rate, determining the value of the profits interest generally would require an appraisal and complicate future accounting on many levels. IRS Notice 2005-43 proposes a Rev. Proc. to allow taxpayers to elect to determine the value based on the awarded partnership interest's liquidation value determined immediately after the grant of the partnership interest. If the partnership interest is merely a profits interest, the liquidation value would be zero. The proposed Rev. Proc. would supersede Rev. Proc. 93-27 and Rev. Proc. 2001-43; however, until the proposed Rev. Proc. is finalized, taxpayers may continue to rely on Rev. Proc. 93-27 and Rev. Proc. 2001-43.

Furthermore, the preamble to subsequent proposed regulations[3105] announced:

> The Treasury Department and the IRS are aware of transactions in which one party provides services and another party receives a seemingly associated allocation and

---

[3103] *Diamond v. Commissioner*, 56 T.C. 530 (1971 reviewed decision) (taxing service partner on issuance of profits interest), *aff'd* 492 F.2d 286 (7th Cir. 1974); *Campbell v. Commissioner*, T.C. Memo. 1990-162 (finding taxation on issuance), *rev'd* 943 F.2d 815 (8th Cir. 1991) (finding no taxation on issuance); *St. John v. U.S.*, 53 A.F.T.R.2d 84-718 (C.D. Ill. 1983) (no taxation because partnership's success was undetermined and speculative); *Kenroy, Inc. v. Commissioner,* T.C. Memo. 1984-232 (no taxation because partnership's liabilities exceeded assets). The Eighth Circuit in *Campbell* cited an earlier version (that has since been updated) of McKee, Nelson & Whitmire, ¶5.02 Distinguishing Taxable From Nontaxable Service-Connected Transfers of Partnership Interests: Is There a Difference Between Capital and Profits Interests? *Federal Taxation of Partnerships & Partners* (WG&L), and of Willis & Postlewaite, ¶4.06 Partnership Profits Interest Received in Exchange for Services, *Partnership Taxation*.

[3104] REG-105346-03, proposing changes to Reg. §§1.83-3, 1.83-6, 1.704-1, 1.706-3, 1.707-1, 1.721-1, and 1.761-1. Over the past several years, various proposals to tax hedge fund managers on the sale of their profits interests have had a chilling effect on the progress of these proposed regulations, particularly since the safeguards needed to make those proposals effective would cause radical changes in this area of tax law, well beyond the scope of taxing hedge fund managers.

[3105] REG-115452-14 (7/22/2015), which continued:

> Further, the Treasury Department and the IRS plan to issue a revenue procedure providing an additional exception to the safe harbor in Rev. Proc. 93-27 in conjunction with the publication of these regulations in final form. The additional exception will apply to a profits interest issued in conjunction with a partner forgoing payment of an amount that is substantially fixed (including a substantially fixed amount determined by formula, such as a fee based on a percentage of partner capital commitments) for the performance of services, including a guaranteed payment under section 707(c) or a payment in a non-partner capacity under section 707(a).
>
> In conjunction with the issuance of proposed regulations (REG-105346-03; 70 FR 29675-01; 2005-1 C.B. 1244) relating to the tax treatment of certain transfers of partnership equity in connection with the performance of services, the Treasury Department and the IRS issued Notice 2005-43, 2005-24 I.R.B. 1221. Notice 2005-43 includes a proposed revenue procedure regarding partnership interests transferred in connection with the performance of services. In the event that the proposed revenue procedure provided for in Notice 2005-43 is finalized, it will include the additional exception referenced.

distribution of partnership income or gain. For example, a management company that provides services to a fund in exchange for a fee may waive that fee, while a party related to the management company receives an interest in future partnership profits the value of which approximates the amount of the waived fee. The Treasury Department and the IRS have determined that Rev. Proc. 93-27 does not apply to such transactions because they would not satisfy the requirement that receipt of an interest in partnership profits be for the provision of services to or for the benefit of the partnership in a partner capacity or in anticipation of being a partner, and because the service provider would effectively have disposed of the partnership interest (through a constructive transfer to the related party) within two years of receipt.

Returning to the law when this portion was written, should one file a Code § 83(b) election, to preserve future capital gain treatment on the profits interest holder's future sale of the profits interest due to any noncompliance with the Revenue Procedures, either by the structure or by subsequent events within two years after the grant? If the profits interest's issuance is determined to be like the issuance a capital interest (for example, if it is determined that the book-up[3106] on issuance of the profits interest undervalued the partnership's assets), then filing a Code § 83(b) election would trigger income on issuance. Consider, however, that the tax economics if capital gain treatment were disallowed are not necessarily so bad, if certain tax indemnification agreements are in place:

Example

Suppose the basis at the time of the subsequent sale is zero (all profits have been paid out), the fair market value is $100x, the federal and state capital rate is 20%, and the federal and state income tax rate is 40%.

If the profits interest is given capital gain treatment, the holder of the profits interest pays $20x tax on the sale.

If the profits interest is deemed not to have been property until the sale (due to lack of vesting, etc.), then the following should occur:

- The holder receives $100x from the sale, which is deemed compensation income.
- The partners pay $67x withholding to the federal and state taxing authorities, covering the tax on the $100x and the $67x (40% of $167x is $67x). This is also deemed income to the holder of the profits interest.
- The partners deduct $167x compensation, saving $67x of tax, assuming they have basis for this deduction.
- The $67x tax savings to the partners pays for $67x withholding they paid.
- Except as described below, nobody pays anything out-of-pocket on the holder's receipt of the $100x sale proceeds.
- The partners pay capital gain tax on the sale proceeds they are deemed to have received.

[3106] See footnote 3021.

- An appropriate adjustment needs to be made to the allocations set forth above so that the holder reimburses the partners for their capital gain tax paid on the sale, which capital gain tax the parties had originally assumed the holder would have paid.

Articles explain some of the nuances and practical implications of profits interests[3107] and some prominent authors' reconsideration of their position that a taxable issuance of a profits interest might not be a big deal.[3108]

II.M.4.f.ii.(b). Certain Sales of Compensatory Partnership Interests Recharacterized from Long-Term to Short-Term Gains

Effective for taxable years beginning after December 31, 2017, special rules apply when a taxpayer transfers certain compensatory partnership interests, with surprising results when transferring to a related party.

Subject to exceptions, Code § 1061 targets an "applicable partnership interest," which is:[3109]

> any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business.

The House report, which was accepted by the Conference Committee, elaborated:

> It is intended that partnership interests shall not fail to be treated as transferred or held in connection with the performance of services merely because the taxpayer also made contributions to the partnership, and the Treasury Department is directed to provide guidance implementing this intent.

However, an "applicable partnership interest," does not include "an interest held by a person who is employed by another entity that is conducting a trade or business (other than an applicable trade or business) and only provides services to such other entity."[3110]

Before getting into which businesses are being targeted, let's focus on the type of equity interest being targeted. Code § 1061(c)(4) provides:

> *Exceptions*. The term "applicable partnership interest" shall not include-
>
> (A) any interest in a partnership directly or indirectly held by a corporation, or
>
> (B) any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with-
>
> (i) the amount of capital contributed (determined at the time of receipt of such partnership interest), or

---

[3107] Schippel, Should My CEO Be My Partner? A Practical Approach to Dealing with LLC and Partnership Equity Compensation, *TM Memorandum*, Vol. 53, No. 5 (2/27/2012).
[3108] Banoff & Lipton's Shop Talk column, "So You Received a Taxable Profits Interest-Maybe You *Should* Care!" *Journal of Taxation* (2/2016), reconsidering their 11/2015 column.
[3109] Code § 1061(c)(1).
[3110] Code § 1061(c)(1).

(ii) the value of such interest subject to tax under section 83 upon the receipt or vesting of such interest.

Thus, if a corporation provides services and receives a partnership interest of any kind, Code § 1061 does not apply. The House report, which was accepted by the Conference Committee, elaborated:

> For example, if two corporations form a partnership to conduct a joint venture for developing and marketing a pharmaceutical product, the partnership interests held by the two corporations are not applicable partnership interests.

However, Notice 2018-18 announced that regulations would provide retroactively that this exception applies to C corporations, not S corporations.

The other exception above is the right to share in partnership capital commensurate with the partner's capital contribution or the actually taxed value of services provided.[3111] The House report, which was accepted by the Conference Committee, elaborated:

> An applicable partnership interest does not include any capital interest in a partnership giving the taxpayer a right to share in partnership capital commensurate with the amount of capital contributed (as of the time the partnership interest was received), or commensurate with the value of the partnership interest that is taxed under section 83 on receipt or vesting of the partnership interest. For example, in the case of a partner who holds a capital interest in the partnership with respect to capital he or she contributed to the partnership, if the partnership agreement provides that the partner's share of partnership capital is commensurate with the amount of capital he or she contributed (as of the time the partnership interest was received) compared to total partnership capital, the partnership interest is not an applicable partnership interest to that extent.

Thus the provision is directly targeting nontaxable issuances of profits interests described in part II.M.4.f.ii.(a) Tax Effects of Issuing a Profits Interest. Consider, however, what happens if the partnership is not a straight pro-rata deal. What if the partnership involves preferred returns? How about multiple tiers of preferred returns – commonly referred to as waterfalls? What does it mean for the right to share in partnership capital to be commensurate with the partner's capital contribution?

Now, on to the targeted businesses:

Code § 1061(c)(1) provides:

> *Applicable trade or business*. The term "applicable trade or business" means any activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of-
>
> (A) raising or returning capital, and
>
> (B) either-

[3111] Code § 1061(c)(4)(B).

(i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or

(ii) developing specified assets.

"Specified asset" means securities,[3112] commodities,[3113] real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.[3114] The House report, which was accepted by the Conference Committee, elaborated:

> Developing specified assets takes place, for example, if it is represented to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider or of others acting in concert with or at the direction of a service provider. Services performed as an employee of an applicable trade or business are treated as performed in an applicable trade or business for purposes of this rule. Merely voting shares owned does not amount to development; for example, a mutual fund that merely votes proxies received with respect to shares of stock it holds is not engaged in development.
>
> *Specified assets*
>
> Under the provision, specified assets means securities (generally as defined under rules for mark-to-market accounting for securities dealers), commodities (as defined under rules for mark-to-market accounting for commodities dealers), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified. A commodity for this purpose means any (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity or notional principal contract, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified. For purposes of the provision, real estate held for rental or investment does not include, for example, real estate on which the holder operates an active farm.
>
> A partnership interest, for purposes of determining the proportionate interest of a partnership in any specified asset, includes any partnership interest that is not otherwise treated as a security for purposes of the provision (for example, an interest in a partnership that is not widely held or publicly traded). For example, assume that a hedge fund acquires an interest in an operating business conducted in the form of a non-publicly traded

[3112] As defined in Code § 475(c)(2) without regard to its last sentence.
[3113] As defined in Code § 475(e)(2).
[3114] Code § 1061(c)(3).

partnership that is not widely held; the partnership interest is a specified asset for purposes of the provision.

Suppose we have a compensatory partnership interest, that shares in capital disproportionately to the contribution, and a targeted business, all as described above, so that the taxpayer has an "applicable partnership interest." What are the consequences?

Code § 1061(a) treats as a short-term capital gain the excess, if any, of the taxpayer's (A) net long-term capital gain with respect to applicable partnership interests for a taxable year, over (B) the taxpayer's net long-term capital gain with respect to such interests for such taxable year computed by using a more-than-three-year holding period in determining whether a gain or loss is long-term.[3115] Thus, if the taxpayer's applicable partnership interests held for more than one year but not more than three years are sold at a net loss, Code § 1061(a) does not recharacterize the character of the loss. Here's how Code § 83 interacts with the holding period rule, according to the Conference Committee report:

> The conferees wish to clarify the interaction of section 83 with the provision's three-year holding requirement, which applies notwithstanding the rules of section 83 or any election in effect under section 83(b). Under the provision, the fact that an individual may have included an amount in income upon acquisition of the applicable partnership interest, or that an individual may have made a section 83(b) election with respect to an applicable partnership interest, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest.

Explaining the exception to this rule in Code §§ 1061(b)[3116] and (c)(5),[3117] the House report, which was followed by the Conference Committee on this issue, said:

[3115] Code § 1061(a) provides:

> *In general*. If one or more applicable partnership interests are held by a taxpayer at any time during the taxable year, the excess (if any) of-
> (1) the taxpayer's net long-term capital gain with respect to such interests for such taxable year, over
> (2) the taxpayer's net long-term capital gain with respect to such interests for such taxable year computed by applying paragraphs (3) and (4) of sections 1222 by substituting "3 years" for "1 year",
>
> shall be treated as short-term capital gain, notwithstanding section 83 or any election in effect under section 83(b).

The Conference Committee report concludes:

> Thus, the provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount of such gain calculated as if a three-year (not one-year) holding period applies. In making this calculation, the provision takes account of long-term capital losses calculated as if a three-year holding period applies.

[3116] Which provides:

> *Special rule*. To the extent provided by the Secretary, subsection (a) shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.

[3117] Which provides:

> *Third party investor*. The term "third party investor" means a person who-
> (A) holds an interest in the partnership which does not constitute property held in connection with an applicable trade or business; and

A special rule provides that, as provided in regulations or other guidance issued by the Secretary, this rule does not apply to income or gain attributable to any asset that is not held for portfolio investment on behalf of third party investors. Third party investor means a person (1) who holds an interest in the partnership that is not property held in connection with an applicable trade or business (defined below) with respect to that person, and (2) who is not and has not been actively engaged in directly or indirectly providing substantial services for the partnership or any applicable trade or business (and is (or was) not related to a person so engaged). A related person for this purpose is a family member (within the meaning of attribution rules[833]) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

[833] Sec. 318(a)(1).

In addition to related party transfers not qualifying for this exception, they also do not qualify for the netting of gains and losses that Code § 1061(a) allows regarding the sale of applicable partnership interests held for more than one year but not more than three years. The House Report explains Code § 1061(d):[3118]

Transfer of applicable partnership interest to related person

If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, then the taxpayer includes in gross income as short-term capital gain so much of the taxpayer's net long-term capital gain attributable to the sale or exchange of an asset held for not more than three years as is allocable to the interest. The amount included as short-term capital gain on the transfer is reduced by the amount treated as short-term capital gain on the transfer for the taxable year under the general rule of the provision (that is, amounts are not double-counted). A related person for this purpose is a family member (within the meaning of attribution rules[834]) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

[834] Sec. 318(a)(1).

(B) is not (and has not been) actively engaged, and is (and was) not related to a person so engaged, in (directly or indirectly) providing substantial services described in paragraph (1) for such partnership or any applicable trade or business.

[3118] Code § 1061(d), "Transfer of applicable partnership interest to related person," provides:

(1) *In general*. If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, the taxpayer shall include in gross income (as short term capital gain) the excess (if any) of-
  (A) so much of the taxpayer's long-term capital gains with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to such interest, over
  (B) any amount treated as short term capital gain under subsection (a) with respect to the transfer of such interest.

(2) *Related person*. For purposes of this paragraph, a person is related to the taxpayer if-
  (A) the person is a member of the taxpayer's family within the meaning of section 318(a)(1), or
  (B) the person performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

The government must require appropriate reporting[3119] and issue regulations or other guidance as is necessary or appropriate to carry out the purposes of Code § 1061.[3120]

II.M.4.f.iii. What Happens If a Nonvested Partnership Interest Does Not Qualify As a Profits Interest

Crescent Holdings, LLC v. Commissioner[3121] determined the tax consequences of an unvested interest in partnership capital and profits:

- The taxpayer's partnership interest was conditioned upon his future performance of substantial services. In other words, it wasn't vested.

- If the partnership had liquidated immediately after the unvested partnership interest was awarded, the agreement would have allocated liquidation proceeds to the taxpayer. Therefore, the unvested partnership interest was not a pure profits interest and was subject to Code § 83 income taxation.

- The Tax Court held that, under Code § 83, the taxpayer did not own the partnership interest for tax purposes and was taxed on only the cash that was distributed to him. Instead, the unvested, undistributed profits were taxable to those who would have received them if he had terminated employment.

- Furthermore, if the taxpayer were to become vested (no requirement to perform future substantial services), he would be taxable on the fair market value of the partnership interest at the time of vesting.

This case illustrates the big swing that can occur when awarding a partnership interest without making sure it is a pure profits interest. Until this case, most tax lawyers assumed that the only tax consequence to not having a pure profits interest was possible inclusion of the fair market value of the profits interest in the recipient's income. The remaining partners would get a corresponding deduction, and presumably they could use the taxes saved from the deduction to pay the recipient's taxes. Now the stakes are higher: if the recipient has a falling out with the partnership and challenges the income tax treatment, the income allocated to the recipient might instead be taxed to the other partners; however, the tax distribution was made to the recipient and might not be available to the remaining partners.

In light of this case, consider the following measures:

- When including in the partnership agreement a reference to the parties' intent that the partnership interest be a profits interest described in Rev. Procs. 93-27 and 2001-43, add language along the lines of: "Without limiting the generality of the foregoing, if the [partnership] were to liquidate immediately after granting [the profits interest], holders of [the profits interest]would receive no payment in respect of [the profits interest]."

3119 Code § 1061(e).
3120 Code § 1061(f).
3121 141 T.C. 477 (2013). For an exhaustive analysis, see Carman and Banoff, *Crescent Holdings*: Unvested Capital Partner Avoids Income Allocations, But Many Questions Remain, *Journal of Taxation* (WG&L), Vol. 120, No. 4 (April 2014).

- Include a savings clause that, if the IRS does find that we didn't have a good profits interest and this reallocation occurs, the recipient shall refund any tax distributions. That would remove a terminated employee's incentive to challenge the K-1 and hopefully provide cash to pay the partners' taxes.

II.M.4.f.iv. Alternative If a Prospective Partner Wants a Capital Interest Instead of a Profits Interest

Profits interests are great because they are forward-looking. Sometimes, however, the prospective partner insists on having a share of the existing business. The easiest, most certain way to do that is to give the new partner a share of capital and report granting the partnership interest as compensation, much as when one would issue corporate stock.[3122]

An alternative approach might work - if the insistent partner is willing to take some risk. The partnership agreement could allocate net income to the new partner until the new partner's capital account increases to the desired level. That approach would not generate the desired results if the partnership does not earn enough income to increase the partner's capital account sufficiently. Also, if the income allocated to the partner is ordinary income, the partner risks having this ordinary income generate a capital loss if the partner is unable to sell the partnership interest for enough in the future (plus the fact that the basis acquired by this ordinary income would tend to offset future capital gain).

Some partnerships allocate gross income to generate this result, leading to more certainty of the partner's capital account attaining the desired level. However, if the IRS views the allocation of gross income as being certain, the IRS might assert that the agreement to allocate gross income generates compensation immediately, so one might want to take that possibility into account when considering the effect of the agreement.

II.P.3. Conversions

Conversion to a C corporation is less taxing than conversion from a C corporation. Often, start-up businesses open as a pass-through entity (partnership or S corporation) to enable the owner to deduct initial losses, and then convert to a C corporation when they become profitable. To the extent that timing is discussed below, it is when changes in entity arise from check-the-box elections, which elections generally may be effective up to 75 days before the date of filing.[3266]

[3122] See part II.M.4.e.i Issuing Stock to an Employee - Generally.

[3266] Reg. § 301.7701-3(c)(1)(iii) provides:

> *Effective date of election*. An election made under paragraph (c)(1)(i) of this section will be effective on the date specified by the entity on Form 8832 or on the date filed if no such date is specified on the election form. The effective date specified on Form 8832 can not be more than 75 days prior to the date on which the election is filed and can not be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days prior to the date on which the election is filed, it will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, it will be effective 12 months after the date it was filed. If an election specifies an effective date before January 1, 1997, it will be effective as of January 1, 1997. If a purchasing corporation makes an election under section 338 regarding an acquired subsidiary, an election under paragraph (c)(1)(i) of this section for the acquired subsidiary can be effective no earlier than the day after the acquisition date (within the meaning of section 338(h)(2)).

An eligible entity may elect to be classified other than its default classification or to change its classification, by filing Form 8832.[3267] If an eligible entity makes an election under the preceding sentence to change its classification (other than an election made by an existing entity to change its classification as of the effective date of this section), the entity cannot change its classification by election again during the 60 months succeeding the effective date of the election.[3268] However, the IRS may permit the entity to change its classification by election within the sixty months if more than 50% of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election.[3269] An election by a newly formed eligible entity that is effective on the date of formation is not considered a change for purposes of the 60-month rule.[3270]

II.P.3.a. Need for New Tax ID

See http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Do-You-Need-a-NeW-EIN.

If one changes names but keeps the same tax ID, request from the IRS Form 147C, Confirmation Letter, to be able to prove to third parties that the name changed but the tax ID did not.

II.P.3.b. From Corporations to Partnerships and Sole Proprietorships

If a corporation has more than one shareholder, the corporation is deemed to distribute all of its assets and liabilities to its owners, who immediately contribute all of the distributed assets and liabilities to the partnership.[3271] The deemed transactions are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective on January 1, the deemed transactions are treated as occurring immediately before the close of December 31 and must be reported as of December 31. Thus, the last day of the corporation's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1.[3272]

[3267] Reg. § 301.7701-3(c)(1)(i).

[3268] Reg. § 301.7701-3(c)(1)(iv). T.D. 8697 (12/18/1996) provides:

> The sixty month limitation only applies to a change in classification by election; the limitation does not apply if the organization's business is actually transferred to another entity.

The preamble to the proposed regulations, PS-43-95 (5/1996), followed a sentence similar to the above with:

> For example, an organization could liquidate into its parent, terminate and reform as another entity (e.g., by merger), or contribute its business to another organization without restriction.

[3269] Reg. § 301.7701-3(c)(1)(iv).

[3270] Reg. § 301.7701-3(c)(1)(iv). The preamble to the proposed regulations, PS-43-95 (5/1996), commented:

> The sixty month limitation only applies to a change in classification by election. Thus, if a new eligible entity elects out of its default classification effective from its inception, that election is not a change in the entity's classification.

Letter Ruling 201516034 confirmed that electing out of default classification is not a change in the entity's classification. The ruling permitted corporate subsidiaries to convert to LLCs under their original state law and for those LLCs to elect corporation taxation, after which the LLCs converted to LLCs governed by a different state's laws, and the newest LLCs were also permitted to elect corporation taxation.

[3271] Reg. § 301.7701-3(g)(1)(ii).

[3272] Reg. § 301.7701-3(g)(3).

If a corporation has only one shareholder, the corporation is deemed to distribute all of its assets and liabilities to its single owner in liquidation of the corporation.[3273] The deemed transaction is treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective on January 1, the deemed transaction is treated as occurring immediately before the close of December 31 and must be reported as of December 31. Thus, the last day of the corporation's taxable year will be December 31 and the first day of the individual's taxable year regarding the activity will be January 1.[3274] If a parent corporation converts a wholly-owned subsidiary corporation to a single member LLC that is disregarded for tax purposes, the conversion constituted a tax free liquidation of the subsidiary under Code § 332.[3275]

The liquidation of a corporation is a taxable event.[3276] The corporation (or its shareholders through K-1s if it is an S corporation) is taxed on the extent by which any asset's fair market value (FMV) exceeds its basis.[3277] Each shareholder generally realizes capital gain or loss on the difference between the FMV received and the stock's adjusted basis. This double tax can be expensive.[3278]

II.P.3.c. Conversion from C Corporation to S corporation

Converting from a C corporation to an S corporation can trigger LIFO recapture for companies that carry an inventory[3279] or built-in gain tax when assets are sold with a certain number of years after the S election.[3280]

Any S corporations that have not cleansed themselves of C corporation earnings and profits encounter constraints regarding too much investment income[3281] and reduced benefits from tax-exempt interest.[3282]

II.P.3.c.i. LIFO Recapture

If a C corporation inventoried goods under the LIFO method immediately before making an S election, it shall include in income the LIFO recapture amount in its last taxable year as a C corporation (for which its inventory then receives appropriate basis adjustments.[3283]

The corporation pays tax imposed on this conversion in its last C year and first three S years.[3284]

[3273] Reg. § 301.7701-3(g)(1)(iii).
[3274] Reg. § 301.7701-3(g)(3).
[3275] Letter Ruling 201452016.
[3276] See Code §§ 336 and 337.
[3277] Contributing property with a built-in loss within 2 years of liquidation so as to avoid gain on liquidation generally would not work. Code § 336(d)(2).
[3278] See, *e.g.*, Everett, Hennig, and Raabe, Converting a C corporation into an LLC: Quantifying the Tax Costs and Benefits, *Journal of Taxation* (Aug. 2010).
[3279] See part II.P.3.c.i LIFO Recapture.
[3280] See part II.P.3.c.ii Built-in Gain Tax.
[3281] See part II.P.3.c.iii Excess Passive Investment Income.
[3282] See part II.P.3.c.iv Problem When S corporation with Earnings & Profits Invests in Municipal Bonds.
[3283] Code § 1363(d)(1).
[3284] Code § 1361(d)(2). FSA 20153001F discussed the treatment of a consolidated group with a C corporation parent being acquired by an S corporation and became a Qualified Subchapter S Subsidiary. The FSA included the following clarification:

Considering that any inventory on hand is likely to be sold during the recognition period for the built-in gain tax, this recapture avoids double taxation. On the other hand, the corporation might have been able to maintain its old layer of inventory for tax purposes during the entire built-in gain recognition period, and this might be viewed as an additional tax burden.

II.P.3.c.ii. Built-in Gain Tax on Former C Corporations under Code § 1374

II.P.3.c.ii.(a). Explanation of Built-in Gain Tax on Former C Corporations under Code § 1374

When any asset is disposed of within 5 years of the S election,[3285] generally double taxation applies - normal taxation as a flow-through entity, plus a separate corporate level tax imposed on

---

The recapture date is the day before the effective date of the S election. Treas. Reg. § 1.1363-2(c)(1). However, with reference to transactions described in § 1.1363-2(a)(2) (including Qsub elections), there appears to be a typo in the regulations. Treas. Reg. § 1.1363-2(c)(1) states that for a nonrecognition transaction described in § 1.1363-2(a)(2) or (b)(2), the recapture date is the date of the transfer of the partnership interest to the S corporation. However, only section (b)(2) refers to a transfer of a partnership interest, (a)(2) refers to transfers of LIFO inventory assets by the C corporation to an S corporation. The LIFO recapture amount is determined as of the end of the recapture date for S corporation elections described in § 1.1363-2(a)(1), and as of the moment before the transfer occurs for nonrecognition transactions (including Qsub elections) described in 1.1363-2(a)(2). Treas. Reg. § 1.1363-2(c)(2).

[3285] Code § 1374(d)(7) generally provides a 5-year recognition period, which was 7 years for a sale in 2009 or 2010 or 10 years for a sale before then. Code § 1374(d)(7) describes the recognition period as follows:

(A) *In general*. The term ‘recognition period’ means the 5-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation. For purposes of applying this section to any amount includible in income by reason of distributions to shareholders pursuant to section 593(e), the preceding sentence shall be applied without regard to the phrase ‘5-year’.

(B) *Installment sales*. If an S corporation sells an asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received shall be governed by the provisions of this paragraph applicable to the taxable year in which such sale was made.

Letter Ruling 201150023 includes some nuances as the 2011 transition rules related to an installment sale. The ABA Section of Taxation S corporations Committee meeting in May 2015 discussed various nuances to Code § 1374(d)(7) before the Protecting Americans from Tax Hikes Act of 2015 enacted the language quoted above; see Thompson Coburn document no. 6214396.

the lesser of the gain on disposition or the unrealized gain on the effective date of the S election.[3286] The corporation must disclose its unrealized built-in gain annually.[3287]

Generally, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer.[3288] Assets subject to this tax include inventory (but see part II.P.3.c.i LIFO Recapture) and a cash basis taxpayer's accounts receivable,[3289] as well as goodwill;[3290] however, an accrual taxpayer's the receipt of franchise fees not constituting a sale or exchange of a capital asset under Code § 1253(a) are not subject to built-in gain tax.[3291] If a corporation sells an asset before or during the recognition period and

---

[3286] Code § 1374. For ways to minimize this tax using a charitable remainder trust, see part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax. Also, see generally, Dealing with the S corporation Built-In Gains Tax, Parts 1 and 2, *Journal of Taxation* (April and May 2008). Reg. § 1.1374-2(a) provides that an S corporation is taxed is the lesser of:

> (1) Its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover (pre-limitation amount);
>
> (2) Its taxable income determined by using all rules applying to C corporations as modified by section 1375(b)(1)(B) (taxable income limitation); and
>
> (3) The amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior taxable years (net unrealized built-in gain limitation).

[3287] Form 1120S (2014), page 2, Schedule B, question 8. To avoid an understatement penalty, the taxpayer might consider hiring an appraiser to value the more significant items that have value that differs from basis. For a taxpayer to rely on a professional's advice, Reg. § 1.6664-4(c)(1)(i) provides;

> *All facts and circumstances considered*. The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

If the taxpayer obtains more than one opinion of value, the taxpayer does not need to provide the tax return preparer with an earlier appraisal if a later appraisal was obtained to correct errors and incorporate more current data. *The Ringgold Telephone Company v. Commissioner*, T.C. Memo. 2010-103 (no penalty assessed for underpayment of built-in gain tax). The court also rejected the IRS' criticism of the taxpayer's failure to give the tax return preparer a copy of a memorandum suggesting a value, because the memorandum was prepared primarily as a marketing tool, not as an objective valuation.

[3288] Reg. § 1.1374-4(b)(1). This determination disregards any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation. Reg. § 1.1374-4(b)(3), Example (4) discusses deferred prepayment income, and Example (5) discusses changes in accounting methods. For further discussion of various items of built-in gain, see McMahon and Simmons, Where Subchapter S Meets Subchapter C, *Tax Lawyer*, vol. 67, No. 2 (Winter 2014), saved as Thompson Coburn LLP doc. no. 6177833.

[3289] For accounts receivable, the S corporation takes them account in full when it collects them, but it takes into account no more than their fair market value at the time of the S election if it sells them to a third party instead. Reg. § 1.1374-4(b)(3), Example (1). For long-term contracts accounted for under the completed contract method, income that would have been earned before the S election under the percentage of completion method is built-in gain. Reg. § 1.1374-4(g).

[3290] Reg. § 1.1374-3(c), Example (1).

[3291] Letter Ruling 200411015 involved the following situation:

> Franchisees pay [taxpayer] a license fee upon grant of the license and monthly royalty fees which are composed of a fixed fee portion and a variable fee portion. Except for the limited use allowed by the Agreements, [taxpayer] retains a significant power, right, or continuing interest in the franchise and terminates any Agreement in violation of the terms and conditions of the license

reports the income from the sale using the installment method during or after the recognition period, that income is subject to built-in gain tax.[3292]

This gain can be offset by built-in losses,[3293] such as a cash basis taxpayer's accounts payable.[3294] Thus, a cash basis taxpayer with accounts receivable at the time of the S election should be able to offset that built-in gain by its board of directors declaring a bonus, constituting reasonable compensation, before the S election, which bonus is payable while an S corporation.[3295]

> grant. The grant or transfer of franchise rights pursuant to an Agreement does not constitute a sale or exchange of a capital asset under section 1253(a).

The ruling held:

> The income of [taxpayer] with respect to the receipt of the license fees and royalty fees from franchisees after the Conversion Date will not be treated as recognized built-in gain within the meaning of section 1374(d).
>
> We express no opinion about the tax treatment of the license fees or royalty fees under other provisions of the Code and regulations or the tax treatment of any conditions existing at the time of, or the effects resulting from, the license fees and royalty fees that are not specifically covered by the above ruling. We also express no opinion about the tax treatment under 1374 of any income or gain that may be realized by [taxpayer] during the recognition period except as specifically provided above.

[3292] Reg. § 1.1374-4(h). Also watch out for acceleration as described in part II.G.14 Limitations on the Use of Installment Sales

[3293] Reg. § 1.1374-2(a)(1).

[3294] Reg. § 1.1374-4(b)(2) provides that, generally:

> …any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation).

Under an accrual method of accounting, a liability is incurred and generally is taken into account in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Reg. § 1.461-1(a)(2)(i). For example, if the corporation is involved in a lawsuit at the time of the S election, amounts paid as a result of the lawsuit are built-in losses only if a judgement had been awarded at the time of the S election. Reg. § 1.1374-4(b)(3), Examples (2) and (3). If an accrual method taxpayer would have been able to deduct amounts owed to related parties before making the S election and Code § 267(a)(2) suspended the deduction until after the S election was made, those expenses might be built-in losses under Reg. § 1.1374-4(c)(1). A similar rule applies to compensation appropriately accrued before the S election but suspended under Code § 404(a)(5) until after the S election was made. Reg. § 1.1374-4(c)(2).

[3295] S. Rep. No. 445, 100th Cong., 2d Sess. 65 (1988), states:

> As an example of these built-in gain and loss provisions, in the case of a cash basis personal service corporation that converts to S status and that has receivables at the time of the conversion, the receivables, when received, are built-in gain items. At the same time, built-in losses would include otherwise deductible compensation paid after the conversion to the persons who performed the services that produced the receivables, to the extent such compensation is attributable to such pre-conversion services. To the extent such built-in loss items offset the built-in gains from the receivables, there would be no amount subject to the built-in gains tax.

Eustice & Kuntz, ¶ 7.06[4][f] Computation of Tax; Use of Certain Losses and Deductions to Reduce Tax Base, Federal Income Taxation of S corporations, views this as an accurate statement of current law.

An accrual taxpayer's deductions deferred by reason of the economic performance rules count as built-in losses.[3296]

Regulations prevent avoiding this tax merely by dropping assets into a partnership.[3297] However, if the corporation owns the partnership at the time of the S election, valuation discounts might reduce the amount of built-in gain.

II.P.3.c.ii.(b). Consider S Election Even If Plan to Sell Within 5 Years

Even if one plans to sell the corporation within five years, one might find an S election useful and then revert back to a C corporation if the sale does occur during that time, if all of the following are present:

- The corporate stock is not eligible for the exclusion from gain on sale of the stock under Code § 1202 described in part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation. Being an S corporation for any significant period would blow the exclusion.[3298]

- The company does not have too much inventory subject to tax under part II.P.3.c.i LIFO Recapture. Note that any tax imposed on LIFO recapture is spread over several years.

- The company does not expect to dispose of significant assets subject to built-in gain tax.[3299] If the company reports on the cash receipts and disbursements method, then its accounts receivable and other accrued income in excess of its accounts payable and other accrued expenses would be subject to built-in gain tax; however, if it is on the accrual method, the income would already have been recognized and the built-in gain tax would not apply.[3300]

Making the S election would allow the shareholders to extract earnings during that period income-tax free, whether those earnings are extracted through distributions or when selling their stock.

If stock in the company is sold as just a straight stock sale, then either the buyer keeps the S election going (and benefits from to) or terminates the S election. If the buyer requires a basis step-up on the corporation's assets as described in part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold, then the seller might need to revoke the S election to avoid the built-in gain tax. Either way, terminating the S election might very well be relatively straightforward so that this process of turning on and then off the S election might have few bad tax effects (if the three bullet points above work out) and are advantageous while the election is in effect. See parts II.P.3.e Conversion from S corporation to C Corporation and II.A.2.k Terminating an S Election.

[3296] Reg. § 1.1374-4(b)(2) provides that:

> In determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer for purposes of this paragraph, section 461(h)(2)(C) and § 1.461-4(g) (relating to liabilities for tort, worker's compensation, breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts, taxes, and other liabilities) do not apply.

[3297] Reg. § 1.1374-4(i).

[3298] See fn. 4317.

[3299] See part II.P.3.c.ii.(a) Explanation of Built-in Gain Tax on Former C Corporations under Code § 1374.

[3300] See fns. 3288-3296.

II.P.3.c.iii. Excess Passive Investment Income

If a C corporation with accumulated earnings and profits (E&P)[3301] elects S status, it might be subject to a supplemental tax and lose its S status if it has excess passive investment income.[3302] The corporation can avoid this treatment by carefully planning its gross receipts or by distributing its E&P.[3303] Inadvertent termination relief may be available if the corporation distributes its E&P after violating the excess passive investment income test.[3304]

Some points on planning gross receipts to avoid excess passive investment income treatment include:

- Although the statute defines rent as tainted income,[3305] that characterization does not apply if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental activity.[3306] For this purpose, "rent" does not include

---

[3301] Reg. § 1.1375-1(b)(4) refers to Code § 1362(d)(3) and the regulations thereunder in determining E&P. E&P is based on C corporation principles under Code § 312 and taxed by Code § 316 when distributed. Code § 1371(c). E&P are the earnings and profits of any corporation, including the S corporation or an acquired or predecessor corporation, for any period with respect to which an S election was not in effect. Reg. § 1.1362-2(c)(3).

[3302] Code §§ 1362(d)(3), 1375. Certain S corporations may disregard pre-1983 earnings and profits. 2007 Small Business Act P.L. 110-28, Sec. 8235.

[3303] Planning before the conversion might also help. Starr and Sobol, *S corporations: Operations*, T.M. 731-2nd, suggests at IV.B:

> Comment: When a C corporation converts to an S corporation, accumulated E&P is likely to be overstated, since timing differences originating in C status will tend to reverse while in S corporation status. As a result, excessive dividend distributions will be necessary to fully deplete the account. Conversely, when an S corporation converts to a C corporation, these timing differences may prove advantageous in that the accumulated E&P would reflect the reversal in C status while not being affected by the origination of the item in S status.
>
> Instances where timing differences come into play when switching from C to S or S to C status include:
>
> - accelerated cost recovery deductions for taxable income, but straight-line for accumulated E&P;
> - installment method elected for taxable income, but not allowed for accumulated E&P; and
> - special LIFO inventory adjustments required for accumulated E&P, but generally not required for taxable income.

[3304] Letter Ruling 201710013.

[3305] Code § 1362(d)(3)(C)(i).

[3306] Reg. § 1.1362-2(c)(5)(ii)(B)(2), which provides:

> *Rents derived in the active trade or business of renting property*. Rents does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Rev. Rul. 81-197 addressed leasing aircraft. Reimbursing the renter's expenses under a one-year lease, where the tenant does all of the work, did not make rental be active. However, chartering aircraft was active, where (a) the owner provides all pilots, fuel, catering, and operating supplies, and pays for all hull and liability insurance, landing and parking fees, taxes, and governmental fees and charges, (b) pilots who are its employees have primary authority for the safety and actual operation of the aircraft, and (c) it enters "income realized by a landowner under a share-farming arrangement where the landowner participates to a material degree in the production of farm commodities through physical work

---

into a management agreement with the aircraft manufacturer to secure assistance in maintaining the aircraft.

A corporation did not provide significant services or incur substantial costs when it provided furniture for the bungalows (used as vacation homes) and a recreation area maintained by the corporation, as well as tables and cards use in that area, sponsored bingo games for the adults and parties for the children at which small prizes were given, and sponsored parties for the adults, providing food and entertainment, all of which cost approximately 0.15% of revenue. *Feingold v. Commissioner*, 49 T.C. 461(1968). Performing decorating, repair, maintenance and cleaning services at the lessee's separate expense did not make active the rental of stadium suites active, but income from concessions, stadium club membership fees and dues, and electronic scoreboard advertising was active. Letter Ruling 8247052 (GCM 38915 apparently provided the underlying analysis).

Letter Ruling 201725022 held that the following medical office lease was active:

> X contracts with an independent leasing agent to assist in soliciting prospective tenants for M, negotiating leases and renewals, and overseeing post-leasing activities such as build-outs and renovations of suite space. X, with the assistance of the independent leasing agent, drafts, proposes, presents, and negotiates letters of intent to lease available suite spaces. Negotiation for leasing regularly requires the use of an independent space planner to design and tailor the spaces for prospective tenants. Once letters of intent are accepted, X, with the assistance of the independent leasing agent, prepares, finalizes, and executes the lease agreements with prospective tenants. Renewals of leases are similarly handled by X, which are often complicated by requests for concessions and renegotiation of the leasing rate. Renewals often require significant time and attention by X.
>
> X, through its employees, its agents, and the agents' employees, provides certain services in maintaining and repairing of the buildings, common areas, and grounds of M. X utilizes a standard lease agreement for its tenants, and under the lease agreements X has the obligation to provide certain services with respect to the leasing of space within M and to maintain or repair the following items: the heat and air conditioning systems, plumbing, hot water heaters, exterior lighting, signs, lawn care and gardening, roofs and exterior walls, exterior walkways, courtyards, parking areas, electricity, water and sewer, drainage, and garbage pickup.
>
> In addition, the following specific services are provided to M and its tenants by an employee or independent contractor/worker of X: daily walk-through inspections of M to report on water breaks, lighting outage, vandalism, damage to building exteriors and certain interior spaces; sweeping, cleaning and maintaining the common areas of M such as sideways, walkways, and parking lot; routine periodic inspection of building exteriors and interiors, including foundations, roofs, exterior lighting, grounds, and parking lot and engaging in maintenance and repairs as needed; treating the roofs of the buildings for moss growth yearly; recoating and resurfacing the parking lot; routine and periodic maintenance of the numerous heating and air conditioning units; renovating vacant suites for leasing; routine and periodic maintenance of the plumbing and sewer lines, and their repair and replacement as needed; maintenance, repair and replacement of exterior lighting and selected interior lighting; janitorial services for selected units and common areas; exterior window washing; regular maintenance of grounds and lawn care, and landscaping services when necessary; seasonal snow removal and ice control; weekly trash removal; periodic pest and vermin control; and emergency response and property access for public safety.

Additional authority is in *United States Tax Reporter* ANN ¶ 13,799.27 Rents; Bittker & Eustice, ¶ 6.04. Events Terminating Election, *Federal Income Taxation of Corporations & Shareholders* (WG&L); Eustice, Kuntz & Bogdanski, ¶ 5.04[2][b] Rents, *Federal Income Taxation of S Corporations*; Christian & Grant, ¶ 11.03 Rents, *Subchapter S Taxation* (WG&L).

or management decisions, or a combination of both,"[3307] but the payment of costs may be sufficient to cause a farm arrangement to be nonpassive under this test.[3308]

- Gross receipts (rather than net income) of nonpassive income from partnerships in which the corporation is invested may be counted;[3309] some income from controlled foreign corporations might also count as nonpassive income.[3310] Investing in oil and gas partnerships frequently helps generate sufficient nonpassive gross receipts.[3311] Any gross receipts separately stated

---

[3307] Rev. Rul. 61-112. See Letter Rulings 8927039, 9003056, 9514005, 200002033, 200217045, and 200739008, all cited in Thompson Coburn LLP doc. no. 6513203 (which would need to be sanitized before sharing), which is the background for Letter Ruling 201812003 (which approved S corporation status and an ESBT election when the trust that was the sole shareholder was required to cause the corporation to distribute real estate to charity, facts that were present but were not discernible from the ruling). *Kennedy v. Commissioner*, T.C. Memo. 1974-149, held that crop-sharing was passive rental when the corporation furnished nothing except the use of the land and the tenant furnished all the management, labor, supplies, etc.

Citing Rev. Rul. 61-112, Rev. Rul. 67-423 held that, when a corporation owns farmland it leases to a tenant under a crop-sharing arrangement that generates government payments under acreage reserve and conservation reserve programs and the landlord materially participates in the management of the farm production, the payments which the landlord receives under the foregoing programs are not "rents" for personal holding company income tax purposes. TAM 6211239430A, which also cited Rev. Rul. 61-112, held that crop-sharing payments were "rents" for personal holding company income tax purposes where the corporation did nothing and the tenant furnishes all of the equipment and performs all of the work.

GCM 35957 (1974) cited Rev. Rul. 61-112, among other authority, in analyzing whether crop-sharing constituted unrelated business taxable income.

GCM 35247 (1973) cited Rev. Rul. 61-112, among other authority, in analyzing whether crop-sharing constituted a business for purposes of estate tax deferral under Code § 6166.

[3308] Letter Ruling 201722019 approved as nonpassive both of the following:

> X is engaged in the business of farming and owns n acres in State. X has leased the land for sharecropping (Sharecropping Lease Arrangement) continuously beginning in Date 3. Beginning in Year, the land was leased to Y. Pursuant to the Sharecropping Lease Arrangement, all taxes, assessments or charges levied or assessed on products of the land must be paid by X and Y based in proportion to the percentage of crops to which X and Y are entitled. X and Y each pay one half of the actual cost of fertilizer and soil conditioner. X pays the cost of the power and fuel necessary to operate the drainage pumping plants as well as the cost of maintaining the irrigation and drainage canals and irrigation pipe line. X is also responsible for paying box rent and the grower's share of the state inspection fee. Any processing expenses incurred with the preparation of crops for sale, which are related to X's share of the crops, are paid by X. X also determines the percentage of Property to be farmed and the types of crops to be planted. Further, X is at risk for crop yields and marketing.
>
> In Year, X signed a new lease agreement (Rental Lease Arrangement) with Y for lease of Property. Under the lease, X's expenses are between o% and p% of X's rental income. X is responsible for providing and maintaining insurance on all improvements and fixtures owned by X. Further, X pays the costs and expenses associated with the repair, maintenance and replacement of the irrigation drainage pumps as well as the insurance, water reclamation tax, water rights fees, water coalition dues and property taxes.

[3309] Rev. Rul. 71-455; see also Reg. § 1.702-1(a)(8)(ii).

[3310] CCA 201030024.

[3311] For a summary of the issue, see 723 T.M. III.D.7.b.; see also part II.P.1.a.i Allocations of Income in Partnerships. Specific examples include Letter Rulings 200005012 (publicly traded partnership engaged in the purchasing, gathering, transporting, storage and resale of crude oil, refined petroleum products, and natural gas liquids, as well as some related activities), 200027037 (publicly traded limited partnerships engaged in the business of purchasing, gathering, transporting, trading, storage, and resale of crude oil, refined petroleum, and other chemical products), 200147034 (one publicly traded partnership's business on such a K-1 would be reflected only in a worksheet provided in the Instructions for Form 1120S.[3312]

- In the case of sales or exchanges of stock or securities, gross receipts shall be taken into account only to the extent of the gains, without deduction for losses.[3313] For other capital assets, losses are netted against gains.[3314]

The corporation can distribute its E&P. Generally, distributions from an S corporation come first as generally[3315] nontaxable distributions of its accumulated adjustments account (AAA), then are treated as dividends to the extent of E&P, and then as a return of basis and gain on sale.[3316] However, an S corporation may, with the consent of all of its affected shareholders, elect to ignore AAA with respect to all distributions made during the taxable year for which the election is made.[3317]

Generally, a distribution of E&P must be effected using a distribution of money or other property.[3318] For these purposes, a distribution is taken into account on the date the corporation makes the distribution, regardless of when the distribution is treated as received by the shareholder.[3319] AAA at the close of the taxable year is applied to distributions during the taxable and pro-rated among them if they exceed AAA.[3320]

"Property" means money, securities, and any other property, but does not include stock in the corporation making the distribution (or rights to acquire such stock).[3321] However, no distribution

---

consisted of purchasing, gathering, transporting, trading, storage and resale of crude oil and refined petroleum products and related activities, and the other's consisted of interstate and intrastate crude oil transportation, terminalling and storage, as well as crude oil gathering and marketing activities), 200240043 (publicly traded partnerships engaged in the business of purchasing, gathering, transporting, trading, storing, and reselling crude oil and refined petroleum products), 200309021 (publicly traded partnership engaged in the purchasing, gathering, transporting, trading, storage, and resale of crude oil, refined petroleum, and other mineral or natural resources), 200327004 (publicly traded partnership engaged in the purchasing, gathering, transporting, trading, marketing, storing, and reselling of crude oil, refined petroleum products, and natural gas liquids), and 200928024 (publicly traded partnerships engaged in the active trade of purchasing, gathering, transporting, trading, storage and/or resale of crude oil and refined petroleum products and related activities). It is best to document that the corporation's investment strategy is to provide for liquidity and also to diversify its investment risk.

[3312] The 2016 Instructions provide a worksheet to compute the excess net passive income tax for line 22a. The schedule computing the excess net passive income items includes+:

> *Income and deductions on lines 1, 2, and 5 are from total operations for the tax year. This includes applicable income and expenses from page 1, Form 1120S, as well as those imported separately on Schedule K.

[3313] Code § 1362(d)(3)(B)(ii).

[3314] Code § 1362(d)(3)(B)(i).

[3315] If and to the extent that the basis of a shareholder's stock is less than the shareholder's allocable AAA, the distribution of AAA would be taxed as a capital gain. Code § 1368(c)(1), (b)(2).

[3316] Code § 1368(c).

[3317] Code § 1368(e)(3)(A). Affected shareholder means any shareholder to whom a distribution is made by the S corporation during the taxable year. Code § 1368(e)(3)(B).

[3318] Code § 316(a). See Reg. § 1.1368-1(c).

[3319] Reg. § 1.1368-1(b).

[3320] Reg. § 1.1368-1(b), (c).

[3321] Code § 317(a).

of property is required if an S corporation elects to distribute all or part of its E&P through a deemed dividend, in which case: [3322]

- The corporation will be considered to elected to bypass AAA for that year.
- The deemed dividend may not exceed the E&P on the last day of the taxable year, reduced by any actual distributions of E&P made during the taxable year.
- The amount of the deemed dividend is considered, for all tax purposes,[3323] as if it were distributed in money to the shareholders in proportion to their stock ownership, received by the shareholders, and immediately contributed by the shareholders to the corporation, all on the last day of the corporation's taxable year.

A corporation makes an election for a taxable year by attaching a statement to a timely filed (including extensions) original or amended return required to be filed for that taxable year, which statement must include the amount of the deemed dividend that is distributed to each shareholder,[3324] as well as consent by each affected shareholder.[3325]

A deemed dividend might be attractive when dividend tax rates are low, if one expects to need to take distributions in excess of AAA is a future year. However, if the shareholder might later sell the stock to a third party or wait to have the stock redeemed until it obtains a basis step-up on death, then it's possible that distributions will never exceed AAA. In that case, investing in assets that generate nonpassive gross receipts might be a lot less painful than paying tax on a deemed dividend. If the majority shareholder does not want to mess with a closely-held business or active rental, then my experience has been that investing 1-3% of the corporation's assets in oil and gas partnerships will be sufficient to generate sufficient nonpassive gross receipts.[3326]

If a corporation does not know about the possible loss of its S election under the excess passive investment income rules and terminates its S election as a result of these rules, consider applying for inadvertent termination relief in which the corporation and shareholders agree to a retroactive deemed dividend described above.[3327]

II.P.3.c.iv. Problem When S corporation with Earnings & Profits Invests in Municipal Bonds

Tax-exempt income does not increase AAA.[3328]

[3322] Reg. § 1.1368-1(f)(3).
[3323] However, the dividend deemed distributed to a qualified subchapter S trust does not constitute trust accounting income and therefore is not required to be distributed to the beneficiary. Letter Ruling 200446007.
[3324] Reg. § 1.1361-1(f)(5)(iii).
[3325] Reg. § 1.1361-1(f)(5)(ii).
[3326] See footnote 3311.
[3327] Letter Rulings 201351013, 201629001.
[3328] Code § 1368(e)(1)(A). This includes tax-free receipts beyond just muni bonds. See part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations and Letter Ruling 201440013.

Therefore, any tax-exempt income, although not taxable to the shareholders when earned, would be taxable dividends when distributed to the shareholders to the extent that the corporation has no remaining AAA but has E&P.

Even if the corporation has plenty of AAA, a need for AAA might later arise, such as tax-free redemptions of part of a shareholder's stock.[3329]

These issues are spelled out more in part II.Q.7.b.iv.(a) S corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations.

II.P.3.c.v. Conversion from S corporation to C Corporation then Back to S corporation

CCA 201446021 asserted that, when an S election terminates, its accumulated adjustments account (AAA) is wiped out. Therefore, the IRS reasoned, if the corporation later becomes an S corporation, its AAA starts from scratch.

However, any distribution of ***money***[3330] by a corporation with respect to its stock during a post-termination transition period (generally, the first C corporation year after the S election terminate) is applied against and reduce the adjusted basis of the stock, to the extent that the amount of the distribution does not exceed AAA.[3331] So, if the S corporation status is terminated, one should consider promptly distributing earnings (and perhaps loaning them back to the corporation if it needs the cash). If one is planning a termination, consider distributing on the last day of the last S corporation taxable year a formula note equal to AAA as of that date. See part II.P.3.e Conversion from S corporation to C Corporation for discussion about additional opportunities for former S corporations whose owners at the time of revocation are the same as those on December 22, 2017.

A better strategy might be for the S corporation to do a tax-free "F" reorganization,[3332] in which the existing S corporation becomes a wholly-owned subsidiary of a new parent S corporation, which parent is owned by the original S corporation's shareholders immediately before the reorganization. The parent makes an S election, and the subsidiary elects taxation as a Qualified Subchapter S Subsidiary (QSub).[3333] The original S corporation initially is disregarded from the parent, giving the parent all of the subsidiary's AAA.[3334] Later, the subsidiary's QSub election is revoked, keeping the AAA intact at the parent level, notwithstanding that the subsidiary is now taxed as a C corporation. That way, if the subsidiary later becomes a QSub, the AAA remain to help carry out distributions to the shareholders.

This strategy also might allow a faster conversion back to taxation as an S corporation, because the S election was never terminated and therefore the five year waiting period[3335] would appear

[3329] If a state law redemption is treated as a distribution under Code § 302(b)(2) or (3) and Code § 302(c), then it is a tax-free distribution to the extent of AAA. See part II.Q.7.b. Redemptions or Distributions Involving S corporations.
[3330] The law refers to "money," and the 2017 legislative history refers to "distributions of cash."
[3331] Code § 1371(e)(1). Code § 1377(b)(1) and Reg. § 1.1377-2(b) determine the post-termination transition period.
[3332] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.
[3333] See part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3334] Reg. § 1.1368-2(d)(2).
[3335] See fn 283 in part II.A.2.k Terminating an S Election.

not to apply.[3336] Because the QSub is wholly owned, the deemed liquidation when the QSub election is made again generally would be nontaxable.[3337]

The "F" reorganization strategy is especially important when converting to a C corporation the stock of which generally would qualify for the exclusion described in part II.Q.7.k. Although a corporation that had been an S corporation cannot qualify for the exclusion, the S corporation can form a C corporation whose stock does qualify for the exclusion,[3338] and this reorganization strategy facilitates a seamless transition.

II.P.3.d. Conversions from Partnerships and Sole Proprietorships to C Corporations or S corporations

Transfers from a sole proprietorship to a corporation, including a disregarded LLC electing corporate taxation,[3339] are generally nontaxable.[3340]

However, shifting from a partnership to a corporation might cause the partners to recognize gain or lose their suspended losses.[3341]

Consider what adjustments might be required to convert a partnership interest, which might have capital accounts disproportionate to profit and loss sharing and might have profit in loss sharing that is not "straight-up," into shares, generally would have identical distribution and liquidation rights (and must have such rights in the case of an S corporation).

II.P.3.d.i. Formless Conversion

When an entity taxed as a partnership elects taxation as a corporation, the partnership is deemed to contribute all of its assets and liabilities to the corporation in exchange for stock in the corporation; and, immediately thereafter, the partnership liquidates by distributing the stock of the corporation to its partners.[3342] The deemed transactions are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective on January 1, the deemed transactions are treated as occurring immediately before the close of December 31 and must be reported by the owners of the entity on December 31. Thus, the last day of the partnership's taxable year will be December 31 and the first day of the corporation's taxable year will be January 1.[3343]

[3336] See fns 185-187 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3337] See fn 192 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
[3338] See fns 4317-4319 in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[3339] Reg. § 301.7701-3(g)(1)(iv).
[3340] See part II.M.2.a. Initial Incorporation – Generally.
[3341] See part II.M.2.c Contribution of Partnership Interest to Corporation.
[3342] Reg. § 301.7701-3(g)(1)(i). Under Rev. Rul. 2004-59, when a formless conversion occurs under state law, Rev. Rul. 84-111 does not apply. Rev. Rul. 84-111 describes the differences in the basis and holding periods of the various assets received by the corporation and the basis and holding periods of the stock received by the former partners provided the steps described are actually undertaken and the underlying assumptions and purposes for the conclusions in the revenue ruling are applicable. Except to the extent inconsistent with the above, see the text accompanying footnotes 4414-4502 for tax effects of liquidating a partnership.
[3343] Reg. § 301.770l-3(g)(3).

A partnership can be converted directly into an S corporation; the corporation is not deemed formed until the partnership is deemed to have distributed its assets to the corporation:[3344]

- Suppose that, on January 1, 2009, X, a calendar year taxpayer, is taxed as a partnership. X elects to be taxed as a corporation for federal tax purposes, effective January 1, 2010. On February 1, 2010, X files an S election, effective January 1, 2010. Each person who held stock in X on January 1, 2010 also holds stock at the time the S election is made. When X elects to be taxed as a corporation, the following steps are deemed to occur: X contributes all of its assets and liabilities to the corporation in exchange for stock in the corporation, and immediately thereafter X liquidates by distributing the stock of the association to its partners. These deemed steps are treated as occurring immediately before the close of the day before the election is effective.[3345] Thus, the partnership's taxable year ends on December 31, 2009, and the corporation's first taxable year begins on January 1, 2010. Therefore, the partnership will not be deemed to own the stock of the corporation during any portion of the association's first taxable year beginning January 1, 2010, and X is eligible to elect to be an S corporation effective January 1, 2010. Additionally, because the partnership's taxable year ends immediately before the close of the day on December 31, 2009, and the corporation's first taxable year begins at the start of the day on January 1, 2010, the deemed steps will not cause X to have an intervening short taxable year in which it was a C corporation.

- On January 1, 2009, Y, a calendar year taxpayer, is taxed as a partnership. Y converts into a corporation under a state law formless conversion statute, effective January 1, 2010. As a result of the conversion, Y is classified as a corporation for federal tax purposes. On February 1, 2010, Y files an S election, effective January 1, 2010. Each person who held stock in Y on January 1, 2010 also holds stock at the time the S election is made. The result is the same as above.

Of course, the simplest way would be just to make the S election, by the partnership filing IRS Form 2553.[3346]

Because S corporations can have only a single class of stock,[3347] capital accounts need to be made proportionate to interests in profits and losses before converting to an S corporation.[3348]

II.P.3.d.ii. Transfer of Partnership Assets and Liabilities to a Newly Formed Corporation in Exchange for All of its Stock

If the conversion is not a formless conversion described above, the IRS provides for three scenarios.[3349] In each situation, the steps the partners and partnerships take are parts of a plan to transfer the partnership operations to a corporation organized for valid business reasons in exchange for its stock and were not devices to avoid or evade recognition of gain. Because the federal income tax consequences of the three situations are the same, each partnership is considered to made a nontaxable contribution of its assets and liabilities to a corporation in

[3344] Rev. Rul. 2009-15.
[3345] Reg. § 301.7701-3(g)(3)(i).
[3346] See fn. 321.
[3347] See II.A.2.i Single Class of Stock Rules, for a description of the single class of stock rules and those rules' surprising flexibility.
[3348] See fn 323 in part II.B Limited Liability Company (LLC).
[3349] Rev. Rul. 84-111.

exchange for its stock,[3350] followed by a distribution of the stock to the partners in liquidation of the partnership.[3351]

In the first situation, the partnership transfers all of its assets to newly-formed corporation in exchange for all the outstanding stock of the corporation and the assumption by the corporation of the partnership's liabilities. The partnership then terminates by distributing all the stock of the corporation to the partners in proportion to their partnership interests. The tax results are:

- No gain or loss is recognized by the partnership when it transfers all of its assets to the corporation in exchange for the corporation's stock and the assumption by the corporation of the partnership's liabilities.[3352]

- The corporation's basis in the assets received from the partnership equals their basis to the partnership immediately before their transfer to the corporation.[3353]

- The partnership's basis of the stock received from the corporation is the same as the partnership's basis in the assets transferred to the corporation, reduced by the liabilities assumed by the corporation, which assumption is treated as a payment of money to the partnership.[3354]

- The corporation's assumption of the partnership's liabilities decreases each partner's share of the partnership liabilities, thus, decreasing the basis of each partner's partnership interest.[3355]

- On distribution of the stock to the partners, the partnership terminates.[3356]

- The basis of the stock distributed to the partners in liquidation of their partnership interests is, with respect to each partner, equal to the adjusted basis of the partner's interest in the partnership.[3357]

- The partnership's holding period for the stock received in the exchange includes its holding period in the capital assets and Code § 1231 assets transferred (to the extent that the stock was received in exchange for such assets).[3358]

- To the extent the stock was received in exchange for neither capital nor Code § 1231 assets, the partnership's holding period for such stock begins on the day following the date of the exchange.[3359]

[3350] Code § 351.
[3351] Rev. Rul. 70-239.
[3352] Code § 351.
[3353] Code § 362(a). However, Reg. § 1.362-3 reduces the basis of property acquired in loss importation transaction.
[3354] Code § 358.
[3355] See Code §§ 752 and 733.
[3356] Code § 708(b)(1)(A).
[3357] Code § 732(b),
[3358] Code § 1223(1).
[3359] See Rev. Rul. 70-598.

- The corporation's holding period in the assets transferred to it includes the partnership's holding period.[3360]

- When the partnership distributes the stock to its partners, the partners' holding periods includes the partnership's holding period of the stock.[3361]

In the second situation, the partnership distributes all of its assets and liabilities to its partners in proportion to their partnership interests, terminating the partnership. The partners then transfer all the assets received from the partnership to a new corporation in exchange for all the corporation's outstanding stock and the corporation's assumption of the partnership's liabilities that had been assumed by the partners. The tax results are:

- On the transfer of all of the partnership's assets to its partners:

  - The partnership terminates.[3362]

  - The basis of the assets (other than money) distributed to the partners in liquidation of their partnership interests is, with respect to each partner, equal to the adjusted basis of the partner's interest, reduced by the money distributed.[3363]

- The decrease in the partnership's liabilities resulting from the transfer to its partners was offset by the partners' corresponding assumption of such liabilities, so that the net effect on the basis of each partner's interest in the partnership, with respect to the liabilities transferred, was zero.[3364]

- No gain or loss is recognized by the partnership's former partners when the partnership transfers its assets and liabilities to the corporation in exchange for its stock.[3365]

- The (former) partners' basis in the corporation's stock is the same as their basis in the assets received in the partnership's liquidation and the transfer to the corporation, reduced by the liabilities assumed by the corporation, which assumption is treated as a payment of money to the partners.[3366]

- The corporation's basis in the assets received from the (former) partners equals the (former) partners' basis immediately before the transfer to the corporation.[3367]

- The partners' holding periods for the assets the partnership distributes to them includes the partnership's holding period.[3368]

[3360] Code § 1223(2).
[3361] Code §§ 735(b) and 1223. Furthermore, such distribution will not violate the Code § 368(c) control requirement.
[3362] Code § 708(b)(1)(A).
[3363] Code § 732(b).
[3364] Code § 752.
[3365] Code § 351.
[3366] Code §§ 358(a) and 732(b).
[3367] Code §§ 362(a) and 732(c). However, Reg. § 1.362-3 reduces the basis of property acquired in loss importation transaction.
[3368] Code § 735(b).

- The partners' holding periods for the stock received in the exchange includes the partners' holding periods in the capital assets and Code § 1231 assets transferred to the corporation (to the extent that the stock was received in exchange for such assets).[3369]

- However, to the extent that the stock received was in exchange for neither capital nor Code § 1231 assets, the holding period of the stock begins on the day following the date of the exchange.

- The corporation's holding period of the partnership's assets received in the exchange includes the partners' holding periods.[3370]

In the third situation, the partners transfer their partnership interests to a newly-formed corporation in exchange for all the corporation's outstanding stock. This exchange terminates the partnership, and all of its assets and liabilities became assets and liabilities of the corporation. The tax result is:

- No gain or loss is recognized by the partners on the transfer of the partnership interests to the corporation in exchange for the corporation's stock.[3371]

- When the transfer partners transfer their partnership interests to the corporation, the partnership terminates.[3372]

- The partners' basis of the stock received from the corporation in exchange for their partnership interests equals the basis of their partnership interests transferred to the corporation, reduced by the partnership's liabilities assumed by the corporation, the release from which is treated as a payment of money to the partners.[3373]

- The corporation's basis for the assets received in the exchange equals the basis of the partners in their partnership interests.[3374]

- The corporation's holding period includes the partnership's holding period in the assets.

- The holding period of the stock received by the former partners includes each respective partner's holding period for the partnership interest transferred,[3375] except that the holding period of the stock that was received by the partners in exchange for their interests in any unrealized receivables, inventory, or various depreciable or amortizable assets of the partnership that are neither capital assets nor Code § 1231 assets begins on the day following the date of the exchange.

II.P.3.e. Conversion from S corporation to C Corporation

Before discussing the consequences of such a conversion, consider forming an S corporation parent before converting an S corporation directly into a C corporation, for the reasons described

---

3369 Code § section 1223(1).
3370 Code § 1223(2).
3371 Code § 351.
3372 Code § 708(b)(1)(A).
3373 Code §§ 358 and 752(d).
3374 Allocated under Code § 732(c).
3375 Code § 1223(1).

in fns 3332-3338 in part II.P.3.c.v Conversion from S corporation to C Corporation then Back to S corporation.

See part II.A.2.k Terminating an S Election, which includes the fact that conversion from S status to C status requires an additional tax return if done mid-year and precludes an S election for 5 years.

Converting from an S corporation to a C corporation may require the corporation to switch from the cash receipts and disbursements method of accounting to the accrual method. Generally, a C corporation cannot use the cash method,[3376] unless the corporation conducts a qualified farming business,[3377] is a qualified personal service corporation,[3378] or has gross receipts that are no more than $25 million (after 2018 adjusted for inflation).[3379]

If a corporation was an S corporation on or before December 21, 2017, during the 2-year period beginning on December 22, 2017 revokes its S election, and the owners of the stock of which, determined on the date the revocation is made, are the same owners (and in identical proportions) as on December 22, 2017 (an "eligible terminated S corporation"), then any adjustment required by a change in accounting method under Code § 481(a)(2) which is attributable to that revocation is taken into account ratably during the 6-taxable year period beginning with the year of change.[3380] A taxpayer may also apply this rule if is not required to change from cash to accrual but does anyway.[3381]

[3376] Code § 448(a)(1).

[3377] Code § 448(d)(1), "Farming business," provides that a "qualified personal service corporation" is any corporation:

(A) *In general*. The term "farming business" means the trade or business of farming (within the meaning of section 263A(e)(4)).

(B) *Timber and ornamental trees*. The term "farming business" includes the raising, harvesting, or growing of trees to which section 263A(c)(5) applies.

[3378] Code § 448(d)(2), "Qualified personal service corporation," provides:

(A) substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and

(B) substantially all of the stock of which (by value) is held directly (or indirectly through 1 or more partnerships, S corporations, or qualified personal service corporations not described in paragraph (2) or (3) of subsection (a)) by-

   (i) employees performing services for such corporation in connection with the activities involving a field referred to in subparagraph (A),

   (ii) retired employees who had performed such services for such corporation,

   (iii) the estate of any individual described in clause (i) or (ii), or

   (iv) any other person who acquired such stock by reason of the death of an individual described in clause (i) or (ii) (but only for the 2-year period beginning on the date of the death of such individual).

To the extent provided in regulations which shall be prescribed by the Secretary, indirect holdings through a trust shall be taken into account under subparagraph (B).

[3379] Code § 448(b), (c).

[3380] Code § 481(d).

[3381] Rev. Proc. 2018-44, modifying Rev. Proc. 2018-31, § 15.01(3).

Note that S corporation earnings might be extracted in cash tax-free in the first C corporation taxable period after the final S corporation yearend.[3382] Converting the corporation into a QSub before converting it to a C corporation might also be used to preserve the AAA of a corporation whose S election is revoked.[3383]

Additionally, after that first C Corporation taxable period, an eligible terminated S corporation's distribution is chargeable to accumulated earnings and profits, in the same ratio as the amount of such AAA bears to the amount of such accumulated earnings and profits.[3384]

II.P.3.f. Conversion from Qualified Subchapter S Subsidiary to Single Member LLC

The merger of a Qualified Subchapter S Subsidiary ("QSub") into an LLC wholly owned by the QSub's parent has no income tax consequences.[3385]

II.P.3.g. Conversions from Partnership to Sole Proprietorships and Vice Versa

When a sole proprietorship organized as an LLC adds a member, it becomes a partnership. If the original member sells part his or her interest in the LLC to a new member, then he or she is deemed to have sold a corresponding portion of the LLC's assets to the new member,[3386] as follows:[3387]

> In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.
>
> Under section 1001, A recognizes gain or loss from the deemed sale of the 50% interest in each asset of the LLC to B.
>
> Under section 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.
>
> Under section 722, B's basis in the partnership interest is equal to $5,000, the amount paid by B to A for the assets which B is deemed to contribute to the newly-created

[3382] See fn. 3331, found in part II.P.3.c.v Conversion from S corporation to C Corporation then Back to S corporation.
[3383] See part II.P.3.c.v Conversion from S corporation to C Corporation then Back to S corporation, especially fns. 3332-3334.
[3384] Code § 1371(f).
[3385] Reg. § 1.1361-5(b)(3), Example (2). See fn. 138 for details.
[3386] See T.D. 8844 (preamble to regulations on entity conversions) (11/29/99) and Rev. Rul. 99-5. See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. See also The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations *TM Memorandum* (BNA) (3/16/2009), and AICPA Comments to IRS on Rev. Rul. 99-5 on Disregarded Entities (6/5/2013), found at http://www.aicpa.org/advocacy/tax/partnerships/downloadabledocuments/comments-on-rev-ruling-99-5-v-6-5-13submit.pdf.
[3387] Rev. Rul. 99-5, Situation 1.

partnership. A's basis in the partnership interest is equal to A's basis in A's 50% share of the assets of the LLC.

Under section 723, the basis of the property treated as contributed to the partnership by A and B is the adjusted basis of that property in A's and B's hands immediately after the deemed sale.

Under section 1223(1), A's holding period for the partnership interest received includes A's holding period in the capital assets and property described in section 1231 held by the LLC when it converted from an entity that was disregarded as an entity separate from A to a partnership. B's holding period for the partnership interest begins on the day following the date of B's purchase of the LLC interest from A. See Rev. Rul. 66-7, 1966-1 C.B. 188, which provides that the holding period of a purchased asset is computed by excluding the date on which the asset is acquired. Under section 1223(2), the partnership's holding period for the assets deemed transferred to it includes A's and B's holding periods for such assets.

However, if the new member pays the LLC for a member interest, then the old and new member are deemed to have formed a partnership, which generally qualifies as a nontaxable transaction,[3388] as follows:[3389]

In this situation, the LLC is converted from an entity that is disregarded as an entity separate from its owner to a partnership when a new member, B, contributes cash to the LLC. B's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest.

Under section 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.

Under section 722, B's basis in the partnership interest is equal to $10,000, the amount of cash contributed to the partnership. A's basis in the partnership interest is equal to A's basis in the assets of the LLC which A was treated as contributing to the newly-created partnership.

Under section 723, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A's hands. The basis of the property contributed to the partnership by B is $10,000, the amount of cash contributed to the partnership.

Under section 1223(1), A's holding period for the partnership interest received includes A's holding period in the capital and section 1231 assets deemed contributed when the

[3388] See T.D. 8844 (preamble to regulations on entity conversions) (11/29/99), Rev. Rul. 99-5, and part II.M.3 Buying into or Forming a Partnership (especially part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership). See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. Letter Ruling 200633019 discusses a large variety of tax issues when a trust contributes a diversified portfolio of marketable securities to a single-member LLC and then distributes LLC interests to the remaindermen; Letter Ruling 201628008 includes a more abbreviated discussion of such a transaction. See also The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations 201351018 (BNA) (3/16/2009).

[3389] Rev. Rul. 99-5, Situation 2.

> disregarded entity converted to a partnership. B's holding period for the partnership interest begins on the day following the date of B's contribution of money to the LLC. Under section 1223(2), the partnership's holding period for the assets transferred to it includes A's holding period.

Thus, the parties can control whether the original owner is taxed and the new owner gets an inside basis step-up, or the original owner is not taxed and the new owner does not get an inside basis step-up.[3390] However, the parties can have their cake and eat it, too: in the latter case, the new owner can transfer the partnership interest to another partnership (or corporation) in a tax-free transaction and get an inside basis step-up.[3391]

When an LLC with more than one member is taxed as a partnership, and the number of members later is reduced to one, it becomes a sole proprietorship for tax purposes. When one member buys out the other(s), the selling member(s) is(are) taxed based on the rules for selling a partnership interest, and the remaining member (essentially the new sole proprietor) is deemed to have bought all of the LLC's assets on that date, with no tacking of holding period for any portion of the assets.[3392] Furthermore, payments that would have been deductible by a partnership had it continued in existence are deductible by the successors to the partnership.[3393]

Pierre v. Commissioner[3394] was a reviewed opinion holding that gifts and sales of interests in a single-member limited liability company (LLC) be treated for gift tax purposes as transfers of interests in an entity rather than transfers of the underlying assets.

Initially, the transferor was the LLC's sole owner. Some LLC interests were gifted, and the rest were sold. The IRS asserted that the transfers were of the LLC's underlying assets, not interests in the LLC. It tried to apply the principles of Rev. Rul. 99-5, Situation 1, which provides:

> In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes.

[3390] See part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue.

[3391] See parts II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss), II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000 and II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

[3392] Rev. Rul. 99-6; see also part II.Q.8 Exiting From or Dividing a Partnership; see Letter Ruling 201723009 when such a transaction is done inside a consolidated group. See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. See also "The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations," *TM Memorandum* (BNA) (3/16/2009). For a myriad of tax issues raised in this situation, criticizing Rev. Rul. 99-6, see AICPA Comments on Revenue Ruling 99-6 on Conversions from Partnerships to Disregarded Entities (10/1/2013), found at http://www.aicpa.org/advocacy/tax/partnerships/downloadabledocuments/comments-on-rev-ruling-99-6-submit.pdf. The AICPA points to very different results when a purchaser buys 99% instead of 100%.

[3393] Rev. Rul. 75-154.

[3394] 133 T.C. 24 (2009) (http://www.ustaxcourt.gov/InOpHistoric/Pierre.TC.WPD.pdf). For income tax treatment of a gift of the entire interest in a single member LLC, see fn. 305.

Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

The Tax Court majority rejected the application of the check-the-box rules[3395] to this gift. Those provisions apply only "where not otherwise distinctly expressed or manifestly incompatible with the intent" of other provisions in the tax law.[3396] Fundamental gift tax precepts require that one look to the bundle of rights transferred.[3397] The Tax Court held that, under state law, an LLC interest (not an interest in the underlying assets) was transferred; applying the check-the-box regulations would be manifestly incompatible with fundamental gift tax precepts.[3398]

The court distinguished between classifying the entity and describing the nature of the assets that were transferred. This fine line might breed litigation in the transfer tax area.

II.P.3.h. Rescissions, Including Rescinding Conversion of Entity

The IRS often respects rescissions for income tax purposes[3399] when a transaction is reversed in the same taxable year. The IRS explains:[3400]

[3395] Reg. §§ 301.7701-1 through 301.7701-3.

[3396] Code § 7701(a) (introductory language).

[3397] The court reasoned:

> The multistep process of determining the nature and amount of a gift and the resulting gift tax under the Federal gift tax provisions described above, i.e., (1) the determination under State law of the property interest that the donor transferred, (2) the determination of the fair market value of the transferred property interest and the amount of the transfer to be taxed, and (3) the calculation of the Federal gift tax due on the transfer, is longstanding and well established. Neither the check-the-box regulations nor the cases cited by respondent support or compel a conclusion that the existence of an entity validly formed under applicable State law must be ignored in determining how the transfer of a property interest in that entity is taxed under Federal gift tax provisions.

[3398] The court held:

> We note that Congress has enacted provisions of the Internal Revenue Code, see secs. 2701, 2703, that disregard valid State law restrictions in valuing transfers. Where Congress has determined that the willing buyer, willing seller and other valuation rules are inadequate, it expressly has provided exceptions to address valuation abuses. See chapter 14 of the Internal Revenue Code, sections 2701 through 2704, which specifically are designed to override the standard willing buyer, willing seller assumptions in certain transactions involving family members.
>
> By contrast, Congress has not acted to eliminate entity related discounts in the case of LLCs or other entities generally or in the case of a single-member LLC specifically. In the absence of such explicit congressional action and in the light of the prohibition in section 7701, the Commissioner cannot by regulation overrule the historical Federal gift tax valuation regime contained in the Internal Revenue Code and substantial and well-established precedent in the Supreme Court, the Courts of Appeals, and this Court, and we reject respondent's position in the instant case advocating an interpretation that would do so. Accordingly, we hold that petitioner's transfers to the trusts should be valued for Federal gift tax purposes as transfers of interests in Pierre LLC and not as transfers of a proportionate share of the underlying assets of Pierre LLC.

[3399] The IRS does not have a clear policy for estate and gift tax law. However, *Neal v. U.S.*, 187 F.3d 626 (3rd Cir. 1999) allowed a rescission under Pennsylvania law and considered the gift incomplete because of it.

[3400] Rev. Rul. 80-58. Although the ruling is old, it is still viable. Rev. Proc. 2013-3, Section 5.02(1) indicated that the IRS was considering its position in the rescission area. Rev. Proc. 2014-3, Section 1.02(6) mentioned that Section 5.02(1) was deleted and that Section 3.02(8) was added, the latter providing that whether a completed transaction can be rescinded for Federal income tax purposes is an issue on which

> The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.
>
> The annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. That is, each taxable year is a separate unit for tax accounting purposes…..
>
> In Situation 1 the rescission of the sale … placed A and B at the end of the taxable year in the same positions as they were prior to the sale. Thus, … the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction…..
>
> In Situation 2, as in Situation 1, there was a completed sale in 1978. However, unlike Situation 1, because only the sale and not the rescission occurred in 1978, at the end of 1978 A and B were not in the same positions as they were prior to the sale….[T]he rescission in 1979 is disregarded with respect to the taxable events occurring in 1978.
>
> In both situations, the annual accounting period principle requires the determination of income at the close of the taxable year without regard to subsequent events.

Gateway Hotel Partners, LLC v. Commissioner[3401] upheld the requirement that the transaction cannot qualify for rescission unless undone by the end of the taxable year. *Blagaich v. Commissioner*[3402] also refused to apply rescission to a payment that the taxpayer returned over

---

the IRS will not issue a private letter ruling. At the May 2014 meeting of the Sales, Exchanges & Basis Committee of the American Bar Association's Section of Taxation, a government representative informally stated that withdrawing its study of the area indicates that the IRS has reaffirmed its commitment to Rev. Rul. 80-58. Materials for that meeting prepared by Section practitioner members are saved as Thompson Coburn document 6044351. For more on Rev. Rul. 80-58, see New York State Bar Association Tax Section Report on the Rescission Doctrine (Report No. 1216) (8/11/2010) at www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1216-Report.pdf, citing Sheldon I. Banoff, Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud, *Taxes – The Tax Magazine* (Dec. 1984) at 942; and David H. Schnabel, Revisionist History: Retroactive Federal Tax Planning (2009) (unpublished manuscript), mentioning that an earlier version is published at 60 *Tax Lawyer* 685 (2007).

[3401] T.C. Memo. 2014-5.

[3402] T.C. Memo. 2016-2, holding:

> … In general, the annual accounting period principle reflected in section 451, considered in the light of the judicially articulated claim-of-right doctrine, limits application of the rescission exception such that, without regard to subsequent events, income received by the taxpayer under a claim of right and retained by her at the close of the taxable year must be included in gross income for that year. See [*Penn v. Robertson*, 115 F.2d 167, 175 (4th Cir. 1940)]; Rev. Rul. 80-58, Situation 2, 1980-1 C.B. at 182.
>
> ….
>
> The facts show that, in 2010, petitioner took possession of the whole amount in question, $400,000, without any substantial limitations or restrictions as to its disposition. She recognized no liability and made no provision to repay that amount until nearly three years later. None of the cases

three years later after payment, when she did so only after being order by a court to do so. However, in another case, a taxpayer was permitted to rescind a disclaimer based on erroneous tax advice, more than two years after the disclaimer, after joining the IRS as a party to a legal action to rescind.[3403]

The IRS approved a rescission of a conversion from partnership to corporation where everything happened in one year and the taxpayer had a good nontax reason.[3404] The IRS has also allowed a taxpayer to rescind a restructuring involving a subsidiary to reverse unintended adverse Federal income tax consequences.[3405] However, the IRS will not issue any more letter rulings in this area.[3406]

A taxpayer cannot unilaterally recast a transaction merely because the taxpayer decides that documenting it differently would have produced a better tax result.[3407]

> petitioner cites as allowing a relaxation of the same-year requirement for rescission is factually comparable to her own, and they provide no rationale for departing from the general rule.
>
> With respect to the equitable concerns petitioner raised in her motion—The equities in this case simply do not support strict adherence to the one-year guideline in the rescission doctrine.—we note only that our statutory mandate does not permit us to decide this case on the basis of general principles of equity. See *Knapp v. Commissioner*, 90 T.C. 430, 440 (1988) (citations omitted) (The Tax Court is a court of limited jurisdiction. *** We have only the powers expressly conferred on us by Congress, and may not apply equitable principles to expand our jurisdiction beyond the limits of section 7442.), *aff'd*, 867 F.2d 749 (2d Cir. 1989).

The court rejected the taxpayer's reliance on *Hope v. Commissioner*, 55 T.C. 1020, 1030 (1971), *aff'd*, 471 F.2d 738 (3d Cir. 1973), which the court said:

> suggests that the rescission doctrine may apply even when repayment of a gain does not formally occur in the year of receipt, but only if, before the end of the year, [the] taxpayer recognizes his liability under an existing and fixed obligation to repay the amount received and makes provisions for repayment.

The court rejected the taxpayer's reliance on *Guffey v. United States*, 339 F.2d 759 (9th Cir. 1964), which case the court described:

> In *Guffey*, the installment purchasers of the Guffeys' home sued to rescind the sale contract when, in the following year, they discovered dry rot, moved out, and refused to make further payments. A settlement was reached under which the purchasers' suit was dismissed and the Guffeys obtained a quitclaim deed and retained the previously received payments as rent.…While the Court of Appeals did state that it can fairly be said that the settlement with the *** original purchasers was, in substance, a reduction in the purchase price, *id.*, the Guffeys returned nothing to the original purchasers, the original purchasers apparently agreeing that the payments could be kept as rent. The sort of passive unwinding of the agreement that occurred in *Guffey* did not and could not occur in the case at bar; the only way Mr. Burns could be restored to status quo ante was if petitioner returned the $400,000.

[3403] *Breakiron v. Gudonis*, 106 A.F.T.R.2d 2010-5999 (D. Mass. 2010). The IRS was joined as a party when it attempted to collect gift tax. In another disclaimer case, the court dismissed the IRS as a party. *Van Vliet v. Van Vliet*, 115 A.F.T.R.2d 2015-803 (E.D. Va. 2015).

[3404] Letter Ruling 200952036.

[3405] Letter Ruling 201008033.

[3406] Rev. Proc. 2017-3, Section 3.02(8), listed as a no-rule area "whether a completed transaction can be rescinded for Federal income tax purposes."

[3407] *Makric Enterprises, Inc. v. Commissioner*, TC Memo 2016-44, 119 A.F.T.R.2d ¶ 2017-580 (5th Cir. 3/27/2017).

For the rescission to be effective, both parties must be put back in their original positions.[3408] A January 2005 article further analyzes the rescission doctrine.[3409]

An S election may be rescinded until the last day on which the election could have been timely made.[3410] The IRS will not permit a revocation that is more retroactive than that.[3411] A corporation may rescind such a revocation at any time before the revocation becomes effective, but only with the consent of each person who consented to the revocation and each person who became a shareholder of the corporation within the period beginning on the first day after the date the revocation was made and ending on the date on which the rescission is made.[3412]

II.P.3.i. Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization

When transferring a corporation's business to a new partnership, consider doing the following:

1. The shareholders form a new corporation with ownership identical to the old corporation's ownership.

2. The old corporation converts or is merged into a limited liability company that is a disregarded entity.

3. Either the new corporation then transfers its member interest in the LLC to a limited partnership, or the LLC itself admits one or more additional members to convert the LLC to an entity taxed as a partnership.

To qualify as an F reorganization[3413] nontaxable for federal income tax purposes (always check state income tax rules), this or any other transaction must result in a mere change in identity,

---

[3408] Citing *Hutcheson v. Commissioner*, T.C. Memo. 1996-127 for that proposition, *Fitch v. Commissioner*, T.C. Memo. 2012-358, rebuffed IRS arguments in favor of rescinding a sale of a CPA practice, which was followed by a repurchase shortly thereafter when the original buyer's health deteriorated unexpectedly:

> The repurchase agreement, by its own terms, effected a sale of the C.P.A. practice from Mr. Gronke to Mr. Fitch and not an unwinding of the earlier sale. There is no evidence that Mr. Fitch and Mr. Gronke intended to abrogate, cancel, or void the sale agreement. Furthermore, we do not believe that the repurchase agreement returned them to their original positions. The C.P.A. practice continued as a dynamic, ongoing enterprise for approximately 4-1/2 months after the sale transaction, and we cannot say that Mr. Fitch received the C.P.A. practice back in the exact same condition in which he had sold it. Accordingly, we find that the sale and repurchase transactions were not rescinded.

Query whether the court was just being sympathetic to the seriously ill parties and really would set such a high bar if the taxpayers had sought to rescind the agreement.

[3409] Morehouse, The Rescission Doctrine: Tax Do-Overs, Another Roll Of the Dice, *TM Real Estate Journal* (BNA) (1/7/2015).

[3410] Reg. § 1.1362-2(a)(2)(i).

[3411] Christian & Grant, ¶32.02. Revocation, *Subchapter S Taxation* (WG&L), cites varies IRS correspondence to that effect.

[3412] Reg. § 1.1362-2(a)(4).

[3413] Code § 368(a)(1)(F).

form, or place of organization of one corporation.[3414] A transaction involving an actual or deemed transfer is a mere change only if:

- Immediately after the reorganization, all the stock of the resulting corporation, including any stock of the resulting corporation issued before the reorganization, must have been distributed (or deemed distributed) in exchange for stock of the transferor corporation;[3415]

- The same person or persons must own all of the stock of the transferor corporation, determined immediately before the reorganization, and of the resulting corporation, determined immediately after the reorganization, in identical proportions;[3416]

- The resulting corporation does not hold any property or have any tax attributes[3417] immediately before the reorganization;[3418]

- The transferring corporation completely liquidates, for federal income tax purposes, in the reorganization;[3419]

- Immediately after the reorganization, no corporation other than the resulting corporation holds property that was held by the transferor corporation immediately before the reorganization, if such other corporation would, as a result, succeed to and take into account the items of the transferor corporation described in Code § 381(c);[3420] and

- Immediately after the reorganization, the resulting corporation does not hold property acquired from a corporation other than the transferor corporation if the resulting corporation would, as

---

[3414] Reg. § 1.368-2(m)(1). For an analysis of the background to this regulation and its impact, see Kliegman and Chen, Some Ado About a Nothing: Final F Reorganization Regulations, *TM Memorandum* (BNA) (4/4/2016). The article suggests that Rev. Rul. 68-349 appears to violate the requirements of the text accompanying fns. 3415-3416; it has been suggested that informal comments at the January 2016 meeting of the American Bar Association's Section of Taxation indicate that the government might not have considered the regulations' impact on that ruling.

[3415] However, a de minimis amount of stock issued by the resulting corporation other than in respect of stock of the transferor corporation to facilitate the organization of the resulting corporation or maintain its legal existence is disregarded. Reg. § 1.368-2(m)(1)(i).

[3416] However, this requirement is not violated if one or more holders of stock in the transferor corporation exchange stock in the transferor corporation for stock of equivalent value in the resulting corporation, but having different terms from those of the stock in the transferor corporation, or receive a distribution of money or other property from either the transferor corporation or the resulting corporation, whether or not in exchange for stock in the transferor corporation or the resulting corporation. Reg. § 1.368-2(m)(1)(ii).

[3417] Including those specified in Code § 381(c).

[3418] However, this requirement is not violated if the resulting corporation holds or has held a de minimis amount of assets to facilitate its organization or maintain its legal existence, and has tax attributes related to holding those assets, or holds the proceeds of borrowings undertaken in connection with the potential F reorganization. Reg. § 1.368-2(m)(1)(iii).

[3419] However, the transferor corporation is not required to dissolve under applicable law and may retain a de minimis amount of assets for the sole purpose of preserving its legal existence. Reg. § 1.368-2(m)(1)(iv).

[3420] Reg. § 1.368-2(m)(1)(v). The preamble, T.D. 9739, explains:

> Thus, a transaction that divides the property or tax attributes of a Transferor Corporation between or among acquiring corporations, or that leads to potential competing claims to such tax attributes, will not qualify as a Mere Change.

a result, succeed to and take into account the items of such other corporation described in Code § 381(c).[3421]

The last two bullet points emphasize that tax attributes cannot change in an F reorganization.[3422] Thus, when a corporation engages in an F reorganization, the part of the tax year before the reorganization and the part after constitute a single tax year,[3423] and the resulting corporation must file a single full-year return; however, if the old corporation was domestic and the new one is foreign, the F reorganization does close the tax year.[3424] In a purely domestic F reorganization, the new corporation's filing a tax return runs the statute of limitations for the old corporation's activity that was reported on the new corporation's return.[3425]

Continuity of the business enterprise and a continuity of interest are not required to qualify as an F reorganization.[3426]

Subject to certain limitations, an F reorganization might consist of a series of related transactions that together result in a mere change of one corporation.[3427]

[3421] Reg. § 1.368-2(m)(1)(vi). The preamble, T.D. 9739, explains:

> Thus, a transaction that involves simultaneous acquisitions of property and tax attributes from multiple transferor corporations (such as the transaction described in Rev. Rul. 58-422, 1958-2 CB 145) will not qualify as a Mere Change.

[3422] The preamble, T.D. 9739, says:

> From a federal income tax perspective, F reorganizations are generally neutral, involving no change in ownership or assets, no end to the taxable year, and inheritance of the tax attributes described in section 381(c) without a limitation on the carryback of losses. See, for example, Rev. Rul. 96-29 (discussed in section 3.B.ii. of the Background); § 1.381(b)-1(a)(2).

[3423] Reg. § 1.381(b)-1(a)(2) provides:

> *Reorganizations under section 368(a)(1)(F)*. In the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the acquiring corporation shall be treated (for purposes of section 381) just as the transferor corporation would have been treated if there had been no reorganization. Thus, the taxable year of the transferor corporation shall not end on the date of transfer merely because of the transfer; a net operating loss of the acquiring corporation for any taxable year ending after the date of transfer shall be carried back in accordance with section 172(b) in computing the taxable income of the transferor corporation for a taxable year ending before the date of transfer; and the tax attributes of the transferor corporation enumerated in section 381(c) shall be taken into account by the acquiring corporation as if there had been no reorganization.

[3424] Reg. § 1.367(a)-1(e).

[3425] *New Capital Fire, Inc. v. Commissioner*, T.C. Memo. 2017-177, rejecting the IRS' contention that failing to file a return for the old corporation kept the statute of limitations open. The new corporation's return properly disclosed the F reorganization. The court held:

> New Capital's 2002 return purported to and did include Old Capital's income from January 1 through December 4, 2002. Respondent has not alleged, and we do not find, that New Capital's 2002 return was false or fraudulent with intent to evade tax as it pertains to Old Capital. It was respondent's duty to determine, within the period of limitations provided by section 6501(a), whether New Capital's 2002 return, as it pertains to Old Capital, was erroneous in any respect. The exception under section 6501(c)(3) does not apply. Accordingly, assessment of the determined deficiency and additions to tax is barred by the statute of limitations.

[3426] Reg. § 1.368-2(m)(2).

[3427] Reg. § 1.368-2(m)(3), which provides:

> *Series of transactions*. A potential F reorganization consisting of a series of related transactions that together result in a mere change of one corporation may qualify as a reorganization under

It has been suggested that substantive changes of ownership that were not allowed before these regulations are now allowed:[3428]

- Exchanging stock for stock of equivalent value but with different terms, or

- Either the old or new corporations distributing cash or other property.

Sometimes a conversion generally involves a direct or indirect merger of a corporation into an unincorporated entity taxed as a corporation.[3429] For example, an LLC that is taxed as an

---

> section 368(a)(1)(F), whether or not certain steps in the series, viewed in isolation, could be subject to other Code provisions, such as sections 304(a), 331, 332, or 351. However, see paragraph (k) of this section for transactions that qualify as reorganizations under section 368(a) and will not be recharacterized as a mere change as a result of one or more subsequent transfers of assets or stock.

The preamble, T.D. 9739, explains:

> In some cases, business or legal considerations may require extra steps to complete a transaction that is intended to qualify as a Mere Change. As discussed in section 3.B.i. of the Background, the Treasury Department and the IRS concluded that the words however effected in the statutory definition of F reorganization reflect a Congressional intent to treat a series of transactions that together result in a Mere Change as an F reorganization, even if the transfer (or deemed transfer) of property from the Transferor Corporation to the Resulting Corporation occurs indirectly. The Final Regulations confirm this conclusion by providing that a Potential F Reorganization consisting of a series of related transactions that together result in a Mere Change may qualify as an F reorganization, whether or not certain steps in the series, viewed in isolation, might, for example, be treated as a redemption under section 304(a), as a complete liquidation under section 331 or section 332, or as a transfer of property under section 351. For example, the first step in an F reorganization of a corporation owned by individual shareholders could be a dissolution of the Transferor Corporation, so long as this step is followed by a transfer of all the assets of the Transferor Corporation to a Resulting Corporation. However, see § 1.368-2(k) for completed reorganizations that will not be recharacterized as a Mere Change as a result of one or more subsequent transfers of assets or stock, such as where a Transferor Corporation transfers all of its assets to its parent corporation in liquidation, followed by the parent corporation's retransfer of those assets to a new corporation. See also Rev. Rul. 69-617, 1969-2 CB 57 (an upstream merger followed by a contribution of all the target assets to a new subsidiary corporation is a reorganization under sections 368(a)(1)(A) and 368(a)(2)(C)).

The preamble further discussed such a reorganization's role in a larger transaction:

> As discussed in section 3.B.ii. of the Background, the Treasury Department and the IRS recognized that an F reorganization may be a step, or a series of steps, before, within, or after other transactions that effect more than a Mere Change, even if the Resulting Corporation has only a transitory existence following the Mere Change. In some cases an F reorganization sets the stage for later transactions by alleviating non-tax impediments to a transfer of assets. In other cases, prior transactions may tailor the assets and shareholders of the Transferor Corporation before the commencement of the F reorganization. Although an F reorganization may facilitate another transaction that is part of the same plan, the Treasury Department and the IRS have concluded that
>
> step transaction principles generally should not recharacterize F reorganizations because F reorganizations involve only one corporation and do not resemble sales of assets.

[3428] McMahon, Recent Developments in Federal Income Taxation of Corporations and Partnerships, 64th Annual Montana Tax Institute (10/14/2016).

[3429] A direct approach is found Reg. § 1.368-2(m)(4), Example (8), and the logistics are explained in Letter Ruling 200839017. See Riser, Hiding Your Stuff in Plain Sight (Without Trusts): Dr. FUnbundle (or How I Learned to Stop Worrying and Love Sec. 368(a)(1)(F)), American Bar Association Section of Real Property, Trust & Estate Law, 2009 Spring Symposia, discussing Letter Ruling 200701017. See also Rev. Ruls. 64-

S corporation can move assets comprising one line of business into a new parent LLC taxed as an S corporation that assumes its tax attributes and then under Code § 355 distribute assets comprising another line of business into another LLC taxed as an S corporation.[3430] Generally, for an S corporation, I recommend that the LLC file a new Form 2553, election to be taxed as an S corporation, which converts the LLC to a corporation and makes an S election at the same

---

250, 73-256, and 2008-18 and Letter Rulings 200528021, 200622025, and 200719005. See also Kalinka, Transfer of an Interest in an LLC Taxed As an S corporation Raises Many Questions, p. 23 *Taxes-The Tax Magazine* (October 2007); Christian & Grant, ¶29.07. 'F' Reorganizations, *Subchapter S Taxation* (WG&L); and Gassman, Crotty, and O'Leary, The Estate Planner's Guide to New Parent F Reorganizations, *Estate Planning Journal* (WG&L), May 2008. These issues were discussed at the Asset Protection Committee Meeting of the American College of Trust & Estate Counsel (ACTEC) in the Fall of 2009, which included some practical materials for LLCs taxed as S corporations that are available to ACTEC Fellows. For whether a new employer identification number (IRS tax ID) is needed, see Rev. Rul. 2008-18 and part II.P.3.a Need for New Tax ID. Although Rev. Rul. 2008-18 says that the new entity retains the new entity's S election, I had suggested that the new entity file IRS Form 2553. However, Form 8869, line 14 asks, "Is this election being made in combination with a section 368(a)(1)(F) reorganization described in Rev. Rul. 2008-18, where the subsidiary was an S corporation immediately before the election and a newly formed holding company will be the subsidiary's parent?" and provides the following instructions:

> This box should be checked "Yes" if this election is being made pursuant to a reorganization under section 368(a)(1)(F) and Rev. Rul. 2008-18. This occurs when a newly formed parent holding company holds the stock of the subsidiary that was an S corporation immediately before the transaction and the transaction otherwise qualifies as a reorganization under section 368(a)(1)(F). No Form 2553, Election by a Small Business Corporation, is required to be filed by the parent. See Rev. Rul. 2008-18, 2008-13 I.R.B. 674, for details.

Letter Ruling 199947034, found in fn. 6157, ruled that Code § 2701 did not apply to such a reorganization. See fn. 321 in part II.B Limited Liability Company (LLC) if the new entity is an LLC electing taxation as an S corporation and fn. 180 in part II.A.2.g Qualified Subchapter S Subsidiary (QSub) regarding the timing of an LLC electing S corporation status before acquiring a QSub.

[3430] Letter Ruling 201638004. The facts were:

(1) The X members will contribute all of their X equity units to Y, a newly formed-State X limited liability company, in exchange for all of the Y equity units.
(2) X will elect to become, or by default will become, a disregarded entity or qualified subchapter S subsidiary for Federal tax purposes. After this step, Y expects to continue X's S corporation election.
(3) X will distribute the assets comprising the Retained Business to Y in a transaction that it expects to be disregarded for Federal income tax purposes. After this step, X would continue to hold the assets comprising the Distributed Business.
(4) Y will transfer all of the equity units of X to Z, a newly-formed State X limited liability company, solely in exchange for all of the Z equity units. After this step, Z will hold only the equity units in X, which continues to hold the assets comprising the Distributed Business.
(5) Y will distribute pro rata all of the equity units of Z to Y's members in a transaction intended to qualify under section 355 of the Internal Revenue Code (the Distribution).

After reciting various representations, the ruling held:

(1) For purposes of determining whether Steps 1 and 2, viewed together, result in the realization of gain or loss under section 1001 (see *Weiss v. Stearn*, 265 U.S. 242 (1924)), or a reorganization under section 368(a)(1)(F) (see Rev. Rul. 72-206, 1972-1 C.B. 104), Steps 3 through 5 shall be disregarded.
(2) For U.S. Federal income tax purposes, Steps 3 through 5 will be treated as a direct transfer of the Distributed Business by Y to Z in exchange for all of the equity units of Z and the assumption of associated liabilities, followed by the pro rata distribution by Y of all of the equity units of Z to Y's members.
(3) X's S election will not terminate as a result of the completion of Steps 1 and 2, but continues for Y.

time;[3431] however, when an existing S corporation passes its S corporation tax attributes to a new parent through a Code § 368(a)(1)(F) reorganization in which the old corporation becomes a qualified subchapter S subsidiary (QSub), only a QSub election is made, which results in the parent becoming an S corporation, as described in fn 3429.

Consider a different approach when the corporation has sold all of its business assets. See part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale.

II.Q.7.a.vi. Redemptions and Accumulated Earnings Tax

Generally, a C corporation that accumulates funds could also be subject to the 20% accumulated earnings tax.[4008] The tax applies to every corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed,"[4009] except:[4010]

(1) a personal holding company (as defined in section 542),

(2) a corporation exempt from tax under subchapter F (section 501 and following), or

(3) a passive foreign investment company (as defined in section 1297).

Thus, it complements the personal holding company tax, which is also designed to force C corporations to declare dividends. See part II.A.1.e Personal Holding Company Tax.

The tax is on "accumulated taxable income."[4011] "Accumulated taxable income" means the adjusted taxable income,[4012] minus the sum of the dividends paid deduction[4013] and the accumulated earnings credit.[4014]

The accumulated earnings credit works as follows:

- "If the corporation is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which $250,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year."[4015]

- Otherwise, the accumulated earnings credit is equal to such part of the earnings and profits for the taxable year as are retained for the business' reasonable needs, minus a certain

[3431] See fn. 321 and the accompanying and following text. Also consider what happens if there is some defect in Form 2553 that might make its filing invalid. Is converting into a partnership or a C corporation the lesser of two evils? If the latter, consider filing Form 8832 before Form 2553.
[4008] Code § 531.
[4009] Code § § 532(a).
[4010] Code § § 532(b).
[4011] Code § 531.
[4012] Code § 535(b) adjusts taxable income, including to deduct federal income and certain other taxes, deduct charitable contributions with modifications, disallow the dividends-received deductions, allow capital losses subject to modifications, and deduct U.S.-source capital gains.
[4013] Code § 561.
[4014] Code § 535(b).
[4015] Code § 535(c)(3).

deduction relating to U.S.-source capital gains.[4016] The dividends paid deduction[4017] reduces retained earnings and profits.[4018] The accumulated earnings credit for such a corporation is no less than the amount by which $250,000 exceeds the corporation's accumulated earnings and profits at the close of the preceding taxable year.[4019] The $250,000 amount is reduced to $150,000 for a corporation the principal function of which is the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.[4020]

Let's examine how the $250,000 credit would work for a mere holding or investment company. Suppose the accumulated earnings and profits at the close of the preceding taxable year were $250,000 or more. The credit would be zero, because $250,000 did not exceed the accumulated earnings and profits at the close of the preceding taxable year. Suppose the accumulated earnings and profits at the close of the preceding taxable year were $200,000. The credit would be $50,000, leaving $200,000 subject to the tax. the sweet spot would seem to be $125,000 accumulated earnings and profits at the close of the preceding taxable year, where a credit of $125,000 ($250,000 minus $125,000) would offset the $125,000 accumulated earnings and profits at the close of the preceding taxable year. Of course, that assumes that the corporation is not a personal holding company, which is exempt from the accumulated earnings tax.[4021]

Earnings and profits of a corporation accumulating beyond the business' reasonable needs is determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence proves otherwise.[4022] A corporation being a mere holding or investment company is prima facie evidence of the purpose to avoid income tax with respect to shareholders.[4023] If the corporation does not the liquidity to pay a cash distribution, it should consider declaring a Code § 565 consent dividend,[4024] being extra careful about the consent dividend if a trust that makes charitable contributions is a shareholder.[4025]

However, reasonable business needs include the business' reasonably anticipated needs, funding a redemption to pay estate tax or expenses of estate administration, or is being used to fund certain redemptions of charitable shareholders.[4026] Consider documenting the business purposes for accumulating earnings in annual meeting minutes. If the earnings get too high and

[4016] Code § 535(c)(1).
[4017] Code § 561.
[4018] Code § 535(c)(1).
[4019] Code § 535(c)(2)(A).
[4020] Code § 535(c)(2)(B).
[4021] See fn 4010 and part II.A.1.e Personal Holding Company Tax.
[4022] Code § 533(a).
[4023] Code § 533(a).
[4024] CCA 201653017 asserted accumulated earnings tax on a holding company and would not accept lack of liquidity as an excuse, pointing to the consent dividend procedure and relying on the discussion of that procedure's purpose in TAM 9124001.
[4025] See part II.Q.7.c.i.(b) Business Income Limiting Trust Income Tax Deduction, including the paragraph accompanying fn. 4069.
[4026] Code § 537(a)(1), (2).

cannot be reduced through high but reasonable compensation (especially qualified retirement plans) or rent, consider making an S election.[4027]

II.Q.7.k. Exclusion of Gain on the Sale of Certain Stock in a C Corporation

II.Q.7.k.i. Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation

This part II.Q.7.k applies to stock issued on or after August 11, 1993. The amount of gain that is subject to partial or complete exclusion from income cannot exceed the greater of:[4278]

(A) $10 million ($5 million for married filing separately)[4279] reduced by the aggregate amount of eligible gain taken into account under this rule for prior taxable years and attributable to dispositions of stock issued by such corporation, or

(B) 10 times the aggregate adjusted bases[4280] of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year. The greater of basis or the fair market value of property contributed for Code § 1202 stock counts towards this basis limitation.[4281] The adjusted basis of any stock is determined without regard to any addition to basis after the date on which such stock was originally issued;[4282] therefore, to maximize the benefit of capital contributions, they should be made only in exchange for new stock when the company has assets of no more than $50 million.[4283]

Gain is eligible only if from the sale or exchange of qualified small business stock held for more than 5 years.[4284] Also:[4285]

[4027] Although S corporations cannot have excessive income from investments, that prohibition is easy to avoid using a modest amount of oil and gas investments. See part II.P.3.c.iii Excess Passive Investment Income, especially fn. 3311.

[4278] Code § 1202(b)(1).

[4279] Code § 1202(b)(3).

[4280] Only the basis on the date of issuance counts for purposes of this test. See the flush language at the end of Code § 1202(b)(1).

[4281] Code § 1202(i)(1) provides that, for purposes of Code § 1202:

> *Stock exchanged for property*. In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation -
> (A) such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and
> (B) the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.

The legislative history quoted in the text accompanying fn 4285 makes me wonder whether this increase in the overall amount excluded was intended, but the statute's literal language appears to provide this result.

[4282] Code § 1202(b)(1) (flush language).

[4283] See fns 4321-4325.

[4284] Code § 1202(b)(2).

[4285] H Rept No. 103-111 (P.L. 103-66), p. 603. Code § 1202(i) provides that, for purposes of Code § 1202:

> (1) *Stock exchanged for property*. In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation-
> (A) such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and

If property (other than money or stock) is transferred to a corporation in exchange for its stock, the basis of the stock received is treated as not less than the fair market value of the property exchanged. Thus, only gains that accrue after the transfer are eligible for the exclusion.

Thus, contributing appreciated property in exchange for stock is a double-edged sword. On one hand, it provides an even greater amount of future gain that can be excluded. On the other hand, the built-in gain at the time of contribution is not eligible for the exclusion, whereas it would have been eligible if the property had been contributed earlier so that the appreciation occurred after contribution. Thus, if a partnership is considering converting to a C corporation, its owners should consider how long before they intend to sell (so that the 5-year holding period is satisfied) and whether appreciation while a partnership is good (to increase the 10-times-basis exclusion) or bad (not post-conversion appreciation and therefore not eligible for the exclusion for the exclusion of the stock's value attributable to the exclusion).[4286]

A taxpayer who wishes to try to exceed these limitations might transfer stock to family members or others by gift before the stock appreciates, and presumably each donee would separately apply the limitation.[4287] Another way to get more than $10 million limitation would be to have a separate C corporation for each qualified business.

For "qualified small business stock" issued after September 27, 2010 and held for more than five years, Code § 1202 excludes from income all of the gain from its sale or exchange, within the limits set forth above.[4288]

For "qualified small business stock" issued before September 28, 2010 and held for more than five years, Code § 1202 excludes from income a portion of the gain from its sale or exchange (within the limits set forth above)[4289]:

- If the above and other requirements are satisfied, then the portion excluded from income is 50% for stock (60% for gain attributable to an empowerment zone business) acquired before February 18, 2009 and 75% for stock acquired on or before September 27, 2010.[4290]

- Any gain that is not excluded is subject to 28% tax instead of the usual, lower capital gain rates.[4291]

(B) the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.

(2) *Treatment of contributions to capital.* If the adjusted basis of any qualified small business stock is adjusted by reason of any contribution to capital after the date on which such stock was originally issued, in determining the amount of the adjustment by reason of such contribution, the basis of the contributed property shall in no event be treated as less than its fair market value on the date of the contribution.

[4286] See fn 4379 in part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership?.

[4287] See Code § 1202(h), discussed at fns. 4351-4352.

[4288] See text accompanying fn 4278.

[4289] See text accompanying fn 4278.

[4290] Code § 1202(a).

[4291] Compare Code § 1(h)(4) (tax on Code § 1202 gain) to Code § 1(h)(1) (tax on capital gains generally).

- Note also that taxable gain from the sale of C corporation stock is subject to the 3.8% tax on net investment income,[4292] whereas gain on the sale of a partnership or S corporation stock engaged in a trade or business is largely excluded from that tax.[4293]

Alternative minimum taxable income includes 7% of the amount excluded from regular taxable income.[4294]

Code § 1045 allows a taxpayer to rollover the gain into new qualified small business stock. Levun describes the Code § 1045 rollover:[4295]

1. The QSBC stock being sold must have been held for more than six months (i.e., the five-year QSBC stock holding period requirement only applies to obtain the QSBC gain exclusion).

2. There is a 60-day period to roll over into qualifying replacement QSBC stock. Note that the taxpayer can hold the proceeds of sale during this period—there is no qualified escrow or qualified intermediary requirements, as there are with respect to like-kind exchanges under Code Sec. 1031.

3. Gain is recognized to the extent of the lesser of gain realized or "boot" received (the same as under the Code Sec. 1031 rules—there is no basis offset against boot).

4. The tax basis of the replacement stock is its purchase price less excluded gain.

5. The holding period of the replacement QSBC stock includes the holding period of the QSBC stock that was sold.

6. The active business requirement of Code Sec. 1202(c) only needs to be met for a period of more than the first six months after the rollover stock is acquired.

"Qualified small business stock" means any stock in a C corporation which the taxpayer acquires on original issue by a qualified small business either in exchange for money or other property (not including stock)[4296] or as compensation for services provided to such corporation (other than services performed as an underwriter of such stock).[4297] An option to acquire stock does not count as stock until the stock is actually issued to the taxpayer.[4298]

[4292] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[4293] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S corporation.
[4294] Code § 57(a)(7).
[4295] See fn. 4383. Also, Rev. Proc. 98-48 explains how to elect Code § 1045 deferral, the deadline for which may be extended using Reg. § 301.9100-3 relief (see, *e.g.*, Letter Ruling 201650010). Reg. § 1.1045-1 provides rules for partnerships and supersedes Rev. Proc. 98-48 to that extent (see T.D. 9353 8/14/2007).
[4296] But see fn 4355 if a corporate reorganization is involved.
[4297] Code § 1202(c)(1).
[4298] *Natkunanathan v. Commissioner*, T.C. Memo. 2010-15, *aff'd* 479 Fed. Appx. 775 (9th Cir. 2012), held that, where the taxpayer had been issued options to buy stock in his employer and did not exercise those options, except to acquire shares in a corporation (Intel) that acquired his employer, the taxpayer could not apply Code § 1202:

> Section 1202 itself does not define the term "stock" or otherwise specify what securities constitute stock for purposes of the qualified small business stock exclusion. By comparison, some provisions of the Code explicitly specify that the term "stock" includes options to acquire stock. See, *e.g.*,

If any stock in a corporation is acquired solely through the conversion of other stock in such corporation which is qualified small business stock in the hands of the taxpayer, the stock so acquired is treated as qualified small business stock in the hands of the taxpayer and is treated as having been held during the period during which the converted stock was held.[4299]

Special rules apply to C corporation stock owned by certain pass-through entities.[4300] A pass-through entity is any partnership, any S corporation,[4301] any regulated Investment Company, or any common trust fund.[4302] If any amount included in gross income by reason of holding an interest in a pass-through entity meets the requirements of the following sentence, the amount shall be treated as Code § 1202(a) gain and, for purposes of applying Code § 1202(b), that amount is treated as gain from a disposition of stock in the corporation issuing the stock disposed of by the pass-thru entity and the taxpayer's proportionate share of the adjusted basis of the pass-through entity in such stock is taken into account.[4303] The amount must be attributable to gain on the sale or exchange by the pass-through entity of stock which is qualified small business stock in the hands of such entity (determined by treating such entity as an individual) and which was held by such entity for more than 5 years, and such amount must be includible in the gross income of the taxpayer by reason of the holding of an interest in such entity which was held by the taxpayer on the date on which such pass-through entity acquired such stock and at all times

---

sec. 305(d)(1) ("For purposes of this section, the term `stock' includes rights to acquire such stock."); sec. 1091(a) (same). We are unaware of any authority that has interpreted the term "stock" for purposes of section 1202. However, we have previously declined to extend the term "stock" beyond its plain meaning in a statutory provision and construe it expansively to include options to acquire stock. See *Gantner v. Commissioner*, 91 T.C. 713 (1988) (options to purchase stock are not "shares" of "stock or securities" under the plain language of section 1091, which was subsequently amended to explicitly provide otherwise), *affd*. 905 F.2d 241 (8th Cir. 1990). Moreover, the legislative history of section 1202 suggests that Congress did not intend section 1202 to cover options to acquire stock. Section 1202 was added to the Code by the Omnibus Budget Reconciliation Act of 1993, Pub.L. 103-66, sec. 13113(a), 107 Stat. 422. The accompanying conference report included the following statement: "Stock acquired by the taxpayer through the exercise of options * * * is treated as acquired at original issue. The determination whether the gross assets test is met is made *at the time of exercise* * * * and the holding period of such stock is treated as beginning at that time." H. Conf. Rept. 103-213, at 526 (1993), 1993-3 C.B. 393, 404 (emphasis added). The second sentence of the excerpt from the conference report quoted above, in the absence of any countervailing argument by petitioner, suggests to us that the original issuance contemplated by section 1202 in petitioner's case would be the issuance of Intel stock to petitioner upon exercise of his options. This conclusion seems appropriate since both the application of the gross assets test and the commencement of the holding period would occur at the time of such exercise.

Reading the term "stock" as used in section 1202 to exclude petitioner's options to acquire stock, we hold that petitioner could not possibly have satisfied the 5-year holding period requirement of section 1202(a)(1). Petitioner concedes that he sold the Intel stock received upon exercise of his options on the same day that he had exercised the options. Therefore, the period during which petitioner could have held qualified small business stock would, at most, have lasted 1 day. Moreover, for the stock underlying petitioner's options to constitute qualified small business stock under section 1202(d)(1), the aggregate gross assets of Intel on the date of exercise would have to have been less than or equal to $50 million. Petitioner makes no such claims with respect to Intel's aggregate gross assets.

[4299] Code § 1202(f).
[4300] Code § 1202(g).
[4301] Code § 1202(g)(4)(B).
[4302] Code § 1202(g)(4).
[4303] Code § 1202(g)(1).

thereafter before the disposition of such stock by such pass-through entity.[4304] This gain exclusion does not apply to any amount to the extent such amount exceeds the amount to this rule would have applied if the amount were determined by reference to the interest the taxpayer held in the pass-through entity on the date the qualified small business stock was acquired.[4305]

The original issuance requirement means that stock bought from another shareholder would not qualify. May one avoid this prohibition by redeeming the seller and issuing stock to the buyer? Code § 1202(c)(3) imposes a waiting period related to redemption activity. Stock is disqualified if, at any time within 2 years before or after the issuance of such stock, the corporation issuing such stock purchased (directly or indirectly) any of its stock from the taxpayer or from a person related[4306] to the taxpayer.[4307] In applying the preceding sentence, one can ignore stock acquired from the taxpayer or a related person if the aggregate amount paid for the stock does not exceed $10,000 and no more than 2% of the stock held by the taxpayer and related persons is acquired.[4308] Also, stock is disqualified if, within the year before or after the issuance of such stock, the corporation made one or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5% of the aggregate value of all of its stock as of the beginning of that 2-year period.[4309] The preceding sentence has a similar de minimis rule.[4310] Although generally a shareholder who transfers stock to an employee or independent contractor (or to a beneficiary of an employee or independent contractor) is treated has transferring the stock to the corporation and the corporation then transferring the stock to the employee or independent contractor,[4311] any such deemed transfer to the corporation is not treated as such for purposes of the anti-redemption rules.[4312] The anti-redemption rules also are not triggered by any of the following:

[4304] Code § 1202(g)(2).

[4305] Code § 1202(g)(3).

[4306] Within the meaning of Code § 267(b) or 707(b). For a description of Code § 267(b), see part II.G.3.i.iv Code § 267 Disallowance of Related-Party Deductions or Losses. For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

[4307] Code § 1202(c)(3)(A).

[4308] Reg. § 1.1202-2(a)(2), which further provides:

> The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

[4309] Code § 1202(c)(3)(B).

[4310] Reg. § 1.1202-2(b)(2) provides that, for purposes of this exception:

> … stock exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of all outstanding stock is purchased. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

[4311] Reg. § 1.83-6(d)(1).

[4312] Reg § 1.1202-2(c).

- The stock was acquired by the seller in connection with the performance of services as an employee or director and the stock is purchased from the seller incident to the seller's retirement or other bona fide termination of such services.[4313]

- Before a decedent's death, the stock (or an option to acquire the stock) was held by the decedent or the decedent's spouse (or by both), by the decedent and joint tenant, or by a trust revocable by the decedent or the decedent's spouse (or by both), and the stock is purchased from the decedent's estate, beneficiary (whether by bequest or lifetime gift), heir, surviving joint tenant, or surviving spouse, or from a trust established by the decedent or decedent's spouse; and the stock is purchased within 3 years and 9 months from the date of the decedent's death.[4314]

- The stock is purchased incident to the disability or mental incompetency of the selling shareholder.[4315]

- The stock is purchased incident to the divorce (within the meaning of Code § 1041(c)) of the selling shareholder.[4316]

During substantially all of the taxpayer's holding period for such stock, the corporation must be a C corporation and use at least 80% (by value) of its assets in the active conduct of one or more qualified trades or businesses.[4317] See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold. Therefore, the C corporation cannot have been an S corporation. However, an S corporation can contribute its assets to a C corporation, and the C corporation could then qualify for the exclusion.[4318] To simplify this process, the owners of the S corporation form a parent S corporation, which new parent assumes all of the original S corporation's tax attributes;[4319] this makes the original corporation a disregarded entity;[4320] then the original corporation elects C corporation treatment.

[4313] Reg. § 1.1202-2(d)(1)(i).
[4314] Reg. § 1.1202-2(d)(2).
[4315] Reg. § 1.1202-2(d)(3).
[4316] Reg. § 1.1202-2(d)(4).
[4317] Code § 1202(c)(2)(A), (e). The taxpayer must affirmatively prove what the business assets are and that they met this 80% test. *Holmes v. Commissioner*, T.C. Memo. 2012-251, held:

> The record is again devoid of documentary evidence showing the amount of corporate assets owned during the years in which he held the stock and the amount of those assets used in its business of providing on demand physician practice management software. In fact, the only evidence in the record concerning LeonardoMD's business is a stipulated paragraph describing its business as providing on demand physician practice management software delivered over the Web, and petitioner's above-cited testimony. We cannot, on the basis of uncorroborated testimony and a stipulation that does not rule out inactive business assets and income, reasonably conclude that petitioner met his burden of proving that, during substantially all of his holding period for LeonardoMD stock, the corporation used at least 80% of its assets in the active conduct of one or more qualified trades or businesses.

[4318] See fn 4301.
[4319] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization, especially fn 3429.
[4320] See part II.A.2.g Qualified Subchapter S Subsidiary (QSub).

The corporation's aggregate gross assets cannot have a basis exceeding $50 million:[4321]

(A) the aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993, and before the issuance did not exceed $50,000,000,

(B) the aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) does not exceed $50,000,000, and

(C) such corporation agrees to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section.[4322]

Although regulations have not been issued regarding reporting requirements, taxpayers will lose the deduction if they do not have records to substantiate that the stock met this requirement.[4323]

[4321] Code § 1202(d). This applies to gross assets at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993 and before the issuance, as well as immediately after the issuance (determined by taking into account amounts received in the issuance).

[4322] [Footnote is mine and not in the statute:] Federal Tax Coordinator Analysis (RIA) ¶ S-4455 Reports With Respect to Exclusion of Gain From Qualified Small Business Stock (QSBS) reports:

> IRS has yet to issue either any reporting requirements described in Code Sec. 1202(d)(1)(C) … or any guidance as to the manner in which, as mandated by Code Sec. 1202(d)(1)(C), a corporation is to agree to meet these requirements. RIA understands that, until IRS provides guidance as to the manner in which a corporation is to agree, a corporation can issue QSBS without the necessity for the corporation to file any sort of agreement that it will comply with any reporting requirements, if and when issued. Presumably, if IRS ever does require reporting, it will prescribe procedures at that time for making the agreement called for in the Code.

[4323] *Natkunanathan v. Commissioner*, T.C. Memo. 2010-15, *aff'd* 479 Fed. Appx. 775 (9th Cir. 2012), held:

> There are no balance sheets or other financial statements of Cognet in the record that establish the amounts of total assets, total liabilities, or owner's equity of Cognet at any time, and petitioner made no attempt to introduce any such evidence at trial.[5] In the absence of any such evidence, we cannot determine the value of Cognet's gross assets at the time that it issued options to petitioner and, therefore, cannot conclude that Cognet constituted a qualified small business within the meaning of section 1202(d)(1) at that time.
>
> [5] After the trial petitioner attached to his reply brief a document purporting to be a statement by the chief executive officer of Cognet at the time of its acquisition by and merger with Intel declaring that "*To the best of my recollection*, the company's assets, including physical assets and total value of outstanding shares did not exceed $50,000,000 before the acquisition." [Emphasis added.] Subsequently, after the record had closed upon the filing of reply briefs, petitioner filed a motion for leave to reopen the record in order to introduce a notarized version of this and other documents. A notarized written statement from Cognet's chief executive officer, even if it were introduced at trial, could have been subject to a hearsay objection and, absent concessions or stipulation by respondent, would probably not have been admitted into evidence. But here, where the purported statement constitutes an affidavit attached to a brief, Rule 143(b) explicitly bars us from considering it as evidence. We have previously issued an order denying petitioner's motion to reopen the record as inappropriate because petitioner has not shown good cause for his failure to introduce such evidence at trial.

Issuing stock options does not necessarily qualify as issuing stock; however, the taxpayer did not hold actual stock for the five-year holding period, so that's why the court looked at when the stock options were issued. See fn 4298 for more about these issues.

As used above, "aggregate gross assets" means the amount of cash and the aggregate adjusted bases of other property held by the corporation.[4324] As used in (A) above:[4325]

> The adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution.

The following businesses are not eligible for this treatment:[4326]

[4324] Code § 1202(d)(2)(A).
[4325] Code § 1202(d)(2)(B).
[4326] Code § 1202(e)(3). Code § 1202(e)(3)(A) is discussed in part II.E.1.c.iv Specified Service Trade or Business (SSTB) If Taxable Income Exceeds Certain Thresholds. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202.

- any trade or business involving the performance of services in the fields of health,[4327] law, engineering, architecture, accounting, actuarial science, performing arts, [4328]

[4327] Letter Ruling 201436001 held that the health service and related exclusion did not apply to the taxpayer:

> Section 1202(e)(3) excludes various service industries and specified non-service industries from the term qualified trade or business. Thus, a qualified trade or business cannot be primarily within service industries, such as restaurants or hotels or the providing of legal or medical services. In addition, § 1202(e)(3) excludes businesses where the principal asset of the business is the reputation or skill of one or more of its employees. This works to exclude, for example, consulting firms, law firms, and financial asset management firms. Thus, the thrust of § 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services, whether those services are the providing of hotel rooms, for example, or in the form of individual expertise (law firm partners).
>
> Company is not in the business of offering service in the form of individual expertise. Instead, Company's activities involve the deployment of specific manufacturing assets and intellectual property assets to create value for customers. Essentially, Company is a pharmaceutical industry analogue of a parts manufacturer in the automobile industry. Thus, although Company works primarily in the pharmaceutical industry, which is certainly a component of the health industry, Company does not perform services in the health industry within the meaning of § 1202(e)(3). Neither are Company's business activities within any of the prohibited categories set forth in § 1202(e)(3).

Letter Ruling 201717010 held that the health service and related exclusion did not apply to a lab:

> Company provides laboratory reports to health care professionals. However, Company's laboratory reports do not discuss diagnosis or treatment. Company neither discusses with, nor is informed by, healthcare providers about the diagnosis or treatment of a healthcare provider's patients. Company's sole function is to provide healthcare providers with a copy of its laboratory report.
>
> Company neither takes orders from nor explains laboratory tests to patients. Company's direct contact with patients is billing patients whose insurer does not pay all of the costs of a laboratory test.
>
> In addition, you represent that the skills employees bring to Company are not useful in performing X tests and that skills they develop at Company are not useful to other employers.
>
> Further, none of Company's revenue is earned in connection with patients' medical care. Other than the laboratory director [who federal law required to have certain qualifications], Company's laboratory technicians are not subject to state licensing requirements or classified as healthcare professionals by any applicable state or federal law or regulatory authority.
>
> Although Company's laboratory reports provide valuable information to healthcare providers, Company does not provide health care professionals with diagnosis or treatment recommendations for treating a healthcare professional's patients nor is Company aware of the health care provider's diagnosis or treatment of the healthcare provider's patients. In addition, the skills that Company's employees have are unique to the work they perform for Company and are not useful to other employers.
>
> Thus, based on the facts and representations submitted, we conclude that for purposes of § 1202(e)(3), Company is not in a trade or business (i) involving the performance of services in the field of health or (ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees.

For additional context, when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See part II.E.1.c.iv.(b) Health. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202.

[4328] For additional context regarding performing arts, when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See part II.E.1.c.iv.(f) Performing Arts. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202.

consulting,[4329] athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees,[4330]

- any banking, insurance, financing, leasing, investing, or similar business,
- any farming business (including the business of raising or harvesting trees),
- any business involving the production or extraction of products, such as oil, gas and mines, eligible for certain depletion deductions, or
- any business of operating a hotel, motel, restaurant, or similar business.

However, engaging in the above activities is not fatal, if it comprises a sufficiently small part of the business.[4331]

The corporation must be a domestic corporation other than a DISC or former DISC, corporation with respect to which an election under Code § 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect, regulated investment company, real estate investment trust, REMIC, or cooperative.[4332]

II.Q.7.k.ii. Limitation on Assets a Qualified Small Business May Hold

The corporation must use at least 80% (by value) of its assets in the active conduct of one or more qualified trades or businesses while the corporation is an eligible corporation.[4333] Assets

---

[4329] For additional context regarding consulting, when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See part II.E.1.c.iv.(g) Consulting. However, that discussion is expressly limited to Code § 199A and cannot be relied upon in applying Code § 1202.

[4330] However, a commission sales business might not be disqualified under this provision. In *Owen v. Commissioner*, T.C. Memo. 2012-21, a company that sold prepaid legal service policies, including estate planning services, which were like insurance in that purchasers would get a reduced fee in legal cost by joining this prepaid legal membership, was a qualified small business. The court seemed to accept the taxpayer's testimony that, in the industry, independent contractors generally sold the products and services offered by the company. The taxpayer performed services as an executive and as a sales representative and his compensation was reported on Form W-2 (as an executive) and Form 1099-MISC (as an independent consultant who furnished services through his personal corporation that received commissions and in turn paid him using Form 1099-MISC. The court held:

> Although respondent argues that FFAEP is not qualified because one of the principal assets is the skill of Mr. Owen, the Court disagrees. While we have no doubt that the success of the Family First Companies is properly attributable to Mr. Owen and Mr. Michaels, the principal asset of the companies was the training and organizational structure; after all, it was the independent contractors, including Mr. Owen and Mr. Michaels in their commission sales hats, who sold the policies that earned the premiums, not Mr. Owen in his personal capacity.

However, ultimately this holding was moot (which did not stop the court from opining on it), because the taxpayer was trying to do a Code § 1045 rollover of gain on sale from one company to another. Although the new company qualified as described above, the company being sold did not (fn. 4341), resulting in the taxpayer losing the case. So, keep in mind the IRS' lack of incentive to appeal this holding when viewing it as instructive.

[4331] See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold, especially fns 4333-4335.

[4332] Code § 1202(e)(4).

[4333] Code § 1202(e)(1).

used for certain start-up or research activities count as qualified.[4334] A specialized small business investment company automatically meets the active business requirement.[4335]

In applying the requirement that the corporation hold active business assets, stock and debt in any subsidiary corporation are disregarded and the parent corporation is deemed to own its ratable share of the subsidiary's assets and to conduct its ratable share of the subsidiary's activities.[4336] The parent owns more than 50% of the combined voting power of all classes of stock entitled to vote, or more than 50% in value of all outstanding stock, of a corporation for the parent to be able to treat the corporation as a subsidiary.[4337] If the holding falls below this threshold, then watch out – the parent fails the active business asset test for any period during which more than 10% of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations which are not subsidiaries of such corporation (other than assets described under the "working capital" exception).[4338]

Under the "working capital" exception, active business assets include assets held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or held for investment and are reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business.[4339] However, for periods after the corporation has been in existence for at least two years, no more than 50% of the assets of the corporation may qualify as used in the active conduct of a qualified trade or business by reason of this rule.[4340] Be careful not to start the C corporation just accumulating cash for possible business operations, which will disqualify

---

[4334] Code § 1202(e)(2), "Special rule for certain activities," provides:

> For purposes of paragraph (1), if, in connection with any future qualified trade or business, a corporation is engaged in—
>
> (A) start-up activities described in section 195(c)(1)(A),
>
> (B) activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under section 174, or
>
> (C) activities with respect to in-house research expenses described in section 41(b)(4),
>
> assets used in such activities shall be treated as used in the active conduct of a qualified trade or business. Any determination under this paragraph shall be made without regard to whether a corporation has any gross income from such activities at the time of the determination.

[4335] Code § 1202(c)(2)(B), referring to an eligible corporation licensed to operate under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993).

[4336] Code § 1202(e)(5)(A).

[4337] Code § 1202(e)(5)(C).

[4338] Code § 1202(e)(5)(B).

[4339] Code § 1202(e)(6).

[4340] Code § 1202(e)(6).

the corporation.[4341] To avoid this issue and for other reasons as well, consider instead starting as an LLC taxable as a partnership then later converting to a corporation.[4342]

A corporation also fails the active business assets test for any period during which more than 10% of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business.[4343] In applying the preceding sentence, the ownership of, dealing in, or renting of real property is not treated as the active conduct of a qualified trade or business.[4344]

In applying the active business asset test, rights to computer software which produces active business computer software royalties[4345] are treated as an asset used in the active conduct of a trade or business.[4346]

Although Code § 1202 authorizes qualified small business stock to be held by a partnership[4347] and corporate subsidiaries,[4348] it does not discuss the corporation conducting its business through one or more partnerships. Accordingly, from a planning perspective, I would not recommend having a corporation seeking qualified small business status invest its assets in a partnership. However, if one is asked to advice an owner of a corporation that is already invested in a partnership, I would look to the active business rules for corporate split-ups, which describe when an interest in a partnership constitutes an active business asset.[4349]

Special rules apply to certain tax-free transfers.[4350] If a transfer is by gift, at death, or from a partnership,[4351] the transferee shall be treated as having acquired such stock in the same manner

---

[4341] *Owen v. Commissioner*, T.C. Memo. 2012-21. The court addressed the qualifications of two companies, one of which did not qualify (this footnote) and one of which did qualify (fn. 4330). In discussing why the company was not a qualified small business under Code § 1202 and therefore not eligible for a capital gain deferral under Code § 1045 (which rollover is not necessary for newer companies), the court imposed a 20% accuracy-related penalty:

> We also find that the Owens did not act with good faith with respect to the section 1045 transaction. Mr. Owen explained that it was his vision to build up J&L Gems as he had the Family First Companies; yet even as late as 2 years after the money had been deposited in the company, J&L Gems had only 16 pieces of jewelry. Mr. Owen should not in good faith have believed that deferring income tax under section 1045, by operating a business, merely involved depositing a large amount of cash in an account. Nor could he reasonably believe that using less than 8 percent of that cash to purchase inventory and selling only a part of what little inventory he did buy to his friends and coworkers was sufficient to defer the tax. Even under Mr. Owen's understanding of section 1045, that he had to operate the business in good faith and reasonably, he failed to meet that requirement.

[4342] See part II.Q.7.k.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership? (especially the text accompanying fns. 4374-4380).
[4343] Code § 1202(e)(7).
[4344] Code § 1202(e)(7).
[4345] Within the meaning of Code § 543(d)(1).
[4346] Code § 1202(e)(7).
[4347] See part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation, especially fns. 4300-4305.
[4348] See fns. 4336-4338.
[4349] See part II.Q.7.f.iii Active Business Requirement for Code § 355.
[4350] Code § 1202(h).
[4351] Code § 1202(h)(2).

as the transferor and having held such stock during any continuous period immediately preceding the transfer during which it was held (or treated as held under these rules) by the transferor:[4352]

- Presumably a taxpayer whose stock's value exceeds the cap of the exclusion of gain[4353] by giving the stock to family members, each of whom could sell the stock separately.

- If the transfer is from a partnership, it must be to a partner of stock with respect to which requirements similar to the pass-through rules described above are met at the time of the transfer (without regard to the 5-year holding period requirement).[4354]

In a Code § 351 formation of a corporation or a Code § 368 reorganization, if qualified small business stock is exchanged for other stock which would not qualify as qualified small business stock but for this rule, such other stock shall be treated as qualified small business stock acquired on the date on which the exchanged stock was acquired.[4355] Unless the stock treated as qualified

---

[4352] Code § 1202(h)(1).
[4353] See fn. 4278.
[4354] Code § 1202(h)(2)(C).
[4355] Code § 1202(h)(4)(A). Letter Ruling 9810010 applied Code § 1202(h)(4) to a corporate split-up that was partly tax-free under Code §§ 355(a)(1) and 368(a)(1)(D). Letter Ruling 9810010 said that Code § 1202(h)(4)(A) necessarily means:

> Thus, stock received in a section 368 reorganization may be treated as QSBS despite the prohibition in section 1202(c)(1)(B)(i) against stock received in exchange for other stock.

Letter Ruling 9810010 continued:

> In the instant case, the taxpayers have represented that the portion of the Distributing stock given up by A through N in exchange for Controlled stock was qualified small business stock (QSBS) and that Controlled was a qualified small business at the time of the reorganization. As part of the section 368 reorganization, A through N received Controlled stock in exchange for a portion of their Distributing stock and thereafter sold their remaining Distributing stock to FX. Unless the specific shares of Distributing stock exchanged for Controlled stock can be adequately identified by each of the exchanging shareholders, it is assumed pursuant to section 1.1012-1(c)(1) that the Distributing stock exchanged will be charged against the earliest of such lots acquired in order to determine cost or other basis and holding period. This rule also applies in determining whether the Distributing QSBS held by each of the exchanging shareholders at the time of the exchange was among the Distributing stock exchanged for Controlled stock.
>
> Based on the assumption that the portion of the Distributing stock given up by A through N was QSBS in the hands of such shareholders as determined by applying the rules of section 1.1012-1, a portion of the Controlled stock received by such shareholders in exchange therefor will be treated as QSBS acquired on the date the exchanged Distributing QSBS was acquired (section 1202(h)(4)(A)). If the stock exchanged by a Distributing shareholder consists of both QSBS and non-QSBS, then only a proportionate amount of the Controlled stock received in exchange will be treated as QSBS.

Ruling 12 of Letter Ruling 9810010 held:

> Based solely on the taxpayer's representations that a portion of the Distributing stock owned by A through N was classified as qualified small business stock under section 1202 (Distributing QSBS), a proportionate amount of Controlled stock received by each of A through N in exchange for such individual's Distributing QSBS will be treated as qualified small business stock (section 1202(h)(4)(A)). The holding period for the Controlled stock treated as qualified small business stock under section 1202(h)(4)(A) includes the holding period for which each of A through N held the Distributing QSBS. Further, based on the representation that Controlled was a qualified small business at the time of the reorganization, the limitation in section 1202(h)(4)(B) will not apply.

small business stock by reason of the preceding sentence is issued by a corporation that (as of the time of that transfer) is a qualified small business, Code § 1202 applies to gain from the sale or exchange of stock treated as qualified small business stock by reason of the preceding sentence only to the extent of the gain which would have been recognized at the time of the transfer described in the preceding sentence if Code § 351 or 368 had not applied at such time.[4356]

To the extent provided in regulations, stock in a corporation, the basis of which (in the hands of a taxpayer) is determined in whole or in part by reference to the basis in his hands of stock in such corporation which meets certain requirements or which is received in a reorganization that is a mere change in form[4357] in exchange for stock which meets such requirements, shall be treated as meeting such requirements.[4358]

If the taxpayer has an offsetting short position with respect to any qualified small business stock, Code § 1202(a) shall not apply to any gain from the sale or exchange of such stock unless the stock was held by the taxpayer for more than 5 years as of the first day on which there was such a short position, and the taxpayer elects to recognize gain as if such stock were sold on such first day for its fair market value.[4359] For purposes of the preceding sentence, the taxpayer shall be treated as having an offsetting short position with respect to any qualified small business stock if the taxpayer has made a short sale of substantially identical property, the taxpayer has acquired an option to sell substantially identical property at a fixed price, or to the extent provided in regulations, the taxpayer has entered into any other transaction which substantially reduces the risk of loss from holding such qualified small business stock; in applying this rule, any reference

---

> Ruling (12) only applies to the Controlled stock that was received in exchange for Distributing stock that was QSBS in the hands of the individual shareholders at the time of the exchange. We have not been asked, and we do not address, whether any stock issued by Distributing was qualified small business stock at any time or whether Controlled is a qualified small business within the meaning of section 1202(d).

[4356] Code § 1202(h)(4)(B). Letter Ruling 9810010 noted:

> Section 1202(h)(4)(B) limits the amount of gain that can be excluded under section 1202(a) if the stock constitutes qualified small business stock by virtue of section 1202(h)(4)(A). However, the limitation does not apply if the stock is issued by a corporation that is itself a qualified small business as of the time of the reorganization.

Code § 1202(h)(4)(C) provides:

> *Successive application*. For purposes of this paragraph, stock treated as qualified small business stock under subparagraph (A) shall be so treated for subsequent transactions or reorganizations, except that the limitation of subparagraph (B) shall be applied as of the time of the first transfer to which such limitation applied (determined after the application of the second sentence of subparagraph (B)).

[4357] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. Converting a corporation into an LLC taxed as a corporation was such a change. Letter Rulings 201603010-201603014.

[4358] Code § 1202(h)(3), incorporating by reference Code § 1244(d)(2).

[4359] Code § 1202(j)(1).

to the taxpayer is treated as including a reference to any person who is related (within the meaning of Code § 267(b)[4360] or 707(b)[4361]) to the taxpayer.[4362]

II.Q.7.k.iii. Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S corporation or a Partnership?

Does the exclusion for the sale of certain stock make being a C corporation more attractive than an S corporation or a partnership? First, we will explore when the sale of such stock has advantages, when the sale does not have advantages, and operational income tax issues.

If and to the extent that the gain on the sale of a business relates to the sale of self-created goodwill, the basis of the ownership interest does not reflect that basis, no matter what kind of entity owns the business. To that extent, the sale of such stock is more favorable than the sale of stock in an S corporation[4363] and the sale for cash of a partnership interest.[4364] However, the seller-financed sale of a partnership interest still produces better results than the sale of such stock.[4365]

In some situations, the exclusion for the sale of certain C corporation stock does not provide any particular advantage, if and to the extent that the owner of a pass-through interest would not have gain on sale. If and to the extent that the sale of the business interest arises from reinvested earnings, the basis of a partnership interest[4366] or stock in an S corporation is increased.[4367] Furthermore, if a pass-through entity redeems only part of one's ownership, the reinvested earnings might offset part or all of the gain on the sale – perhaps even that attributable to self-created goodwill.[4368]

[4360] Code § 267(b) is reproduced in part II.G.3.i.iv Code § 267 Disallowance of Related-Party Deductions or Losses.
[4361] For a description of Code § 707(b), see part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.
[4362] Code § 1202(j)(2).
[4363] Compare part II.Q.1.a.i.(c) with part II.Q.1.a.i.(d) (moderate tax states) and part II.Q.1.a.ii.(c) with part II.Q.1.a.ii.(d) (California).
[4364] The sale of a partnership interest for cash generally would have similar dynamics regarding goodwill as the sale of S corporation stock. The sale of a partnership interest would have a slight advantage, in that the goodwill could obtain a basis step-up (part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S corporations and fn. 4716, unless the anti-churning rules apply per part II.Q.1.c.iv Goodwill Anti-Churning Rules, especially fn. 3525), but amortization would be over a 15-year period under Code § 197 (fn. 4608). Also, amortizing goodwill turns it into a hot asset, reducing opportunities for deferral on its sale; for more information on the sale of goodwill, including disadvantages of goodwill being amortized, see part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.
[4365] See parts II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill and II.Q.1.a.ii.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill (California).
[4366] Code § 705. However, as described in part II.Q.8.e.ii.(a) Unitary Basis, a partner does not have the flexibility of a shareholder to pick and choose which shares to sell.
[4367] Code § 1367.
[4368] For S corporations, see part II.Q.7.b.i Redemptions or Distributions Involving S corporations - Generally, especially fns. 4040-4042. Of course, the basis resulting reduction basis reduces the ability to

Furthermore, the exclusion is available only for qualified stock that is issued, gifted, or bequeathed to the taxpayer,[4369] making it unavailable to subsequent purchasers of the stock.

Many business sales are asset sales, much of which would be capital gain subjected to lower tax rates to the owners of pass-throughs and subjected to higher rates when sold by a C corporation.[4370] This is especially important when an entity sells only a business line,[4371] rather than the entire business. When the entity sells all of its assets, it might as well liquidate to take full advantage of the exclusion on the gain on sale of the stock and let the shareholders move the sale proceeds outside of a potentially risky business environment.[4372]

A stock sale tends to have a lower sale price than an asset sale, due to buyer's concerns about assuming undisclosed or unseen liabilities and perhaps not receiving a basis step-up in the corporation's assets.[4373]

For the effect of structure on operations, see:

- Part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S corporations (concluding that they don't)

- Part II.E Recommended Structure for Entities (explaining why a partnership structure is better than a corporate structure).

Furthermore, if one decides that a C corporation structure is ultimately desirable, one might consider instead starting as an LLC taxable as a partnership or sole proprietorship, which enables

---

take distributions and increases future gains on the sale of the stock, the latter which might not be of concern if and to the extent the stock receives a new basis on the shareholder's death. See part II.H.9 Basis Step-Up In S corporations That Had Been C Corporations.
For partnerships, see part II.Q.8.b Partnership Redemption or Other Distribution.

[4369] See various requirements described in part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[4370] See part II.A.1.a C Corporations Generally, especially fns. 5-7.

[4371] One cannot easily divide a business tax-free, sell a business line, and liquidate the corporation owning just that business lines. See part II.Q.7.f.ii Code § 355 Requirements.

[4372] See part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale. Levun's article, cited at fn. 4383, comments:

> Note that the receipt of liquidation proceeds after a corporate asset sale also qualifies for the QSBC exclusion. However, because of the corporate-level tax exacerbated by the lack of a corporate capital gains rate, the scales would still tip in favor of flow-through taxation, notwithstanding no tax due on liquidation. In other words, assume all an entity owns is zero-basis self-created goodwill having a value of $1 million. In the case of an asset sale as an LLC, there would be federal tax due of $200,000 (assuming a 20-percent maximum capital gains rate). In the case of the same asset sale by a QSBC, while there would be no shareholder tax on the liquidation of the corporation, the corporate entity-level federal tax burden would be $340,000 (or tax at a 35-percent rate, to the extent the corporation has taxable income in excess of $10 million).

[4373] Regarding the latter, see part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S corporations, noting that the inside basis step-up may apply under part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold, the latter which is considered most attractive for S corporation holders but also may be attractive when using the Code § 1202 exclusion.

start-up losses to be deducted more easily anyway;[4374] then, if one determines that a C corporation is the ideal structure, convert[4375] to a qualified small business corporation[4376] the earlier of five years before a sale is anticipated or shortly before the $50 million gross asset limitation is exceeded.[4377] The delay in forming the corporation can help avoid being disqualified for not deploying start-up capital quickly enough.[4378] During this initial operating period, the owners could build value in the business, and the greater of value or basis of the partnership's assets when it converts to a C corporation is used in computing the exclusion of ten times the investment.[4379] However, if the entity accumulates debt in excess of basis, forming the corporation might be a taxable event.[4380] Before converting to ***a*** qualified small business corporation, consider whether the LLC might divide into separate entities, each of which conducts a separate business,[4381] and then each separate business would become its own qualified small business corporation with a separate limitation on the amount of gain that is excluded. That may also help stay under the $50 million gross asset limitation for each corporation.

For a case study on converting a partnership to a C corporation to accommodate a venture capital firm's desire for this exclusion, whether converting to a C corporation is a good idea, the

---

[4374] See part II.G.3 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner, especially part II.G.3.c.iii Comparing C Corporation Loss Limitations to Those for Partnership and S corporation Losses.

[4375] See part II.P.3.d Conversions from Partnerships and Sole Proprietorships to C Corporations or S corporations. One might simply file Form 8832 to elect corporate taxation, assign the LLC to a corporation, or convert or merge the LLC into a corporation. As to the former, Letter Ruling 201636003 held:

> While ownership of a corporation is normally tied to stock ownership, and under state law LLC owners hold a member interest and not formal stock, the term "stock" for federal tax purposes is not restricted to cases where formal stock certificates have been issued. Rather, it has been consistent Service position that for federal tax purposes stock ownership is a matter of economic substance, *i.e.*, the right to which the owner has in management, profits, and ultimate assets of a corporation. The presence or absence of pieces of paper called "stock" representing that ownership is immaterial. See Rev. Rul. 69-591, 1969-2 C.B. 172.
>
> Therefore, based on the facts and representations submitted, we rule that the Corporation stock meets the definition of qualified small business stock under §§§ 1202(c), 1202(f) and 1202(h).

[4376] See part II.P.3.d Conversions from Partnerships and Sole Proprietorships to C Corporations or S corporations.

[4377] See fn. 4321.

[4378] See part II.Q.7.k.ii Limitation on Assets a Qualified Small Business May Hold, especially the text accompanying fns. 4339-4341.

[4379] See part II.Q.7.k.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation, especially fns. 4280-4286.

[4380] See parts II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities and II.M.2.c Contribution of Partnership Interest to Corporation.

[4381] See part II.Q.8.d Partnership Division.

Code § 1045 rollover, and issues facing recipients of profits interests on conversion,[4382] see Levun, "Using Partnerships to Leverage "Zero-Tax" Code Sec. 1202 Stock."[4383]

II.Q.7.l. Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244

An individual[4384] may deduct the first $50,000 of loss[4385] on the sale of "section 1244 stock" as an ordinary loss, rather than a capital loss.[4386]

"Section 1244 stock" is stock of a domestic corporation if:[4387]

- at the time such stock is issued, such corporation was a small business corporation,
- such stock was issued by such corporation for money or other property (other than stock and securities), and
- such corporation, during the period of its five most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50% of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.

[4382] See part II.M.4.f Issuing a Profits Interest to a . Levun, fn. 4383, points out:

> As a final observation, and somewhat of a frolic and detour, let's assume that the LLC being discussed in this column had a service provider that had been previously admitted as a partner (either by reason of (1) having received a fully vested LLC interest, (2) having received a profits interest subject to a substantial risk of forfeiture but for which the requirements of Rev. Proc. 2001-43, 2001-2 CB 191, had been satisfied or (3) having received a capital interest subject to a substantial risk of forfeiture for which a timely Code Sec. 83(b) election had been made. Also assume that, as part of the incorporation transaction contemplated above (to obtain QSBC stock), the service provider was required to agree to a substantial risk of forfeiture with respect to the C corporation stock he was now obtaining in the LLC to C corporation conversion transaction. Rev. Rul. 2007-49, 2007-2 CB 237, would require that a Code Sec. 83(b) election be made in order for the service partner to be treated as a shareholder in the corporation. This revenue ruling provides that the transfer of vested stock in exchange for nonvested stock in a tax-free corporate reorganization requires a Code Sec. 83(b) election in order for the service provider to be considered the tax owner of the shares received in the reorganization. While the revenue ruling addresses a tax-free reorganization under Code Sec. 368(a), there is no reason to believe that the result would be any different in a Code Sec. 351 transaction. Note that making a Code Sec. 83(b) election does not result in any tax to the service provider, as under the principles contained in Rev. Rul. 2007-49, the service provider would be considered to have paid an amount for the QSBC stock equal to its fair market value.

[4383] *Partnership Tax Watch Newsletter* (Current), No. 349, PARTNERSHIP TAX PLANNING and PRACTICE 11/22/2016, saved as Thompson Coburn LLP document no. 6486765.

[4384] Trust, estates, and corporations are not eligible for this treatment. Code § 1244(d)(4); see Part II.J.11.b Code § 1244 Treatment Not Available for Trusts. Individuals may deduct losses flowing through partnerships if the partnerships were the original owners, and corporations may not claim this benefit. Reg. § 1.1244(a)-1(b)(2).

[4385] $100,000 if married filing jointly. Code § 1244(b).

[4386] Code § 1244(a).

[4387] Code § 1244(c).

The corporation cannot be capitalized with more than $1 million adjusted basis of assets.[4388]

Although it applies to the sale of stock in an S corporation, it might not provide much of a benefit, as often such a loss arises from loss due to operations and therefore was already deducted as a loss on the K-1 issued to the shareholder each year. Similarly, this provision might not provide much of a benefit when choosing whether to be taxed as a corporation instead of a partnership, as often such a loss arises from loss due to operations and therefore was already deducted as a loss on the K-1 issued to the partners each year. Furthermore, S corporation shareholders and partners in a partnership would likely obtain a current deduction for such losses, rather than having to wait until their ownership is disposed of, and they would not be required to jump through any statutory hoops similar to Code § 1244 to obtain the ordinary loss deduction. For more information on the concepts described in this paragraph, see part II.G.3 Limitations on Losses.

II.Q.7.m. Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company

Generally, an individual may defer $50,000 or a corporation may defer $250,000 of gain on the sale of any publicly traded securities by reinvesting in a specialized small business investment company (SSBIC).[4389]

An SSBIC is any partnership or corporation licensed by the Small Business Administration under section 301(d) of the Small Business Investment Act of 1958 as in effect on May 13, 1993.[4390] That provision authorizes the licensing of small business investment companies organized to invest in small business concerns in such a way as to facilitate ownership by persons whose participation in the free enterprise system has been hampered by social or economic disadvantages.[4391]

II.Q.8. Exiting From or Dividing a Partnership

See part II.Q.8.e.vi Required Documentation to Avoid Withholding on Sale or Redemption of Partnership Interest.

Below, a few themes emerge:

- Exiting a partnership in exchange for a portion of the partnership's assets can be a nontaxable event, in which the exiting partner's basis is reallocated among the distributed assets.[4392]

- Seller-financed redemptions for cash can save a level of capital gain tax, and the buyer and seller can come out ahead, if structured properly.

- If a partner contributes property with a basis not equal to its fair market value, and that partner or that property leaves the partnership within seven years of the contribution, beware of the tax effects!

4388 Code § 1244(c)(3).
4389 Code § 1044.
4390 Code § 1044(c)(3).
4391 Federal Tax Coord. 2d ¶ I-3794.
4392 See Abrams, Now You See It; Now You Don't: Exiting a Partnership and Making Gain Disappear, *TM Memorandum* (2/16/2009).

Contrasting partnership and corporate tax-free divisions:

- A partnership division does not require a business purpose to be nontaxable, but a corporate division does. Generally, a partnership division is not taxable.[4393]

- Contrast a seven-year waiting period for partnership distributions (other than divisions) described further below with a five-year waiting period for corporate divisions. However, the waiting periods are for different reasons! In partnerships, it is to account for contributed property. In corporations, it is to make sure business activities are conducted continuously for at least five years.

Generally, the parties can designate whether a transaction constitutes a sale between partners or a redemption by the partnership.[4394]

See also part II.P.3.g Conversions from Partnership to Sole Proprietorships and Vice Versa.

II.Q.8.a. Partnership as a Master Entity

II.Q.8.a.i. Partnership Rules Allowing Basis Shifting

Partnerships provide the opportunity to shift basis from one asset to another, which can be helpful when it appears that a low basis asset will be sold; see part II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property.[4395]

However, the partnership needs to be properly seasoned, which generally means at least 7 years from the time that property is contributed to the partnership until the time property is distributed.[4396] Changes in or issuances of partnership interests when the partnership has property with basis different from fair market value can also bring this 7-year waiting period into play.[4397]

If one has considerable marketable securities that one would like to be in a partnership, one should consider placing them in a partnership that has no business assets.[4398] Although the strategy described in this part II.Q.8.a is not geared toward marketable securities, if the estate is large enough then one might consider dividing the marketable securities into a few partnerships that move in different directions and using a series of rolling, asset-splitting GRATs to shift value

---

[4393] Reg. § 1.708-1(d).

[4394] Letter Ruling 9715008 (respecting the form of a sale between partners). The ruling relied on *Foxman v. Commissioner*, 41 T.C. 535, 551 (1964) (treating a transaction as a sale between partners), aff'd 352 F.2d 466 (3d Cir. 1965) and also cited *Cooney v. Commissioner*, 65 T.C. 101, 109 (1975) (treating a transaction as a redemption).

[4395] Paul S. Lee of Northern Trust has been exploring this idea and has called this the mother ship partnership.

[4396] See part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

[4397] See text accompanying fn. 4496, which is part of the link from fn. 4396.

[4398] Distributions of marketable securities from a partnership might be a taxable transaction. See parts II.Q.8.b.i.(a) Code § 731: General Rule for Distributions (distributions from a partnership generally do not generate income tax) and II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them) (special rules taxing such distributions). See particularly text accompanying fn. 4437 et. seq.

to the next generation.[4399] This might be a good strategy for the cash generated from an equity-stripping transaction designed to obtain a basis step-up on real estate with minimal estate tax cost.[4400]

The basis shifting opportunity might work best when few assets are involved. Furthermore, generally it requires a Code § 754 election to be in effect, and such an election requires record-keeping that is often quite complex.[4401] Thus, one might consider dividing the partnership and making the Code § 754 election only with respect to the property involved in the basis shifting strategy.[4402]

Various basis stripping strategies involve plays on differences between outside basis and inside basis.[4403] A transfer of a partnership interest allocates basis according to the value of the transferred interest, rather than according to the proportion of rights to income, distributions, etc.[4404]

One might consider having any marketable securities be held in their own partnership that qualifies as an "investment partnership." See part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them).

Also, note that certain assets are not conducive to non-pro rata distributions of property. See part II.Q.8.b.i.(f) Code § 751 – Hot Assets. To the extent practicable, one might consider holding such assets in a separate partnership and leasing them to the businesses they serve.[4405] Consider the effect, if any, this isolation of leasing activity might have on the passive loss rules and the 3.8% net investment income tax.[4406]

4399 See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust, especially the text accompanying fn. 5507.

4400 See part II.H.10 Extracting Equity to Fund Large Gift. This strategy requires leveraging and maintaining a security interest in loan proceeds, and placing different baskets of marketable securities into separate LLCs (that start as single member LLCs but sooner or later become taxed as partnerships) can facilitate maintaining this security interest. See part II.H.10.d Maintaining the Security Interest in the Loan Proceeds If Using a Donee Guarantee.

4401 See generally part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

4402 See part II.Q.8.d Partnership Division, especially fn. 4622 (division should result in identical percentage interests before and after the division for each partnership).

4403 For an example, see part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue. For a more generic description of inside basis and outside basis, see my blog article, "Tax basis: The key to reducing gain on sale or deducting asset purchases," at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions/post/2017-01-10/tax-basis-the-key-to-reducing-gain-on-sale-or-deducting-asset-purchases.

4404 See part II.Q.8.e.ii.(a) Unitary Basis.

4405 Leasing tangible personal property generally constitutes self-employment income, whereas leasing real generally does not. See part II.L.2.a.ii Rental Exception to SE Tax.

4406 See parts II.K Passive Loss Rules and II.I 3.8% Tax on Excess Net Investment Income (NII), especially II.K.1.e Rental Activities.

Similarly, consider whether consolidating assets inside of a partnership affects the passive loss grouping rules,[4407] which impact not only the use of passive losses and credits but also the 3.8% tax on net investment income.[4408]

Check to see whether the applicable jurisdiction imposes fees or taxes on partnerships or LLCs.[4409]

II.Q.8.a.ii. Caution When Using Master Entity If Liquidity Needed to Pay Estate Tax

Estate tax generated by business interests can be deferred. Obtaining a deferral for a year or two does not require any special structuring.[4410] Obtaining longer deferrals requires the right structure and involves more uncertainty with partnerships than with corporations.[4411]

If one places assets in a master partnership, consider whether those might affect the owner's estate's ability to make a Code § 6166 to defer estate tax if the owner has insufficient liquidity.[4412] If the partnership is merely a holding entity and does not itself engage in business activity, it might be considered a nonbusiness asset ineligible for such an election.[4413]

II.Q.8.a.iii. Examples of Using Partnership to Shift Basis

II.Q.8.a.iii.(a). Applying Outside Basis to Very Low Inside Basis

Each of A, B, and C invests $500 in a partnership that uses its $1,500 capital to buy land: Parcel X for $100 and Parcel Y for $1,400.

Parcel X grows in value to $900, and Parcel Y increases in value to $1,800. Thus, the partnership's assets are worth $2,700 ($900 plus $1,800). Thus, ignoring valuation adjustments, each partner's interest is worth $900 ($2,700 divided by 3).

The partnership distributes Parcel X to C in liquidation of C's partnership interest. C's $500 basis is applied to Parcel X, increasing its basis from $100 to $500.

If a Code § 754 election is not in place, then Parcel Y's basis does not change.

Although as a group the partners have managed to increase the real estate's tax basis, C did not get a great deal. If C sells Parcel X, C recognizes a $400 gain ($900 value minus its new $500 basis). If the partnership had sold Parcel X, the $800 gain ($900 value minus $100 basis before the distribution), then each partner (including C) would recognize a $267 gain ($800 divided by 3). Thus, C would pay tax on $133 more gain ($400 minus $267) than if the partnership had not distributed Parcel X. On the other hand, C is relieved of responsibility for $133 gain inherent in

---

[4407] See part II.K.1.b Grouping Activities.
[4408] See part II.I.8 Application of 3.8% Tax to Business Income, especially part II.I.8.a.ii Passive Activity Grouping Rules.
[4409] For example, New York City imposes a 4% tax on unincorporated business organizations.
[4410] See part III.B.5.d.i Overview of Discretionary Extensions Under Section 6161.
[4411] See part III.B.5.d.ii Code § 6166 Deferral.
[4412] See part III.B.5.d.ii Code § 6166 Deferral, especially part III.B.5.d.ii.(a) What is a Business?
[4413] Code § 6166(b)(9). Although Code § 6166(b)(8) provides special rules making corporate holding companies eligible, it does not apply to partnership holding companies. For more details, see fn. 5990.

Parcel Y ($1,800 value minus $1,400 basis equals $400 gain; $400 gain divided by 3 partners equals $133).

II.Q.8.a.iii.(b). Basis Stripped from Distributed Property and Applied to Remaining Property

Each of D, E, and F contributes $200 to a partnership, which uses its $600 contributions to buy land: $200 for Parcel M and $400 for Parcel N. Parcel M increases in value to $400, and Parcel N decreases in value to $200. The partnership distributes Parcel N to F in redemption of F's partnership interest. Parcel N's basis is reduced to F's $200 basis, which is a $200 ($400 basis inside the partnership minus $200 in F's hands) basis reduction. If the partnership has a Code § 754 election in place, the $200 basis that is stripped from Parcel N is added to the basis of Parcel M, which is increased from $200 to $400.

II.Q.8.a.iii.(c). Basis Stripped from New Property and Applied to Existing Property

Each of G, H, and I contributes $100 to a partnership, which buys Parcel T (raw land) for $300. Parcel T's value increases to $900, and the partners take advantage of this value increase by causing the partnership to borrow $600 (which is $200 debt per partner) and distribute that $600 equally to G, H and I ($600 divided by 3 equals $200 distribution each), resulting in each having a capital account of -$100 ($100 initial contribution minus $200 distribution), which also happens to equate to $100 debt in excess of basis ($200 share of debt minus $100 original capital contribution). Note that each partner's share of Parcel T's unrealized appreciation is $200, which is $600 ($900 value minus $300 basis) divided by 3.

The partnership borrows $300 to buy Parcel U (raw land) for $300. Parcel U retains its value. Thus, the partnership's net value continues to be $300, which is the excess of the $1,200 values of Parcels T ($900) and U ($300) over the partnership's debt of $900 ($600 on Parcel T and $300 on Parcel U).

The partnership distributes Parcel U to G to redeem G's partnership interest. G assumes $200 of the debt on Parcel U, and the partnership shifts $100 of the debt on Parcel U to Parcel T. Thus, G receives $100 net value ($300 value of Parcel U minus $200 debt assumed). The basis of G's partnership interest before the distribution was $200, consisting of $100 original contribution plus $300 debt (1/3 of the partnership's $900 debt before distribution) minus $200 prior cash distribution. On the distribution, G assumed $200 of debt and was relieved of $300 of debt, for a net reduction in debt of $100. This $100 net debt reduction is treated as a $100 cash distribution. Thus, the basis of G's partnership interest after the distribution is $100 ($200 basis before distribution minus $100 deemed distribution), and G recognizes no gain or loss on the redemption on G's partnership interest. After the redemption:

- Parcel U's basis is reduced from its original $300 to the $100 basis of G's partnership interest. This $200 basis strip ($300 original basis minus $100 remaining basis) from Parcel U will be applied to increase the partnership's basis in Parcel T from its initial $300 to a new $500 if the partnership has a Code § 754 election in effect.

- G winds up with Parcel U with a $300 value, $100 basis, and a $200 debt. Thus, the net value of G's position is $100 ($300 value minus $200 debt). Before the redemption, G had net debt in excess of basis of $100; after the redemption, G continues to have $100 debt in excess of basis ($200 debt minus $100 basis in Parcel U).

- The partnership has Parcel T with $900 value, $500 basis, and $700 debt ($600 from the original borrowing and $100 from Parcel U). Thus, the partnership has property with $400 value in excess of basis ($900 value minus $500 basis), which is $200 value in excess of basis per partner ($400 divided by 2 partners), the same as before the redemption. Furthermore, the partnership has $200 debt in excess of basis ($700 debt minus $500 basis), which translates to each partner having $100 debt in excess of basis ($200 divided by 2 partners).

Has the partnership made a disguised sale of Parcel U to G? See Reg. § 1.707-6(b)(2).

II.Q.8.a.iii.(d). Basis Shift When Parent Owns Large Majority

Parent owns 98%, Son owns 1%, and Daughter owns 1% of a partnership. The partnership has land that the partnership previously bought that has $100 value and $100 debt, so the partnership has net equity of zero and each partner's interest is worthless. Based on prior distributions that zeroed out everyone's basis, Parent is allocated $98 debt in excess of basis, and each of Son and Daughter is allocated $1 debt in excess of basis ($2 total).

Partnership plans to sell the property, would result in $98 gain to Parent, $1 gain to Son, and $1 gain to Daughter.

Instead, Parent contributes $25 to the partnership, which the partnership uses, together with $100 of additional borrowing to buy Parcel Q (land) for $125.

The partnership then redeems Parent, distributing Parcel Q and its associated $100 debt to Parent. Parent's basis in Parent's partnership interest before the redemption was $123, which comes from $98 original debt plus $98 new debt (98% of the $100 borrowed to buy Parcel Q) plus $25 contributed toward the purchase of Parcel Q minus $98 prior distributions. In the redemption, Parent assumed the $100 debt but was relieved of Parent's $196 ($98 original debt plus $98 new debt) share of liabilities before the redemption, the basis of Parent's partnership interest decreased by $96 ($196 liabilities relieved minus $100 liabilities assumed) to $27 ($123 minus $96). Thus, Parcel Q's basis deceases from its original $125 basis to $27 (the basis of Parent's partnership interest), a $98 reduction in basis. If the partnership has a Code § 754 election in place, this $98 basis strip from Parcel Q translates into a $98 increase in the basis of the original land.

After the redemption, each of Son and Daughter owns one half of the partnership. The partnership has the original land, with a value of $100, basis of $98, and liabilities of $100. When Parent was redeemed, Son and Daughter assumed the partnership's original debt, so their share of liabilities increases by $98 from $2 combined to $100 combined. Their basis increases correspondingly, so that, instead of having $2 debt in excess of basis, they have $98 debt in excess of basis ($100 liabilities allocated minus $2 prior distributions).

Thus, when the partnership sells the original property for $100, the partnership recognizes a $2 gain ($100 proceeds minus $98 basis), the same $2 gain that would have been allocated to Son and Daughter if Parcel Q had never come into the picture.

The difference is in Parent's treatment. Parent would have been allocated $98 gain before Parcel Q came into the picture. Now, Parent does not pay any tax on the sale of the original land. Instead, the basis of Parcel Q has been reduced by $98 because of the redemption. If Parent holds Parcel Q until death, Parcel Q's unrealized gain is wiped out by a basis step-up.

II.Q.8.b. Partnership Redemption or Other Distribution

II.Q.8.b.i. Distribution of Property by a Partnership

Distributions to a partner may be taxable under Code §§ 731, 704(c)(1)(B), and 737.[4414] After the parts describing Code § 731 are the discussions of the other two sections.

II.Q.8.b.i.(a). Code § 731: General Rule for Distributions

Partnership distributions of property are usually tax-free to both the partnership and the partner under Code § 731(a)[4415] and (b), whether current distributions or liquidating distributions.[4416]

[4414] Partnership distributions might also be subject to the anti-abuse rules (regulations issued under Code § 701), which was asserted in CCA 200650014 when a partnership acquired real estate to be distributed to a partner and that partner was allocated all of the economic risks of that real estate purchase.

[4415] A loan from a partnership to a partner who is obligated to repay the amount of the loaned money or property does not constitute a distribution subject to Code § 731 but is a loan governed by Code § 707(a). To the extent that such an obligation is canceled, the obligor partner will be considered to have received a distribution of money or property at the time of cancellation. Reg. § 1.731-1(c)(2). The partnership has taxable income or loss in an amount equal to the difference between its basis in the distributed debt and the debt's fair market value at the time of the distribution, just as if the partnership had sold the debt for this amount and distributed the sale proceeds to the distributee-partner-debtor. The distributee-partner generally does not recognize any gain on the distribution unless the amount of the distribution exceeds the basis of his interest and, unless the special liquidating distribution rule in Code § 731(a)(2) applies, does not recognize a loss; however, the distributee-partner might recognize cancellation-of-indebtedness income on the deemed purchase of the debt. McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners* (WG&L), ¶ 19.02[5] Distributions of a Partner's Debt to the Debtor-Partner. Letter Ruling 201314004 confirmed the Code § 731 aspects of such a distribution but did not address any other issues. The IRS treats differently partner indebtedness that the partnership bought from a third party. In that case, if the partnership distributes (in a liquidating or nonliquidating distribution) the indebtedness to the partner so that the debt is extinguished, the distribution of property rules will apply to determine the consequences for the partnership. Under Code § 61(a)(12) (and Reg. § 1.61-12(c)(2)), the partner is treated as having repurchased its indebtedness for an amount equal to the fair market value of the indebtedness and therefore will recognize capital gain or loss to the extent the fair market value of the indebtedness differs from the basis of the indebtedness determined under Code § 732. Rev. Rul. 93-7. CCA 201525010 stated, The regulations under § 752 do not determine if a debt is recourse or nonrecourse to a partnership for purposes of determining whether, upon foreclosure of the property, the partnership has cancellation of debt income under § 61(a)(12) or gains from dealings in property under § 61(a)(3). A panel at the May 2016 meeting of the ABA Section on Taxation seemed to disagree with the assumption of the parties in *Great Plains Gasification Associates v. Commissioner*, T.C. Memo. 2006-276, that certain debt was nonrecourse based on Code § 752. The author of CCA 201525010 indicated that the CCA was not just her view but rather was a consensus approach at the IRS.
A deficit capital account is not by itself sufficient to establish the creation of a loan. Similarly, the fact that on a final accounting the partners will take a deficit capital account into consideration is not sufficient to create an obligation to repay a loan. If there is no unconditional and legally enforceable obligation that requires a partner to repay any of the amounts withdrawn to the partnership on or before a determinable date, then withdrawals by that partner that created a deficit in his capital account are not loans governed by Code § 707(a) but are partnership distributions received by him in his capacity as a partner. Rev. Ruls. 73-301, 81-241.

[4416] Reg. § 1.731-1(a)(1)(i).

Exceptions to this rule include:

- Part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value

- Part II.Q.8.b.i.(f) Code § 751 – Hot Assets

- Part II.M.3.e Exception: Disguised Sale.

Also, Code § 731(a)(1) requires a partner to recognize gain on a monetary distribution when the distribution exceeds the partner's adjusted basis in the partnership;[4417] for the taxation of any gain, see part II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner. A reduction in a partner's share of liabilities[4418] is considered a cash payment in the amount of the liabilities discharged.[4419] The amount of gain recognized is the excess of the distribution over the partner's

---

[4417] Code § 731(a)(2) explains potential loss recognition consequences of a partnership distribution.

[4418] See part II.C.3 Allocating Liabilities (Including Debt).

[4419] Rev. Rul. 74-40, Situations 2 and 3 are most relevant, but let's look at all three for the sake of completeness. Situation 1 involved the following facts and conclusions:

> L is a limited partner in partnership GL to which he contributed $10,000 in cash on its formation. His distributive share of partnership items of income and loss is 10 percent and he is not entitled to receive any guaranteed payments. The adjusted basis of his partnership interest at the end of the current year is $20,000. His proportionate share of partnership liabilities, on which neither he, the other partners nor the partnership have assumed any personal liability, is $15,000. The partnership has no other liabilities. L sells his interest in the partnership to M, an unrelated taxpayer, for $10,000 in cash. At the time of the transaction the partnership had no unrealized receivables or inventory items described in section 751 of the Internal Revenue Code of 1954 nor any goodwill and L had been paid his distributive share of partnership income.
>
> [Citations to Code §§ 752(c) and 741 and to Reg. §§ 1.752-1(e) and 1.751-1(d) follow.]
>
> Accordingly, in the instant situation, the amount realized by L from the sale of his partnership interest is $25,000, consisting of cash in the amount of $10,000 and release from his share of partnership liabilities in the amount of $15,000. Since the adjusted basis of L's interest in the partnership is $20,000, he realized a gain of $5,000 determined under the provisions of section 741 of the Code.

Situation 2 involved the following facts and conclusions:

> The facts are the same as in situation 1, except that L withdraws from the partnership and the partnership distributes $10,000 to him in cash in complete liquidation of his interest in the partnership.
>
> [Citations to Code §§ 752(b), 731(a), 731(c) and 736 and to Reg. § 1.736-1(b)(1) follow.]
>
> Accordingly, in the instant situation, distributions to L with respect to his partnership interest total $25,000 and consist of cash in the amount of $10,000 and a decrease in his share of the partnership liabilities in the amount of $15,000 that is considered under section 752(b) of the Code as a distribution of money to L by the partnership.
>
> Furthermore, since the money distributed ($25,000) exceeds the adjusted basis of L's interest in the partnership immediately before the distribution ($20,000), he realizes a gain of $5,000 determined under the provisions of section 731(a) of the Code.

Situation 3 involved the following facts and conclusions:

> Instead of selling his interest L withdraws from the partnership at a time when the adjusted basis of his interest in the partnership is zero and his proportionate share of partnership liabilities, all of which consist of liabilities on which neither he, the other partners nor the partnership have assumed any personal liability, is $15,000.

adjusted basis;[4420] basis in a partnership interest includes any partnership debt allocated to it.[4421] If the partnership distributes cash and property to a partner in the same transaction, the partner applies the cash to basis and then allocates basis to the property distributed.[4422] However, if a liquidating distribution consists of only cash, unrealized receivables, or inventory with an adjusted basis to the recipient partner that is less than the partner's adjusted basis in the partnership, then the partner would recognize loss.[4423]

However, special rules apply to marketable securities, which might be treated as cash for purposes of Code § 731(a)(1) and therefore might trigger gain on distributions.[4424]

II.Q.8.b.i.(b). Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them)

Although marketable securities are not normally considered cash for income tax purposes, they are treated as "money" for purposes of Code § 731(a)(1) gain calculation.[4425] Thus, distributions of marketable securities can result in gain under Code § 731(a)(1), if the total amount of money and securities distributed is higher than the adjusted basis of the partner's partnership interest. Beware that "marketable securities" means not only financial instruments[4426] and foreign currencies which are, as of the date of the distribution, actively traded,[4427] but also:[4428]

- any interest in a common trust fund or a regulated investment company, the latter which is offering for sale or has outstanding any redeemable security[4429] of which it is the issuer,

---

> Accordingly, L is considered to have received a distribution of money from the partnership of $15,000 and realizes a gain of $15,000 determined under the provisions of section 731(a) of the Code.

See also Rev. Rul. 77-402 (similar result when grantor trust status terminates with respect to a partnership interest), discussed in fn. 5581, found in part III.B.2.a Tax Basis Issues When Using Irrevocable Grantor Trusts, and Rev. Rul. 75-194 (deemed bargain sale of partnership interest contributed to charity), discussed in fn. 3841, found in part II.Q.6.b Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity.

[4420] Code § 731(a)(1).

[4421] See part II.C.3 Allocating Liabilities (Including Debt), especially part II.C.3.a Basic Consequences of Changes in Liability Allocations.

[4422] Although Code § 731 and the regulations thereunder do not appear to address this issue, Reg. § 1.732-1(a) and (b) implicitly mandate this result when determining the basis of assets distributed to a partner.

[4423] Code § 731(a)(2).

[4424] See part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them).

[4425] Code § 731(c)(1). Marketable securities are defined in Code § 731(c)(2)(A) as financial instruments and foreign currencies which are, as of the date of distribution, actively traded. Code § 731(c)(2)(B) includes mutual funds, derivatives and various other financial instruments. Code § 731(c)(2)(C) defines financial instruments to include stocks and other equity interests, evidences of indebtedness, options, forwards, futures, notional principal contracts and derivatives.

[4426] Financial instrument includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, and derivatives. Code § 731(c)(2)(C).

[4427] Code § 731(c)(2)(A).

[4428] Code § 731(c)(2)(B).

[4429] As defined in section 2(a)(32) of the Investment Company Act of 1940. Code § 731(c)(2)(B)(i)(II).

- any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities,[4430]

- any financial instrument the value of which is determined substantially by reference to marketable securities,

- except to the extent provided in regulations, any interest in a precious metal which, as of the date of the distribution, is actively traded[4431] unless such metal was produced, used, or held in the active conduct of a trade or business by the partnership,

- except as otherwise provided in regulations, interests in any entity[4432] if substantially all of the assets[4433] of such entity consist (directly or indirectly) of marketable securities, money, or both, and

- to the extent provided in regulations,[4434] any interest in an entity[4435] not described in the preceding bullet point to the extent of the value of such interest which is attributable to marketable securities, money, or both.

However, two exceptions to the "marketable securities are money" rule of Code § 731(c) often apply. First, a marketable security is not treated as money if the security was contributed to the partnership by the partner receiving the distribution, except to the extent the security's value is attributable to other marketable securities or money contributed to the entity to which the distributed security relates.[4436] Second, Code § 731(c) does not apply to distributions of

---

[4430] FSA 200219008 asserted that short-term (nine-month) debt instruments issued by a bank should be treated as financial instruments that were readily convertible into money. The IRS probably viewed them as the equivalent of certificates of deposit.

[4431] Within the meaning of Code § 1092(d)(1). Code § 731(c)(2)(B)(iv).

[4432] According to Letter Ruling 200223036, this includes a partnership division under part II.Q.8.d Partnership Division. More details on the Letter Ruling are at fn. 4652.

[4433] Reg. § 1.731-2(c)(3)(i) provides:

> *Substantially all*. For purposes of section 731(c)(2)(B)(v) and this section, substantially all of the assets of an entity consist (directly or indirectly) of marketable securities, money, or both only if 90 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

This rule also applies for purposes of the investment company rules that might trigger gain recognition when a partnership is formed. See part II.M.3.b Exception: Diversification of Investment Risk, fn. 2945.

[4434] Reg. § 1.731-2(c)(3)(ii) provides:

> *Less than substantially all*. For purposes of section 731(c)(2)(B)(vi) and this section, an interest in an entity is a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to marketable securities, money, or both, if less than 90 percent but 20 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

This rule also applies for purposes of the investment company rules that might trigger gain recognition when a partnership is formed. See part II.M.3.b Exception: Diversification of Investment Risk, fn. 2945.

[4435] Letter Ruling 200223036 provides helpful analysis of the consequences of a situation similar to this arising from a partnership division. See fn. 4652.

[4436] Code § 731(c)(3)(A)(i); Reg. § 1.731-2(d)(1)(i). Letter Rulings 201537002 and 201537003 applied that rule to replacement stock certificates (referring to Reg. § 1.1012-1(c)(2)) for purposes of this rule and Code §§ 704(c)(1)(B) and 737; the rulings appear to be merely comfort rulings, because nothing jumped out at me as in doubt.

marketable securities by investment partnerships to eligible partners.[4437] An investment partnership is defined in Code § 731(c)(3)(C)(i) as a partnership that never has been engaged in any trade or business[4438] and whose assets have always substantially consisted of money, stock, notes and bonds, interest rate or currency contracts, foreign currencies, interests in or derivate financial instruments, and other specifically prescribed assets; and an eligible partner is a partner who has contributed only the aforementioned types of assets to the partnership.[4439] With regard to investment partnership status, remember that, if the partnership owns an interest in an entity that is a disregarded entity or partnership for federal income tax purposes, that entity's activity will be treated as a trade or business activity of the holding partnership. Thus, it could be beneficial to set up two partnerships and have one hold the assets that will prevent investment partnership status and another that would be an investment partnership. Furthermore, certain investment partnerships formed with almost all contributions being in the form of cash might be eligible for avoiding the mandatory inside basis step-down that applies when certain transfers of partnership interests or assets occur when a partnership has significant loss assets.[4440]

Two more exceptions might not apply frequently, but are still important to note. First, if the security was acquired in a nonrecognition transaction and the value of the securities and money exchanged in that nonrecognition transaction is less than 20% of the value of all the assets exchanged in the nonrecognition transaction, the securities will not be considered money.[4441] Additionally, the security is not treated as money if it was not a marketable security on the date the partnership acquired it and the issuing entity did not have any outstanding marketable securities at that time, the partnership held the security for at least six months before it became

---

[4437] Reg. § 1.731-2(e)(1). An eligible partner includes a remainderman of a trust that was an eligible partner. Letter Rulings 200824005 and 200824009. This includes the remaindermen when the LLC starts as a disregarded entity and becomes a partnership when distributed to the remaindermen. Letter Ruling 201421001 (described more fully in fn. 333). However, it does not include the transferor or transferee in a nonrecognition transaction involving a transfer of any portion of an interest in a partnership with respect to which the transferor was not an eligible partner. Code § 731(c)(3)(C)(iii)(II). The committee reports to P.L. 103-465 (12/8/94) explained:

> A partner who is not an eligible partner may not remove the taint from his partnership interest by transferring any portion of his interest to another person in a transaction in which gain or loss is not recognized in whole or in part.

This suggests a more limited scope to Code § 731(c)(3)(C)(iii)(II), but the regulations did not adopt any such limitation, so I would not rely on this suggestion of limited scope for planning purposes.

[4438] Reg. § 1.731-2(e)(4) provides:

> *Partnership tiers*. For purposes of section 731(c)(3)(C)(iv) and this section, a partnership (upper-tier partnership) is not treated as engaged in a trade or business engaged in by, or as holding (instead of a partnership interest) a proportionate share of the assets of, a partnership (lower-tier partnership) in which the partnership holds a partnership interest if—
>
> (i) The upper-tier partnership does not actively and substantially participate in the management of the lower-tier partnership; and
>
> (ii) The interest held by the upper-tier partnership is less than 20 percent of the total profits and capital interests in the lower-tier partnership.

[4439] Code § 731(c)(3)(C)(iii). Investment partnerships, as defined in 86 Ill. Admin. Code § 100.9730, are also exempted from the Illinois replacement tax that generally would otherwise apply to an Illinois partnership. 35 ILCS 5/205(b).

[4440] See text accompanying footnote 4747.

[4441] Reg. § 1.731-2(d)(1)(ii).

marketable, and the partnership distributed the security within five years of when it became marketable.[4442]

In addition to these four general exceptions to Code § 731(c), Code § 731(c)(3)(B) limits the amount of marketable securities treated as money, thereby limiting the amount of gain a recipient partner has to recognize. The limitation is calculated by first determining the partner's share of the partnership's built-in gain in all of its marketable securities, before the distribution is made.[4443] From this amount you subtract the partner's distributive share of the built-in gain that is attributable to marketable securities held by the partnership immediately after the transaction.[4444] The end result is the amount of marketable securities that are treated as "property other than money." Thus, to the extent a distribution of marketable securities does not decrease the recipient's share of built-in gain, the recipient will not be taxed under Code § 731(c). In other words:

- Try to make sure that each person retains a proportionate amount of unrealized appreciation.
- If the parties miss the mark a little, then they are taxed on shifted unrealized appreciation only to the extent that they missed the mark.
- Consider that any tax imposed will increase basis. Given that marketable securities tend to turn over anyway, part or all of the tax due to missing the mark a little might very well be saved when the marketable securities are later sold.

II.Q.8.b.i.(c). Disguised Sale from Partnership to Partner

A distribution of property from a partnership to a partner may be recharacterized as sale of that property in exchange for the partner's contribution of cash or property.[4445] Generally, one would apply rules similar to those described in part II.M.3.e Exception: Disguised Sale.[4446]

Thus, when a partnership distributes property and within two years after the distribution the recipient contributes cash, the partnership is deemed to have sold the property if the rules described in part II.M.3.e Exception: Disguised Sale would have recharacterized the opposite transaction.[4447]

[4442] Reg. § 1.731-2(d)(1)(iii).
[4443] Code § 731(c)(3)(B); Reg. § 1.731-2(b)(2).
[4444] *Id*.
[4445] Reg. § 1.707-6(a) provides:

> Rules similar to those provided in § 1.707-3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or in part, to the partner.

[4446] See fn. 4445, in which Reg. § 1.707-6(a) refers to Reg. § 1.707-3.
[4447] Reg. § 1.707-6(d), Example (1), "Sale of property by partnership to partner," provides:

> (i) A is a member of a partnership. The partnership transfers property X to A. At the time of the transfer, property X has a fair market value of $1,000,000. One year after the transfer, A transfers $1,100,000 to the partnership. Assume that under the rules of section 1274 the imputed principal amount of an obligation to transfer $1,100,000 one year after the transfer of property X is $1,000,000 on the date of the transfer.
>
> (ii) Since the transfer of $1,100,000 to the partnership by A is made within two years of the transfer of property X to A, under rules similar to those provided in § 1.707-3(c), the transfers are presumed to be a sale unless the facts and circumstances clearly establish otherwise. If no facts exist that would rebut this presumption, on the date that the partnership transfers

Disclosure rules similar to those described in part II.M.3.e Exception: Disguised Sale would apply.[4448]

II.Q.8.b.i.(d). Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property

When the distribution is a liquidating distribution, the partner's adjusted basis in the distributed property is equal to the adjusted basis of the partner's interest in the partnership, less any money distributed.[4449] Therefore, if a high basis partnership interest is redeemed in exchange for low basis property, the property receives a new basis equal to the basis of the redeemed partnership interest;[4450] this basis increase has no consequences to the partnership if a Code § 754 election is not in place (and certain mandatory basis adjustments are not in effect)[4451] and no consequences to the redeemed partner or other partners so long as none of the exceptions to the nonrecognition apply.[4452] The consequence would be a basis reduction.[4453] However, this basis reduction would apply only to the extent of any unrealized losses in the partnership's assets; it would not reduce the basis of any assets with unrealized gains.[4454]

In non-liquidating distributions, the partner's adjusted basis in the property distributed is simply the partnership's adjusted basis in the property before the distribution.[4455] However, the partner's

---

property X to A, the partnership is treated as having sold property X to A in exchange for A's obligation to transfer $1,100,000 to the partnership one year later.

[4448] Reg. § 1.707-6(c) provides:

Disclosure rules. Similar to the rules provided in §§ 1.707-3(c)(2) and 1.707-5(a)(7)(ii), a partnership is to disclose to the Internal Revenue Service, in accordance with § 1.707-8, the facts in the following circumstances:

(1) When a partnership transfers property to a partner and the partner transfers money or other consideration to the partnership within a two-year period (without regard to the order of the transfers) and the partnership treats the transfers as other than a sale for tax purposes; and

(2) When a partner assumes or takes subject to a liability of a partnership in connection with a transfer of property by the partnership to the partner, and the partnership incurred the liability within the two-year period prior to the earlier of the date the partnership agrees in writing to the transfer of property or the date the partnership transfers the property, and the partnership treats the liability as a qualified liability under rules similar to § 1.707-5(a)(6)(i)(B).

[4449] Code § 732(b).

[4450] Code § 732(b).

[4451] Part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 2583 briefly describes the effect on basis when a Code § 754 election is in place or in connection with certain substantial built-in loss transactions.

[4452] For possible exceptions to nonrecognition, see parts II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them), II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, and II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

[4453] See part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election.

[4454] See fn. 4775, found in part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

[4455] Code § 732(a)(1).

adjusted basis in the distributed property cannot exceed his adjusted basis in his partnership interest less any money distributed at the same time.[4456]

The substituted basis portion continues the contributing partner's depreciation schedule.[4457]

If a transferee partner receives a distribution of property from the partnership within two years after acquiring an interest or part thereof in the partnership by a transfer with respect to which a Code § 754 election was not in effect, the partner may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have as if a Code § 754 election were in effect; see part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election. This applies whether or not the distribution liquidates the partnership interest.

However, when a partnership distributes unrealized receivables (Code § 751(c)) or substantially appreciated inventory items (Code § 751(d)) in exchange for any part of a partner's interest in other partnership property (including money), or, conversely, partnership property (including money) other than unrealized receivables or substantially appreciated inventory items in exchange for any part of a partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items, the distribution will be treated as a sale or exchange of property under the provisions of Code § 751(b).[4458] In such case, Code § 732 determines the partner's basis of the property which the partner is treated as having sold to or exchanged with the partnership (as constituted after the distribution); the partner is considered as having received such property in a current distribution and, immediately thereafter, as having sold or exchanged it.[4459] However, Code § 732 does not apply in determining the basis of that part of property actually distributed to a partner which is treated as received by the partner in a sale or exchange under Code § 751(b), so the basis of such property shall be its cost to the partner.[4460]

The rule that assets received in a liquidating distribution get a basis equal to the liquidated partnership interest's basis can result in the liquidated asset receiving a basis step-up:[4461]

> Partner B, with a partnership interest having an adjusted basis to him of $12,000, retires from the partnership and receives cash of $2,000, and real property with an adjusted basis to the partnership of $6,000 and a fair market value of $14,000. The basis of the real property to B is $10,000 (B's basis for his partnership interest, $12,000, reduced by $2,000, the cash distributed).

However, this can turn around to bite the taxpayer, when the basis of the distributed assets exceeds the basis of the recipient's partnership interest (even if not in liquidation):[4462]

> Partner R has an adjusted basis of $10,000 for his partnership interest. He receives a current distribution of $4,000 cash and property with an adjusted basis to the partnership

4456 Code § 732(a)(2).
4457 Code § 168(i)(7).
4458 Reg. § 1.732-1(e).
4459 Reg. § 1.732-1(e), referring to Code § 751(b) and Reg. § 1.751-1(b).
4460 Reg. § 1.732-1(e).
4461 Reg. § 1.732-1(b).
4462 Reg. § 1.732-1(a), Example (2).

of $8,000. The basis of the distributed property to partner R is limited to $6,000 ($10,000, the adjusted basis of his interest, reduced by $4,000, the cash distributed).

Thus, the distributed property's basis decreased by $2,000, the excess of the $8,000 basis before the distribution over the $6,000 basis after the distribution.

However, Code § 734(b)(1), which applies if a Code § 754 election is in effect,[4463] causes the partnership to allocate this basis to other assets.

Special opportunities are available if the partnership has low basis property and a partner has a low basis partnership interest. (The partner might need to receive a large cash distribution to turn a high basis partnership interest into a low basis partnership interest.)[4464] The partnership borrows to buy property. The partnership then distributes the new property to the partner with the low basis. If a Code § 754 election is in place or if the distribution falls within the special rules of Code § 732(d), the distribution strips basis from the new property and results in the partnership allocating that stripped basis to the old, low basis property.

This basis stripping technique requires more work than is described above. The debt the partnership incurred generally would give everyone's partnership interest a higher basis.[4465] Increasing the basis of the distributee partner's partnership interest would reduce the basis stripping. Keeping the basis of the distributee partner's partnership interest low requires one of the following to occur:

- Make the distribution terminate the partner's interest in the partnership. Because the distributee will no longer be a partner, he will no longer be allocated any liabilities in the partnership. This reallocation of liabilities will be treated as a cash distribution,[4466] reducing the basis of his partnership interest available to allocate to the distributed property.[4467]
    - If the partner whose interest is being redeemed contributed to the partnership within seven years assets that the partnership retains <u>or</u> was allocated some built-in gain in the property when other partners were later admitted to the partnership, the partner would recognize gain when leaving the partnership,[4468] undercutting part or all of the short-term tax saving from the basis stripping transaction. To plan in advance for the possibility of using this

---

4463 See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

4464 If the partnership borrows to finance this distribution, consider the interest tracing rules to make sure that the partnership can deduct the interest. Because the debt the partnership incurred generally would give everyone's partnership interest a higher basis, note the suggestions further below in this part II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property for keeping the basis of the distributee partner's partnership interest low.

4465 Code §§ 752(a) (a partnership's incurring debt is treated as a cash contribution to the partnership), 722 (contribution of cash increases the basis of the contributor's partnership interest).

4466 Code § 752(b).

4467 Reg. § 1.732-1(b).

4468 See part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

strategy, on might consider forming a partnership many years before the opportunity arises.[4469]

- o If the partner wishes to stay in the partnership, consider dividing the partnership before this series of transactions,[4470] so that only the low basis asset remains in the partnership that eventually would buy this new property. Note, however, that a partnership division that distributes a partnership holding marketable securities might trigger Code § 731(c) gain.[4471]

- Take some special action to make sure that the partners other than the distributee partner are allocated the debt used to buy the new property. These actions relate to the nature of the debt, loan guarantees, and other documentation shifting risk of loss regarding the debt.[4472]

- If the distributed property is encumbered by debt to reduce the equity distributed to the redeemed partner, make sure that the debt is old and cold.[4473]

[4469] See part II.Q.8.a Partnership as a Master Entity.

[4470] See part II.Q.8.d Partnership Division. The division should keep the partners' percentage ownership the same in each partnership before and after the division to prevent the 7-year anti-mixing bowl rules (see fn. 4468) from applying to either partnership; see fn. 4622.

[4471] See fns. 4432 and 4652.

[4472] See part II.C.3 Allocating Liabilities (Including Debt). Code § 752 analysis can interact with the Code § 465 at-risk rules; see part II.G.3.g At Risk Rules, especially CCA 201606027, including key excerpts in fns. 1069-1072.

[4473] See Reg. § 1.707-6(b)(2) (dealing with liabilities incurred in connected with disguised sales). Reg § 1.707-6(d) includes the following example:

Example (2). *Assumption of liability by partner*.

(i) B is a member of an existing partnership. The partnership transfers property Y to B. On the date of the transfer, property Y has a fair market value of $1,000,000 and is encumbered by a nonrecourse liability of $600,000. B takes the property subject to the liability. The partnership incurred the nonrecourse liability six months prior to the transfer of property Y to B and used the proceeds to purchase an unrelated asset. Assume that, under the rule of § 1.707-5(a)(2)(ii) (which determines a partner's share of a nonrecourse liability), B's share of the nonrecourse liability immediately before the transfer of property Y was $100,000.

(ii) The liability is not allocable under the rules of § 1.163-8T to capital expenditures with respect to the property transferred to B and was not incurred in the ordinary course of the trade or business in which the property transferred to the partner was used or held. Since the partnership incurred the nonrecourse liability within two years of the transfer to B, under rules similar to those provided in § 1.707-5(a)(5), the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish the contrary. Assuming no facts exist to rebut this presumption, the liability taken subject to by B is not a qualified liability. The partnership is treated as having received, on the date of the transfer of property Y to B, $500,000 ($600,000 liability assumed by B less B's share of the $100,000 liability immediately prior to the transfer) as consideration for the sale of one-half ($500,000/$1,000,000) of property Y to B. The partnership is also treated as having distributed to B, in B's capacity as a partner, the other one-half of property Y.

Also, be careful not to trip the anti-abuse regulations, which set forth basic ideas generally respecting[4474] or criticizing[4475] partnership transactions, including a facts and circumstances

[4474] Reg. § 1.701-2(a) provides:

> *Intent of subchapter K*. Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements—
>
> (1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.
>
> (2) The form of each partnership transaction must be respected under substance over form principles.
>
> (3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. See, for example, paragraph (d) Example 6 of this section (relating to the value-equals-basis rule in § 1.704-1(b)(2)(iii)(c)), paragraph (d) Example 9 of this section (relating to the election under section 754 to adjust basis in partnership property), and paragraph (d) Examples 10 and 11 of this section (relating to the basis in property distributed by a partnership under section 732). See also, for example, §§ 1.704-3(e)(1) and 1.752-2(e)(4) (providing certain de minimis exceptions).

For regulations under Code § 752 that were changed in October 2016, see part II.C.3 Allocating Liabilities (Including Debt).

[4475] Reg. § 1.701-2(b) provides:

> *Application of subchapter K rules.* The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in paragraph (a) of this section (intent of subchapter K). Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K—
>
> (1) The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;
>
> (2) One or more of the purported partners of the partnership should not be treated as a partner;
>
> (3) The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income;
>
> (4) The partnership's items of income, gain, loss, deduction, or credit should be reallocated; or
>
> (5) The claimed tax treatment should otherwise be adjusted or modified.

test.[4476] These regulations accept some basis shifting, which is inherent in Code § 732 itself, such as apportioning among tangible assets with equal value[4477] or among a group of nonmarketable

---

[4476] Reg. § 1.701-2(c) provides:

Facts and circumstances analysis; factors. Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. The factors set forth below may be indicative, but do not necessarily establish, that a partnership was used in such a manner. These factors are illustrative only, and therefore may not be the only factors taken into account in making the determination under this section. Moreover, the weight given to any factor (whether specified in this paragraph or otherwise) depends on all the facts and circumstances. The presence or absence of any factor described in this paragraph does not create a presumption that a partnership was (or was not) used in such a manner. Factors include:

(1) The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;

(2) The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners;

(3) One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guaranty agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

(4) Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

(5) Partnership items are allocated in compliance with the literal language of §§ 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of section 704(b) and those regulations. In this regard, particular scrutiny will be paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);

(6) The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or

(7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).

[4477] Reg. § 1.701-2(d) provides:

Example (10). Basis adjustments under section 732; use of partnership consistent with the intent of subchapter K.

(i) A, B, and C are partners in partnership PRS, which has for several years been engaged in substantial bona fide business activities. For valid business reasons, the partners agree that A's interest in PRS, which has a value and basis of $100x, will be liquidated with the following assets of PRS: a nondepreciable asset with a value of $60x and a basis to PRS of $40x, and related equipment with two years of cost recovery remaining and a value and securities[4478] the basis of a partnership interest that is being liquidated. On the other hand, the regulations view as abusive duplication of losses a partner contributing property with a built-in

basis to PRS of $40x. Neither asset is described in section 751 and the transaction is not described in section 732(d). Under section 732(b) and (c), A's $100x basis in A's partnership interest will be allocated between the nondepreciable asset and the equipment received in the liquidating distribution in proportion to PRS's bases in those assets, or $50x to the nondepreciable asset and $50x to the equipment. Thus, A will have a $10x built-in gain in the nondepreciable asset ($60x value less $50x basis) and a $10x built-in loss in the equipment ($50x basis less $40x value), which it expects to recover rapidly through cost recovery deductions. In selecting the assets to be distributed to A, the partners had a principal purpose to take advantage of the fact that A's basis in the assets will be determined by reference to A's basis in A's partnership interest, thus, in effect, shifting a portion of A's basis from the nondepreciable asset to the equipment, which in turn would allow A to recover that portion of its basis more rapidly. This shift provides a federal tax timing advantage to A, with no offsetting detriment to B or C.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but the application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) A's basis in the assets distributed to it was determined under section 732(b) and (c). The transaction does not properly reflect A's income due to the basis distortions caused by the distribution and the shifting of basis from a nondepreciable to a depreciable asset. However, the basis rules under section 732, which in some situations can produce tax results that are inconsistent with the proper reflection of income standard (see paragraph (a)(3) of this section), are intended to provide simplifying administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose. Taking into account all the facts and circumstances of the transaction, the application of the basis rules under section 732 to the distribution from PRS to A, and the ultimate tax consequences of the application of that provision of subchapter K, are clearly contemplated. Thus, the application of section 732 to this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

[4478] Reg. § 1.701-2(d) provides:

Example (9). Absence of section 754 election; use of partnership consistent with the intent of subchapter K.

(i) PRS is a bona fide partnership formed to engage in investment activities with contributions of cash from each partner. Several years after joining PRS, A, a partner with a capital account balance and basis in its partnership interest of $100x, wishes to withdraw from PRS. The partnership agreement entitles A to receive the balance of A's capital account in cash or securities owned by PRS at the time of withdrawal, as mutually agreed to by A and the managing general partner, P. P and A agree to distribute to A $100x worth of nonloss and later receiving other assets with low value in liquidation of his partnership interest (to get a high basis allocated to the distributed assets), then selling the distributed assets at a loss,[4479] a

---

marketable securities (see section 731(c)) in which PRS has an aggregate basis of $20x. Upon distribution, A's aggregate basis in the securities is $100x under section 732(b). P RS does not make an election to adjust the basis in its remaining assets under section 754. Thus, PRS's basis in its remaining assets is unaffected by the distribution. In contrast, if a section 754 election had been in effect for the year of the distribution, under these facts section 734(b) would have required PRS to adjust the basis in its remaining assets downward by the amount of the untaxed appreciation in the distributed property, thus reflecting that gain in PRS's retained assets. In selecting the assets to be distributed, A and P had a principal purpose to take advantage of the facts that A's basis in the securities will be determined by reference to A's basis in its partnership interest under section 732(b), and because PRS will not make an election under section 754, the remaining partners of PRS will likely enjoy a federal tax timing advantage (i.e., from the $80x of additional basis in its assets that would have been eliminated if the section 754 election had been made) that is inconsistent with proper reflection of income under paragraph (a)(3) of this section.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. A's basis in the distributed securities is properly determined under section 732(b). The benefit to the remaining partners is a result of PRS not having made an election under section 754. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) In general, the adjustments that would be made if an election under section 754 were in effect are necessary to minimize distortions between the partners' bases in their partnership interests and the partnership's basis in its assets following, for example, a distribution to a partner. The electivity of section 754 is intended to provide administrative convenience for bona fide partnerships that are engaged in transactions for a substantial business purpose, by providing those partnerships the option of not adjusting their bases in their remaining assets following a distribution to a partner. Congress clearly recognized that if the section 754 elections were not made, basis distortions may result. Taking into account all the facts and circumstances of the transaction, the electivity of section 754 in the context of the distribution from PRS to A, and the ultimate tax consequences that follow from the failure to make the election with respect to the transaction, are clearly contemplated by section 754. Thus, the tax consequences of this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

[4479] Reg. § 1.701-2(d) provides the following example in which the lack of a Code § 754 was viewed as abusive:

Example (8). Plan to duplicate losses through absence of section 754 election; use of partnership not consistent with the intent of subchapter K.

result largely deterred by changes in the law since then.[4480] They also view as abusive distributing an insubstantial asset, allocating substantial basis to it, and then selling it at a substantial loss.[4481]

(i) A owns land with a basis of $100x and a fair market value of $60x. A would like to sell the land to B. A and B devise a plan a principal purpose of which is to permit the duplication, for a substantial period of time, of the tax benefit of A's built-in loss in the land. To effect this plan, A, C (A's brother), and W (C's wife) form partnership PRS, to which A contributes the land, and C and W each contribute $30x. All partnership items are shared in proportion to the partners' respective contributions to PRS. PRS invests the cash in an investment asset (that is not a marketable security within the meaning of section 731(c)). PRS also leases the land to B under a three-year lease pursuant to which B has the option to purchase the land from PRS upon the expiration of the lease for an amount equal to its fair market value at that time. All lease proceeds received are immediately distributed to the partners. In year 3, at a time when the values of the partnership's assets have not materially changed, PRS agrees with A to liquidate A's interest in exchange for the investment asset held by PRS. Under section 732(b), A's basis in the asset distributed equals $100x, A's basis in A's partnership interest immediately before the distribution. Shortly thereafter, A sells the investment asset to X, an unrelated party, recognizing a $40x loss.

(ii) PRS does not make an election under section 754. Accordingly, PRS's basis in the land contributed by A remains $100x. At the end of year 3, pursuant to the lease option, PRS sells the land to B for $60x (its fair market value). Thus, PRS recognizes a $40x loss on the sale, which is allocated equally between C and W. C's and W's bases in their partnership interests are reduced to $10x each pursuant to section 705. Their respective interests are worth $30x each. Thus, upon liquidation of PRS (or their interests therein), each of C and W will recognize $20x of gain. However, PRS's continued existence defers recognition of that gain indefinitely. Thus, if this arrangement is respected, C and W duplicate for their benefit A's built-in loss in the land prior to its contribution to PRS.

(iii) On these facts, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes (see paragraph (c) of this section). Accordingly, the transaction lacks a substantial business purpose (see paragraph (a)(1) of this section). In addition, factors (1), (2), and (4) of paragraph (c) of this section indicate that PRS was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K. On these facts, PRS is not bona fide (see paragraph (a)(1) of this section), and the transaction is not respected under applicable substance over form principles (see paragraph (a)(2) of this section). Further, the tax consequences to the partners do not properly reflect the partners' income; and Congress did not contemplate application of section 754 to partnerships such as PRS, which was formed for a principal purpose of producing a double tax benefit from a single economic loss (see paragraph (a)(3) of this section). Thus, PRS has been formed and availed of with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance over form doctrine or the disguised sale rules under section 707 (see paragraph (h) of this section)), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

[4480] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

[4481] Reg. § 1.701-2(d) provides:

Example (11). Basis adjustments under section 732; plan or arrangement to distort basis allocations artificially; use of partnership not consistent with the intent of subchapter K.

(i) Partnership PRS has for several years been engaged in the development and management of commercial real estate projects. X, an unrelated party, desires to acquire

Depending on the situation, not making a Code § 754 election might be considered abusive[4482] or not abusive.[4483] Also, the IRS reserves the right to assert and to rely upon applicable nonstatutory principles and other statutory and regulatory authorities to challenge transactions,[4484] which might subject taxpayers to penalties,[4485] so be careful not to get too cute.

Other partnership transactions might also be helpful.[4486]

---

undeveloped land owned by PRS, which has a value of $95x and a basis of $5x. X expects to hold the land indefinitely after its acquisition. Pursuant to a plan a principal purpose of which is to permit X to acquire and hold the land but nevertheless to recover for tax purposes a substantial portion of the purchase price for the land, X contributes $100x to PRS for an interest therein. Subsequently (at a time when the value of the partnership's assets have not materially changed), PRS distributes to X in liquidation of its interest in PRS the land and another asset with a value and basis to PRS of $5x. The second asset is an insignificant part of the economic transaction but is important to achieve the desired tax results. Under section 732(b) and (c), X's $100x basis in its partnership interest is allocated between the assets distributed to it in proportion to their bases to PRS, or $50x each. Thereafter, X plans to sell the second asset for its value of $5x, recognizing a loss of $45x. In this manner, X will, in effect, recover a substantial portion of the purchase price of the land almost immediately. In selecting the assets to be distributed to X, the partners had a principal purpose to take advantage of the fact that X's basis in the assets will be determined under section 732(b) and (c), thus, in effect, shifting a portion of X's basis economically allocable to the land that X intends to retain to an inconsequential asset that X intends to dispose of quickly. This shift provides a federal tax timing advantage to X, with no offsetting detriment to any of PRS's other partners.

(ii) Although section 732 recognizes that basis distortions can occur in certain situations, which may produce tax results that do not satisfy the proper reflection of income standard of paragraph (a)(3) of this section, the provision is intended only to provide ancillary, simplifying tax results for bona fide partnership transactions that are engaged in for substantial business purposes. Section 732 is not intended to serve as the basis for plans or arrangements in which inconsequential or immaterial assets are included in the distribution with a principal purpose of obtaining substantially favorable tax results by virtue of the statute's simplifying rules. The transaction does not properly reflect X's income due to the basis distortions caused by the distribution that result in shifting a significant portion of X's basis to this inconsequential asset. Moreover, the proper reflection of income standard contained in paragraph (a)(3) of this section is not treated as satisfied, because, taking into account all the facts and circumstances, the application of section 732 to this arrangement, and the ultimate tax consequences that would thereby result, were not clearly contemplated by that provision of subchapter K. In addition, by using a partnership (if respected), the partners' aggregate federal tax liability would be substantially less than had they owned the partnership's assets directly (see paragraph (c)(1) of this section). On these facts, PRS has been formed and availed of with a principal purpose to reduce the taxpayers' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under applicable judicial principles and statutory authorities, such as the disguised sale rules under section 707, see paragraph (h) of this section), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

4482 Reg. § 1.701-2(d), Example (8).
4483 Reg. § 1.701-2(d), Example (9).
4484 Reg. § 1.701-2(i).
4485 See part II.G.16 Economic Substance Penalty.
4486 See Abrams, Now You See It; Now You Don't: Exiting a Partnership and Making Gain Disappear, *TM Memorandum* (2/16/2009).

Note that partners can shift basis without going through this process, but the transactions also require seasoning. Suppose A has for many years held low basis real estate worth $1 million. Last year, B bought real estate for $1 million, intending to hold it for investment. A and B swap real estate in a tax-free Code § 1031 exchange.[4487] The old property now has a high basis in B's hands, and the new property has a low basis in A's hands. Code § 1031 generally requires A and B to have intended to hold the property for investment when they bought them and to intend to hold the swapped property for investment after the Code § 1031 exchange.

In reviewing anything in this part II.Q.8.b.i.(d), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

II.Q.8.b.i.(e). Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value

The Code § 731(a) rule that there are no tax consequences to a partner when the partner receives a partnership distribution is subject to two exceptions if the distribution is made within seven years after the partner contributed property to the partnership:

- First, earlier it was discussed that Code § 704(c)(1)(B) triggers gain when the partnership distributes contributed property to a partner other than the contributing partner[4488] within seven years after the contribution; it also applies if the partnership agreement is amended within seven years to shift to the other partner the burdens and benefits and the property is distributed to that other partner more than seven years after contribution.[4489]

- Second, Code § 737 will trigger gain to a distributee partner if the partner contributes property to the partnership and then receives a distribution of some other property[4490] within seven years of the partner's original contribution. When such a distribution is made, the partner must recognize gain equal to the lesser of (1) the excess of the fair market value of the distributed property over the partner's partnership interest's adjusted basis (less any money received in the distribution) or (2) the partner's net pre-contribution gain.[4491] Net pre-contribution gain, as defined in Code § 737(b), is the gain that would have been recognized by the distributee partner under Code § 704(c)(1)(B) if all property the partner had contributed to the partnership within seven years of the distribution that was still held by the partnership immediately before the distribution was distributed by the partnership to some other partner.

These rules relate to Code § 704(c) responsibility – the allocation to a partner of built-in gain or loss when the partnership contributes to a partnership property the basis of which differs from its fair market value – which integrates with part II.P.1.a.i Allocations of Income in Partnerships.

"The transferee of all or a portion of a contributing partner's partnership interest succeeds to the transferor's net precontribution gain, if any, in an amount proportionate to the interest

[4487] See part II.G.15 Like-Kind Exchanges.

[4488] When a partnership distributes to a partner property that the partnership contributed, none of Code § 704(c)(1)(B), 731(c) or 737 applied. See fn. 4436.

[4489] Reg. § 1.704-4(f)(2), Example (1).

[4490] When a partnership distributes to a partner property that the partnership contributed, none of Code § 704(c)(1)(B), 731(c) or 737 applied. See fn. 4436.

[4491] Code § 737(a)(1) and (2).

transferred."[4492] Because debt associated with contributed property is allocated to a partner to the extent of Code § 704(c) gain,[4493] anti-abuse rules prevent the acceleration or duplication of loss through the assumption of potentially suspect obligations.[4494] Obligations that are not potentially suspect include those that generate basis (such as buying or improving an asset), result in an immediate deduction, or give rise to a nondeductible expense.[4495]

[4492] Reg. § 1.737-1(c)(2)(iii), which further provides:

> See § 1.704-3(a)(7) and § 1.704-4(d)(2) for similar provisions in the context of section 704(c)(1)(A) and section 704(c)(1)(B).

Reg. § 1.704-3(a)(7) provides:

> *Transfer of a partnership interest*. If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner. This rule does not apply to any person who acquired a partnership interest from a § 1.752-7 liability partner in a transaction to which paragraph (e)(1) of § 1.752-7 applies. See § 1.752-7(c)(1).

Reg. § 1.704-4(d)(2) provides:

> *Transfers of a partnership interest*. The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner. See § 1.704-3(a)(7).

[4493] See paragraph (2) of the text accompanying fn 401 in part II.C.3.c.iii Allocating Nonrecourse (Remaining) Liabilities.

[4494] Reg. § 1.752-7(a) provides:

> *Purpose and structure*. The purpose of this section is to prevent the acceleration or duplication of loss through the assumption of obligations not described in § 1.752-1(a)(4)(i) in transactions involving partnerships. Under paragraph (c) of this section, any such obligation that is assumed by a partnership from a partner in a transaction governed by section 721(a) is treated as section 704(c) property. Paragraphs (e), (f), and (g) of this section provide rules for situations where a partnership assumes such an obligation from a partner and, subsequently, that partner transfers all or part of the partnership interest, that partner receives a distribution in liquidation of the partnership interest, or another partner assumes part or all of that obligation from the partnership. These rules prevent the duplication of loss by prohibiting the partnership and any person other than the partner from whom the obligation was assumed from claiming a deduction, loss, or capital expense to the extent of the built-in loss associated with the obligation. These rules also prevent the acceleration of loss by deferring the partner's deduction or loss attributable to the obligation (if any) until the satisfaction of the § 1.752-7 liability (within the meaning of paragraph (b)(8) of this section). Paragraph (d) of this section provides a number of exceptions to paragraphs (e), (f), and (g) of this section, including a de minimis exception. Paragraph (i) provides a special rule for situations in which an amount paid to satisfy a § 1.752-7 liability is capitalized into other partnership property. Paragraph (j) of this section provides special rules for tiered partnership transactions.

Reg. § 1.752-7(c)(1)(i) provides:

> *Section 704(c)*. Except as otherwise provided in this section, sections 704(c)(1)(A) and (B), section 737, and the regulations thereunder, apply to § 1.752-7 liabilities. See § 1.704-3(a)(12). However, §1.704-3(a)(7) does not apply to any person who acquired a partnership interest from a § 1.752-7 liability partner in a transaction to which paragraph (e)(1) of this section applies.

Reg. § 1.752-7(e)(1) limits deduction, loss, or capital expense is allowed to the partnership on the satisfaction of a Reg. § 1.752-7 liability.

[4495] Reg. § 1.752-1(a)(4)(i). For details, see fn 354 in part II.C.3.b What Is a "Liability" and also fn 5324 in part III.B.1.a.ii.(c) Income Tax Consequences Involving Loan Guarantees.

If a new partner joins a partnership (or an existing partner makes a non-pro rata contribution) when the partnership holds property the basis of which differs from its fair market value:

- The existing partners' capital accounts obtain Code § 704(c) responsibility;[4496] this is called a "reverse-Code § 704(c))" allocation. Thus, any unrealized gain that occurred between the time the partnership acquired the property and the time a new partner joined (or an existing partner makes a non-pro rata contribution) constitutes Code § 704(c) responsibility that is allocated to all of the existing partners.[4497] This responsibility can be reflected by either a special allocation of gain in the partnership agreement or by revaluing capital accounts on the

---

[4496] See Reg. § 1.704-3(a)(6). See also Reg. § 1.704-1(b)(2)(iv)(s)(2).

[4497] Reg. §§ 1.704-1(b)(5), Example (14)(i), provides:

> MC and RW form a general partnership to which each contributes $10,000. The $20,000 is invested in securities of Ventureco (which are not readily tradable on an established securities market)…. Assume that the Ventureco securities subsequently appreciate in value to $50,000. At that time SK makes a $25,000 cash contribution to the partnership (thereby acquiring a one-third interest in the partnership), and the $25,000 is placed in a bank account. Upon SK's admission to the partnership, the capital accounts of MC and RW (which were $10,000 each prior to SK's admission) are, in accordance with paragraph (b)(2)(iv)(f) of this section, adjusted upward (to $25,000 each) to reflect their shares of the unrealized appreciation in the Ventureco securities that occurred before SK was admitted to the partnership. Immediately after SK's admission to the partnership, the securities are sold for their $50,000 fair market value, resulting in taxable gain of $30,000 ($50,000 less $20,000 adjusted tax basis) and no book gain or loss. An allocation of the $30,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the $30,000 taxable gain will, in accordance with section 704(c) principles, be shared $15,000 to MC and $15,000 to RW, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

Reg. §§ 1.704-1(b)(5), Example (14)(ii), provides:

> Assume the same facts as (i), except that after SK's admission to the partnership, the Ventureco securities appreciate in value to $74,000 and are sold, resulting in taxable gain of $54,000 ($74,000 less $20,000 adjusted tax basis) and book gain of $24,000 ($74,000 less $50,000 book value). Under the partnership agreement the $24,000 book gain (the appreciation in value occurring after SK became a partner) is allocated equally among MC, RW, and SK, and such allocations have substantial economic effect. An allocation of the $54,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the taxable gain will, in accordance with section 704(c) principles, be shared $23,000 to MC $23,000 to RW, and $8,000 to SK, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

Reg. §§ 1.704-1(b)(5), Example (14)(iii), provides:

> Assume the same facts as (i) except that after SK's admission to the partnership, the Ventureco securities depreciate in value to $44,000 and are sold, resulting in taxable gain of $24,000 ($44,000 less $20,000 adjusted tax basis) and a book loss of $6,000 ($50,000 book value less $44,000). Under the partnership agreement the $6,000 book loss is allocated equally among MC, RW, and SK, and such allocations have substantial economic effect. An allocation of the $24,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the $24,000 taxable gain will, in accordance with section 704(c) principles, be shared equally between MC and RW, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

books,[4498] but the partnership must take one of these steps for the partnership agreement to be respected.[4499] An unexpected part of this issue is that one can become saddled with Code § 704(c) responsibility for assets one did not contribute; consider whether this might reset the seven-year period with respect to that newly acquired Code § 704(c) responsibility (I have not researched the latter).

- If the partnership included a nominal partner merely to get the seven-year period running and the previously contributed property is promptly distributed to a partner who is admitted just after the seven-year had run, the nominal partner's existence is ignored in determining the seven-year period, so Code § 704(c)(1)(B) taxes the contributing partner.[4500]

Note that Code § 737 is applied after Code § 731(c), which means that any marketable securities that are treated as money for Code § 731(c) purposes are ignored when applying Code § 737.[4501] This can lead to a favorable result for a distributee partner in two ways. First, since the property

---

[4498] For how to revalue, see Reg. § 1.704-1(b)(2)(iv)(f), which is reproduced in fn. 450 in part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts). See also Reg. § 1.704-1(b)(5), Example (33). Although generally this responsibility is determined separately for each asset, see an alternative approach is in part II.P.1.a.i.(b) Special Rules for Allocations of Income in Securities Partnerships.

[4499] See Reg. § 1.704-1(b)(5), Example (14)(iv), referencing Reg. § 1.704-1(b)(1)(iii), (iv).

Reg. § 1.704-1(b)(1)(iii) provides:

> *Effect of other sections*. The determination of a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) under section 704(b) and this paragraph is not conclusive as to the tax treatment of a partner with respect to such distributive share. For example, an allocation of loss or deduction to a partner that is respected under section 704(b) and this paragraph may not be deductible by such partner if the partner lacks the requisite motive for economic gain (see, *e.g.*, *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966)), or may be disallowed for that taxable year (and held in suspense) if the limitations of section 465 or section 704(d) are applicable. Similarly, an allocation that is respected under section 704(b) and this paragraph nevertheless may be reallocated under other provisions, such as section 482, section 704(e)(2), section 706(d) (and related assignment of income principles), and paragraph (b)(2)(ii) of § 1.751-1. If a partnership has a section 754 election in effect, a partner's distributive share of partnership income, gain, loss, or deduction may be affected as provided in § 1.743-1 (see paragraph (b)(2)(iv)(m)(2) of this section). A deduction that appears to be a nonrecourse deduction deemed to be in accordance with the partners' interests in the partnership may not be such because purported nonrecourse liabilities of the partnership in fact constitute equity rather than debt. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address the effect of other sections or limitations on such allocations.

Reg. § 1.704-1(b)(1)(iv) provides:

> *Other possible tax consequences*. Allocations that are respected under section 704(b) and this paragraph may give rise to other tax consequences, such as those resulting from the application of section 61, section 83, section 751, section 2501, paragraph (f) of § 1.46-3, § 1.47-6, paragraph (b)(1) of § 1.721-1 (and related principles), and paragraph (e) of § 1.752-1. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address other tax consequences that may result from such allocations.

Implicit in clause (iv) is that failure to maintain proper capital accounts can have gift tax consequences under Code § 2501.

Also see Reg. § 1.704-1(b)(2)(iv)(b), which is reproduced in the text accompanying fn. 445 in part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts).

[4500] Reg. § 1.704-4(f)(2), Example (2).

[4501] Reg. § 1.731-2(g).

piece of the distribution is reduced by treating marketable securities as money, the Code § 737 gain potential is reduced. Second, the total amount of cash and marketable securities treated as money could be less than the basis of the distributee partner's partnership interest, resulting in no gain recognition under Code § 731.

As in the Code § 704(c) analysis, the prevailing view among commentators seems to be that a transferee of a partnership interest will "step into" the transferor's shoes in Code § 737 situations. This view is supported by the fact that regulations supporting Code § 704(c)(1)(B) and Code § 737 were written by the same people, at the same time, in the same project, and are likely to have been designed to work in coordination with one another. A partner should not be able to avoid the rules of Code § 737 by transferring the partnership interest to a third party. Thus, the transferee partner should be treated as the contributing partner under Code § 737.[4502]

When contributed property is distributed to any non-contributing partner within seven years of its contribution, the contributing partner is treated as if the property were sold to the recipient partner at its fair market value and must recognize the proper gain or loss under Code § 704(c)(1)(A); however, an exception applies for certain deemed like-kind exchanges.[4503] This like-kind exception applies not only to Code § 704(c) but also to Code § 737.[4504] Thus, partners in a real

---

[4502] I am very comfortable with the statement in the text, although it is not totally free from doubt. See Robinson, Don't Nothing Last Forever – Unwinding the FLP to the Haunting Melodies of Subchapter K, *ACTEC Journal*, Spring 2003, p. 302; Blum and Harrison, Another View: A Response to Richard Robinson's Don't Nothing Last Forever – Unwinding the FLP to the Haunting Melodies of Subchapter K, *ACTEC Journal*, Spring 2003, p. 313; and Robinson's Comments on Blum and Harrison's Another View, *ACTEC Journal*, Spring 2003, p. 318.

[4503] Code § 704(c)(2). See Borden and Longhofer, The Effect of Like-Kind Property on the Section 704(c) Anti-Mixing Bowl Rules, *TM Real Estate Journal* (3/2/2011). Reg. § 1.704-4(d)(3) provides:

> *Distributions of like-kind property*. If section 704(c) property is distributed to a partner other than the contributing partner and like-kind property (within the meaning of section 1031) is distributed to the contributing partner no later than the earlier of (i) 180 days following the date of the distribution to the non-contributing partner, or (ii) the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the noncontributing partner, the amount of gain or loss, if any, that the contributing partner would otherwise have recognized under section 704(c)(1)(B) and this section is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner immediately after the distribution. The contributing partner's basis in the distributed like-kind property is determined as if the like-kind property were distributed in an unrelated distribution prior to the distribution of any other property distributed as part of the same distribution and is determined without regard to the increase in the contributing partner's adjusted tax basis in the partnership interest under section 704(c)(1)(B) and this section. See § 1.707-3 for provisions treating the distribution of the like-kind property to the contributing partner as a disguised sale in certain situations.

Reg. § 1.704-4(d)(4) provides an example.

[4504] In determining the precontribution gain subject to possible taxation under Code § 737, Reg. § 1.737-1(c)(2)(iv) provides:

> *Section 704(c)(1)(B) gain recognized in related distribution*. A distributee partner's net precontribution gain is determined after taking into account any gain or loss recognized by the partner under section 704(c)(1)(B) and § 1.704-4 (or that would have been recognized by the partner except for the like-kind exception in section 704(c)(2) and § 1.704-4(d)(3)) on an actual distribution to another partner of section 704(c) property contributed by the distributee partner that is part of the same distribution as the distribution to the distributee partner.

However, Reg. § 1.737-1(c)(2)(v) requires an actual distribution:

> *Section 704(c)(2) disregarded*. A distributee partner's net precontribution gain is determined without regard to the provisions of section 704(c)(2) and § 1.704-4(d)(3) in situations in which the

estate mixing bowl partnership might completely avoid gain recognition under Code §§ 704(c)(1)(B) and 737 if the partnership is liquidated before the seven year waiting period and the different partners each receive part or complete ownership of various properties owned by the partnership.[4505]

For issues relating to built-in losses, see the American Bar Association Section of Taxation's "Comments on Proposed Regulations on Certain Partnership Provisions of the American Jobs Creation Act of 2004," *Tax Lawyer*, vol. 69, No. 1, p. 5 (Fall 2015).

II.Q.8.b.i.(f). Code § 751 – Hot Assets

Code § 751(a) and Reg. § 1.751-1(a)(1) provide that part of the gain attributable to hot assets (substantially appreciated inventory or unrealized receivables) "shall be considered as an amount realized from the sale or exchange of property other than a capital asset." Because capital gain treatment does not apply, this gain tends to be viewed colloquially as ordinary income, even though it is actually gain from the sale of property. This noncapital gain is "qualified business income" that may receive a deduction of up to 20% under Code § 199A.[4506]

A partner might be deemed to have entered into a transaction regarding hot assets if:[4507]

- The partner receives hot assets in exchange for all or a part of the partner's interest in other partnership property (including money), or

- The partner receives partnership property (including money) in exchange for all or a part of the partner's interest in hot assets.

This rule does not apply to not apply to a distribution of property that the distributee contributed to the partnership or Code § 736(a) payments to a retiring partner or successor in interest of a deceased partner.[4508]

Proposed regulations "prescribe how a partner should measure its interest in a partnership's unrealized receivables and inventory items.. and … provide guidance regarding the tax consequences of a distribution that causes a reduction in that interest."[4509]

> property contributed by the distributee partner is not actually distributed to another partner in a distribution related to the section 737 distribution.

[4505] Breitstone and Wilensky, Dividing a Real Estate Empire: The Mixing Bowl Alternative, *TM Memorandum* (BNA) (3/9/2015).

[4506] See Prop. Reg. § 1.199A-3(b)(1)(i), reproduced in part II.E.1.c.ii.(a) Generally; List of Items Included in QBI.

[4507] Code § 751(b)(1).

[4508] Code § 751(b)(2).

[4509] REG-151416-06, Certain Distributions Treated as Sales or Exchanges [FR Doc. 2014-25487 Filed 10/31/2014 at 8:45 am; Publication Date: 11/03/2014]. The proposed regulations would obsolete Rev. Rul. 84-102. For the effective date:

> The regulations, as proposed, apply to distributions occurring in any taxable period ending on or after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register. The rules contained in § 1.751-1(a)(2) would apply to transfers of partnership interests that occur on or after [11/03/2014]. However, the rules contained in § 1.751-1(a)(2) are a clarification of existing rules, and no inference is intended from the change to § 1.751-1(a)(2) with respect to sales or exchanges of partnership interests prior to the effective date for § 1.751-1(a)(2).

A partnership's inventory items are "substantially appreciated" if their fair market value exceeds 120% of the partnership's adjusted basis in such property, unless a principal purpose for acquiring such property was to avoid these rules regarding inventory items.[4510] "Inventory items" include:[4511]

- the partnership's Code § 1221(a)(1) property,[4512]
- any other partnership property that, if the partnership sold or exchanged them, would be considered property other than a capital asset and other than Code § 1231 property,[4513] and
- any other property the partnership held that, if held by the selling or distributee partner, would be considered property of the type described above.

"Unrealized receivables" include, to the extent not previously includible in income under the partnership's tax accounting method, any rights (contractual or otherwise) to payment for:[4514]

- goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or
- services rendered, or to be rendered.

For purposes of Code §§ 731, 732, 741, and 751, but not for purposes of Code § 736,[4515] "unrealized receivables" includes the following as if the partnership had been sold it at its fair market value, to the extent that their sale would trigger certain unfavorable tax treatment:[4516]

- mining property,[4517]
- stock in a DISC,[4518]

> The rules contained in § 1.751-1(a)(3) continue to apply to transfers of partnership interests that occur on or after December 15, 1999. A partnership and its partners would be able to rely on § 1.751-1(b)(2) of these proposed regulations for purposes of determining a partner's interest in the partnership's section 751 property on or after [11/03/2014] provided the partnership and its partners apply each of § 1.751-1(a)(2), § 1.751-1(b)(2), and § 1.751-1(b)(4) of these proposed regulations consistently for all partnership distributions and sales or exchanges, including for any distributions and sales or exchanges the partnership makes after a termination of the partnership under section 708(b)(1)(B).

See Longhofer and Rimmke, Proposed Section 751(b) Regulations: An Exchange for the Better? *Journal of Taxation* (Aug. 2015).

[4510] Code § 751(b)(3).

[4511] Code § 751(d).

[4512] Real estate might or might not constitute inventory. See part II.G.12 Future Development of Real Estate, especially fn. 1300.

[4513] Code § 1231 is discussed in part II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business. Code § 1245 depreciation recapture overrides Code § 1231; see fn. 1223.

[4514] Code § 751(c).

[4515] P.L. 103-66 (8/10/1993), § 13262(b), deleted the reference to Code § 736.

[4516] Code § 751(c).

[4517] As defined in Code § 617(f)(2), to the extent that Code § 617(d)(1) would apply.

[4518] As described in Code § 992(a), to the extent that Code § 995(c) would apply.

- Code § 1245 property (generally, depreciable personal property),[4519]
- stock in certain foreign corporations,[4520]
- Code § 1250 property (generally, real estate depreciated faster than straight-line depreciation),[4521]
- farm land,[4522]
- franchises, trademarks, or trade names,[4523] or
- an oil, gas, or geothermal property.[4524]

For purposes of Code §§ 731, 732, 741, and 751, but not for purposes of Code § 736, "unrealized receivables" also includes any market discount bond[4525] and any short-term obligation[4526] but only to the extent of the amount which would be treated as ordinary income if the partnership had sold such property.

More drastic consequences may apply when selling to a controlled corporation interests in a partnership holding depreciable property (including depreciable real estate that would not have depreciation recapture under Code § 1250), taxing the entire gain as ordinary income, not just the part that might have constituted depreciation recapture.[4527]

See also part II.Q.8.c Related Party Sales of Non-Capital Assets by or to Partnerships.

II.Q.8.b.i.(g). Characteristics of Distributed Property

Often, asset distributions precede, follow, or are substitutes for the transfer of partnership interests. Therefore, the concepts of distributions and transfers of partnership interests should be considered together. For the latter, see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

[4519] As defined in Code § 1245(a)(3), to the extent that Code § 1245(a) would apply.
[4520] As described in Code § 1248, to the extent that Code § 1248(a) would apply. For purposes of applying Code § 731, 741, and 751, in the case of an individual, the tax attributable to such amount shall be limited in the manner provided by Code § 1248(b) (relating to gain from certain sales or exchanges of stock in certain foreign corporation). Code § 751(e).
[4521] As defined in Code § 1250(c), to the extent that Code § 1250(a) would apply. Code § 1250(a)(1)(A)(i) applies Code § 1250(a) to additional depreciation, referring to subsections (b)(1) and (b)(4). Subsection (b)(1) applies to depreciation faster than straight line. Subsection (b)(4) applies to certain rehabilitation expenditures.
[4522] As defined in Code § 1252(a), to the extent that Code § 1252(a) would apply.
[4523] Referred to in Code § 1253(a), to the extent that Code § 1253(a) would apply.
[4524] As defined in Code § 1254, to the extent that Code § 1254(a) would apply.
[4525] As defined in Code § 1278.
[4526] As defined in Code § 1283.
[4527] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), especially the text accompanying fns. 4214-4219.

A distributed property's basis depends on whether the distribution liquidated the partner's partnership interest:

- Generally, the basis of property (other than money) distributed by a partnership to a partner, other than in liquidation of the partner's interest, is its adjusted basis to the partnership immediately before such distribution.[4528] However, this basis cannot exceed the adjusted basis of the partner's interest in the partnership, reduced by any money distributed in the same transaction.[4529]

- The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is the partnership interest's adjusted basis, reduced by any money distributed in the same transaction.[4530]

However, neither of these rules applies to the extent that a distribution is treated as a sale or exchange of property under Code § 751(b) (relating to unrealized receivables and inventory items).[4531]

Also, special rules apply to a partner who acquired all or a part of his interest by a transfer with respect to which a Code § 754 election is not in effect, and to whom a distribution of property (other than money) is made with respect to the transferred interest within two years after such transfer.[4532] The partner may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in Code § 743(b) were in effect.[4533] Depending on the situation, this basis adjustment requires elections or is mandatory.[4534]

A partner's holding period for property received in a distribution from a partnership generally includes the partnership's holding period.[4535]

[4528] Code § 732(a)(1).

[4529] Code § 732(a)(2). If that cap causes a loss of basis, the partnership can reallocate that lost basis to the partnership's other assets under Code § 734 if a Code § 754 election is in place. See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S corporations.

[4530] Code § 732(b).

[4531] Code § 732(e). For details regarding these assets, see part II.Q.8.b.i.(f) Code § 751 – Hot Assets.

[4532] Code § 732(d). For a discussion of these rules, including any opportunity to shift basis from non-depreciable to depreciable assets, see McKee, Nelson & Whitmire, ¶26.01 Transferees' Special Basis Adjustments in Connection With Subsequent Distributions, *Federal Taxation of Partnerships & Par*tners (WG&L).

[4533] Reg. § 1.732-1(d)(1)(iii). The amount of this adjustment is not diminished by any depletion or depreciation of that portion of the basis of partnership property arising from this special basis adjustment, since depletion or depreciation on such portion before distribution is allowed or allowable only if the optional adjustment under Code § 743(b) is in effect. Reg. § 1.732-1(d)(1)(iv). If this property is not the same property which would have had a special basis adjustment, then such special basis adjustment applies to any like property received in the distribution, if the transferee, in exchange for the property distributed, has relinquished the transferee's interest in the property with respect to which the transferee would have had a special basis adjustment. Reg. § 1.732-1(d)(1)(v).

[4534] Reg. § 1.731-1(d)(2), (3), (4).

[4535] Code § 735(b). See Goold & Schneider, Finding the Gold Nuggets in Partnership Holding Periods, *Passthrough Entities* 31 (Nov./Dec. 2002). See also Borden, Navigating State Law and Tax Issues Raised by Partnership and LLC Reorganizations, *Business Entities* (Jul./Aug. 2014), suggesting that the holding

When a partner who receives "hot assets" later disposes of them, the partner will recognize ordinary income:

- The disposition of Code § 751(c) unrealized receivables received from a partnership is ordinary gain or loss.[4536]

- The disposition of Code § 751(d) inventory received from a partnership, within 5 years from the date of the distribution,[4537] is ordinary gain or loss.[4538]

If any of these hot assets is disposed of in a nonrecognition transaction or a series of nonrecognition transactions, the above tax treatment shall also apply to any substituted basis property resulting from such transaction(s).[4539]

---

period of distributed property might be the longer of the partnership's holding period or the partnership interest's holding period.

[4536] Code § 735(a)(1).

[4537] For purposes of this rule, the partnership's holding period does not tack, and Code § 751(d) (defining inventory item) shall be applied without regard to any holding period in Code § 1231(b). Code § 735(b), (c)(1).

[4538] Code § 735(a)(1).

[4539] Code § 735(c)(2)(A). This rule does not apply to any stock in a C corporation received in a Code § 351 exchange. Code § 735(c)(2)(B).

II.Q.8.b.ii. Partnership Redemption – Complete Withdrawal Using Code § 736

II.Q.8.b.ii.(a). Introduction to Code § 736

When a partnership redeems[4540] a partner's interest in full,[4541] Code § 736(a) provides that payments may be deductible to the partnership and ordinary income to the selling partner;[4542] if and to the extent that these payments are based on partnership income rather than being fixed, they constitute a shifting of a distributive share of partnership income to the retiring partner, rather than a deduction to the partnership and income to the retiring partner.[4543] Or, one may choose to apply Code § 736(b) so that they are nondeductible to the partnership (although possibly depreciated or amortized) and gain to the partner.[4544] (In analyzing the discussion below, note

---

[4540] Code § 736 applies only to payments made by the partnership and not to transactions between partners. Reg. § 1.736-1(a)(1)(i). If the responsibility for making payments in a transaction between partners is assigned to the partnership, the assignment does not transform the sale into a Code § 736 redemption. *Coven v. Commissioner*, 66 T.C. 295 (1976), *acq.* 1976-2 C.B. 1, reasoning:

> We therefore conclude that petitioner sold his partnership interest to Suttenberg individually. The resulting tax consequences accordingly cannot be determined by section 736, since that section applies "only to payments made by the partnership and not to transactions between the partners." Sec. 1.736-1(a)(1)(i), Income Tax Regs. See also *Karan v. Commissioner*, 319 F.2d 303, 307 (7th Cir. 1963), *affg.* a Memorandum Opinion of this Court; *Smith v. Commissioner*, 313 F.2d 16, 19 (10th Cir. 1962), *affg.* 37 T.C. 1033 (1962); *Charles F. Phillips*, 40 T.C. 157, 161 (1963); 1 Willis, Partnership Taxation, sec. 46.01, p. 606 (2d ed. 1976).[10]
>
> [10] Although the agreement made a specific allocation for goodwill, capital gains treatment under sec. 736(b)(2)(B) would still not be possible, even if that agreement were not later superseded, because sec. 736 is inapplicable to this sale between partners. Furthermore, even if sec. 736 were applicable, the Consultant Contract, which was adopted, does not make any reference to goodwill, and the partnership did not operate under a written agreement: no operative written partnership agreement specifying payments for goodwill thus existed. Sec. 736(b)(2)(B) would therefore still be inapplicable. See *V. Zay Smith*, 37 T.C. 1033, 1037 (1962), *affd.* 313 F.2d 16 (10th Cir. 1962).

[4541] Code § 736 applies only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. Code § 736 does not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Reg. § 1.736-1(a)(1)(i). A partner retires when that person ceases to be a partner under local law. However, for partnership income tax purposes, a retired partner or a deceased partner's successor will be treated as a partner until such partner's interest in the partnership has been completely liquidated. Reg. § 1.736-1(a)(1)(ii). Thus, if one of the members of a two-person partnership retires or dies and the retiring member or deceased member's estate is to receive Code § 736 payments, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's or deceased member's estate's entire interest is liquidated, since the retiring partner or deceased member's estate continues to hold a partnership interest in the partnership until that time. Reg. § 1.736-1(a)(6).

[4542] For whether such payments are subject to self-employment tax, see part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.

[4543] Reg. § 1.736-1(a)(4). The retiring partner might like (if credits are passed through) or dislike (if nondeductible expenses increase taxable income) this result.

[4544] Except to the extent Code § 751(b) applies (see part II.Q.8.b.i.(f) Code § 751 – Hot Assets), the amount of any gain or loss with respect to such payments shall be determined under Code § 731. Reg. § 1.736-1(b)(6). However, where the total of such payments is a fixed sum, the seller may elect (in the seller's tax return for the first taxable year for which the seller receives such payments), to report and to measure the amount of any gain or loss by the difference between the amount treated as a distribution under Code § 736(b) in that year, and the portion of the partner's adjusted basis that bears the same proportion to the partner's total adjusted basis for the partner's partnership interest as the amount distributed under Code § 736(b) in that year bears to the total amount to be distributed under Code § 736(b). *Id*.

that one must be careful in relying on the regulations, which were last amended before P.L. 103-66 was enacted in 1993.[4545])

Code § 736 prevails over the rules of Code § 1001 that normally govern sales.[4546] For further discussion, see part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.

We will see below that generally a Code § 736(b) payment is taxed under Code § 731(a), so one might wonder how important it might be to be within the scope of Code § 736. Part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale, especially the text accompanying fns. 4574-4577, explains why Code § 736 treatment can be extremely important.

Further below, a brief discussion illustrates why a partner whose interest is being redeemed would generally prefer Code § 736(a) treatment, even though at first glance it would seem that the retiring partner would prefer Code § 736(b) treatment, since capital gains rates are lower than ordinary income rates.

II.Q.8.b.ii.(b). Flexibility in Choosing between Code § 736(a) and (b) Payments

Before explaining this counter-intuitive rule, let's discuss the flexibility allowed. Within certain limits, the redemption agreement can provide that as much or as little of the redemption payments

---

4545 The legislative history to 1993 changes to Code § 736 provides:

> *In general*.
>
> The bill generally repeals the special treatment of liquidation payments made for goodwill and unrealized receivables. Thus, such payments would be treated as made in exchange for the partner's interest in partnership property, and not as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent. The bill does not change present law with respect to payments made to a general partner in a partnership in which capital is not a material income-producing factor. The determination of whether capital is a material income-producing factor would be made under principles of present and prior law [e.g., sections 401(c)(2) and 911(d) of the Code and old section 1348(b)(1)(A) of the Code]. For purposes of this provision, capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual. The practice of his or her profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts his or her practice so long as such capital investment is merely incidental to such professional practice. In addition, the bill does not affect the deductibility of compensation paid to a retiring partner for past services.
>
> *Unrealized receivables*.
>
> The bill also repeals the special treatment of payments made for unrealized receivables (other than unbilled amounts and accounts receivable) for all partners. Such amounts would be treated as made in exchange for the partner's interest in partnership property. Thus, for example, a payment for depreciation recapture would be treated as made in exchange for an interest in partnership property, and not as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent.

Regarding payments for past services, see part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner, regarding when such payments are not subject to self-employment tax.

4546 The first sentence of Reg. § 1.1001-1(a) says, **<u>Except as otherwise provided in subtitle A of the Code</u>**, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. (emphasis added) receive treatment under Code § 736(a) or (b).[4547] However, Code § 736(b) payments cannot exceed the fair market value of the withdrawing partner's share of the partnership property;[4548] therefore, Code § 736(a) must apply to such excess.

Except as discussed below, Code § 736(b) payments cannot be for (and therefore Code § 736(a) must apply to) the partnership's:

- Unrealized receivables;[4549]

- Goodwill, except to the extent that the partnership agreement provides for a payment with respect to goodwill.

The above limitation on what constitutes Code § 736(b) payments means that such payments must be classified as Code § 736(a) payments. It does not mean that such payments are the

---

[4547] Reg. § 1.736-1(b)(5)(iii). For what constitutes an agreement designating payments, see *Commissioner v. Jackson Investment Company*, 346 F.2d 187 (9th Cir. 1965), *rev'g* 41 T.C. 675 (reviewed decision 1964 holding that a withdrawal agreement was not given effect under Code § 736 as it did not constitute a partnership agreement); the Tax Court seems to have abandoned its decision in *Jackson Investment Company* in other Circuits as well – see *Spector v. Commissioner*, T.C. Memo. 1982-433, characterizing *Jackson Investment Company* as involving an ambiguous provision. If an agreement between all the remaining partners and the withdrawing partner or his successor in interest does not designate payments, then, subject to the limits described further below, Reg. § 1.736-1(b)(5)(i), (ii) provide the following:

> If a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number of years, the portion of each payment to be treated as a distribution under section 736(b) for the taxable year shall bear the same ratio to the total fixed agreed payments for such year (as distinguished from the amount actually received) as the total fixed agreed payments under section 736(b) bear to the total fixed agreed payments under section 736(a) and (b). The balance, if any, of such amount received in the same taxable year shall be treated as a distributive share or a guaranteed payment under section 736(a)(1) or (2). However, if the total amount received in any one year is less than the amount considered as a distribution under section 736(b) for that year, then any unapplied portion shall be added to the portion of the payments for the following year or years which are to be treated as a distribution under section 736(b). For example, retiring partner W who is entitled to an annual payment of $6,000 for 10 years for his interest in partnership property, receives only $3,500 in 1955. In 1956, he receives $10,000. Of this amount $8,500 ($6,000 plus $2,500 from 1955) is treated as a distribution under section 736(b) for 1956; $1,500, as a payment under section 736(a).
>
> If the retiring partner or deceased partner's successor in interest receives payments which are not fixed in amount, such payments shall first be treated as payments in exchange for his interest in partnership property under section 736(b) to the extent of the value of that interest and, thereafter, as payments under section 736(a).

Whether a Code § 754 election is in effect or is deemed to be in effect might affect whether undesignated payments are 736(a) or 736(b) payments. McBride, Alice's Estate in the Wonderland of Subchapter K, *Tax Notes* 2/23/2009, pages 971-980.

[4548] Reg. § 1.736-1(b)(5)(iii).

[4549] Code § 736(b)(2)(A). Unrealized receivables include the right to payments for (1) goods delivered, or to be delivered, to the extent the proceeds would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered. Code § 751(c), which is further described in part II.Q.8.b.i.(f) Code § 751 – Hot Assets. However, for purposes of Code § 736, they do not include other items that Code § 751 would normally treat as unrealized receivables. See text accompanying fns. 4515-4526.

only types of payments that can be classified as Code § 736(a) payments instead of Code § 736(b) payments.[4550]

However, starting in 1993, payments for unrealized receivables and goodwill are eligible for Code § 736(a) treatment only if capital is not a material income-producing factor for the partnership and the retiring or deceased partner was a general partner in the partnership.[4551] The regulations have not been updated to take into account this rule. In applying this rule, capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual.[4552] The professional practice of a doctor, dentist, lawyer, architect, or accountant is not treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts that practice if the capital investment is merely incidental to such professional practice.[4553]

Code § 736(a) payments are available for payments in the form of mutual insurance not determined by reference to any partnership asset,[4554] payments of compensation to a retired partner for past services,[4555] and perhaps a portion[4556] of payments where capital is a material income-producing factor.[4557]

If and to the extent that goodwill would not be eligible for Code § 736(a) treatment, consider how one would measure goodwill. For example, if the retiring partner was undercompensated for prior services before the company reached its full potential or for any other reason, payments could be allocated to past services.

If none of the above works around the inability to apply Code § 736(a) to goodwill, consider doing a partial redemption instead of a complete termination. Code § 736 applies only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership.[4558] Instead, provide a preferred interest in the partnership's profits up to a certain limit. Generally, reallocating profits between partners is not a taxable event.[4559]

II.Q.8.b.ii.(c). Comparing Code § 736(a) with (b) Strategically

See the example in part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis. The "Capital Gains to Seller" scenario corresponds to part II.Q.1.a.i.(d) S corporation Double Taxation, which corresponds to Code § 736(b) payments, and the "Ordinary Income to Seller" scenario corresponds to part II.Q.1.a.i.(e) Partnership Single

---

[4550] Reg. § 1.736-1(b)(3) provides a ceiling on payments for goodwill, not a floor under which they may not be lowered. *Tolmach v. Commissioner*, T.C. Memo. 1991-538.
[4551] Code § 736(b)(3).
[4552] See fn. 4545.
[4553] See fn. 4545.
[4554] Reg. § 1.736-1(a)(2).
[4555] See fn. 4545.
[4556] If the partners have agreed that the value of the Code § 736(b) payments is not to exceed a certain amount that is below fair market value, the remainder would be Code § 736(a) payments.
[4557] Banoff, More on Section 736(a) Payments After RRA '93 Changes, 83 *Journal of Taxation* 191 (Sept. 1995).
[4558] See fn. 4541.
[4559] See part II.C.6 Shifting Rights to Future Profits.

Taxation of Goodwill, which corresponds to Code § 736(a) payments. The contrast between these scenarios is illustrated in part II.Q.1.a.i.(f) Partnership Use of Same Earnings as S corporation in Sale of Goodwill.

Main Points

1. Using a capital gain Code § 736(b) scenario, taxes consume much more to the parties as a whole than would the ordinary income Code § 736(a) scenario in meeting the targeted payments of "principal." Thus, the ordinary income scenario provides more money available to buy out the seller and ease the stress of the buy-out.

2. To compensate the seller for a higher ordinary income tax rate, the seller must receive more to generate the same after-tax flow. Thus, the stated sales price would appear to be higher and more burdensome, although really the buyer is better off because deducting the payments saves more than the additional purchase price cost.

3. In the § 736(a) scenario, increases in ordinary income tax rates harm the seller disproportionately, although it might be possible for the buyer to agree to pay seller more because the buyer saves more tax by making those additional payments. On the other hand, in a capital gain scenario, an increase in capital gain rates without a corresponding increase in ordinary income rates would not help the buyer save as much tax by paying the seller more.

4. Code § 736(a) requires a complete liquidation in the redeemed partner's interest.[4560] However, the complete redemption may be made over time, and Code § 736 does not terminate the partnership, even if only one owner is left (but Code § 736 does not prevent termination if the partnership ceases activity).[4561] If the partnership assumes the partner's

[4560] Reg. § 1.736-1(a)(1)(i).

[4561] Rev. Rul. 75-154 involved the following facts:

> ABC partnership was formed in 1968 to conduct a management consulting business. Under the terms of the partnership agreement, upon retirement, the retiring partner was entitled to receive, in addition to amounts paid for his interest in partnership property, a specified amount payable in monthly installments over a three-year period following his retirement. There was no provision in the partnership agreement with respect to the payment to a retiring partner for goodwill. Partner C retired on January 2, 1972, and received 12 monthly payments from the partnership during 1972. On January 2, 1973, all of the business and financial activities of the partnership ended and A and B withdrew from the business. The former partners, A and B, assumed their share of the remaining liability to C and made the required payments for the years 1973 and 1974.

The ruling analyzed and held:

> Section 1.736-1(a)(6) of the Income Tax Regulations provides, in part, that a retiring partner or a deceased partner's successor in interest receiving payments under section 736 of the Code is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated. Therefore, if one of the members of a 2-man partnership retires under a plan whereby he is to receive payments under section 736, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's entire interest is liquidated, since the retiring partner continues to hold a partnership interest in the partnership until that time.
>
> Section 1.736-1(a)(6) of the regulations prevents the termination of a partnership under section 708 of the Code, only in those situations in which the partnership would otherwise be terminated because of the withdrawal of a retiring or a deceased partner who is entitled to receive payments under section 736(a)(2). However, in the instant case, section 1.736-1(a)(6) of the regulations does not prevent the termination of the partnership under section 708, even though C was receiving

share of liabilities, it cannot deduct the payment of those liabilities under Code § 736 later than the year in which the partner's relationship with the partnership terminated;[4562] the liabilities are treated as relieved (and therefore cash is deemed paid) when the withdrawing partner is no longer a partner (ignoring the Code § 736 deemed continuation).[4563]

5. The above treatment does not apply to the extent that the LLC is repaying the seller's capital account, to the extent that the seller's capital account would be the LLC's earnings that are allocated to the seller but not distributed. The seller would not be taxed on such distributions, because they were taxed when originally earned.

6. Combined with a Code § 754 election, a Code § 736(b) payment would generate a separate basis for each asset whose basis is adjusted, and each year a new set of assets would be created.[4564] Rather than try to recover that tax benefit, a Code § 736(a) is an easier way for the remaining partners to avoid tax on earnings used to buy the redeemed partner.

7. A partnership might be structured with profits interests that shift over time, which might achieve results similar to that of Code § 736 without the partner completely retiring. For example, suppose an older partner brought in a lot of business, but the agreement would be that the younger partners would take over the business after a number of years. The partnership might be structured to give the older partner a larger profits interest in early years and a smaller profits interest in later years. Generally, merely shifting interests in future profits is not a taxable event.[4565] The objective would be to structure it not as a sale, but rather as an allocation of profits related to the business each partner generates and the services each partner performs.

8. A technique similar to Code § 736 ordinary income payments used to be available to corporations in some situations. If the corporation could make a case that the departing shareholder was under-compensated for prior services, the corporation would pay compensation to him or her, with economic results similar to that of Code § 736 ordinary income payments. Code § 409A has made that strategy more difficult to use, imposing a 20% penalty on deferred compensation to the extent substantially vesting occurs after December 31, 2004, unless the statute's strict requirements are satisfied. To use deferred compensation payments based on prior services, the parties would need to prove that it is fair

---

liquidating payments under section 736(a)(2). It was the withdrawal of A and B that caused the partnership to terminate, not C's prior retirement.

Accordingly, the partnership did not continue to exist under section 736 of the Code, but terminated under section 708 when partners A and B discontinued the financial operation of the partnership and withdrew from the business.

It has been previously held that payments that would have been deductible by a partnership had it continued in existence were deductible by the former partners after termination of the partnership. See *Flood v. United States*, 133 F.2d 173 (1st Cir. 1943).

Thus, in the instant case, after the partnership terminated, payments made by former partners A and B, in satisfaction of the liability to retired partner C, are deductible by them as trade or business expenses under section 162(a) of the Code in the year paid, since the payments would have been deductible by the partnership if it had not terminated. Furthermore, the payments to C are includible in C's gross income under section 61(a) in the year received.

[4562] *Whitman & Ransom v. Commissioner*, T.C. Memo. 2005-172.

[4563] See Reg. § 1.736-1(b)(7), Example (1), implementing Reg. § 1.736-1(a)(2) (treating assumption of liabilities treated as a distribution of money under Code § 752 in applying Code § 736).

[4564] See the paragraph of text accompanying fn. 4593 in part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.

[4565] See part II.C.6 Shifting Rights to Future Profits.

to compensate the selling owner-employee for prior services even though the employer was previously not legally obligated to do so. The sooner one plans for this future compensation, the easier it will be to prove reasonableness, since the owner-employee will be earning the compensation over time in a manner that is specifically referred to as an incentive for continued efforts. A challenge is that an appropriate level of compensation may be difficult to determine many years in advance of a sale.

Additional Code § 736 Issues

As discussed above, to the extent permitted by law, generally:

- Returns of basis should be structured as Code § 736(b) payments, because the seller is not taxed on them, and
- Profit on the sale of a partnership should be structured as Code § 736(a) payments, and the sale price should be increased at least enough to compensate the seller for paying taxes at ordinary income and self-employment and similar tax rates instead of any applicable capital gain rates.

II.Q.8.b.ii.(d). Comparing Code § 736(b) to an Installment Sale

Suppose one partner is exiting and being bought out over time, and one or more remaining partners will have higher interests in profits and losses. Should it be structured as a sale from one partner to another, or should the partnership redeem the exiting partner? If the latter, should the partnership issue a note to the partner?

In many cases, the partnership should redeem the exiting partner, documented by the partnership agreement without a separate promissory note. Code § 736 redemptions of a retiring partner are often better than an installment sale; and issuing a note might move the transaction into an unclear tax posture, whereas relying solely on the partnership agreement avoids certain questions. Merely shifting the right to future profits would not generate an income tax consequence;[4566] however, shifting a partner's capital account and any gain or loss inherent in that partner's share of the partnership's existing value would have income tax consequences. We have already seen how Code § 736(a) payments tend to work better for the partnership's value relating to goodwill;[4567] the rest of this part II.Q.8.b.ii.(d) discusses all components of value in a general sense.

Code § 736 taxes the retired partner on Code § 736 payments as if the retired partner were still a partner;[4568] complete liquidation of a partner's interest does not occur until no more payments

[4566] See part II.C.6 Shifting Rights to Future Profits.

[4567] See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis, especially parts II.Q.1.a.i.(f) Partnership Use of Same Earnings as S corporation in Sale of Goodwill and II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill.

[4568] Reg. § 1.736-1(a)(6). Although a partner retires when he ceases to be a partner under local law, a retired partner or a deceased partner's successor will be treated as a partner for partnership income tax purposes (subchapter K, chapter 1 of the Code) until the partner's interest in the partnership has been completely liquidated. Reg. § 1.736-1(a)(1)(ii). Does this continuation of treatment as a partner apply for purposes of the income in respect of a decedent rules of Code § 1014(c), which is found in subchapter O may be made to the withdrawn partner.[4569] Code § 736(a) payments are taxed in the year for which they are made, rather than in the year of receipt.[4570] Furthermore, except to the extent Code § 751(b) applies, the amount of any gain or loss with respect to payments under Code § 736(b) for a retiring or deceased partner's interest in property for each year of payment shall be determined under Code § 731.[4571]

Code § 736 redemptions do not appear to contemplate the installment sale rules applying. If Code § 736 applies instead of the installment sale rules applying, then, rather than pro rating basis among the scheduled installment payments the way an installment sale would work, basis is applied fully to the earliest payments until it is used up. Thus, Code § 736 payments defer recognition of gain on sale relative to installment sales, a benefit that is not present in the sale of stock in a C or an S corporation; it also allows distributions to be applied to the partner's entire basis in the partnership,[4572] whereas distributions to shareholders are applied pro rata to their shares and are taxed according to the basis in each block of shares,[4573] perhaps heightening the impact of deferred basis recovery for those sales that are redemptions recharacterized as distributions.

The installment sale of a partnership interest can be particularly disastrous if the partnership has significant "hot assets," which can include not only inventory and accounts receivable but also depreciable property,[4574] because income from those items is taxable immediately – even if it exceeds the amount that the seller received up front.[4575] However, depreciable property and certain other property[4576] are not "hot assets" when applying Code § 736.[4577]

Not all redemptions qualify for Code § 736 treatment – they need to be "in liquidation of the interest of a retiring partner or a deceased partner."[4578] If a Code § 736 payment obligation is evidenced as a promissory note rather than contract right, do the installment sale provisions apply

---

of chapter 1 of the Code? See part II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411.

[4569] *Brennan v. Commissioner*, T.C. Memo, 2012-209 (citing Reg. § 1.761-1(d) and imposing a negligence penalty for failure to report the partner's distributive share of income earned before the partner received the final payment) , *aff'd* 116 A.F.T.R.2d 2015-6569 (9th Cir. 2015).

[4570] Reg. § 1.736-1(a)(5).

[4571] Reg. § 1.736-1(b)(6).

[4572] See part II.Q.8.e.ii.(a) Unitary Basis.

[4573] See part II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property, especially fn. 4223.

[4574] See part II.Q.8.b.i.(f) Code § 751 – Hot Assets.

[4575] See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests, especially fn. 4695.

[4576] See part II.Q.8.b.i.(f) Code § 751 – Hot Assets, especially fns. 4517-4524.

[4577] See part II.Q.8.b.i.(f) Code § 751 – Hot Assets, especially fn. 4515.

[4578] Code § 736(a), (b)(1). Reg. § 1.736-1(a)(1)(i) elaborates:

> Section 736 and this section apply only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. See section 761(d). Section 736 and this section do not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Section 736 and this section apply only to payments made by the partnership and not to transactions between the partners. Thus, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of section 736.

when the partner receives the note?[4579] The amounts paid for his interest in assets are treated in the same manner as a distribution in complete liquidation under Code §§ 731, 732, and, where applicable, 751.[4580]

Neither Code § 731 nor Code § 732 nor the regulations under either statute address the effect of distributing a note in which the partnership is the maker. For purposes of maintaining capital accounts, generally distributions of notes do not count as distributions except to the extent that the partner disposes of or the partnership repays the note, but a distribution of a note will count as a distribution if the note is readily tradable on an established securities market,[4581] is

---

[4579] See Kim and Saunders, Redeeming a Partner with The Partnership's Note, *TM Memorandum* (BNA) (3/21/2016) (saved as Thompson Coburn doc. 6817740).

[4580] Reg. § 1.736-1(a)(2), which also refers to Reg. § 1.751-1(b)(4)(ii). Reg. § 1.751-1(b)(4)(ii) provides:

> Section 751(b) does not apply to payments made to a retiring partner or to a deceased partner's successor in interest to the extent that, under section 736(a), such payments constitute a distributive share of partnership income or guaranteed payments. Payments to a retiring partner or to a deceased partner's successor in interest for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, constitute payments under section 736(a) and, therefore, are not subject to section 751(b). However, payments under section 736(b) which are considered as made in exchange for an interest in partnership property are subject to section 751(b) to the extent that they involve an exchange of substantially appreciated inventory items for other property. Thus, payments to a retiring partner or to a deceased partner's successor in interest under section 736 must first be divided between payments under section 736(a) and section 736(b). The section 736(b) payments must then be divided, if there is an exchange of substantially appreciated inventory items for other property, between the payments treated as a sale or exchange under section 751(b) and payments treated as a distribution under sections 731 through 736. See subparagraph (1)(iii) of this paragraph, and section 736 and § 1.736-1.

However, the scope of unrealized receivables is narrower under Code § 736 than on other transactions involving hot assets; see part II.Q.8.b.i.(f) Code § 751 – Hot Assets, especially the text accompanying fn. 4515.

[4581] In addition to Reg. § 1.704-1(b)(2)(iv)(e)(2) that is reproduced in fn. 4582, consider that Code §§ 731(c)(2)(B)(ii) (any financial instrument which, pursuant to its terms or any other arrangement, is readily … exchangeable for, money or marketable securities) and 731(c)(2)(C) (The term 'financial instrument' includes … evidences of indebtedness ….) treat a distribution of publicly traded debt as a cash distribution.

negotiable,[4582] or perhaps if it is payable upon demand.[4583] However, a leading treatise strongly opposes counting a note in which the partnership is the maker, whether or not negotiable, as a distribution;[4584] the treatise does, suggest, however, reducing the basis available to allocate to other distributed assets by the amount of payments expected to be made.[4585] Issuing a formal

---

[4582] Reg. § 1.704-1(b)(2)(iv)(e)(2) provides:

> *Distribution of promissory notes*. Notwithstanding the general rule of paragraph (b)(2)(iv)(b)(5), except as provided in this paragraph (b)(2)(iv)(e)(2), if a promissory note is distributed to a partner by a partnership that is the maker of such note, such partner's capital account will be decreased with respect to such note only when there is a taxable disposition of such note by the partner or when the partnership makes principal payments on the note. The previous sentence shall not apply if a note distributed to a partner by a partnership who is the maker of such note is readily tradable on an established securities market. Furthermore, the capital account of a partner whose interest in a partnership is liquidated will be reduced to the extent of (i) the fair market value, at the time of distribution, of any negotiable promissory note (of which such partnership is the maker) that such partnership distributes to the partner on or after the date such partner's interest is liquidated and within the time specified in paragraph (b)(2)(ii)(b)(2) of this section, and (ii) the fair market value, at the time of liquidation, of the unsatisfied portion of any negotiable promissory note (of which such partnership is the maker) that such partnership previously distributed to the partner. For purposes of the preceding sentence, the fair market value of a note will be no less than the outstanding principal balance of such note, provided that such note bears interest at a rate no less than the applicable federal rate at time of valuation.

[4583] Consider that Code §§ 731(c)(2)(B)(ii) (any financial instrument which, pursuant to its terms … is readily convertible into, or exchangeable for, money) and 731(c)(2)(C) (The term 'financial instrument' includes … evidences of indebtedness ….) treat a distribution of a demand note as a cash distribution.

[4584] McKee, Nelson & Whitmire, ¶19.05. Distributions in Complete Liquidation of a Partnership Interest, *Federal Taxation of Partnerships & Partners* (WG&L), reasons (footnotes omitted):

> Treating even a secured negotiable promissory note of the partnership as cash or a cash equivalent, the distribution of which triggers gain under § 731(a), would be inconsistent with the statutory scheme of Subchapter K because a § 754 election by the partnership would permit the partnership to increase the basis of its assets as the result of the distribution of zero-basis property. Similarly, treating a partnership's promissory note as property for purposes of applying §§ 731 and 732 also would produce results totally inconsistent with the Subchapter K scheme. Property characterization in connection with a current distribution would give the note a zero basis in the distributee-partner's hands under § 732(a)(1) because it would have a zero basis in the partnership's hands immediately prior to the distribution. Subsequent payments on the note would have to be treated as payments rather than distributions; the expenditure of partnership assets with no corresponding overall impact on the bases of the partners' interests would destroy the symmetry between the partnership's basis in its assets and the partners' bases in their interests, which Subchapter K strives to preserve. Similarly, if a partnership note were treated as property distributed as the sole consideration for the liquidation of a partner's entire interest in the partnership, it would take on a basis equal to the distributee-partner's basis in his interest. If a § 754 election were in effect, the partnership would be required to reduce the basis of its retained assets under § 734(b)(2)(B) by the amount of the distributee-partner's post-distribution basis in the note. By contrast, a cash distribution in the amount of the note would produce an increase in the basis of partnership assets if the cash distributed exceeded the distributee-partner's predistribution basis in his interest. A partnership note should thus not be treated as property under §§ 731 and 732, either. Payments on the note should be treated as distributions of cash, subject to all the rules applicable to such distributions.

[4585] McKee, Nelson & Whitmire, ¶19.05. Distributions in Complete Liquidation of a Partnership Interest, *Federal Taxation of Partnerships & Partners* (WG&L), reasons in a footnote:

> See Reg. § 1.732-1(b) (Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of his interest in the partnership reduced by the amount of any

note creates much complexity and uncertainty,[4586] so one might consider keeping the payment right a contract right not reduced to a note. On the other hand, using a note and installment sale treatment would enable a cleaner break between the redeemed partner and the partnership and simplify inside basis step up issues (fn. 4593). The clean break from the partnership allows the retiring partner not to be treated as a partner any more for income tax purposes[4587] but also locks in the installment sale gain as income in respect of a decedent, the latter making the installment obligation ineligible for a basis step-up at death, whereas mere Code § 736(b) installments appear eligible for a basis step-up at death.[4588]

One might also be cautious when admitting a partner and redeeming a partner close in time to each, lest the IRS argue a disguised sale between the retiring partner and the new partner.[4589]

> money distributed to him *in the same transaction*. (emphasis added)). The reference to the same transaction should be interpreted to refer to the entire series of liquidating distributions in order to be consistent with the Regulations § 1.761-1(d) definition of liquidation. Further, any other interpretation of Regulations § 1.732-1(b) would make the timing of liquidating distributions a key ingredient in determining the basis of distributed property, and would allow taxpayers to artificially inflate the basis of property distributed in liquidation by agreeing to defer cash distributions. For example, assume a partner, whose basis of his interest is $10,000, is to receive $4,000 cash and a capital asset in liquidation of his interest. Under the interpretation suggested in the text, the distributed capital asset will have a basis of $6,000 to the partner regardless of the order in which the distributions are made. If subsequent cash distributions are not taken into account in computing the basis of the distributed capital asset, the capital asset will take a basis of $10,000 if it is distributed first and the $4,000 cash distribution will be taxable when received, a combination that would allow the distributee to accelerate losses (by selling the distributed capital asset) in exchange for a deferred gain on the eventual receipt of the cash.

[4586] See Cuff, Distributions of Promissory Notes In Liquidation of a Partner's Interest, *Journal of Real Estate Taxation* (now simply *Real Estate Taxation*) (WG&L), (1st Qtr. 2006) (capital accounting for promissory note distributions to a partner, allocations with respect to contributed property, allocations after a book-up of partnership assets, the minimum gain chargeback, the qualified income offset, unrecaptured Code § 1250 gain, allocation of partnership liabilities, and collapsible partnerships); Cuff, Promissory Notes In Liquidation of a Partner's Interest Still Hold Questions, *Journal of Real Estate Taxation* (now simply *Real Estate Taxation*) (WG&L), (2nd Qtr. 2006) (considering the interplay of the rules described in the 1st Qtr. Article, and the rules on disguised sales and collapsible partnerships).

[4587] See fns. 4568-4569.

[4588] See fns. 4591 and 4592 and part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[4589] See Kim and Saunders, Redeeming a Partner with The Partnership's Note, *TM Memorandum* (BNA) (3/21/2016) (saved as Thompson Coburn doc. 6817740). Announcement 2009-4 stated:

> Until new guidance is issued, any determination of whether transfers between a partner or partners and a partnership is a transfer of a partnership interest will be based on the statutory language, guidance provided in legislative history, and case law.

Announcement 2009-4 looks askance at a couple of cases in this area, which cases are discussed in the Kim and Saunders article but which might control, notwithstanding the IRS' view. Announcement 2009-4 stated:

> Section 707(a)(2)(B) provides that, under regulations prescribed by the Secretary, if transfers of property between a partner or partners and a partnership, when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated as either transactions between the partnership and one who is not a partner or between two or more partners acting other than in their capacity as partners. The legislative history of section 707(a)(2)(B) indicates the provision was adopted as a result of Congressional concern that taxpayers were deferring or avoiding tax on sales of partnership property, including sales of partnership interests, by characterizing sales as contributions of property, including money, followed or preceded by related partnership distributions. See H.R. Rep. No. 861, 98th Cong. 2nd Sess. 861 (1984), 1984-

Letter Ruling 8304059 assumed that using a promissory note to redeem a partner does not necessarily take the transaction out of Code § 736 and ruled that any interest paid constitutes a Code § 707(c) guaranteed payment and that Reg. §§ 1.267(b)-1(b) and 1.707-1(c) prevent Code § 267 from limiting the timing of the interest deduction. Although a Code § 736 payment may bear interest, it need not.[4590] For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

It appears that a basis adjustment would apply at the retiring partner's death, which might eliminate a considerable part of the gain to be recognized on future installments (to the extent

---

3 (Vol. 2) CB 115. Specifically, Congress was concerned about court decisions that allowed tax-free treatment in cases that were economically indistinguishable from sales of property to a partnership or another partner, and believed that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance. See H.R. Rep. No. 432, 98th Cong. 2nd Sess. 1218 (1984) (H.R. Rep.), and S. Prt. No. 169 (Vol. I), 98th Cong. 2nd Sess. 225 (1984) (S. Prt.) (discussing *Communications Satellite Corp. v. United States*, 625 F.2d 997 (Ct. Cl. 1980), and *Jupiter Corp. v. United States*, 2 Cl. Ct. 58 (1983), both of which involved disguised sales of a partnership interest).

[4590] Garlock, ¶1308 Debt Contributed To And Distributed From Partnerships, *Federal Income Taxation of Debt Instruments* (CCH), asserts in ¶1308.02 Distributions of Debt Instruments from Partnerships, [B] Debt of the Partnership:

> …The real issue, then, is whether interest will be imputed on partnership notes to partners that do not bear adequate stated interest. As noted above, the better view is that interest should not be imputed.
>
> If a partnership's note distributed to a partner is respected for all tax purposes, and if the partner's interest in the partnership is not reduced as a result of the distribution (as would be the case in a situation involving a pro rata distribution of notes to all partners), the determination of its issue price is unclear. The note is not issued for cash or property because the partner is not giving anything to the partnership in exchange for the note. There is no partnership analogue to section 1275(a)(4), which deems a corporation's note distributed to a shareholder as being issued in exchange for property. Hence, section 1273(b) does not provide any rule for determining the note's issue price.[258] Reg. § 1.1273-2(d)(1), which is broader than the corresponding statutory rule, effectively treats any debt instrument not issued for money or publicly traded property or subject to section 1274 as having an issue price equal to its stated redemption price.
>
> If the debt distributed provides for qualified stated interest (QSI), then its stated redemption price at maturity equals its stated principal amount and little is at stake here. The stated interest is respected as interest, and the stated principal amount is respected as principal. Even if the interest is at a rate below the AFR (or is zero), no interest is imputed under section 1274 because the debt was not issued in exchange for property and no interest is imputed under section 7872 because a loan from a partnership to a partner is not one of the categories of loans subject to that section, absent regulations treating the loan as a significant tax effect loan.[259] The only real problem arises if the debt provides for stated interest that is not QSI. Because all payments other than QSI are included in a debt's stated redemption price at maturity,[260] the effect of treating the debt's issue price as being equal to its stated redemption price at maturity would be to recharacterize all stated interest on the debt as principal. It is doubtful that this result was intended. The more sensible rule is to treat the debt instrument as issued for its stated principal amount in this situation.
>
> [258] See ¶ 203. Section 1273(b)(1) and (2) apply to debt instruments not issued for property, but the rules in those paragraphs depend on the price at which the instruments were offered for sale or actually sold, and this does not apply in the present case. Section 1273(b)(4) is generally the rule that applies if no other rule applies (and it deems the issue price to be equal to the stated redemption price at maturity), but it only applies to debt issued for property.
>
> [259] See ¶ 402.02.
>
> [260] See ¶ 202.01.

that gain is not attributable to the deceased partner's share of items constituting income in respect of a decedent)[4591] and might also lead to depreciation and goodwill amortization deductions.[4592] Thus, installment sales lock in gain as income in respect of a decedent, whereas Code § 736 payments appear eligible for a basis step-up. A partnership agreement might even convert Code § 736(a) payments to Code § 736(b) payments upon death, perhaps reducing the installments to take into account the smaller tax burden imposed on the seller.

Suppose that the partnership agreement provided for a Code § 736(b) payment with respect to goodwill. Each Code § 736(b) installment would give rise to a new goodwill asset that could be amortized over 180 months.[4593] Thus, the parties could get some tax arbitrage by the buyer getting ordinary deductions over 15 years when the seller gets capital gain, but query what the time value of money would be like in a business deal, which generally requires a faster payback. If assets have a faster depreciation period but the number of assets to track is high, consider abandoning the use of Code § 736(b) payments and simply using Code § 736(a); see part II.Q.8.b.ii.(c) Comparing Code § 736(a) with (b) Strategically.

Presumably, this lack of installment sale treatment would allow partnership redemptions to avoid the interest on deferred tax liabilities that Code § 453A imposes on installment sales. A prominent treatise states:[4594]

> A selling partner who receives deferred payments and reports gain under § 453 may be subject to acceleration of deferred gain under the pledge rule in § 453A(d) and may be required to pay interest on his deferred tax liability under § 453A(c). There are no analogous provisions applicable to deferred distributions to partners whose partnership interests are liquidated under § 736.

The treatise later states:[4595]

> In general, amounts that are computed like interest and paid to a partner for the use of partnership capital constitute guaranteed payments under § 707(c). Because a retired partner who receives post-retirement liquidation distributions is treated as a continuing partner (and not as a partnership creditor) for Subchapter K purposes until his interest is

---

[4591] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 4721.

[4592] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, especially fn. 4723.

[4593] Reg. § 1.734-1(e)(1), referred to by McKee, Nelson & Whitmire, ¶25.02. Allocations of Section 734(b) Adjustments to Partnership Assets: Section 755, *Federal Taxation of Partnerships & Partners* (WG&L), interpreting the consequence of Rev. Rul. 93-13, which provides:

> If a partnership that has in effect an election to adjust basis under section 754 of the Internal Revenue Code completely liquidates the interest of a partner by agreeing to make a series of cash payments that are treated as distributions under section 736(b)(1), the section 734(b) basis adjustments to partnership property respond in timing and amount with the recognition of gain or loss by the retiring partner with respect to those payments.

If the Code § 736(b) payments were contingent, perhaps Reg. § 1.197-2(f)(2) would apply to amortize the new payments over the remaining months of the 180-month period.

[4594] McKee, Nelson & Whitmire, ¶16.02. Transfers of Partnership Interests by Sale or Exchange: Tax Consequences of Liquidations Compared, *Federal Taxation of Partnerships & Partners*.

[4595] McKee, Nelson & Whitmire, ¶22.02[4][c] Interest on Deferred Section 736(b) Payments, *Federal Taxation of Partnerships & Partners*. For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

> completely liquidated, it seems that any "interest" paid with respect to deferred § 736(b) distributions should be treated as guaranteed payments to the retired partner for the use of his unreturned capital. This notion is buttressed by the fact that § 736(a)(2) treats all payments "made in liquidation of the interest of a retiring partner" as § 707 guaranteed payments if they are determined without regard to partnership income and are not paid for the retiring partner's interest in partnership property under § 736(b).
>
> If deferred liquidation payments cannot bear tax-recognized interest, it follows that the imputed interest rules of §§ 483, 1272, and 7872 do not apply to deferred liquidation distributions under § 736. [In other words, deferred payments under Code § 736 should not be recharacterized as part principal and part interest.] From a policy perspective, inapplicability of these rules may not be as offensive as might first appear, since the timing of any tax benefits and burdens of deferred liquidation payments under § 736 are matched. Thus, because deferred liquidation payments are not treated as liabilities, the continuing partners cannot increase the bases of their partnership interests by the amount of deferred payments under § 752(a). In addition, the partnership is entitled to adjust the basis of its assets under § 734(b) only when the deferred payments are actually made and the retired partner actually recognizes gain or loss. Finally, if amounts payable to a retired partner include interest-like payments, such payments constitute § 736(a)(2) payments that will be included in the income of the retired partner at the same time that they are deducted by the partnership under the matched timing rules of § 707(c).

I am not aware of any primary authority addressing the above issue.

II.Q.8.b.ii.(e). Effect of Code § 736 Payments, Installment Sale Payments, or Deferred Compensation on Balance Sheet

Generally, Code § 736(a)(1) payments that are structured as preferred distributions of profits are considered equity and do not affect the entity's net worth.

On the other hand, Code § 736(a)(2) guaranteed payments and Code § 736(b) installment sale payments would be liabilities on the entity's balance sheet. Similarly, in a cross-purchase, the buyers would have liability on their balance sheets (which can also impede the use of guaranties). Finally, deferred compensation agreements, which are the corporate attempt to replicate Code § 736(a)(2) guaranteed payments, would also constitute a liability on the entity's balance sheets.

Liabilities on balance sheets can impede access to credit before and during the buy-out period. That a business is transitioning from the successful founder to new management doesn't help that situation.

Thus, Code § 736(a)(1) payments that are structured as preferred distributions of profits might very help the business' operations relative to the other ways of structuring buyouts.

II.Q.8.b.ii.(f). Planning for the 3.8% Tax on Net Investment Income and Passive Loss Rules When Using Code § 736 Payments

For purposes of the 3.8% tax on net investment income,[4596] see part II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411.

See also part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736.

II.Q.8.b.ii.(g). Code § 736 Payments as Retirement Income – Possible FICA and State Income Tax Benefits

Compensatory payments to be made for the rest of a partner's life, which generally would be Code § 736(a) payments, might be excluded from FICA but would be subject to Code § 409A. See part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.

No state may impose income tax on any retirement income of an individual who is not a resident or domiciliary of that state (as determined under that state's laws).[4597] "Retirement income" includes income from a written plan, program, or arrangement that is in effect immediately before retirement begins and provides retirement payments in recognition of prior service to be made to a retired partner,[4598] if the income is from an excess benefit plan[4599] or if the income is part of a series of substantially equal periodic payments payable at least annually for either the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and a designated beneficiary of the recipient) or a period of not less than 10 years.[4600]

[4596] See part II.I 3.8% Tax on Excess Net Investment Income.

[4597] 4 U.S.C. § 114(a). Missouri Private Letter Ruling No. LR 3570 (1/2/2007) held that this statute protected the following payments from state income tax:

> Applicant is a participant of a Retirement Plan (RP) and is also a participant of an Insurance Plan (collectively, the Plans). The purpose of the Plans is to supplement retirement benefits from the Pension Plan (Pension Plan) and the Retirement Plan for eligible corporate officers in recognition of service to their employer. The administrator of the RP is the Corporation and the administrator of the insurance plan is a committee within the Pension Plan.
>
> ….
>
> In this case the Plans are plans or arrangements as described in IRC section 3121(v)(2)(C) and the monthly payments meet the requirements of section 114(b)(1)(I)(i) of Title 4 of the United States Code. Therefore, for purposes of state income tax, the monthly payments from the Plans received by Applicant will be treated as retirement income as defined in section 114(b) of Title 4 of the United States Code.

[4598] 4 U.S.C. § 114(b)(4) provides:

> For purposes of this section, the term retired partner is an individual who is described as a partner in section 7701(a)(2) of the Internal Revenue Code of 1986 and who is retired under such individual's partnership agreement.

[4599] 4 U.S.C. § 114(b)(1)(I)(ii) refers to:

> a payment received after termination of employment and under a plan, program, or arrangement (to which such employment relates) maintained solely for the purpose of providing retirement benefits for employees in excess of the limitations imposed by 1 or more of sections 401(a)(17), 401(k) , 401(m) , 402(g), 403(b), 408(k), or 415 of such Code or any other limitation on contributions or benefits in such Code on plans to which any of such sections apply.

I have assumed, without verification, that withdrawal from a partnership counts as termination of employment, consistent with the treatment of partners as employees eligible to participate in a qualified retirement plan. Please let me know what you discover when you research this issue.

[4600] 4 U.S.C. § 114(b)(1)(I)(i).

II.Q.8.b.ii.(h). Interaction of Death with Code § 736 Payments

Generally, the retiring partner's payments would consist of:

- Code § 736(a) payments (taxable as ordinary income), grossed up for income taxes as illustrated in the different purchase prices used in parts II.Q.1.a.i.(f) Partnership Use of Same Earnings as S corporation in Sale of Goodwill and II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.k Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill, would be paid during the retiring partner's life, and

- Code § 736(b) payments, not grossed up but generally tax-free because the deceased partner's successor in interest has received a basis step-up, would be made after the retiring partner's death.[4601]

Perhaps the partnership has life insurance to pay a retired partner. The life insurance is received tax-free (so long as the partnership complies with the rules on employer-owned life insurance, which apply to any 5% partner, whether or not the partner actually works in the business).[4602] Thus, the partnership does not need to deduct payments it makes to the retired partner's beneficiaries. Furthermore, the basis step-up mentioned above, if my assumption is correct, means that there is no capital gain tax for the retired partner's beneficiaries to avoid. Code § 753 denies a basis step-up to Code § 736(a) payments but does not address Code § 736(b) payments, which implies that Code § 736(b) payments receive a basis step-up. Therefore, consider converting Code § 736(a) payments to Code § 736(b) payments when a partner dies, perhaps reducing the payments to take into account that the seller does not need to be grossed up to pay the seller's taxes on the distribution.

II.Q.8.b.iii. Partnership Alternative to Seller-Financed Sale of Goodwill

Is goodwill an asset that belongs to the individual owner or to the entity? Where a non-compete agreement is not in place and business is largely attributable to the close personal relationships that the owner has developed and maintained for decades, goodwill belongs to the owner personally.[4603] Where a contract allocates large amounts to the entity's goodwill and the owner enters into a noncompete agreement to preserve the entity's goodwill, the owner's receipt of noncompetition payments is ordinary income rather than the sale of personal goodwill.[4604] Given

---

[4601] For the basis step-up, see fns. 4591 and 4592 in part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.

[4602] See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

[4603] See part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees?

[4604] *Muskat v. U.S.*, 554 F.3d 183 (1st Cir. 2009), *aff'g* 101 AFTR 2d 2008-1606 (D.N.H. 2008). When Muskat sold his business to Jac Pac and agreed not to compete, nothing in the contract mentioned that Muskat was selling personal goodwill. The trial court described the negotiations for the sale:

> During the negotiation process, the parties were well-aware of Jac Pac's business goodwill, to which more than $15,000,000 of the purchase price was allocated. Warren testified that he was not aware of any goodwill in the transaction other than Jac Pac's goodwill. The noncompetition agreement defines Goodwill as an asset of Jac Pac including its goodwill and business as a going concern. The purpose of the noncompetition agreement was to protect Jac Pac's Goodwill in the transaction. Muskat acknowledged in the agreement that the noncompetition provisions were necessary to preserve and protect the proprietary rights and the goodwill of [MAC] (including [Jac

that the buyer's deductions relating to goodwill are the same as for a noncompetition agreement,[4605] the seller should consider maximizing the extent to which payments directly to the seller are for personal goodwill rather than a covenant not to compete.[4606]

As a practical matter, often the buyer will be able to pay the promissory note for goodwill only if the business is sufficiently profitable. If the business is not profitable, the seller would need to sue the buyer to enforce the note, and all that lawsuit would accomplish would be a judgment against someone who cannot pay it. The seller's most effective recourse might be to take over the business, which the judgment on the promissory note is unlikely to accomplish without further legal action.

The seller might prefer a mechanism in which:

- The seller has a quicker route to gaining control over the business if the buyer does not attain the results necessary to pay the seller.

- The deal is more tax-efficient than the traditional sale of goodwill.

This mechanism recognizes that, although the transfer of goodwill is technically a debt-financed deal, it really carries risks similar to an equity interest. Below is a diagram showing the transaction, in which the seller contributes the goodwill to a new entity in exchange for what for tax purposes is considered a preferred partnership interest.[4607]

Pac's goodwill]) and the Related Entities as going concerns. The consideration paid under the agreement was expressly for the covenants not to compete, with no mention of personal goodwill.

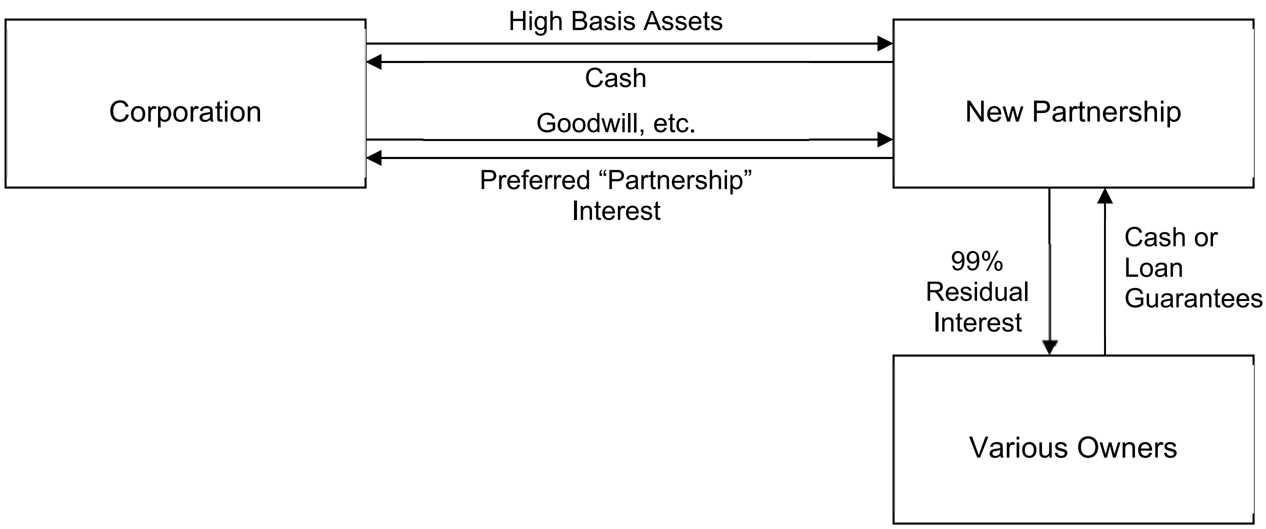
The District Court applied First Circuit precedent requiring the taxpayer to produce strong proof before applying tax treatment that varied from the transaction's legal documentation. The First Circuit agreed with the District Court and also clarified what strong proof means: To constitute "strong proof" a taxpayer's evidence must have persuasive power closely resembling the "clear and convincing" evidence required to reform a written contract on the ground of mutual mistake. For a discussion of whether a taxpayer may use substance over form, see also cases cited in fn 4735 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

In *Duffy v. U.S.*, 120 Fed. Cl. 55 (Ct. Fed. Cl. 2015), *aff'd* 117 A.F.T.R.2d 2016-397 (Fed. Cir. 2016), the recipient of proceeds in a settlement in a case for retaliatory firing asserted that the settlement was for personal injury or as compensation for impaired personal goodwill, the latter because he could not find a job because his former employer would not give him a reference. However, the settlement agreement provided that the payment was for the exclusive purpose of avoiding the expense and inconvenience of further litigation. The Court of Claims used that language to throw out the taxpayer's personal injury and goodwill assertions and held for the IRS. The Federal Circuit cited the quoted language and also noted, Mr. Duffy simply extinguished his claims, and any goodwill in his business remained with him.

[4605] Compare Code § 197(d)(1)(A) (goodwill) with Code § 197(d)(1)(E) (covenant not to compete).

[4606] One might also consider whether applicable state law allows the buyer more latitude in imposing restrictions relating to sale of goodwill than for a noncompetition agreement and whether the seller is trading off state law rights for favorable tax treatment.

[4607] For more information on preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.



This new arrangement needs to involve a real sharing of profits. Therefore, ideally the existing corporation would continue to own a residual interest. The amount and duration of the retained residual interest depend on the facts and circumstances.

The sale of high basis assets is optional. The high basis assets can instead be included in the contribution to capital. Because preferred partnership rates are higher than interest rates, the new partnership – essentially the various owners who own a 99% residual interest in the new partnership in the agreement – would be incurring a higher cost of capital than if the partnership bought the assets for a note. On the other hand, transferring all assets in the business in one fell swoop is appealing and might be the most practical; for how to transfer assets by operation of law to avoid issues that might arise from piecemeal or inadvertently incomplete transfers, see part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

Usually this structure is not for new owners but rather so that the existing owners can own the business in a more tax-efficient structure. The shareholders, as individual owners of the new entity, sign a covenant not to compete (together with other provisions protecting the new entity's intellectual property, etc.) in consideration for their interest in the new entity, as well as contributing some reasonable amount of cash. When an individual retires, that person's capital account is returned over time, and the perpetual residual profits interest is converted to a preferred profits interest until a target amount is reached. This new preferred profits interest would consist of Code § 736(a) payments (taxable as ordinary income), grossed up for income taxes, and Code § 736(b) payments, not grossed up; see part II.Q.8.b.ii.(h) Interaction of Death with Code § 736 Payments.

For the new entity's structure, see part II.E Recommended Structure for Entities, except that this arrangement involves the corporate partner owning not only the 1% of profits commonly shared but also a preferred partnership interest.

Let's look at the non-tax financial issues, then discuss the tax issues in addition to the advantages discussed in parts II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis and II.Q.7.h Distributing Assets; Drop-Down into Partnership.

II.Q.8.b.iii.(a). Non-Tax Financial Issues When Using a Preferred Partnership to Acquire Goodwill and Other Assets

The seller receives preferred payments equal to the lesser of the entity's net operating cash flow or a target amount before any amounts are distributed to the buyer. Because the payments are targets and not mandatory, they do not constitute debt or a fixed obligation; rather, they are a return of investment to the owners. Stock purchases for a note and deferred compensation constitute liabilities on financial statement that can impair financing– enough that such arrangements might be considered highly unattractive. This liability might very well be required to be disclosed in financial statements even if the event triggering the notes or deferred compensation have not occurred and are unlikely to occur soon. Clients and advisors tend not to consider this issue when planning, so be sure to raise it early and have the CPA directly address this issue.

If the target is not attained, then:

- The deficiency is added to the following year's target amount.

- The seller might be given control over certain aspects of running the business. This could be as modest as limiting the buyer's compensation for services rendered or as far-reaching as taking over control of part or all of the business' operations. The partial or total shift on control would be a focal point of negotiations.

These provisions would be built directly into the partnership agreement. So that they know that authority has not been transferred to the seller, third-party lenders would require assurances that the buyer is complying with the agreement with the seller, thus providing an independent check on the buyer's compliance with the deal.

After the seller has received all that has been bargained-for, the seller would no longer be an owner of the entity.

II.Q.8.b.iii.(b). Tax Issues When Transferring Assets to New Entity

Suppose the seller is an S corporation. If all of an S corporation's assets were sold to a new entity, the corporation would recognize income taxable to its shareholder. The sale of goodwill would be taxable, but the new entity's deduction for that payment would be spread over 180 months (15 years).[4608] Furthermore, if the IRS were to find that goodwill was transferred to the new entity at a substantial value, without the S corporation retaining a sufficient interest in the new entity, then:

- 1. The S corporation would have income equal to the goodwill.

- 2. The shareholders would have immediate dividend income equal to the goodwill, which they then contributed to the new entity without receiving an immediate deduction (the deduction would be spread over 180 months).

[4608] Code § 197 provides for 15 years, and Reg. § 1.197-2(f)(1)(i) applies this starting with a particular month.

If the entity transfers its assets to a new LLC, retaining a preferred interest at no more than 150% of the AFR[4609] that distributes only to the extent of operating cash flow, a sale is presumed not to have occurred.[4610] If the S corporation is receiving a return whose present value (using the AFR) is equal to the value of the contributed goodwill (if any), the S corporation should not be treated as having distributed such goodwill to its shareholders. It might be advisable to give the corporation a small but significant profits interest in the LLC.

This concept of transferring to a new LLC also works better when the transferring entity is a partnership. Suppose the transferring entity sells all of its assets in exchange for a promissory note, and the buyer is unable to make all of the payments. Any basis remaining in the note would need to be written off as a bad debt.[4611] Contrast that to a partnership redemption, in which distributions or payments generally are applied to basis first and generate a gain only after recovering basis,[4612] subject to possible application of the disguised sale rules for payments made in the first two years.[4613]

II.Q.8.c. Related Party Sales of Non-Capital Assets by or to Partnerships

Gain on the sale of property is ordinary income if it is not a capital asset in the hands of the transferee and the sale is between:[4614]

- a partnership and a person owning, directly or indirectly, more than 50% of the capital interest, or profits interest, in such partnership, or
- two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital interest or profits interests.

Property subject to this rule includes trade accounts receivable, inventory, stock in trade, and depreciable or real property used in the trade of business.[4615]

In applying the first bullet point above, grantor trusts are disregarded from their deemed owners. See CCA 201343021.[4616]

The corporate provision most closely related to this one is part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), including possible ordinary income taxation when selling to a controlled corporation interests in a partnership holding depreciable property.[4617]

4609 AFR meaning the applicable federal rate provided under the tax laws as an arms-length interest rate.
4610 See part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales.
4611 CCA 201328031.
4612 See parts II.Q.8.b.i Distribution of Property by a Partnership and II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.
4613 See part II.M.3.e Exception: Disguised Sale, explaining the rules and simple steps to avoid their application.
4614 Code § 707(b)(2). Code § 707(b)(1) lists the same parties.
4615 Reg. § 1.707-1(b)(2).
4616 See fn 5519 in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation.
4617 See text accompanying fns. 4214-4219.

II.Q.8.e.iii. Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S corporations

II.Q.8.e.iii.(a). Illustration of Inside Basis Issue

For a more generic description of inside basis and outside basis, see my blog article, "Tax basis: The key to reducing gain on sale or deducting asset purchases."[4702]

Here is an example:

Suppose each of A and B contributes $500,000 to a partnership that buys land worth $1 million without any debt.

Each of A and B has $500,000 basis in his/her/its partnership interest. This is called "outside basis."

The partnership's $1 million basis in the land is called "inside basis," because it is the basis of assets inside the partnership.

Suppose the land increases in value to $1.5 million, and C buys B's partnership interest for $750,000. C's outside basis is $750,000; however, C's inside basis – C's share of the partnership's basis in the land – would be $500,000, the same as B's inside basis.

Thus, if the partnership sold the land for $1.5 million, the partnership would recognize a $500,000 gain – the $1.5 million proceeds minus the land's $1.0 million inside basis. Each of A and C would report $250,000 of gain ($500,000 gain multiplied by their respective 50% interest in the partnership).

C, who paid $750,000 for essentially one-half of the land, is paying tax on C's $750,000 one-half of the proceeds, which is an unfair result.

C has two ways out of this dilemma. One way is to liquidate the partnership or fully redeem C's partnership interest. C's outside basis is $1 million, consisting of C's $750,000 purchase price[4703] and $250,000 of gain.[4704] C recognizes a $250,000 loss, which is C's $1 million outside basis minus the $750,000 cash that C receives in liquidation. For an S corporation analogy, see part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S corporation.

The other way is, on the partnership tax return for the year in which C buys B's interest (if this election is not already in place), the partnership elects to adjust C's share of the inside basis of the land. Thus, C would have a separate, additional $250,000 inside basis in the land, so that C's inside basis would be $750,000 ($500,000 from B's inside basis plus $250,000 additional special asset). This option is not available to a C or an S corporation. For more details on when an inside basis step-up applies, see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on

---

[4702] http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions/post/2017-01-10/tax-basis-the-key-to-reducing-gain-on-sale-or-deducting-asset-purchases.
[4703] Code § 742.
[4704] Code § 705(a)(1)(A).

Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss). For a single member LLC, any change to outside basis would automatically apply to the inside basis.[4705]

However, Code § 338(h)(10) provides a special opportunity when all of the stock in an S corporation is sold and the S corporation is liquidated. The election allows the parties to treat all of the S corporation's assets as having been sold to the person that bought the S corporation stock, enabling the buyer to get a new tax basis on the assets. Meanwhile, the deemed gain on sale of the S corporation's assets increases the basis of the stock in the S corporation, so that often the shareholders are not taxed on the stock's sale and might even have a loss on the sale.[4706] The main downside[4707] to the selling shareholders is that the deemed asset sale might trigger ordinary income taxation (including without limitation depreciation recapture of Code § 1245 property, which is generally depreciable tangible personal property) or higher capital gain taxation (including without limitation the sale of Code § 1250 property, which generally is depreciable real estate), whereas they generally would have paid lower regular long-term capital gain rates on the sale of their S corporation stock had they not made the Code § 338(h)(10) election.

Code § 338(h)(10) is also available for C corporations, but it does not provide the same benefits to the sellers, in that the corporation's recognition of gain on its deemed sale of assets does not increase its shareholders' stock basis.

[4705] See fn. 1733 in part II.H.2.h Basis Step-Up for Property Held Outside an Entity; Moving Liabilities Outside of an Entity to Maximize Deductions for Estate Tax Purposes, the latter which points out that results may be better not holding assets in an entity.

[4706] Reg. § 1.338(h)(10)-1(d)(5)(i) provides:

> *In general*. If T is an S corporation target, S corporation shareholders (whether or not they sell their stock) take their pro rata share of the deemed sale tax consequences into account under section 1366 and increase or decrease their basis in T stock under section 1367. Members of the selling consolidated group, the selling affiliate, or S corporation shareholders are treated as if, after the deemed asset sale in paragraph (d)(3) of this section and before the close of the acquisition date, they received the assets transferred by old T in the transaction described in paragraph (d)(4)(i) of this section. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 331 or 332 applies.

See part II.Q.7.a.vii Corporate Liquidation for the tax consequences of the deemed liquidation.

[4707] For former C corporations that have made their S election too recently, beware of part II.P.3.c.ii Built-in Gain Tax.

II.Q.8.e.iii.(b). Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss)

Upon a partner's death (including the death of the grantor of a revocable trust[4708] or of the beneficiary of a QTIP trust[4709]) or on the sale or exchange of a partnership interest, the partnership's property's basis is adjusted under Code § 743 if the partnership has in effect a Code § 754 election[4710] and makes a Code § 754 election on the return that covers the taxable period that includes the date of death, which election might be filed up to 12 months after the due date.[4711] However, whether or not the election provided in Code § 754 is in effect, the basis of

[4708] Rev. Rul. 79-84, which reasoned as follows in arriving at that conclusion:

> Before A's death, A had powers over T of the types described in sections 676 and 677 of the Code, and T was therefore a grantor trust. Additionally, T held a partnership interest. Under the principles of Rev. Rul. 77-402, A is considered to have been the partner during this period for federal income tax purposes. Further, at the time of A's death T ceased to be a grantor trust. The partnership interest is thus considered to have been transferred from A to T at that time. As a result, a transfer of a partnership interest occurred upon the death of a partner.

Query whether an irrevocable trust for the benefit of A's spouse, which would have been a grantor trust under Code § 677 but excluded from A's estate, would qualify for this treatment.

[4709] The IRS seems to believe that a Code § 743(a) adjustment would apply when a QTIP trust holds a partnership interest and the surviving spouse dies, even though the individual who died is not actually a partner. See Letter Ruling 200019029 (approving a late Code § 754 election without addressing the literal language of Code § 743(a)). Note that Code § 1014(b)(10), which provides a basis adjustment for QTIP assets when the surviving spouse dies, was enacted after Code § 743(a). Thus, considering the surviving spouse to be a partner for purposes of Code § 743(a) is consistent with the philosophy of Code § 1014(b)(10) and should, as a matter of tax policy, be the correct result, even though it seems inconsistent with the literal language of Code § 743(a). See also part II.Q.8.e.i Distribution of Partnership Interests regarding the effect of a distribution on Code § 743.

[4710] Code § 743(a) does not address whether an adjustment of basis in partnership property may occur by reason of other transfers without a Code § 754 election. For example, the statute does not address whether an adjustment would be made with respect to a transfer by gift (i.e., not a transfer by sale or exchange or the death of a partner which are referenced in Code § 743) even if a Code § 754 election is in place. Code § 1015(d), allowing a basis adjustment for gift tax paid, was not in existence when Code § 743 was enacted That might be why Code § 743 does not discuss the gift situation. The legislative history when Code § 1015(d) was adopted makes no mention at all of this partnership issue. The issue would seem to be: would an inside adjustment of partnership property be made in the absence of a statute (since no statute is applicable) under general tax principles? That is further complicated by the fact that tax principles sometimes use an aggregate theory and sometimes an entity theory with respect to partnerships. Although perhaps a position might be taken that the payment of gift tax should trigger an inside basis adjustment, if I were to take that position I would disclose it on Form 8725. A safer approach might be to follow the payment of gift tax by a transfer, which part II.Q.8.e.i Distribution of Partnership Interests discusses generally would give rise to an inside basis adjustment.

[4711] Reg. § 1.754-1(b); REG-116256-17 (10/12/2017) issued proposed regulations, on which taxpayers may now rely, dropping the regulation's requirement that a partner sign the Code § 754 election. Reg. § 301.9100-2(a)(2)(vi) grants an automatic 12-month extension from the due date of the partnership's return, including extensions (Reg. § 301.9100-2(a)(1)), with the election made on an amended return (Reg. § 301.9100-2(c)).

In addition to making the election, the partnership must attach a statement to its tax return that reports the name and taxpayer identification number of the transferee partner, the basis adjustment computation, and the allocation of the basis adjustment to the partnership's properties. Reg. § 1.743-1(k)(1). The transferee partner has an obligation to provide written notice to the partnership of the information needed to compute the basis adjustment, as listed in Reg. § 1.743-1(k)(2). Once that notice is given, the partnership can rely on that information in preparing the adjustment, as long as no partner who is responsible for federal income tax reporting has any knowledge that the information is clearly erroneous. Reg. § 1.743-1(k)(3). Failure to partnership property is not adjusted as the result of a contribution of property, including money, to the partnership.[4712] The Code § 754 election may not be filed in a year before death occurs, unless some other Code § 743 or 734 event occurs in the year covered by the filing.[4713] When a partnership interest is community property and receives an outside basis adjustment of both halves, both halves are eligible for a corresponding inside basis adjustment by reason of that death.[4714] See also part II.Q.8.e.i Distribution of Partnership Interests regarding the effect of a distribution on Code § 743, including a suggestion that a trust's or estate's distribution of a partnership interest (other than distributing specifically bequeathed property) triggers application of a Code § 743 adjustment. Thus, even though ideally one should make a Code § 754 as of the year if death (if one decides to make the election), if the suggestion described in the preceding sentence is correct then one may also make a Code § 754 election as of the year in which the revocable trust or estate distributes property (other than a specific bequest). A corporate liquidation would also be a triggering event – even if it is a nontaxable event.[4715]

---

attach this statement would not appear to invalidate the Code § 754 election; this result is inferred by the fact that Reg. § 1.743-1(k)(2) provides procedures for when errors or omissions are made in complying with obligations under Reg. § 1.743-1(k).

Does the long term holding period under Code § 1233(9), that applies when assets are included in a decedent's estate, also apply to the portion of the basis of a partnership's assets that constitutes a basis adjustment under Code § 743? Rev. Rul. 68-79 says that, generally, the change in the holding period of a partnership interest does not change the partnership's holding period in its assets. However, it does not address the impact, if any, on a Code § 754 election. With one exception, regulations under Code §§ 743, 755 and 1233 do not address this issue. Reg. § 1.743-1(j)(4)(i)(B)(1) restarts the holding period for depreciable property when there is a positive adjustment but does not change it when there is a negative adjustment, Reg. § 1.743-1(j)(4)(ii)(B).

[4712] Reg. § 1.743-1(a). Instead, see part II.M.3.a General Rule: No Gain Or Loss on Contribution to Partnership.

[4713] Reg. § 1.754-1(b), which is modified in certain ways as described in fn 4711, provides:

> An election under section 754 and this section to adjust the basis of partnership property under sections 734(b) and 743(b), with respect to a distribution of property to a partner or a transfer of an interest in a partnership, shall be made in a written statement filed with the partnership return for the taxable year during which the distribution or transfer occurs. For the election to be valid, the return must be filed not later than the time prescribed by paragraph (e) of § 1.6031-1 (including extensions thereof) for filing the return for such taxable year (or before August 23, 1956, whichever is later). Notwithstanding the preceding two sentences, if a valid election has been made under section 754 and this section for a preceding taxable year and not revoked pursuant to paragraph (c) of this section, a new election is not required to be made….

[4714] Rev. Rul. 79-124.

[4715] CCA 201726012 (under the signature of David R. Haglund), in addressing, "Issue 1: Whether the transfer of a partnership interest in a complete liquidation to which § 332(a) applies or a reorganization to which § 368(a)(1)(A) and/or (D) applies is a transfer by sale or exchange for purposes of § 743(b)," reasoned:

> Sale or exchange is not defined in § 743, the regulations thereunder, or the legislative history of the provision. Section 743 was enacted to ameliorate the tax consequences to a transferee partner by giving a partnership the option to eliminate discrepancies between a transferee partner's inside and outside basis when the partnership's inside basis in its property is not equal to the fair market value of the property. Jt. Comm. On Taxation, *Summary of the New Provisions of the Internal Revenue Code of 1954*, at 92 (1955).
>
> General Counsel Memorandum 35921 (July 29, 1974) held that for purposes of § 743(b), a transfer of a partnership in a liquidation under former § 333 was not a transfer of an interest by sale or exchange. As demonstrated by the GCM, whether the distribution of a partnership interest by a liquidating corporation was a sale or exchange was considered an open question prior to the Deficit

If the basis of the transferee partner's partnership interest is greater than the former partner's share of the basis of the partnership's assets, then the election will give the new partner a stepped-up basis in the partnership assets.[4716] This basis adjustment is not necessarily tied to the change in basis between the old and new partner; rather, it is based on the relationship between the basis in the partnership interest (the "outside basis") and basis of the partnership's assets allocable to that partner (the "inside basis"). Of course, a change in basis of the partnership interest affects this relationship. However, prior changes in basis of the partnership also count. In fact, a substituted basis transaction, in which the basis in the partnership interest might or might not change, triggers the basis adjustment;[4717] however, no adjustment is made in a substituted basis transaction if the outside basis equals the inside basis.[4718] If a partnership does not make a Code § 754 election when a partner dies, consider asking the partnership to make the election when the decedent's estate or (former) revocable trust funds bequests by distributing the partnership interest, which also might be an event triggering a basis adjustment;[4719] as described above, that basis adjustment is not tied to any change in basis but rather generally catches up the "inside basis" to the "outside basis."

In a sale or exchange situation, the transferee partner's basis step-up in partnership assets is based on the extent to which the partner's basis in the partnership interest exceeds the basis of the partner's share of the partnership's assets; any contingent payments cause a basis increase to the extent they constitute gain to the seller and potentially deductible interest to the extent they constitute interest income to the seller.[4720] If the transfer is caused because of a partner's death, the basis step-up is based on the fair market value of the deceased partner's partnership interest as of the date of death, plus the transferee partner's share of partnership liabilities, minus any allocable income in respect of a decedent items;[4721] although liabilities are included in the basis of a partnership interest, they do not generate a basis increase in the partnership's assets.

Reduction Act of 1984 (1984 Act). See, *e.g.*, John S. Pennell and Terence F. Cuff, "Tax Results of Liquidation of Corporate Partner Still Unclear Despite DRA 1984," *Journal of Taxation*, Vol. 62, No. 2 (February 1985).

[4716] Code § 743(b). Note that previously non-amortizable self-created goodwill becomes purchased amortizable goodwill. Letter Ruling 9715008 (but only if the remaining partners and the selling partner are not related under Code § 197(f)(9)(C)).

[4717] Reg. § 1.755-1(b)(5). Reg. § 1.755-1(b)(5)(iv), Example (2) provides a basis adjustment as the result of a wholly nontaxable contribution to a partnership under Code § 721.

[4718] Reg. § 1.755-1(b)(5)(ii) provides, If the total amount of the basis adjustment under section 743(b) is zero, then no adjustment to the basis of partnership property will be made under this paragraph (b)(5).

[4719] See part II.Q.8.e.i Distribution of Partnership Interests.

[4720] Letter Ruling 9715008, which also held that contingent payments made more than 6 months after the date of the sale would be divided into additional principal and unstated interest under Reg. § 1.1275-4(c).

[4721] Code § 743; Reg. § 1.742-1. Code § 691 income in respect of a decedent includes the portion of the distributive share of partnership income of the decedent partner's successor in interest that is attributable to the decedent for the period ending with the date of the decedent's death. Letter Ruling 9715008. See also Rev. Rul. 66-325 (no basis step-up for accounts receivable under Code § 743 because Code § 736(a) applied); *Long v. Commissioner*, 71 T.C. 1 (1978), *aff'd* 660 F.2d 416 (10th Cir. 1981) (estate increased its basis in partnership interest to extent it paid liabilities); *Hesse v. Commissioner*, 74 T.C. 1307 (1980) and Letter Ruling 9102018 (no basis step-up for distributive share of income that is attributable to decedent for the period ending with the date of his death – obsoleted by later changes to Code § 706 because the income is reported on the decedent's final return and therefore not an unrecognized item at death). Regarding basis step-up attributable to liabilities, see fn 1727 in part II.H.2.g Partnership Basis Adjustments.

A partner's share of income in respect of a decedent under Code § 691 (including unrealized receivables) does not receive a basis step-up.[4722] Unrealized receivables are not eligible for a basis step-up, but goodwill that is not being amortized is eligible for a basis step-up.[4723]

When a person's partnership interest is liquidated, the basis of the partnership interest is allocated to the assets that person receives:[4724]

- This has led to the observation that, if one is going to liquidate the partnership anyway, a Code § 754 election might not be necessary. However, if the partnership sells its assets and then liquidates, then this strategy might not work as well for state income tax purposes as it does for federal income tax purposes;[4725] a Code § 754 election might be particularly important if the owner of the partnership interest resides in a state other than the state in which the partnership does business.

- These rules can generate opportunities to enhance the basis of an asset to be sold (but might be attacked if used to accelerate or duplicate recognition of loss):[4726]

    - A partner who receives low basis assets can uses the basis in his partnership interest to increase the basis in those assets. If a Code § 754 election is not in effect, then this basis increase is not matched by a corresponding decrease in the distributed asset. Absence of a Code § 754 election might[4727] or might not[4728] be considered abusive in such a case.

    - If a partnership interest with a low basis is liquidated in exchange for high basis assets, a Code § 754 election will take into account the basis reduction in the distributed asset and increase the basis in its remaining assets by a corresponding amount.

Once a Code § 754 election is made, it cannot be revoked without IRS consent. This is extremely important to remember, since the election can lead to a step-down in the basis of partnership assets if the basis of the transferee's interest is less than the transferor's partnership property adjusted basis.

Because a Code § 754 election is irrevocable, consider dividing a partnership before making the election; divisions generally are income tax-free.[4729] Reasons to avoid Code § 754 elections except to the extent necessary include:

[4722] Reg. § 1.755-1(b)(4)(i).
[4723] Example provided in Reg. § 1.755-1(b)(4)(ii).
[4724] Code § 732(b).
[4725] By analogy, when an S corporation sells its assets to a third party and liquidates, it can replicate in many ways the partnership result for federal income purposes but not necessarily for state income tax purposes. Compare part II.H.8.a.i Solution That Works for Federal Income Tax Purposes with part II.H.8.a.ii State Income Tax Disconnect.
[4726] See part II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property.
[4727] See example in fn. 4479 (absence of Code § 754 election considered a duplication of loss). However, Congress has since attacked this abuse (see part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000), so the concerns expressed in the example might be less likely to be applied now.
[4728] See fn. 4478.
[4729] See part II.Q.8.d Partnership Division.

- Avoiding record-keeping requirements regarding events where basis changes are not worth the complexity.

- Reducing the possibility of events causing an inside basis step-down. However, sometimes basis reductions must be made as if a Code § 754 election were in effect.[4730] To avoid possible unwanted inside basis reductions, one should consider monitoring a partnership's unrealized losses and realizing losses to the next necessary to keep net unrealized losses comfortably below $250K.

The partnership and the transferee partner, including a decedent's estate, should consider extending their income tax returns so that any IRS adjustments to basis, including the value of assets in the decedent's gross estate, can be reflected in the transferee partner's income tax returns; ignoring the interplay of these statutes of limitations can cause the taxpayer to lose the benefit of the basis step-up.[4731] For example, suppose decedent died December 1, 2004, and the partnership sold assets December 31, 2004. The estate tax return is due August 1, 2005 (nine months after death) and may be audited as late as August 1, 2008. The estate's income tax return for calendar year 2004 is due April 15, 2005 and may be amended only as late as April 15, 2008. Thus, audit adjustments on the estate tax return might be made between April 15, 2008 and August 1, 2008, but the estate could not amend its income tax return to reflect any increase in basis due to the audit. The partnership should extend the due date of its return.[4732] Additionally, the estate could file an extension for its initial income tax return, so that the return is filed timely between August 1, 2005 and October 15, 2005 (six months being the latest date for an extension). An alternative to extending the estate's income tax return might be for the estate to choose a fiscal year ending on or after April 30, 2005; note that a Code § 645 election would be required if the decedent's partnership interest were held in a revocable trust.

If the partnership's assets are included in the decedent's gross estate under Code § 2036, the partnership's assets will receive a basis adjustment, without regard to whether a Code § 754 election was made.[4733] Consider whether an estate that is well below the threshold for paying estate tax would argue that any partnership interest it holds should be disregarded under Code § 2036 and the underlying assets included in the estate, so that the assets could get a

---

[4730] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

[4731] In *Malm v. U.S.*, 420 F.Supp. 1040 (D.C. N.D. 2005), the court stated:

> Harry Malm died on August 5, 1998. His estate included shares of Medtronic stock. The IRS disputed the estate's valuation of that stock. The dispute wound up in court, and on July 23, 2003, this Court ruled that the IRS' stock valuation was correct….As a result of this ruling, the Medtronic stock had a higher fair market value than reported by the estate on its federal estate tax return. Therefore, the estate's federal income tax return overstated the amount of the gain on the sale of this stock….The estate filed its income tax return on November 14, 1999. Since the estate did not file a claim for a refund on that return until February 12, 2004, its claim is barred by the statute of limitations.

[4732] The partnership will need to make any Code § 754 election no later than the extended due date of the return. If the election does not look worthwhile but upon audit it starts looking worthwhile, the IRS will not grant Code § 9100 relief. Letter Ruling 200626003.

[4733] Letter Ruling 200626003. See *Hurford*, discussed in fn 1274 in part II.G.6 Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy.

higher basis step-up.[4734] Query the level of proof required to invoke Code § 2036 in such a situation.[4735]

In reviewing anything in this part II.Q.8.e.iii.(b), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

[4734] See fns 93-94 in part II.A.2.d.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders (which part highlighted an S corporation's ability to avoid Code § 2036).

[4735] For an estate tax TAM, see fn 208 in part II.A.2.i.i.(b) Why Nonvoting Shares Are Needed for Estate Planning. The TAM cited *Estate of Robinson v. Commissioner*, 101 T.C. 499, 513-514 (1993), which case, involving annual exclusion gifts, stated:

> The ability of a taxpayer to avoid the form of a transaction requires strong proof in this Court, and is even more restricted by the Court of Appeals for the Eleventh Circuit, the court to which an appeal in the instant case would be taken. *Bradley v. United States*, 730 F.2d 718, 720 (11th Cir. 1984). The rule, first announced in *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967), vacating and remanding 44 T.C. 549 (1965), is as follows:
>
> > A party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.…
>
> Although *Danielson* involved the allocation of payments to a covenant not to compete, it is clear that the rule applies beyond the confines of such an allocation. *Sullivan v. United States*, 618 F.2d 1001 (3d Cir. 1980); *Coleman v. Commissioner*, 87 T.C. 178, 202 (1986), *affd.* in an unpublished order 833 F.2d 303 (3d Cir. 1987). The Court of Appeals for the Eleventh Circuit has also adopted a similar rule to the rule in *Danielson*. *Bradley v. United States*, *supra*. We are bound to follow *Bradley* under the rule of *Golsen v. Commissioner*, 54 T.C. 742 (1970), *affd.* 445 F.2d 985 (10th Cir. 1971).
>
> The rule in *Danielson* prevents a taxpayer from arguing against the form of a transaction adopted by the taxpayer and the other parties to the transaction unless mistake, undue influence, fraud, duress, or other defenses to the formation of a contract could be shown by the taxpayer in action against the other parties to the transaction. The rule in *Danielson* is not applicable when the form of the transaction adopted by the parties is ambiguous. *Smith v. Commissioner*, 82 T.C. 705, 713-714 (1984).
>
> In the instant case, neither the form of the transaction nor the deeds used to facilitate the transaction can be reasonably construed as ambiguous. The deeds do not refer to any interests that petitioner contends decedent's great-grandchildren had in the transferred properties. Therefore, under the rule in *Danielson*, petitioner is prevented from arguing that implied trusts were created under Georgia law for the benefit of decedent's great-grandchildren.

Along the lines of a case cited above that the taxpayer could not report as goodwill – taxed as capital gain - payments under a covenant not to compete, which was ordinary income, *Muskat v. U.S.*, 554 F.3d 183 (1st Cir. 2009), *aff'g* 101 AFTR 2d 2008-1606 (D.N.H. 2008), which is further described in fn 4604 in part II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill, stated:

> In our view, to constitute "strong proof" a taxpayer's evidence must have persuasive power closely resembling the "clear and convincing" evidence required to reform a written contract on the ground of mutual mistake.

In rejecting a taxpayer's argument that an S corporation of which he owned 49% had a second class of stock, *Mowry v. Commissioner*, T.C. Memo. 2018-105, which is also discussed in fns 235-236 in part II.A.2.i.iii Disproportionate Distributions, held:

> Generally taxpayers are bound by the form of the transaction that they choose unless they can provide "strong proof" that the parties intended a different transaction in substance. *Schulz v. Commissioner*, 294 F.2d 52, 55 (9th Cir. 1961), *aff'g* 34 T.C. 235 (1960); see also *Vandenbosch v. Commissioner*, T.C. Memo. 2016-29, at *19-*20. There is no proof that either petitioner or G. Mowry intended an arrangement different from that which they agreed to and reported consistently on their tax filings.

II.Q.8.e.iii.(c). When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000

Generally, Code § 754 election adjusts the basis of a partnership's assets when certain events occur that change the basis of any interest in that partnership.[4736] The idea is that the value of the partnership's assets was reflected in the change of basis in the partnership interest; therefore, some element of the basis in the partnership's assets should reflect the change of basis in the partnership interest.

In one limited case involving straddles, the IRS ruled that failure to make a Code § 754 election constituted an abuse.[4737]

When a Code § 754 election is in place, any Code § 743 adjustments that apply to the transfers of partnership interests require the partnership to essentially create a separate set of books for each partner,[4738] whereas any Code § 734 adjustments (increasing or decreasing inside basis as a result of a change in the basis of distributed property) apply to the partnership as a whole.[4739] For more details on the implementation of a Code § 743(b) basis step-up, see part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

CCA 201521012 explained the interaction of Code § 734(b) with Code § 481 adjustments for change in accounting method.[4740] Also, in reviewing anything in this part II.Q.8.e.iii.(c), consider

---

[4736] For more on Code § 754 elections, see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

[4737] Notice 2002-50; see also Reg. § 1.701-2(e)(1) and the discussion of the anti-abuse regulations described in part II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property.

[4738] Reg. § 1.743-1(j).

[4739] Code § 734(b) provides:

> *Method of adjustment*. In the case of a distribution of property to a partner by a partnership with respect to which the election provided in section 754 is in effect or with respect to which there is a substantial basis reduction, the partnership shall—
>
> (1) increase the adjusted basis of partnership property by—
>
> (A) the amount of any gain recognized to the distributee partner with respect to such distribution under section 731(a)(1) , and
>
> (B) in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732(d)) over the basis of the distributed property to the distributee, as determined under section 732, or
>
> (2) decrease the adjusted basis of partnership property by—
>
> (A) the amount of any loss recognized to the distributee partner with respect to such distribution under section 731(a)(2) , and
>
> (B) in the case of distributed property to which section 732(b) applies, the excess of the basis of the distributed property to the distributee, as determined under section 732, over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted by section 732(d)).
>
> Paragraph (1)(B) shall not apply to any distributed property which is an interest in another partnership with respect to which the election provided in section 754 is not in effect.

[4740] When the IRS determined that a partnership had improperly deferred gain:

> When there is a change in accounting method to which IRC § 481(a) is applied, income for taxable years preceding the year of change must be determined under the accounting method that was

whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

The taxpayer can take advantage of a basis step-up, without the partnership making a Code § 754 election, by receiving a distribution of appreciated assets within two years after death or sale or exchange of the partnership interest; see part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election. Such a distribution would tend to undermine valuation discounts, which might be good (higher basis step-up) or bad (potentially higher estate tax).

If a partnership holds assets with built-in losses greater than $250,000, one must consider harvesting those losses before engaging in any disposition or acquisition of any interest in the partnership, including the death of a partner. The rest of this section explains why.

The American Jobs Creation Act added three new mandatory basis adjustment rules that can cause serious problems if a partnership does not have a Code § 754 election in effect.[4741] The first rule applies to limit the transfer of built-in losses on property contributed to a partnership after

---

then used, and income for the year of change and the following taxable years must be determined under the new accounting method as if the new method had always been used. Accordingly, Taxpayer's IRC § 734(b) adjustments for years preceding the year of change must be computed using the accounting method that was then used. Taxpayer's IRC § 734(b) adjustments for the year of change and subsequent years must be redetermined consistent with the new accounting method.

In computing the net § 481(a) adjustment, a taxpayer must take into account all relevant accounts. See Rev. Proc. 2002-18, section 2.04(1), Rev. Proc. 97-27, 1997-1 C.B. 680, section 2.05(1). Here, the IRC § 481(a) adjustment represents the difference in gain or loss for all of the underlying securities that would have been recognized under the new method, less the gain or loss that was recognized under the prior method as of the beginning of the year of change. Taxpayer's IRC § 734(b) adjustments for taxable years prior to the year of change, as calculated under the prior method, are fully taken into account in calculating the basis in the securities. In addition, beginning in the year of change, Taxpayer's basis in its securities will be modified to reflect the gain or loss recognized in connection with the change in accounting method.

The determination of whether a partnership has a change in accounting method does not depend on whether the partnership made an election under IRC § 754, whose only purpose and effect is to eliminate distortions caused by partnership distributions and sales of partnership interests. The partners of a partnership using a given accounting method ultimately recognize the same amount of cumulative taxable income over the life of the partnership whether or not the partnership makes an election under IRC § 754. A change in accounting method under IRC § 446 occurs when Taxpayer/partnership no longer treats certain securities transactions as options and thus, stops deferring the gains, losses, income, or deductions associated with those transactions.

[4741] For more details, see IRS Notice 2005-32; see also Rosenberg, AJCA Imposes New Burdens for Partnership Basis Adjustments Under Sections 734 and 743, *Journal of Taxation*, vol. 101, No. 6, 12/2004 at 334, which was followed by Lipton and Golub, Dealing With the Service's Interim Guidance on Downward Basis Adjustments Under 734 and 743, *Journal of Taxation*, vol. 103, No. 1, 7/2005 at 33; Schneider, New Basis Rules Aim at Transfer and Duplication of Built-in Losses, *Taxes – The Tax Magazine*, May 2005 at 39. Also note that Reg. § 1.701-2(d), Ex. 8 also considers failure to make a Section 754 election to be an abuse, but Ex. 9 does not consider failure to make a Section 754 election to be an abuse. Similarly, if a tax-indifferent party attempts to shift built-in losses to a U.S. taxpayer who has not incurred an economic loss so that the U.S. taxpayer may claim a deduction of the built-in losses from the distressed assets, the transaction might be a listed transaction under Notice 2008-34.

October 22, 2004.[4742] The second rule applies when a partnership distributes cash or property after October 22, 2004 that results in the transferee either recognizing a loss or receiving a stepped-up basis in the property greater than $250,000.[4743] The third rule applies when a partner dies or transfers an interest in a partnership after October 22, 2004 and the partnership has built-in losses greater than $250,000.[4744] Furthermore, starting in 2018, this adjustment applies when the transferee partner would be allocated a loss of more than $250,000 if the partnership assets were sold for cash equal to their fair market value immediately after such transfer.[4745]

Limited exceptions apply to certain electing investment partnerships and securitization partnerships.[4746] One of these provisions encourages taxpayers to structure marketable securities partnerships as follows: all contributions are cash in exchange for partnership interests issued within 24 months of formation; the partnerships buys investment assets but does not engage in a trade or business; no partner can readily redeem that partner's partnership interest; and the partnership has a term of no more than 15 years;[4747] this structure has other advantages as well.[4748]

These adjustments can be particularly disturbing when a partnership interest is sold to a related party. Let's start with an example from IRS Notice 2005-32 that tracks the legislative history:

> PRS is a partnership which does not have an election under § 754 in effect. PRS has no liabilities. The fair market value of PRS's assets is $4 million and the adjusted basis of PRS's assets is $4.3 million. Under § 743(d), PRS has a substantial built-in loss because the adjusted basis of the partnership property exceeds the fair market value of the partnership property by more than $250,000. A, a partner of PRS, sells a 25

[4742] Code § 704(c)(1)(C). For a discussion of proposed regulations, see Kim and Carrasco, Proposed Regulations on Contributions of Built-in Loss Property: Paving a Framework for Super C, *TM Memorandum* (BNA), 10/20/2014, Vol. 55, No. 21. See also the American Bar Association Section of Taxation's Comments on Proposed Regulations on Certain Partnership Provisions of the American Jobs Creation Act of 2004, *Tax Lawyer*, vol. 69, No. 1, p. 5 (Fall 2015).

[4743] Code § 734(b).

[4744] Code § 743(a) and (b), as amended.

[4745] Code § 743(d)(1)(B). The Senate Report said:

> For example, a partnership of three taxable partners (partners A, B, and C) has not made an election pursuant to section 754. The partnership has two assets, one of which, Asset X, has a built-in gain of $1 million, while the other asset, Asset Y, has a built-in loss of $900,000. Pursuant to the partnership agreement, any gain on sale or exchange of Asset X is specially allocated to partner A. The three partners share equally in all other partnership items, including in the built-in loss in Asset Y. In this case, each of partner B and partner C has a net built-in loss of $300,000 (one third of the loss attributable to asset Y) allocable to his partnership interest. Nevertheless, the partnership does not have an overall built-in loss, but a net built-in gain of $100,000 ($1 million minus $900,000). Partner C sells his partnership interest to another person, D, for $33,333. Under the provision, the test for a substantial built-in loss applies both at the partnership level and at the transferee partner level. If the partnership were to sell all its assets for cash at their fair market value immediately after the transfer to D, D would be allocated a loss of $300,000 (one third of the built-in loss of $900,000 in Asset Y). A substantial built-in loss exists under the partner-level test added by the provision, and the partnership adjusts the basis of its assets accordingly with respect to D.

[4746] Code §§ 734(e) and 743(e), (f).

[4747] Code § 743(e).

[4748] Distributions of marketable securities might be considered nontaxable distributions of property rather than potentially taxable distributions of cash. See text accompanying footnotes 4437-4439.

> percent partnership interest in PRS to B for its fair market value of $1 million. Under § 743(b), an adjustment is required to the adjusted basis of PRS's assets with respect to B....

Presumably that adjustment would be to reduce the basis of the partnership's assets by $75,000, which is the excess of A's $1,075,000 pro rata share of the basis of the partnership's assets (25% of $4,300,000) over the sale price ($1,000,000).

This provision was intended to prevent double deductions as follows, assuming that the basis of A's partnership interest is 25% of the basis of the partnership's assets:

- A has a $75,000 loss, since A's basis of $1,075,000 (25% of $4.3 million) exceeds A's $1,000,000 proceeds.

- B reports a $75,000 loss when PRS sells its assets.

What if, however, B were a related party, and Code § 267 prevented A from deducting the loss? Generally, the perceived double deduction would not apply, since A cannot deduct A's $75,000 loss. Therefore, as a matter of policy, the $75,000 mandatory basis adjustment should not apply. However, the statute does not appear to have any exceptions that take into account a Code § 267 loss disallowance, so it appears that B would be stuck with the negative basis adjustment. Thus, neither A nor B recognizes this loss.[4749]

The situation is worsened when one applies valuation adjustments, since (unlike the example in Notice 2005-32) A's partnership interest is worth less than a pro-rata-share of the underlying assets. For example, suppose A sold A's partnership interest to B for $750,000? Then a special allocation of basis adjustment would reduce B's share of the basis from A's original $1,075,000 to only $750,000. So, at first glance, the basis reduction is $325,000 ($1,075,000 minus $750,000), which exceeds the $300,000 ($4.3 million minus $4 million) substantial built-in loss that triggered the whole situation. However, the basis reduction cannot decrease an asset's basis below its fair market value,[4750] so this provision is not as onerous as it might have seemed.

One might sell the partnership's loss assets so that the partners recognize the loss, then buy other assets that have similar investment attributes but do not constitute "substantially identical stock or securities" under the wash sale rules of Code § 1091. That should avoid the mandatory basis reductions and give A the losses that would otherwise have been disallowed.

II.Q.8.e.iii.(d). Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest

For when a transfer triggers a Code § 743 inside basis adjustment, see part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000. This part II.Q.8.e.iii.(d) assumes that one has determined that a Code § 743(b) adjustment applies. In reviewing anything in this

---

[4749] B would be able to take advantage of this disallowed loss if and to the extent that B later sells B's partnership interest for a gain. Code § 267(d).

[4750] See fn. 4775 in part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

part II.Q.8.e.iii.(d), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

Before getting into how the allocations work, consider various reporting issues:

- Make a Code § 754 election on the partnership return covering the year of transfer, if not yet in effect.

- A transferee that acquires, by sale or exchange, an interest in a partnership with a Code § 754 election in effect for the taxable year of the transfer, must notify the partnership, in writing, within 30 days of the sale or exchange.[4751] A transferee that acquires, on the death of a partner, an interest in a partnership with a Code § 754 election in effect for the taxable year of the transfer, must notify the partnership, in writing, within one year of the death of the deceased partner.[4752] In making the adjustments under Code § 743(b) and any statement or return relating to such adjustments under this section, a partnership may rely on the written notice described above to determine the transferee's basis in a partnership interest, unless any partner who has responsibility for the partnership's federal income tax reporting has knowledge of facts indicating that the statement is clearly erroneous.[4753] A partnership is not required to make Code § 743(b) adjustments (or any statement or return relating to those adjustments) with respect to any transfer until it has been notified of the transfer.[4754] If the transferee fails to provide the partnership with the written notice described above, the partnership must attach a statement to its return in the year that the partnership is otherwise notified of the transfer.[4755]

- A partnership that must adjust the bases of partnership properties under Code § 743(b)) must attach a statement to the partnership return for the year of the transfer setting forth the name

[4751] Reg. § 1.743-1(k)(2)(i) (also referred to by Reg. § 1.755-1(d)), which further provides:

> The written notice to the partnership must be signed under penalties of perjury and must include the names and addresses of the transferee and (if ascertainable) of the transferor, the taxpayer identification numbers of the transferee and (if ascertainable) of the transferor, the relationship (if any) between the transferee and the transferor, the date of the transfer, the amount of any liabilities assumed or taken subject to by the transferee, and the amount of any money, the fair market value of any other property delivered or to be delivered for the transferred interest in the partnership, and any other information necessary for the partnership to compute the transferee's basis.

[4752] Reg. § 1.743-1(k)(2)(ii), which further provides:

> The written notice to the partnership must be signed under penalties of perjury and must include the names and addresses of the deceased partner and the transferee, the taxpayer identification numbers of the deceased partner and the transferee, the relationship (if any) between the transferee and the transferor, the deceased partner's date of death, the date on which the transferee became the owner of the partnership interest, the fair market value of the partnership interest on the applicable date of valuation set forth in section 1014, and the manner in which the fair market value of the partnership interest was determined.

[4753] Reg. § 1.743-1(k)(3).

[4754] Reg. § 1.743-1(k)(4), which provides that a partnership is notified of a transfer when either:

> (i) The partnership receives the written notice from the transferee required under paragraph (k)(2) of this section; or
>
> (ii) Any partner who has responsibility for federal income tax reporting by the partnership has knowledge that there has been a transfer of a partnership interest.

[4755] Reg. § 1.743-1(k)(5), which describes the attachment, as well as what to do when the transferee supplies the information.

and taxpayer identification number of the transferee as well as the computation of the adjustment and the partnership properties to which the adjustment has been allocated.[4756]

As noted in part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, special rules apply when built-in losses are involved. For a discussion of proposed regulations implementing Code § 743(b) adjustments in such cases, see the American Bar Association Section of Taxation's "Comments on Proposed Regulations on Certain Partnership Provisions of the American Jobs Creation Act of 2004," *Tax Lawyer*, vol. 69, No. 1, p. 5 (Fall 2015).

Before we get into details, note that this part II.Q.8.e.iii.(d) deals with basis adjustments. Although any positive adjustments are treated as the purchase of new assets for purposes of Code § 168 depreciation,[4757] they retain their character as adjustments and that treatment applies only for Code § 168, and proposed regulations provide that they do not affect certain calculations of the Code § 199A deduction for qualified business income.[4758]

Effect of Basis Adjustments

The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of death, increased by the estate's share of partnership liabilities, and reduced to the extent that such value is attributable to IRD.[4759] Thus, the basis increase has two effects:

- Restoring Basis Arising from Liabilities. To the extent a partner assumes a liability, that partner is deemed to have contributed cash equal to the liabilities that person is allocated. To the extent a partner's allocable share of liabilities is reduced, that person is deemed to have received a cash distribution, reducing basis or triggering gain if and to the extent basis is insufficient to absorb the distribution. During life, distributions or losses might have reduced or eliminated basis generated by the assumption of liabilities. By passing through a decedent's estate, a partnership interest's basis due to allocated liabilities is fully restored.

- Basis Adjustment Due to Value. The partnership interest's value, which includes appropriate reductions for the balance sheet effect of liabilities and appropriate increases or decreases for control or lack thereof, reductions for lack of marketability, and any other features, is added to the amount of allocable liabilities.

In implementing the Code § 743(b) adjustments:[4760]

[4756] Reg. § 1.743-1(k)(1)(i); in addition to referring to this requirement, Reg. § 1.755-1(d) indicates that this statement should include the partnership properties to which the adjustment is allocated under section 755, which is what this part II.Q.8.e.iii.(d) is all about. See Reg. § 1.743-1(k)(1)(ii) for special rules for oil and gas properties that are depleted at the partner level under Code § 613A(c)(7)(D).

[4757] See fn 4763.

[4758] See part II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A.

[4759] Reg. § 1.742-1. For more details on Reg. § 1.742-1, see fn 4721 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

[4760] Reg. § 1.743-1(j)(1). Reg. § 1.743-1(j)(2) provides more details:

> *Computation of partner's distributive share of partnership items*. The partnership first computes its items of income, deduction, gain, or loss at the partnership level under section 703. The

No adjustment is made to the common basis of partnership property. Thus, for purposes of calculating income, deduction, gain, and loss, the transferee will have a special basis for those partnership properties the bases of which are adjusted under section 743(b) and this section. The adjustment to the basis of partnership property under section 743(b) has no effect on the partnership's computation of any item under section 703.

In other words, the partnership keeps two or more separate sets of books for transferee partner: one that applies to all partners based on the partnership's transactions and is reflected in their capital accounts, and one or more than applies to each partner separately based on that partner's events that affect outside basis (that do not involve transfers of the partnership's assets) and is reflected in the partnership's basis records specially allocated to the applicable partners. When a partnership interest is transferred, the transferor's capital account attributable to the transferred interest (which might be part or all of the transferor's capital account, depending on what portion is transferred) shifts to the transferee.[4761]

The amount of any positive basis adjustment that is recovered by the transferee in any year is added to the transferee's distributive share of the partnership's depreciation or amortization deductions for the year, which deductions also reduce the basis adjustment.[4762] For purposes of depreciation under Code § 168, if the basis of a partnership's recovery property is increased as a result of the transfer of a partnership interest, then the increased portion of the basis is taken into account as if it were newly-purchased recovery property placed in service when the transfer occurs.[4763] Thus, any applicable recovery period and method may be used to determine the recovery allowance with respect to the increased portion of the basis, but none of this affects the portion of the basis for which there is no increase.[4764] Special rules apply if the partnership uses the remedial allocation method.[4765]

---

partnership then allocates the partnership items among the partners, including the transferee, in accordance with section 704, and adjusts the partners' capital accounts accordingly. The partnership then adjusts the transferee's distributive share of the items of partnership income, deduction, gain, or loss, in accordance with paragraphs (j)(3) and (4) of this section, to reflect the effects of the transferee's basis adjustment under section 743(b). These adjustments to the transferee's distributive shares must be reflected on Schedules K and K-1 of the partnership's return (Form 1065). These adjustments to the transferee's distributive shares do not affect the transferee's capital account. [additional references re: accounting for long-term contracts]

CCA 201726012 (under the signature of David R. Haglund) stated:

Adjustments to the adjusted tax basis of partnership property under § 743 are not reflected in the capital account of the transferee partner or on the books of the partnership. § 1.704-1(b)(2)(iv)(m)(2). No adjustment is made to the common basis of partnership property, and the § 743(b) adjustment has no effect on the partnership's computation of any item under § 703. § 1.743-1(j)(1). Section 743(b) adjustments are personal to the transferee partners and are not subject to reallocation under § 704(b).

[4761] Reg. § 1.704-1(b)(2)(iv)(*l*). See also Reg. § 1.704-1(b)(5), Ex. (13).

[4762] Reg. § 1.743-1(j)(4)(i)(A).

[4763] Reg. § 1.743-1(j)(4)(i)(B)(1).

[4764] Reg. § 1.743-1(j)(4)(i)(B)(1). Reg. § 1.743-1(j)(4)(i)(C) provides examples.

[4765] Reg. § 1.743-1(j)(4)(i)(B)(2) provides:

Remedial allocation method. If a partnership elects to use the remedial allocation method described in § 1.704-3(d) with respect to an item of the partnership's recovery property, then the portion of any increase in the basis of the item of the partnership's recovery property under section 743(b) that is attributable to section 704(c) built-in gain is recovered over the remaining recovery period for the partnership's excess book basis in the property as determined in the final

CCA 201726012 (under the signature of David R. Haglund) asserted that Reg. § 1.1502-13 did not permit increased deductions for depreciation and amortization that are attributable to Code § 743(b) adjustments arising from the transfer of a partnership interest in an intercompany reorganization to which Code § 368 applies and from the distribution of a partnership interest in an intercompany liquidation to which Code § 332(a) applies. It also asserted that the basis adjustment provisions of Code § 743(b) do not conflict with the carryover basis provisions of Code § 362(a) when a partnership interest is transferred in an intercompany reorganization to which Code § 368 applies or with the carryover basis provisions of Code § 334(b)(1) when a partnership interest is distributed in an intercompany liquidation to which Code § 332(a) applies.[4766]

For basis decreases, however, Reg. § 1.743-1(j)(4)(ii)(A) provides:

> *Reduced deduction*. The amount of any negative basis adjustment allocated to an item of depreciable or amortizable property that is recovered in any year first decreases the transferee's distributive share of the partnership's depreciation or amortization deductions from that item of property for the year. If the amount of the basis adjustment recovered in any year exceeds the transferee's distributive share of the partnership's depreciation or amortization deductions from the item of property, then the transferee's distributive share of the partnership's depreciation or amortization deductions from other items of partnership property is decreased. The transferee then recognizes ordinary income to the extent of the excess, if any, of the amount of the basis adjustment recovered in any year over the transferee's distributive share of the partnership's depreciation or amortization deductions from all items of property.

For purposes of Code § 168, the decrease is recovered over the remaining useful life of the item of the partnership's recovery property, using the following formula:[4767]

> The portion of the decrease that is recovered in any year during the recovery period is equal to the product of-

---

sentence of § 1.704-3(d)(2). Any remaining portion of the basis increase is recovered under paragraph (j)(4)(i)(B)(1) of this section.

[4766] CCA 201726012 reasoned:

> In the case of property transferred in a reorganization to which § 368 applies, in which no gain or loss is recognized, the basis of such property in the hands of the transferee generally is the same as it would be in the hands of the transferor under § 362(a). Similarly, in the case of property distributed to a corporate parent from a subsidiary in a complete liquidation to which § 332(a) applies, in which no gain or loss is recognized, the basis of such property in the hands of the distributee generally is the same as it would be in the hands of the distributor under § 334(b)(1).
>
> Thus, with respect to the transfer of the Partnership1 interest from SubsidiaryH to SubsidiaryF in the Reorganization (to which § 368 applies), and the distribution of the Partnership1 interest from SubsidiaryC to SubsidiaryE in the Liquidation (to which § 332 applies), the transferee's and distributee's basis in their Partnership1 interest is the same as it would be in the hands of the respective transferor and distributor.
>
> Application of § 743(b), by contrast, has no effect on the basis of a *partnership interest* transferred in a reorganization or distributed in a complete liquidation. Rather, in such cases, if the partnership has a § 754 election in effect, § 743(b) provides for an increase or decrease in the adjusted basis of *partnership property*.

[4767] Reg. § 1.743-1(j)(4)(ii)(B). Reg. § 1.743-1(j)(4)(ii)(C) provides examples.

(1) The amount of the decrease to the item's adjusted basis (determined as of the date of the transfer); multiplied by

(2) A fraction, the numerator of which is the portion of the adjusted basis of the item recovered by the partnership in that year, and the denominator of which is the adjusted basis of the item on the date of the transfer (determined prior to any basis adjustments).

Also, Reg. § 1.743-1(j)(5) provides:

> *Depletion*. Where an adjustment is made under section 743(b) to the basis of partnership property subject to depletion, any depletion allowance is determined separately for each partner, including the transferee partner, based on the partner's interest in such property. See § 1.702-1(a)(8). For partnerships that hold oil and gas properties that are depleted at the partner level under section 613A(c)(7)(D), the transferee partner (and not the partnership) must make the basis adjustments, if any, required under section 743(b) with respect to such properties. See § 1.613A-3(e)(6)(iv).

Calculating Basis Adjustment

The partnership increases the adjusted basis of its property by the excess of the basis to the transferee partner of the partner's interest in the partnership over the partner's proportionate share of the adjusted basis of the partnership property.[4768] Consistent with the rule for outside basis stated above, a transferee's share of the adjusted basis to the partnership of partnership property is equal to the sum of the transferee's interest as a partner in the partnership's previously taxed capital, plus the transferee's share of partnership liabilities.[4769] Generally, a transferee's interest as a partner in the partnership's previously taxed capital is equal to:[4770]

- The amount of cash that the transferee would receive on a liquidation of the partnership following a certain hypothetical transaction, to the extent attributable to the acquired partnership interest; increased by

- The amount of tax loss,[4771] that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest); and decreased by

- The amount of tax gain,[4772] that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest).

The hypothetical transaction referred to in the first bullet point above means the disposition by the partnership of all of the partnership's assets, immediately after the transfer of the partnership interest, in a fully taxable transaction for cash equal to the fair market value of the assets.[4773]

[4768] Code § 743(b).
[4769] Reg. § 1.743-1(d)(1).
[4770] Reg. § 1.743-1(d)(1).
[4771] Including any remedial allocations under Reg. § 1.704-3(d).
[4772] Including any remedial allocations under Reg. § 1.704-3(d).
[4773] Reg. § 1.743-1(d)(2).

Note that the basis adjustment does not refer to the basis change that triggered the adjustment. Rather, the basis adjustment seeks to reconcile the cumulative effect of anything that changed inside and outside basis.

Code § 755 and the regulations thereunder determine the allocation of the Code § 743(b) basis adjustment among the individual items of partnership property.[4774] Generally, any Code § 743(b) change in the adjusted basis of partnership property will be allocated in a manner which has the effect of reducing the difference between the fair market value in any other manner permitted by regulations.[4775]

In applying this rule, changes in the adjusted basis of property consisting of capital assets and Code § 1231(b) property (property used in a trade or business), or any other property of the partnership, is allocated to partnership property of a like character, except that the basis of any such partnership property shall not be reduced below zero.[4776] Reg. § 1.755-1(a)(1) provides:

- First, the partnership must determine the value of each of its assets.
- Second, the basis adjustment is allocated between the two classes of property consisting of capital assets and Code § 1231(b) property (capital gain property), and any other property of the partnership (ordinary income property). Furthermore, properties and potential gain treated as unrealized receivables under Code § 751(c) and the regulations thereunder are treated as separate assets that are ordinary income property. References to "capital gain" or "ordinary income" property appear to disregard whether there is an unrealized gain or loss.
- Third, the portion of the basis adjustment allocated to each class is allocated among the items within the class.

Valuation issues include:

- If the assets of the partnership constitute a trade or business,[4777] then the partnership is required to use the residual method to assign values to the partnership's section 197

[4774] Code § 743(c); Reg. § 1.743-1(e).
[4775] Code § 755(a), which the regulations follow by allocating according to gain or loss arising from a hypothetical sale. This concept prevents an outside basis decrease due to valuation discounts from reducing the basis of assets with unrealized gain (although such a discount may reduce any basis increase); see part II.H.3 Valuation Discounts – Friend or Enemy, especially fn. 1763. Similarly, a distribution shifting basis to distributed assets under Code § 732 that ordinarily would reduce inside basis cannot reduce the basis of assets with unrealized gain; see parts II.H.2.f Partnership Basis Shifting Opportunities and II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property (with fn. 4453 referring to this footnote).
[4776] Code § 755(b).
[4777] As defined in Reg. § 1.1060-1(b)(2), which provides that a group of assets constitutes a trade or business if:

(A) The use of such assets would constitute an active trade or business under section 355; or
(B) Its character is such that goodwill or going concern value could under any circumstances attach to such group.

See part II.Q.7.f.iii Active Business Requirement for Code § 355.

intangibles (goodwill, etc.).[4778] The IRS is not bound by the parties' allocation of purchase price, even if the parties are bound by a statement required to be filed with the IRS.[4779]

- Except for certain Code § 743(b) basis adjustments resulting from substituted basis transactions,[4780] partnership gross value generally is equal to the amount that, if assigned to all partnership property, would result in a liquidating distribution to the partner equal to the transferee's basis in the transferred partnership interest immediately following the relevant transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities).[4781] However, in certain circumstances, such as where income or loss with respect to particular section 197 intangibles are allocated differently among partners, partnership gross value may vary depending on the values of particular section 197 intangibles the partnership held.[4782] Also, where a partnership interest is transferred as a result of the death

---

[4778] Reg. § 1.755-1(a)(2), which further provides:

> To do so, the partnership must, first, determine the value of partnership assets other than section 197 intangibles under paragraph (a)(3) of this section. The partnership then must determine partnership gross value under paragraph (a)(4) of this section. Last, the partnership must assign values to the partnership's section 197 intangibles under paragraph (a)(5) of this section. For purposes of this section, the term section 197 intangibles includes all section 197 intangibles (as defined in section 197), as well as any goodwill or going concern value that would not qualify as a section 197 intangible under section 197.

Reg. § 1.755-1(a)(3) provides:

> For purposes of this section, the fair market value of each item of partnership property other than section 197 intangibles shall be determined on the basis of all the facts and circumstances, taking into account section 7701(g).

Code § 7701(g) provides:

> *Clarification of fair market value in the case of nonrecourse indebtedness*. For purposes of subtitle A, in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject.

[4779] Reg. § 1.1060-1(c)(4) provides:

> *Effect of agreement between parties*. If, in connection with an applicable asset acquisition, the seller and purchaser agree in writing as to the allocation of any amount of consideration to, or as to the fair market value of, any of the assets, such agreement is binding on them to the extent provided in this paragraph (c)(4). Nothing in this paragraph (c)(4) restricts the Commissioner's authority to challenge the allocations or values arrived at in an allocation agreement. This paragraph (c)(4) does not apply if the parties are able to refute the allocation or valuation under the standards set forth in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967) (a party wishing to challenge the tax consequences of an agreement as construed by the Commissioner must offer proof that, in an action between the parties to the agreement, would be admissible to alter that construction or show its unenforceability because of mistake, undue influence, fraud, duress, etc.).

[4780] Reg. § 1.755-1(a)(4)(ii):

> applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in the interest or to the basis of other property held at any time by the transferee (substituted basis transactions). In the case of a substituted basis transaction, partnership gross value equals the value of the entire partnership as a going concern, increased by the amount of partnership liabilities at the time of the exchange giving rise to the basis adjustment.

[4781] Reg. § 1.755-1(a)(4)(i)(A).

[4782] Reg. § 1.755-1(a)(4)(i)(B), which further provides:

> In these special situations, the partnership must assign value, first, among section 197 intangibles (other than goodwill and going concern value) in a reasonable manner that is consistent with the

of a partner, the transferee's basis in its partnership interest is determined without regard to Code § 1014(c), and is deemed to be adjusted for that portion of the interest, if any, that is attributable to items representing income in respect of a decedent under Code § 691.[4783]

If the aggregate value of partnership property other than section 197 intangibles[4784] is equal to or greater than partnership gross value,[4785] then all section 197 intangibles are deemed to have a value of zero for purposes of this allocation.[4786] Otherwise, the aggregate value of the partnership's section 197 intangibles (the residual section 197 intangibles value) is deemed to equal the excess of partnership gross value over the aggregate value of partnership property other than section 197 intangibles.[4787] The residual section 197 intangibles value must be allocated first among section 197 intangibles other than goodwill and going concern value[4788] and then to goodwill and going concern value.[4789]

---

ordering rule in paragraph (a)(5) of this section and would cause the appropriate liquidating distribution under paragraph (a)(4)(i)(A) of this section. If the actual fair market values, determined on the basis of all the facts and circumstances, of all section 197 intangibles (other than goodwill and going concern value) is not sufficient to cause the appropriate liquidating distribution, then the fair market value of goodwill and going concern value shall be presumed to equal an amount that if assigned to goodwill and going concern value would cause the appropriate liquidating distribution.

[4783] Reg. § 1.755-1(a)(4)(i)(C).

[4784] Reg. § 1.755-1(a)(3) provides:

For purposes of this section, the fair market value of each item of partnership property other than section 197 intangibles shall be determined on the basis of all the facts and circumstances, taking into account section 7701(g).

[4785] Gross value as determined in Reg. § 1.755-1(a)(4).

[4786] Reg. § 1.755-1(a)(5)(i).

[4787] Reg. § 1.755-1(a)(5)(i).

[4788] Reg. § 1.755-1(a)(5)(ii) provides:

Values assigned to section 197 intangibles other than goodwill and going concern value. The fair market value assigned to a section 197 intangible (other than goodwill and going concern value) shall not exceed the actual fair market value (determined on the basis of all the facts and circumstances) of that asset on the date of the relevant transfer. If the residual section 197 intangibles value is less than the sum of the actual fair market values (determined on the basis of all the facts and circumstances) of all section 197 intangibles (other than goodwill and going concern value) held by the partnership, then the residual section 197 intangibles value must be allocated among the individual section 197 intangibles (other than goodwill and going concern value) as follows. The residual section 197 intangibles value is assigned first to any section 197 intangibles (other than goodwill and going concern value) having potential gain that would be treated as unrealized receivables under the flush language of section 751(c) (flush language receivables) to the extent of the basis of those section 197 intangibles and the amount of income arising from the flush language receivables that the partnership would recognize if the section 197 intangibles were sold for their actual fair market values (determined based on all the facts and circumstances) (collectively, the flush language receivables value). If the value assigned to section 197 intangibles (other than goodwill and going concern value) is less than the flush language receivables value, then the assigned value is allocated among the properties giving rise to the flush language receivables in proportion to the flush language receivables value in those properties. Any remaining residual section 197 intangibles value is allocated among the remaining portions of the section 197 intangibles (other than goodwill and going concern value) in proportion to the actual fair market values of such portions (determined based on all the facts and circumstances).

[4789] Reg. § 1.755-1(a)(5)(i), (iii).

Substituted basis transactions and other transactions have different methodologies.[4790] Subject to certain exceptions for substituted basis transaction:[4791]

- The portion of the basis adjustment allocated to one class of property may be an increase while the portion allocated to the other class is a decrease. This would be the case even though the total amount of the basis adjustment is zero.

- The portion of the basis adjustment allocated to one item of property within a class may be an increase while the portion allocated to another is a decrease. This would be the case even though the basis adjustment allocated to the class is zero.

If the Code § 743(b) basis adjustment does not result from a substituted basis transaction, then the allocation of that adjustment between the classes of property and among the items of property within each class are made based on the allocations of income, gain, or loss[4792] that the transferee partner would receive (to the extent attributable to the acquired partnership interest) if, immediately after the transfer of the partnership interest, all of the partnership's property were disposed of in a fully taxable transaction for cash in an amount equal to the fair market value of such property (the hypothetical transaction):[4793]

1. The amount of the basis adjustment allocated to the class of ordinary income property is equal to the total amount of income, gain, or loss[4794] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the sale of all ordinary income property in the hypothetical transaction.[4795] The amount of the basis adjustment to each item of property within the class of ordinary income property is equal to:

   A. The amount of income, gain, or loss[4796] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item;[4797] reduced by

   B. The product of:[4798]

      - Any decrease to the amount of the basis adjustment to ordinary income property required pursuant to fn 4810; multiplied by

---

[4790] Reg. § 1.755-1(b)(1)(i) provides:

> For basis adjustments under section 743(b) resulting from substituted basis transactions, paragraph (b)(5) of this section shall apply. For basis adjustments under section 743(b) resulting from all other transfers, paragraphs (b)(2) through (4) of this section shall apply.

[4791] Reg. § 1.755-1(b)(1)(i).

[4792] Including remedial allocations under Reg. § 1.704-3(d).

[4793] Reg. § 1.755-1(b)(1)(ii), which further provides:

> See § 1.460-4(k)(3)(v)(B) for a rule relating to the computation of income or loss that would be allocated to the transferee from a contract accounted for under a long-term contract method of accounting as a result of the hypothetical transaction.

[4794] Including any remedial allocations under Reg. § 1.704-3(d).

[4795] Reg. § 1.755-1(b)(2)(i).

[4796] Including remedial allocations under Reg. § 1.704-3(d).

[4797] Reg. § 1.755-1(b)(3)(i)(A).

[4798] Reg. § 1.755-1(b)(3)(i)(B).

- A fraction, the numerator of which is the fair market value of the item of property to the partnership and the denominator of which is the total fair market value of all of the partnership's items of ordinary income property.

2. The amount of the basis adjustment to capital gain property is equal to the total amount of the basis adjustment under Code § 743(b) minus he amount of the basis adjustment allocated to ordinary income property.[4799] The amount of the basis adjustment to each item of property within the class of capital gain property is equal to:[4800]

   A. The amount of income, gain, or loss[4801] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item;[4802] minus

   B. The product of:[4803]

      - The total amount of gain or loss[4804] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all items of capital gain property, minus the amount of the positive basis adjustment to all items of capital gain property or plus the amount of the negative basis adjustment to capital gain property; multiplied by

      - A fraction, the numerator of which is the fair market value of the item of property to the partnership, and the denominator of which is the fair market value of all of the partnership's items of capital gain property.

   An asset with respect to which the transferee partner has no interest in income, gain, losses, or deductions shall not be taken into account in calculating this product.[4805] Furthermore, the amount of any decrease in basis allocated to an item of capital gain property above[4806] may not exceed the partnership's adjusted basis in that item; if a decrease in basis allocated above to an item of capital gain property would otherwise exceed the partnership's adjusted basis in that item, the excess must be applied to reduce the remaining basis, if any, of other capital gain assets pro rata in proportion to the bases of such assets (as adjusted under these rules).[4807]

3. In no event may the amount of any decrease in basis allocated to capital gain property exceed the partnership's basis[4808] in capital gain property.[4809] If a decrease in basis allocated to

[4799] Reg. § 1.755-1(b)(2)(i).
[4800] Reg. § 1.755-1(b)(3)(ii).
[4801] Including remedial allocations under Reg. § 1.704-3(d).
[4802] Reg. § 1.755-1(b)(3)(ii)(A).
[4803] Reg. § 1.755-1(b)(3)(ii)(B).
[4804] Including remedial allocations under Reg. § 1.704-3(d).
[4805] Reg. § 1.755-1(b)(3)(iii)(A).
[4806] In the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under Reg. § 1.704-3(d) from the hypothetical transaction.
[4807] Reg. § 1.755-1(b)(3)(iii)(B)
[4808] In the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under Reg. § 1.704-3(d) from the hypothetical transaction.
[4809] Reg. § 1.755-1(b)(2)(i)(B).

capital gain property would otherwise exceed the partnership's basis in capital gain property, the excess must be applied to reduce the basis of ordinary income property.[4810]

4. Where a partnership interest is transferred as a result of the death of a partner, under Code § 1014(c) the transferee's basis in its partnership interest is not adjusted for that portion of the interest, if any, which is attributable to items representing income in respect of a decedent under Code § 691.[4811]

Next we discuss substituted basis transactions.[4812] Initially, this was limited to Code § 743(b) basis adjustments resulting from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest.[4813] For exchanges on or after June 9, 2003, it also applies to Code § 743(b) basis adjustments that result from exchanges in which the transferee's basis in the partnership interest is determined by reference to other property held at any time by the transferee, including when a partnership interest:[4814]

- Is contributed to a corporation in a Code § 351 transaction,
- Is contributed to a partnership in a Code § 721(a) transaction, or
- Is distributed by a partnership in a Code § 731(a) transaction.

The substituted basis transaction's effect depends on whether the Code § 743(b) basis adjustment is zero, positive, or negative:[4815]

- If the overall Code § 743(b) basis adjustment is zero, then no adjustment to the basis of partnership property will be made.
- If the overall Code § 743(b) basis adjustment is positive, the increase is allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss[4816] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net gain or net income, as the case may be, to the transferee. If an increase in basis may be allocated to both capital gain assets and ordinary income assets, the increase is allocated to each class in proportion to the net gain or net income, respectively, which would be allocated to the transferee from the sale of all assets in each class.
- If the overall Code § 743(b) basis adjustment is negative, the decrease is allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss[4817] that would be allocated to the transferee (to the extent attributable to the acquired

[4810] Reg. § 1.755-1(b)(2)(i).
[4811] Reg. § 1.755-1(b)(4)(i), referring to Reg. § 1.742-1. For more details on Reg. § 1.742-1, see fn 4721 in part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).
[4812] Reg. § 1.755-1(b)(5).
[4813] Reg. § 1.755-1(b)(5)(i).
[4814] Reg. § 1.755-1(b)(5)(i).
[4815] Reg. § 1.755-1(b)(5)(ii).
[4816] Including any remedial allocations under Reg. § 1.704-3(d).
[4817] Including any remedial allocations under Reg. § 1.704-3(d).

partnership interest) from the hypothetical sale of all such property would result in a net loss to the transferee. If a decrease in basis may be allocated to both capital gain assets and ordinary income assets, the decrease is allocated to each class in proportion to the net loss that would be allocated to the transferee from the sale of all assets in each class.

Any substituted basis increase within a class is allocated in the following order:[4818]

1. To properties with unrealized appreciation in proportion to the transferee's share of the respective amounts of unrealized appreciation before such increase (but only to the extent of the transferee's share of each property's unrealized appreciation), then any remaining increase

2. In proportion to the transferee's share of the amount that would be realized by the partnership upon the hypothetical sale of each asset in the class.

Any substituted basis decrease within a class is allocated in the following order:[4819]

1. To properties with unrealized depreciation in proportion to the transferee's shares of the respective amounts of unrealized depreciation before such decrease (but only to the extent of the transferee's share of each property's unrealized depreciation), then any remaining decrease

2. In proportion to the transferee's shares of their adjusted bases (as adjusted under the preceding sentence).

However, if a substituted basis decrease must be allocated to capital gain assets, ordinary income assets, or both, and the amount of the decrease otherwise allocable to a particular class exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in that class, the transferee's negative basis adjustment is limited to the transferee's share of the partnership's adjusted basis in all depreciated assets in that class.[4820] Also, if a Code § 743(b) transferee's negative basis adjustment cannot be allocated to any asset, because the adjustment exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in a particular class, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.[4821]

II.Q.8.e.iii.(e). Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election

The basis of partnership property is adjusted as the result of a distribution of property to a partner if a Code § 754 election is in effect with respect to such partnership or if there is a substantial basis reduction with respect to such distribution:[4822]

[4818] Reg. § 1.755-1(b)(5)(iii)(A).
[4819] Reg. § 1.755-1(b)(5)(iii)(B).
[4820] Reg. § 1.755-1(b)(5)(iii)(C).
[4821] Reg. § 1.755-1(b)(5)(iii)(D).
[4822] Code § 734(a), see part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

(1) To the extent that the adjustment is an increase, the partnership increases the basis of its property by:[4823]

- o (A) the amount of any gain recognized to the distributee partner with respect to such distribution under Code § 731(a)(1), and

- o (B) in the case of distributed property to which Code § 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by Code § 732(d) – see further below) over the basis of the distributed property to the distributee, as determined under Code § 732.[4824]

(2) To the extent that the adjustment is a decrease, the partnership increases the basis of its property by:[4825]

- o (A) the amount of any loss recognized to the distributee partner with respect to such distribution under Code § 731(a)(2), and

- o (B) in the case of distributed property to which Code § 732(b) applies, the excess of the basis of the distributed property to the distributee, as determined under Code § 732, over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted by Code § 732(d)).

Reg. § 1.734-1(e), "Recovery of adjustments to basis of partnership property," includes:

> (1) *Increases in basis*. For purposes of section 168, if the basis of a partnership's recovery property is increased as a result of the distribution of property to a partner, then the increased portion of the basis must be taken into account as if it were newly-purchased recovery property placed in service when the distribution occurs. Consequently, any applicable recovery period and method may be used to determine the recovery allowance with respect to the increased portion of the basis. However, no change is made for purposes of determining the recovery allowance under section 168 for the portion of the basis for which there is no increase.
>
> (2) *Decreases in basis*. For purposes of section 168, if the basis of a partnership's recovery property is decreased as a result of the distribution of property to a partner, then the decrease in basis must be accounted for over the remaining recovery period of the property beginning with the recovery period in which the basis is decreased.

Although any positive adjustments are treated as the purchase of new assets for purposes of Code § 168 depreciation, that treatment applies only for Code § 168, and proposed regulations provide that they do not affect certain calculations of the Code § 199A deduction for qualified business income.[4826]

[4823] Code § 734(b)(1).
[4824] The rule in (B) does not apply to any distributed property which is an interest in another partnership with respect to which a Code § 754 election is not in effect.
[4825] Code § 734(b)(2).
[4826] See part II.E.1.c.vi.(b) Unadjusted Basis Immediately after Acquisition (UBIA) of Qualified Property under Code § 199A.

Code § 755 allocates the basis adjustment described above.[4827] Generally, any Code § 743(b) change in the adjusted basis of partnership property will be allocated in a manner which has the effect of reducing the difference between the fair market value in any other manner permitted by regulations;[4828] this concept prevents any increase in the basis of assets that are distributed from reducing the basis of the partnership's assets with unrealized gain. In applying Code § 755 allocations to Code § 734(b) basis adjustments:

(1) Where a distribution of partnership property results in an adjustment to the basis of undistributed partnership property under Code § 734(b)(1)(B) or (b)(2)(B), the adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose.[4829] Where a distribution results in an adjustment under Code § 734(b)(1)(A) or (b)(2)(A) to the basis of undistributed partnership property, the adjustment is allocated only to capital gain property.[4830]

(2) If a basis increase is allocated within a class, the increase is allocated first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation), and any remaining increase must be allocated among the properties within the class in proportion to their fair market values.[4831] If a basis decrease is allocated within a class, the decrease is allocated first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease (but only to the extent of each property's unrealized depreciation), and any remaining decrease must be allocated among the properties within the class in proportion to their adjusted bases (as adjusted under the preceding sentence).[4832]

(3) Where Code § 734(b)(2) requires a decrease in the basis of partnership assets and the amount of the decrease exceeds the adjusted basis to the partnership of property of the required character, the basis of that property is reduced to zero (but not below zero).[4833]

(4) Where an increase or a decrease in the basis of undistributed property cannot be made because the partnership owns no property of the character required to be adjusted, or because the basis of all the property of a like character has been reduced to zero, the

[4827] Code § 732(c).

[4828] See fn. 4775, found in part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

[4829] Reg. § 1.755-1(c)(1)(i), which continues:

> Thus, when the partnership's adjusted basis of distributed capital gain property immediately prior to distribution exceeds the basis of the property to the distributee partner (as determined under section 732), the basis of the undistributed capital gain property remaining in the partnership is increased by an amount equal to the excess. Conversely, when the basis to the distributee partner (as determined under section 732) of distributed capital gain property exceeds the partnership's adjusted basis of such property immediately prior to the distribution, the basis of the undistributed capital gain property remaining in the partnership is decreased by an amount equal to such excess. Similarly, where there is a distribution of ordinary income property, and the basis of the property to the distributee partner (as determined under section 732) is not the same as the partnership's adjusted basis of the property immediately prior to distribution, the adjustment is made only to undistributed property of the same class remaining in the partnership.

[4830] Reg. § 1.755-1(c)(1)(ii).

[4831] Reg. § 1.755-1(c)(2)(i).

[4832] Reg. § 1.755-1(c)(2)(ii).

[4833] Reg. § 1.755-1(c)(3).

> adjustment is made when the partnership later acquires property of a like character to which an adjustment can be made.[4834]

If a transferee partner receives a distribution of property (other than money) from the partnership within two years after the partner acquired the partner's interest or part thereof in the partnership by a transfer with respect to which a Code § 754 election was not in effect, the partner may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the Code § 754 election were in effect.[4835] For these purposes, a "transfer of a partnership interest occurs upon a sale or exchange of an interest or upon the death of a partner."[4836] Also, if a Code § 754 election is not in place, a partner is required to apply this rule to a distribution to him, whether or not made within two years after the transfer, if at the time of his acquisition of the transferred interest:[4837]

[4834] Reg. § 1.755-1(c)(4).

[4835] Reg. § 1.732-1(d)(1)(iii). Reg. § 1.732-1(d)(1)(iv) provides:

> If an election under section 732(d) is made upon a distribution of property to a transferee partner, the amount of the adjustment with respect to the transferee partner is not diminished by any depletion or depreciation of that portion of the basis of partnership property which arises from the special basis adjustment under section 732(d), since depletion or depreciation on such portion for the period prior to distribution is allowed or allowable only if the optional adjustment under section 743(b) is in effect.

The final regulations did not change the proposed regulations much. The preamble to the proposed regulations, REG 209682-94, provides:

> Section 732(d) provides a special rule that applies to determine the basis of property distributed to a transferee partner who acquired any part of its partnership interest in a transfer when an election under section 754 was not in effect. When the special rule applies, the basis of distributed property is adjusted immediately before the distribution to reflect the basis that the property would have had if the partnership had a section 754 election in effect at the time the transferee acquired the partnership interest. As a result, the basis of the distributed property in the hands of the partnership immediately before the distribution more closely approximates its fair market value. Consequently, the transferee's basis in the distributed property will also more closely approximate its fair market value.

[4836] Reg. § 1.732-1(d)(1)(i).

[4837] Reg. § 1.732-1(d)(4). The preamble to the proposed regulations, REG 209682-94, provided:

> The purpose of § 1.732-1(d)(4) was to prevent distortions caused by section 732(c) that might inflate the basis of depreciable, depletable, or amortizable property above its fair market value. At the time that the regulations were adopted, such distortions might occur because section 732(c) allocated basis among distributed properties based on their relative bases. The changes made to section 732(c) by the Taxpayer Relief Act of 1997, Public Law 105-34, section 1061, 111 Stat. 788, 945-46 (1997), make the distortions targeted by the regulations less likely to occur. As a result, the Service and Treasury request comments on the proper scope of section 732(d), and specifically, under what circumstances, if any, the Secretary should exercise its authority to mandate the application of section 732(d) to a transferee.

T.D. 8847 described and responded to the requested comments:

> Several commentators suggested that the mandatory application of section 732(d) no longer should be required, because the changes made to section 732(c) by the Taxpayer Relief Act of 1997, Public Law 105- 34, 111 Stat. 788, 945-46 (1997), make the distortions targeted by the regulations less likely to occur. However, other commentators noted that distortions caused by section 732(c) still may occur. Accordingly, the rule contained in § 1.732-1(d)(4), which requires the mandatory application of section 732(d) in certain cases, remains in effect.

- The fair market value of all partnership property (other than money) exceeded 110% of its adjusted basis to the partnership,

- An allocation of basis under Code § 732(c) upon a liquidation of his interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance, and

- A Code § 743(b) basis adjustment would change the basis to the transferee partner of the property actually distributed.

If property is distributed to a transferee partner who makes a Code § 732(d) election, and if such property is not the same property which would have had a special basis adjustment, then the special basis adjustment applies to any like property received in the distribution, provided that the transferee, in exchange for the property distributed, has relinquished his interest in the property with respect to which he would have had a special basis adjustment.[4838] This rule applies whether the property in which the transferee has relinquished his interest is retained or disposed of by the partnership.[4839]

Special rules apply to unrealized receivables and substantially appreciated inventory items.[4840] Also, in reviewing anything in this part II.Q.8.e.iii.(e), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

II.Q.8.e.iii.(f). Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold

When an asset sale is desirable for tax purposes but a stock sale is necessary for nontax purposes, Code § 338(g) permits a corporation that buys another corporation from the target's parent in a qualified purchase to elect to treat the stock purchase as an asset purchase.

Similarly, the owners of an S corporation should consider making a Code § 338(h)(10) election when selling their S corporation stock to a corporation.[4841]

The election causes the stock sale to be treated as if the S corporation sold all its assets while owned by the sellers and while still an S corporation. Gain is therefore recognized by the S corporation and taxed to the selling shareholders, which creates additional basis in their S corporation stock. The actual sale of the stock is ignored for tax purposes and the shareholders are treated as receiving the sale proceeds in liquidation of the S corporation.

Thus, the selling shareholders will be taxed on a deemed asset sale and liquidation, rather than on a stock sale. Unless they bought a portion of their stock at a premium over the value of the corporation's assets, the Code § 338(h)(10) election will generally not significantly affect the amount of gain on which they would be taxed. However, it will cause a portion of their gain to be

---

[4838] Reg. § 1.732-1(d)(1)(v).
[4839] Reg. § 1.732-1(d)(1)(v). For a shift of transferee's basis adjustment under Code § 743(b) to like property, see Reg. § 1.743-1(g).
[4840] See fns. 4458-4460, found in part II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property.
[4841] Reg. § 1.338(h)(10)-1(c)(1) authorizes a Code § 338(h)(1) election when a corporation buys all of the stock of the target corporation.

ordinary income, rather than capital gain, to the extent that a sale of the S corporation's assets would generate ordinary income, and state income tax surprises might occur; for a discussion of the some of the issues mentioned in the sentence, see similar issues raised in part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S corporation. But, the whole point was to replicate an asset sale for tax purposes, so the Code § 338(h)(10) election merely allows a different form to be used for the deemed asset sale.

If the purchaser is not a corporation, a Code § 336(e) election might allow the buyer to replicate the results of a Code § 338(h)(10) election.[4842] The selling corporation or S corporation shareholder(s) must dispose of stock of another corporation (target) in a qualified stock disposition.[4843] "Qualified stock disposition" means any transaction or series of transactions in which stock meeting the requirements of Code § 1504(a)(2) of a domestic corporation is either sold, exchanged, or distributed, or any combination thereof, by another domestic corporation or by the S corporation shareholders in a disposition,[4844] during the 12-month disposition period.[4845] "Disposition" means any sale, exchange, or distribution of stock, but only if:[4846]

(A) The basis of the stock in the hands of the purchaser is not determined in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom the stock is acquired or under Code § 1014(a) (property acquired from a decedent);

(B) Subject to an exception for certain Code § 355(d)(2) and (e)(2) transactions,[4847] the stock is not sold, exchanged, or distributed in a transaction to which Code § 351, 354, 355, or 356 applies and is not sold, exchanged, or distributed in any transaction described in regulations in which the transferor does not recognize the entire amount of the gain or loss realized in the transaction; and

(C) The stock is not sold, exchanged, or distributed to a related person.

Both the rules governing Code § 338(h)(10) elections and Code § 336(e) elections[4848] provide that stock acquired by a purchasing corporation from a related corporation is generally not considered acquired by purchase.[4849] The seller cannot be a person the ownership of whose stock would, under Code § 318(a) (other than Code § 318(a)(4)), be attributed to the buyer.[4850]

[4842] Reg. § 1.336-1(a) provides that the effects of Code § 338(h)(10) and the regulations thereunder generally apply to Code § 336(e) elections.

[4843] Reg. § 1.336-2(a), referring to Reg. § 1.336-1(b)(6) in defining a qualified stock disposition.

[4844] Within the meaning of Reg. § 1.336-1(b)(5).

[4845] Reg. § 1.336-1(b)(6).

[4846] Reg. § 1.336-1(b)(5).

[4847] Reg. § 1.336-1(b)(5)(ii) provides that:

> a distribution of stock to a person who is not a related person in a transaction in which the full amount of stock gain would be recognized pursuant to section 355(d)(2) or (e)(2) shall be considered a disposition.

[4848] Reg. § 1.336-1(b)(5)(iii) provides:

> *Transactions with related persons*. In determining whether stock is sold, exchanged, or distributed to a related person, the principles of section 338(h)(3)(C) and § 1.338-3(b)(3) shall apply.

[4849] Reg. § 1.338-3(b)(3).

[4850] Code § 338(h)(3)(A)(iii). See Harris & Kessler, Constructive Ownership under Section 318, *Business Entities* (WG&L), Mar/Apr 2016.

(Also, in reviewing anything in this part II.Q.8.b.i.(d), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.)

A Code § 336(e) election for an S corporation target is made by completing the following requirements:[4851]

- All of the S corporation shareholders, including those who do not dispose of any stock in the qualified stock disposition, and the S corporation target must enter into a written, binding agreement, on or before the due date (including extensions) of the Federal income tax return of the S corporation target for the taxable year that includes the disposition date, to make a Code § 336(e) election;
- The S corporation target must retain a copy of the written agreement; and
- The S corporation target must attach the Code § 336(e) election statement, to its timely filed (including extensions) Federal income tax return for the taxable year that includes the disposition date. A Reg. § 301.9100-3 extension of time to file the election may be available.[4852]

Instead of the seller(s) being treated as selling stock, the target is treated as selling its assets to an unrelated person in a single transaction at the close of the disposition date (but before the deemed liquidation described below)[4853] in exchange for the aggregate deemed asset disposition price.[4854] The target realizes the deemed disposition tax consequences from the deemed asset disposition before the close of the disposition date while the target is owned by seller or the S corporation shareholders.[4855] If the target is an S corporation, its S election continues in effect through the close of the disposition date (including the time of the deemed asset disposition and the deemed liquidation) notwithstanding the usual rules for S corporation terminations.[4856] Also,

---

[4851] Reg. § 1.336-2(h)(3).

[4852] Letter Rulings 201652014 and 201711007, the latter holding:

> WITHIN 45 DAYS OF THE DATE ON THIS LETTER, S Corporation Target and the S Corporation Shareholder must enter into a written, binding agreement to make a section 336(e) election and S Corporation Target must file the section 336(e) election statement in accordance with § 1.336-2(h). The section 336(e) election statement must be attached to S Corporation Target's tax return for B Year. In addition, a copy of this letter must be attached to S Corporation Target's return. Alternatively, if S Corporation Target files its return electronically, it may satisfy the requirement of attaching a copy of this letter to the return by attaching a statement to its return that provides the date and control number (PLR-131803-16) of this letter ruling.
>
> WITHIN 120 DAYS OF THE DATE ON THIS LETTER, all relevant parties must file or amend, as applicable, all returns and amended returns (if any) necessary to report the transaction consistently with the making of a section 336(e) election for the taxable year in which the transaction was consummated (and for any other affected taxable year).
>
> The above extension of time is conditioned on the taxpayers' (*i.e.*, Purchaser's, S Corporation Target's, and S Corporation Shareholder's) tax liability (if any) being not lower, in the aggregate, for all years to which the section 336(e) election applies than it would have been if the Election had been timely filed (taking into account the time value of money). No opinion is expressed as to the taxpayers' tax liability for the years involved. A determination thereof will be made by the applicable Director's office upon audit of the federal income tax returns involved.

[4853] Reg. § 1.336-2(b)(1)(iii).

[4854] Reg. § 1.336-2(b)(1)(i)(A).

[4855] Reg. § 1.336-2(b)(1)(i)(A).

[4856] Reg. § 1.336-2(b)(1)(i)(A).

if the target is an S corporation (but not a qualified subchapter S subsidiary (QSub)[4857]), any direct or indirect subsidiaries of the target that the target has elected to treat as QSubs remain qualified QSubs through the close of the disposition date.[4858] If the target is an S corporation, its shareholders (whether or not they sell or exchange their stock) take their pro rata share of the deemed disposition tax consequences into account under Code § 1366 and increase or decrease their basis in target stock under Code § 1367.[4859]

Immediately after the deemed asset disposition described above, the target is treated as acquiring all of its assets from an unrelated person in a single, separate transaction at the close of the disposition date in exchange for an amount equal to the adjusted grossed-up basis.[4860] The target remains liable for the tax liabilities it had before this deemed sale and purchase (including the tax liability for the deemed disposition tax consequences).[4861]

The target and seller (or S corporation shareholders) are treated as if, before the close of the disposition date, after the deemed asset disposition described above, and while target is owned by seller or S corporation shareholders, the target transferred all of the consideration deemed received in the deemed asset disposition to seller or S corporation shareholders, any S corporation election for the original target terminated, and the original target ceased to exist.[4862] This transfer to the seller or S corporation shareholders is characterized for Federal income tax purposes in the same manner as if the parties had actually engaged in the transactions deemed to occur above and taking into account other transactions that actually occurred or are deemed to occur.[4863]

Thus, the following transactions are deemed to have occurred:

1. The target sells its assets to a hypothetical buyer.

2. The target is treated as having bought its assets from a hypothetical seller.

3. The target liquidates, while the old shareholders are deemed to continue owning the stock.

The time for taking into account liabilities in the hypothetical asset transaction and the amount of the liabilities taken into account is determined as if the consideration included the discharge of the liabilities by the unrelated person.[4864] For example, if no amount of a liability is properly taken into account in amount realized as of the beginning of the day after the disposition date, the liability is not initially taken into account in determining the purchase price, but it may be taken into

---

4857 See part II.A.2.g Qualified Subchapter S Subsidiary (QSub).
4858 Reg. § 1.336-2(b)(1)(i)(A).
4859 Reg. § 1.336-2(b)(1)(iii)(A).
4860 Reg. § 1.336-2(b)(1)(ii).
4861 Reg. § 1.336-2(b)(1)(ii).
4862 Reg. § 1.336-2(b)(1)(iii)(A).
4863 Reg. § 1.336-2(b)(1)(iii)(A), which continues:

> For example, the transfer may be treated as a distribution in pursuance of a plan of reorganization, a distribution in complete cancellation or redemption of all of its stock, one of a series of distributions in complete cancellation or redemption of all of its stock in accordance with a plan of liquidation, or part of a circular flow of cash. In most cases, the transfer will be treated as a distribution in complete liquidation to which sections 331 or 332 and sections 336 or 337 apply.

4864 Reg. § 1.336-3(d)(2).

account at some later date.[4865] At the January 2017 American Bar Association Section of Taxation meeting, a discussion of Code § 336(e) gave this example:[4866]

- Deemed asset purchase price equals cash paid plus "liabilities" assumed.

- Liabilities do not include amounts which are not currently deductible or amounts not borrowed from a third party.

- Assume that the assets are worth 100 and are associated with 20 of liabilities, and that the purchaser pays 80 for the target's stock.

- On the target's deemed liquidation after filing a conversion election, assets distributed are worth 100, but basis is limited to 80, which potentially triggers 20 of gain.

The meeting gave the following examples of liabilities that may trigger this gain:

- Environmental and other contingent liabilities

- Deferred compensation (Code § 404(a)(5))

- Obligations to perform future services (*Pierce*)

- Economic performance (Code § 461(h))

However, it was suggested that such a mismatch may occur in a straight asset sale as well.

A minority shareholder who retains its target stock does not recognize gain or loss with respect to its shares of target stock; thus, the minority shareholder's basis (except as noted below) and holding period for that target stock are not affected by Code § 336(e) election.[4867] Notwithstanding this treatment of the minority shareholder, if a Code § 336(e) election is made, target will still be treated as disposing of all of its assets in the deemed asset disposition.[4868] If the target is an S corporation, any K-1 items the minority shareholder reports by reason of the deemed sale will affect the shareholder's basis.[4869]

A handy list comparing Code § 338(h)(10) elections and Code § 336(e) elections is found at Harper & Andersen, "Section 336(e)-Another Tool in the Toolbox," *BNA Daily Tax Report* (5/28/2014).[4870]

[4865] Reg. § 1.336-3(d)(2).
[4866] Slides discussed by Bakal, Bakke, Mottahedeh, and Weiss are saved as Thompson Coburn LLP document no. 6563470.
[4867] Reg. § 1.336-3(d)(3).
[4868] Reg. § 1.336-3(d)(3).
[4869] Note the parenthetical in this quote from Reg. § 1.336-2(b)(1)(iii)(A):

> If old target is an S corporation, S corporation shareholders (whether or not they sell or exchange their stock) take their pro rata share of the deemed disposition tax consequences into account under section 1366 and increase or decrease their basis in target stock under section 1367.

[4870] A copy of which is saved as Thompson Coburn LLP document no. 6344607.

At the May 2017 American Bar Association Section of Taxation meeting, a discussion of Code §§ 336(e), 338(h)(10), 453(h), and 453B(h), included:[4871]

- Helpful flowcharts showing the transactions deemed to occur in Code § 336(e) or 338(h)(10) elections.
- Potential surprises, how to avoid them using a one-day note for 100% of the transaction, and disadvantages of doing so.[4872]
- State approaches.

One way to avoid the complexity of these elections and disparate state law treatment may be to create a new parent corporation, convey or merge the old corporation into a new single-member, tax-disregarded LLC, and then sell the LLC to the buyers. The first two steps constitute a tax-free Code § 368(a)(1)(F) transaction.[4873] Selling the LLC to the buyers means that the buyer is not concerned with the old corporation's status as an S corporation.[4874]

II.Q.8.e.iii.(g). Certain Changes in Inside Basis May Reduce Foreign Tax Credits

A "covered asset acquisition" may disqualify a portion of the foreign tax credit.[4875]

For purposes of this rule, "covered asset acquisition" means:[4876]

(A) a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies,

(B) any transaction which-

(i) is treated as an acquisition of assets for purposes of this chapter, and

(ii) is treated as the acquisition of stock of a corporation (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction,

(C) any acquisition of an interest in a partnership which has an election in effect under section 754, and

---

[4871] "Converting Stock Sales to Assets Sales (and Back Again)," slides discussed by Dolan, Harper, and Waters, is saved as Thompson Coburn LLP document no. 6617969.

[4872] If the buyer was willing to pay cash and the seller wanted the one-day note, the buyer's willingness to pay cash does not prevent the seller from using the installment method – only the actual deal counts. Rev. Rul. 73-396.

[4873] See parts II.E.7.c.i.(b) Use F Reorganization to Form LLC and II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

[4874] For example, the S corporation may have had an ineligible shareholder. See parts II.A.2.f Shareholders Eligible to Hold S corporation Stock and III.A.3.a.ii How a Trust Can Fall Short of Being Wholly Owned by One Person, the latter explaining how one might think that a trust is a wholly-owned grantor trust but may be incorrect.

[4875] Code § 901(m)(1).

[4876] Code § 901(m)(2).

(D) to the extent provided by the Secretary, any other similar transaction.

Prop. Reg. § 1.901(m)-2(b) would add:[4877]

(4) Any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as an acquisition of assets for purposes of U.S. income tax and as the acquisition of an interest in a fiscally transparent entity for purposes of a foreign income tax;

(5) Any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as a partnership distribution of one or more assets the U.S. basis of which is determined by section 732(b) or 732(d) or which causes the U.S. basis of the partnership's remaining assets to be adjusted under section 734(b), provided the transaction results in an increase in the U.S. basis of one or more of the assets distributed by the partnership or retained by the partnership without a corresponding increase in the foreign basis of such assets; and

(6) Any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as an acquisition of assets for purposes of both U.S. income tax and a foreign income tax, provided the transaction results in an increase in the U.S. basis without a corresponding increase in the foreign basis of one or more assets.

Generally, international structures and most of subchapter C are beyond the scope of this paper. This part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits is merely one consideration when an international structure is affected by the tools described in parts II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property, II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss) and II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

II.Q.8.e.iv. Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by 2017 tax reform)

Caution – This part II.Q.8.e.iv was repealed by 2017 tax reform.

[4877] These supplement Reg. § 1.901(m)-2T(b) (which is not repeated in the text because it does not seem to add to the statute):

Covered asset acquisitions. Except as provided in paragraph (d) of this section, the transactions set forth in this paragraph (b) are CAAs.

(1) A qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies (section 338 CAA);

(2) Any transaction that is treated as an acquisition of assets for U.S. income tax purposes and as an acquisition of stock of a corporation (or the transaction is disregarded) for foreign income tax purposes;

(3) Any acquisition of an interest in a partnership that has an election in effect under section 754 (section 743(b) CAA);

(4)-(6) [Reserved].

If a sale or exchange of 50% or more of the total interest in partnership capital ***and***[4878] profits occurs (in the aggregate) within a 12-month period, the partnership is deemed to have terminated.[4879] However, a disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, the liquidation of a partnership interest, and the contribution of property to a partnership do not constitute such a sale or exchange is not a sale or exchange for purposes of this test.[4880]

If a partnership is terminated by a sale or exchange of an interest, the partnership is deemed to contribute all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership is deemed to distribute interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up:[4881]

- Subject to the points made below in this part II.Q.8.e.iv, see parts II.Q.8.b.i Distribution of Property by a Partnership and II.M.3 Buying into or Forming a Partnership for the deemed distribution from the old partnership and contribution to the new partnership, respectively (which tend to be tax-free transactions).

- Book values and capital accounts from the old partnership carry over to the new partnership.[4882] Therefore, no Code § 704(c) accounting for newly contributed property applies; instead, the terminating entity's Code § 704(c) accounting carries over.[4883]

- These deemed transactions do not trigger Code § 704(c)(1)(B)[4884] or Code § 737[4885] taxation on the distribution of property within seven years after contribution, which makes sense given the continuation of Code § 704(c) accountability.

- The partner who acquired the partnership interest in the sale or exchange that triggered the deemed termination would obtain a basis adjustment in the partnership's assets that this partner is deemed to acquire if a Code § 754 election is in place.[4886] A partner with a Code § 743 basis adjustment in the partnership's property will continue to have the same basis adjustment with respect to property deemed contributed by the terminated partnership to the new partnership,[4887] regardless of whether the new partnership makes a Code § 754

[4878] For example, the sale of a 30% interest in partnership capital and a 60% interest in partnership profits is not the sale or exchange of 50% or more of the total interest in partnership capital and profits. Reg. § 1.708-1(b)(2).
[4879] Code § 708(b)(1)(B).
[4880] Reg. § 1.708-1(b)(2).
[4881] Reg. § 1.708-1(b)(4).
[4882] Reg. § 1.704-1(b)(2)(iv)(l).
[4883] Reg. § 1.704-3(a)(3)(i). See part (iii) of the example in Reg. § 1.708-1(b)(4).
[4884] Reg. § 1.704-4(c)(3).
[4885] Reg. § 1.737-2(a).
[4886] Reg. § 1.708-1(b)(5).
[4887] Referring to Reg. § 1.708-1(b)(1)(iv).

election.[4888] See part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest, which describes inside basis adjustments.[4889]

[4888] Reg. § 1.743-1(h)(1).
[4889] See part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue.

- Any start-up expenditures being amortized under Code § 195(b) or organizational expenses being amortized under Code § 709(b)(1) continue to use the same schedule.[4890] However, depreciation of tangible property starts over,[4891] as does the method for accounting for book-tax differences when depreciating assets.[4892] The terminating partnership cannot depreciate any assets it places in service during the termination year;[4893] rather the new partnership depreciates them, including receiving bonus depreciation[4894] for any assets placed in service during the termination year.[4895]

- For purposes of certain procedures regarding changing accounting methods, a technical termination constitutes cessation of a trade or business.[4896]

[4890] Reg. § 1.708-1(b)(6). See also Reg. §§ 1.197-2(g)(2) and 1.197-2(k), Example (16), the latter providing:

(i) A and B are partners with equal shares in the capital and profits of general partnership P. P's only asset is an amortizable section 197 intangible, which P had acquired on January 1, 1995. On January 1, 2000, the asset had a fair market value of $100 and a basis to P of $50. On that date, A sells his entire partnership interest in P to C, who is unrelated to A, for $50. At the time of the sale, the basis of each of A and B in their respective partnership interests is $25.

(ii) The sale causes a termination of P under section 708(b)(1)(B). Under section 708, the transaction is treated as if P transfers its sole asset to a new partnership in exchange for the assumption of its liabilities and the receipt of all of the interests in the new partnership. Immediately thereafter, P is treated as if it is liquidated, with B and C each receiving their proportionate share of the interests in the new partnership. The contribution by P of its asset to the new partnership is governed by section 721, and the liquidating distributions by P of the interests in the new partnership are governed by section 731. C does not realize a basis adjustment under section 743 with respect to the amortizable section 197 intangible unless P had a section 754 election in effect for its taxable year in which the transfer of the partnership interest to C occurred or the taxable year in which the deemed liquidation of P occurred.

(iii) Under section 197, if P had a section 754 election in effect, C is treated as if the new partnership had acquired two assets from P immediately preceding its termination. Even though the adjusted basis of the new partnership in the two assets is determined solely under section 723, because the transfer of assets is a transaction described in section 721, the application of sections 743(b) and 754 to P immediately before its termination causes P to be treated as if it held two assets for purposes of section 197. See paragraph (g)(3) of this section. B's and C's proportionate share of the new partnership's adjusted basis is $25 each in one asset, which continues to be amortized over the 10 years remaining in the original 15-year amortization period. For the other asset, C's proportionate share of the new partnership's adjusted basis is $25 (the amount of the basis increase resulting from the application of section 743 to the sale or exchange by A of the interest in P), which is amortized over a new 15-year period beginning in January 2000.

(iv) If P did not have a section 754 election in effect for its taxable year in which the sale of the partnership interest by A to C occurred or the taxable year in which the deemed liquidation of P occurred, the adjusted basis of the new partnership in the amortizable section 197 intangible is determined solely under section 723, because the transfer is a transaction described in section 721, and P does not have a basis increase in the intangible. Under section 197(f)(2) and paragraph (g)(2)(ii) of this section, the new partnership continues to amortize the intangible over the 10 years remaining in the original 15-year amortization period. No additional amortization is allowable with respect to this asset.

[4891] In proposing regulations that T.D. 8717 (5/8/1997) finalized, [PS-5-96], Termination of a Partnership under Section 708(b)(1)(B), stated:

In addition, the proposed regulations will not change the effect of a termination on the depreciation of partnership property by the new partnership. Property deemed contributed to the new partnership will continue to be subject to the anti-churning provisions of section 168(f)(5), which

- The new partnership retains the old partnership's tax ID.[4897] Each of the old and new partnership files a short period return, with the new partnership filing a return for its taxable year beginning after the date of termination of the terminated partnership.[4898]

Contrast this with a corporation (whether or not an S election is in place). It is not deemed to terminate when its shareholders change, although a change in shareholders could impair the use of net operating losses, etc.[4899]

II.Q.8.e.v. Partnership Mergers

For partnership mergers, see IRS Notice 2005-15 and any related proposed regulations.[4900] For an overview of mergers, with helpful charts and diagrams, see Borden, "Navigating State Law and Tax Issues Raised by Partnership and LLC Reorganizations," *Business Entities*

> generally require the new partnership to depreciate the property as if it were newly-acquired property under the same depreciation system used by the terminated partnership. This result is required by statute and is not affected by the specific mechanics of a termination under section 708(b)(1)(B). See Code sections 168(f)(5); 168(i)(7); 168(e)(4) and (f)(10)(repealed 1986).

Code § 168(i)(7) provides that the transferee steps into the shoes of the transferor when depreciating an asset to which Code § 332, 351, 361, 721, or 731 applies. However, Code § 168(i)(7)(B) provides that this rule does not apply in the case of a partnership's termination under Code § 708(b)(1)(B). By negative implication, such a termination restarts the depreciation period. See McKee, Nelson & Whitmire, ¶ 13.05[2][k] Effect on Depreciation of Partnership Property, *Federal Taxation of Partnerships & Partners* (WG&L).

4892 Reg. § 1.704-3(a)(2).

4893 Reg. § 1.168(d)-1(b)(3)(ii) includes:

> No depreciation deduction is allowed for property placed in service and disposed of during the same taxable year.

4894 See part II.G.4 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation.

4895 Reg. § 1.168(k)-1(b)(5)(iii).

4896 See Section 3.04(2)(f) of Rev. Proc. 2015-13, the other provisions of which Rev. Proc. 2015-33 clarified. Lovett, "Technical Termination of LLCs and Partnerships: Overview, Mechanics and Opportunities," *TM Real Estate Journal* (BNA) (2/1/2017), suggests that the termination's closing the tax year will require that two separate installments of a prior Code § 481(a) adjustment be taken into account in one calendar year.

4897 Reg. § 301.6109-1(d)(2)(iii); see also the Example in Reg. § 1.708-1(b)(4).

4898 Notice 2001-5.

4899 Code § 382.

4900 See also CCA 201315026. RIA Checkpoint *Catalyst*, ¶ 218:111 Merger or Consolidation of Partnerships, described a ruling:

> In IRS Letter Ruling 201619001, a real estate investment trust (REIT) formed a partnership (OP), then transferred cash and its own stock to the partnership in exchange for a partnership interest. A second partnership (M) then transferred all of its assets to OP in exchange for OP partnership interests and the REIT stock. M then liquidated, distributing the REIT stock to some of its partners and the OP partnership interests to the remaining partners. The IRS ruled that the transaction was a merger of OP and M under Reg. § 1.708-1(c). IRS Letter Ruling 201619001.
>
> > Comment: In IRS Letter Ruling 201619001, M was formed immediately before the merger as the result of the division of a third partnership (X) into two separate partnerships. The IRS respected the form of the transaction as a division followed by a merger. The apparent purpose of this form was to permit the partners of X receiving REIT stock (who were also partners of M after the division) as having sold their partnership interests in M to OP under Reg. § 1.708-1(c)(4) (see ¶ 218:114) For further discussion, see Substance Over Form Exception in ¶ 218:113.

(Jul./Aug. 2014), suggesting using an "assets-over" form to preserve basis or holding period and an "assets-up" type to change basis or holding period.[4901] Below are some details.

If two or more partnerships merge or consolidate into one partnership, the resulting partnership is considered a continuation of the merging or consolidating partnership the members of which own an interest of more than 50% in the capital and profits of the resulting partnership.[4902] Generally, if this resulting partnership can be considered a continuation of more than one of the merging or consolidating partnerships, it is considered the continuation solely of that partnership which is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership, and any other merging or consolidating partnerships shall be considered as terminated.[4903] However, if the members of none of the merging or consolidating partnerships have an interest of more than 50% in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results.[4904]

The taxable years of any merging or consolidating partnerships which are considered terminated shall be closed in under Code § 706(c) the regulations thereunder, and those partnerships shall file their returns for a taxable year ending upon the date of merger or consolidation.[4905] Any resulting partnership shall file a return for the taxable year of the merging or consolidating partnership that is considered as continuing.[4906]

A merger is an "assets-over" merger unless it as an "assets-up" merger.[4907] In an "assets-up" merger, the merged or consolidated partnership that is considered terminated as described above distributes all of its assets to its partners (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) in liquidation of the partners' interests in the terminated partnership, and immediately thereafter, the partners in the terminated partnership contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership.[4908] The form of such a partnership merger or consolidation will be respected for federal income tax purposes despite the partners' transitory ownership of the terminated partnership's assets.[4909]

When two or more partnerships merge or consolidate into one partnership under the applicable jurisdictional law, without undertaking a form for the merger or consolidation, or undertake a form for the merger or consolidation that is not an assets-up merger, any merged or consolidated partnership that is considered terminated is treated as undertaking the assets-over form for Federal income tax purposes.[4910] Under the assets-over form, the merged or consolidated partnership that is considered terminated contributes (or is treated as contributing) all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership,

4901 For a description of the two types of transactions, see part II.Q.8 Exiting From or Dividing a Partnership, especially part II.Q.8.d.iii Assets-Over vs. Assets-Up Division.
4902 Code § 708(b)(2)(A); Reg. § 1.708-1(c)(1).
4903 Reg. § 1.708-1(c)(1).
4904 Reg. § 1.708-1(c)(1).
4905 Reg. § 1.708-1(c)(2).
4906 Reg. § 1.708-1(c)(2), which also provides that the resulting partnership shall keep its original taxpayer identification number and include certain tax disclosures.
4907 Reg. § 1.708-1(c)(3)(i).
4908 Reg. § 1.708-1(c)(3)(ii).
4909 Reg. § 1.708-1(c)(3)(ii).
4910 Reg. § 1.708-1(c)(3)(i).

and immediately thereafter, the terminated partnership distributes interests in the resulting partnership to its partners in liquidation of the terminated partnership.[4911]

Code §§ 704(c)(1)(B) and 737 and Reg. §§ 1.704-4 and 1.737-2 do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in Code § 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.[4912] A later distribution of Code § 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to Code § 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to Code § 704(c)(1)(B).[4913] Similarly, a later distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner of the transferor partnership is subject to Code § 737 to the same extent that a distribution from the transferor partnership would have been subject to Code § 737.[4914]

In an assets-over merger, a sale of all or part of a partner's interest in the terminated partnership to the resulting partnership that occurs as part of a merger or consolidation will be respected as a sale of a partnership interest if the merger agreement (or another document) specifies that the resulting partnership is purchasing interests from a particular partner in the merging or consolidating partnership and the consideration that is transferred for each interest sold, and if the selling partner in the terminated partnership, either before or at the same time as the transaction, consents to treat the transaction as a sale of the partnership interest.[4915]

When merging, consider whether any relief of debt or other actual or deemed distributions within two years might constitute a disguised sale. See part II.M.3.e Exception: Disguised Sale. However, some divisions might be taxable to the extent that they rely on Code § 721(a) nonrecognition.[4916]

The IRS expects to issue regulations, effective for distributions from partnerships made after January 19, 2005, providing the following regarding Code § 704(c) gain and reverse-Code § 704(c) gain:[4917]

> The regulations will apply the principles of Rev. Rul. 2004-43 to distributions of property following assets-over partnership mergers. The regulations will apply to distributions of

---

[4911] Reg. § 1.708-1(c)(3)(i).
[4912] Reg. §§ 1.704-4(c)(4), 1.737-2(b)(1).
[4913] Reg. § 1.704-4(c)(4).
[4914] Reg. § 1.737-2(b)(3).
[4915] Reg. § 1.708-1(c)(4), referring to Code § 741 and Reg. § 1.741-1 for determining the selling partner's gain or loss on the sale or exchange of the partnership interest; see part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest. Letter Ruling 201619001 (described in fn. 4900) respected a sale under Reg. § 1.708-1(c)(4), when the contribution agreement relating to a merger will specify (i) that the partnership is purchasing its interest in another partnership from each particular partner in the purchasing partnership and (ii) the consideration that is transferred for each interest purchased.
[4916] If a foreign person is directly or indirectly involved, see the discussion of when Code § 721(a) does not apply to any deemed contribution to a partnership in part II.M.3.g Exception: Foreign Partner (among various other exceptions to Code § 721(a).
[4917] Notice 2005-15. Query whether the regulations would be retroactive, given all of the time that has passed. For a description of reverse-Code § 704(c) allocations, see part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 4496-4499.

> property with newly created § 704(c) gain or loss whether or not that gain or loss is treated as reverse § 704(c) gain or loss as the result of a revaluation by the transferor partnership. The regulations also will apply to distributions of property with original § 704(c) gain or loss that existed upon contribution to the transferor partnership. However, the regulations will provide that if the transferor partnership in an assets-over merger holds contributed property with original § 704(c) gain or loss, the seven year periods in §§ 704(c)(1)(B) and 737 do not restart with respect to that gain or loss as a result of the merger.
>
> The regulations will provide that § 704(c)(1)(B) does not apply to newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger involving partnerships owned by the same owners in the same proportions. In addition, the regulations will provide that for purposes of § 737, net precontribution gain does not include newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger involving partnerships owned by the same owners in the same proportions. In order for merging partnerships to qualify for the exceptions described in this paragraph, each partner's percentage interest in the transferor partnership's capital, profits, losses, distributions, liabilities, and all other items must be the same as the partner's percentage interest in those items of the continuing partnership.

The survivor of merged partnerships may want to see whether it qualifies for special Code § 704(c) accounting for securities partnerships.[4918]

When two or more partnerships merge or consolidate in an assets-over merger, increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger under the Code § 752 rules allocating liabilities to partners and determining whether a change in liabilities constitutes a distribution or contribution.[4919] For more information, see part II.C.3 Allocating Liabilities (Including Debt).

If any merger described above is part of a larger series of transactions and the substance of the larger series of transactions is inconsistent with following the form prescribed above, the IRS may disregard the form and recast the larger series of transactions according to their substance.[4920]

[4918] See fn. 3239 (especially Letter Ruling 201710008), found in part II.P.1.a.i Allocations of Income in Partnerships.

[4919] Reg. § 1.752-1(f).

[4920] Reg. § 1.708-1(c)(6)(i), providing the following example in Reg. § 1.708-1(c)(6)(ii):

> A, B, and C are equal partners in partnership ABC. ABC holds no section 704(c) property. D and E are equal partners in partnership DE. B and C want to exchange their interests in ABC for all of the interests in DE. However, rather than exchanging partnership interests, DE merges with ABC by undertaking the assets-up form described in paragraph (c)(3)(ii) of this section, with D and E receiving title to the DE assets and then contributing the assets to ABC in exchange for interests in ABC. As part of a prearranged transaction, the assets acquired from DE are contributed to a new partnership, and the interests in the new partnership are distributed to B and C in complete liquidation of their interests in ABC. The merger and division in this example represent a series of transactions that in substance are an exchange of interests in ABC for interests in DE. Even though paragraph (c)(3)(ii) of this section provides that the form of a merger will be respected for Federal income tax purposes if the steps prescribed under the assets-up form are followed, and paragraph (d)(3)(i) of this section provides a form that will be followed for Federal income tax purposes in the case of partnership divisions, these forms will not be respected for Federal income

II.Q.8.e.vi. Required Documentation to Avoid Withholding on Sale or Redemption of Partnership Interest

Generally, if any portion of the gain (if any) on any disposition of an interest in a partnership would be treated under Code § 864(c)(8) as effectively connected with the conduct of a trade or business within the United States, the transferee shall be required to deduct and withhold a tax equal to 10% of the amount realized on the disposition.[4921]

However, this requirement does not apply if the transferor furnishes to the transferee an affidavit by the transferor stating, under penalty of perjury, the transferor's United States taxpayer identification number and that the transferor is not a foreign person.[4922]

A sample affidavit is in Thompson Coburn LLP doc. no. 6729373.

Also see Notice 2018-29, "Guidance Regarding the Implementation of New Section 1446(f) for Partnership Interests That Are Not Publicly Traded."

III.A.3.e. QSSTs and ESBTs

III.A.3.e.i. QSSTs

After reviewing a variety of QSST issues that apply during the beneficiary's life, see part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, for a discussion of various issues one should consider when a beneficiary makes a QSST election.

III.A.3.e.i.(a). QSSTs Generally

After determining a trust's eligibility for its beneficiary to make a "qualified subchapter S trust" (QSST) election, see part III.A.3.c.iii Deadlines for QSST and ESBT Elections.

---

tax purposes under these facts, and the transactions will be recast in accordance with their substance as a taxable exchange of interests in ABC for interests in DE.

[4921] Code § 1446(f)(1).

[4922] Code § 1446(f)(2)(A). Subparagraphs (B) and (C) provide:

(B) *False affidavit*. Subparagraph (A) shall not apply to any disposition if -

(i) the transferee has actual knowledge that the affidavit is false, or the transferee receives a notice (as described in section 1445(d)) from a transferor's agent or transferee's agent that such affidavit or statement is false, or

(ii) the Secretary by regulations requires the transferee to furnish a copy of such affidavit or statement to the Secretary and the transferee fails to furnish a copy of such affidavit or statement to the Secretary at such time and in such manner as required by such regulations.

(C) *Rules for agents*. The rules of section 1445(d) shall apply to a transferor's agent or transferee's agent with respect to any affidavit described in subparagraph (A) in the same manner as such rules apply with respect to the disposition of a United States real property interest under such section.

A QSST may have only one beneficiary[5049] (who also must be a U.S. citizen or resident) who may receive income or corpus during the beneficiary's lifetime, and all of its income[5050] must be

---

[5049] Code § 1361(d)(3)(A) and Reg. § 1.1361-1(j)(1)(ii), (iii). A trust cannot qualify as a QSST if it provides that, if the trust does not hold shares of an S corporation, the trust may terminate during the life of the current income beneficiary and distribute its corpus to persons other than the current income beneficiary. Rev. Rul. 89-55. Consistent with this limitation, Reg. § 1.1361-1(j)(2)(iii) restricts powers of appointment:

> If, under the terms of the trust, a person (including the income beneficiary) has a special power to appoint, during the life of the income beneficiary, trust income or corpus to any person other than the current income beneficiary, the trust will not qualify as a QSST. However, if the power of appointment results in the grantor being treated as the owner of the entire trust under the rules of subpart E, the trust may be a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section.

Note, however, that failure to make a trust a spendthrift trust (and therefore allowing the beneficiary's interest to be assignable) will not disqualify the trust as a QSST unless it gets assigned (and then it might or might not disqualify the trust). Reg. § 1.1361-1(j)(2)(iv). On the other hand, Letter Ruling 9437021 viewed the possibility of distribution from the QSST to another trust for that same beneficiary as an error, but ruled that it was harmless error in that case because the recipient trust never existed and therefore could never receive a distribution (see also fn. 5051 regarding the distribution of income other than directly to the beneficiary); however, one might not want to assume that the IRS' national office will repeat this kind and gentle approach. Thus, one may need to avoid authorizing the merger or decanting of any trust that has a QSST election in place. For decanting, see fn. 2180, found in part II.J.4.i Modifying Trust to Make More Income Tax Efficient. However, the Uniform Trust Decanting Act allows decanting to be done by trust amendment rather than actual transfer of assets, in which case a QSST need not prevent decanting; for details on decanting by mere amendment, see fn. 2444, found in part II.J.18 Trust Mergers and Divisions; Decanting.

Also, the grantor trust treating a person other than the current income beneficiary as the owner of a part or all of that portion of a trust which does not consist of the S corporation stock does not disqualify the trust from making a QSST election. Reg. § 1.1361-1(j)(2)(vi). Does that, by negative implication, suggest that the settlor (who is not the beneficiary) being treated as deemed owner of the portion of a trust that includes the S corporation stock precludes a QSST election? Reg. § 1.1361-1(j)(4) suggests that prohibition exists; Reg. § 1.1361-1(k)(1), Example (10), paragraph (iii) (reproduced in fn. 5056) confirms that result.

[5050] All of the trust's income, not just the income from the S stock, must be distributed or distributable currently. Letter Ruling 9603007. This refers to trust accounting income, not taxable income. Reg. § 1.1361-1(j)(1)(i). Letter Ruling 200446007 held that the amount of a deemed dividend under Code § 1361(d)(3)(B) was not required to be distributed. Letter Ruling 200451021 clarifies that, when Code § 302(d) taxes a partial liquidation as a distribution rather than as a redemption, the trust itself is not taxed on any income on the distribution if the trust has sufficient AAA to absorb the basis reduction (Ruling Request 1) and the proceeds from the sale of stock in partial liquidation are principal that the QSST does not need to distribute (Ruling Request 2).

distributed currently to that beneficiary[5051] while the trust[5052] holds S stock.[5053] The income distribution rule is that all income either actually is distributed each year or is required to be distributed each year;[5054] inadvertent termination relief may be available if the income is not distributed and catch-up distributions are made.[5055] Special rules apply to an inter vivos QTIP or another trust for a spouse.[5056] If a QSST cases to meet any of the requirements of Reg. § 1.1361-

---

[5051] Code § 1361(d)(3). Letter Ruling 9014008 ruled that a distribution to a grantor trust created by the beneficiary would not qualify, but Letter Rulings 9442036, 9444022, 9444024, and 9444059 permitted distributions to a disability trust because the beneficiary did not have legal capacity, and Letter Rulings 8831020, 9001010, and 9140055 approved distributions to custodial accounts under the Uniform Transfers to Minors Act (the latter also approved distributions to "a court-appointed guardian or conservator of the beneficiary"). This requirement does not preclude secured sales in which all income is used to buy the stock (part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls)), nor does it prevent the trust from agreeing to make payments to a third party if stock the trust bought is resold within a certain number of years after the trust's purchase (Letter Ruling 200140040).

[5052] In Letter Ruling 200404037, the IRS accepted the representation that applicable state law deemed a life estate in the shares of stock to give rise to a trust relationship between the life tenant and the remaindermen and that the deemed trust satisfies the requirements for treatment as a QSST. Letter Ruling 200247030 elaborated on the basis for this deemed trust treatment:

> It is represented that under State law, a life tenant, with the power to sell or dispose of property devised to him or her for life with remainder to designated persons, is a trustee or quasi trustee and occupies a fiduciary relationship to the remaindermen. In the exercise of that power, the life tenant owes to the remaindermen the highest duty to act honorably and in good faith. A life tenant is a trustee in the sense that he cannot injure or dispose of property to the injury of the rights of the remaindermen, but differs from a pure trustee in that he may use property for his exclusive benefit and take all income and profits.

[5053] Rev. Rul. 92-20 held that a provision in a trust agreement authorizing the trustee to accumulate trust income if the trust does not hold any shares of an S corporation does not, by itself, preclude the trust's qualification as a QSST.

[5054] Code § 1361(d)(3)(B); Reg. § 1.1361-1(j)(1)(i), the latter which expressly recognizes that income distributed in the first 65 days of the year may be treated under Code § 663(b) as being distributed in the immediately preceding year. Letter Rulings 8508048, 8836057, and 199927011 approved trusts in which the income must be distributed currently, but the beneficiary may elect in any year to have the trustee retain all or any portion of the income of the trust (it is not clear whether the trusts expressly permitted their beneficiaries to elect that retention or whether that was simply a practice that was contemplated); for related issues not discussed in the rulings, see part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts, especially part III.B.2.i.viii Creditor and Gift/Estate Tax Issues Regarding Withdrawal Rights, Whether Currently Exercisable or Lapsed.

[5055] Letter Ruling 201710001.

[5056] Reg. § 1.1361-1(j)(4) approves testamentary QTIP trusts but, for inter vivos ones, prohibits a QSST election during marriage and requires one to ensure that the grantor is treated as wholly owning the trust:

> However, if property is transferred to a QTIP trust under section 2523(f), the income beneficiary may not make a QSST election even if the trust meets the requirements set forth in paragraph (j)(1)(ii) of this section because the grantor would be treated as the owner of the income portion of the trust under section 677. In addition, if property is transferred to a QTIP trust under section 2523(f), the trust does not qualify as a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section (a qualified subpart E trust), unless under the terms of the QTIP trust, the grantor is treated as the owner of the entire trust under sections 671 to 677.

Reg. § 1.1361-1(k)(1), Example (10), provides:

> (i) *Transfers to QTIP trust*. On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A's spouse B, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, B is the sole income beneficiary for life. In addition, corpus may be distributed to B, at the trustee's discretion, during B's lifetime. However, under section 677(a), A is treated as the owner of the trust. Accordingly,

1(j)(1)(ii), the QSST rules will cease to apply as of the first day on which that requirement ceases to be met.[5057] If such a trust ceases to meet the income distribution requirement of Reg. § 1.1361-1(j)(1)(i), but continues to meet all of the requirements Reg. § 1.1361-1(j)(1)(ii), the QSST rules will cease to apply as of the first day of the first taxable year beginning after the first taxable year for which the trust ceased to meet that income distribution requirement. See parts III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S corporation[5058] and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.

Some annual expenses are ordinarily allocated one-half to income and one-half to principal. Generally, these include (1) the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee, and (2) expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests.[5059] If S corporation distributions are the trust's only source of cash, this rule is impractical, because the trust would be unable to pay the portion of the expense allocated to principal. Accordingly, I often suggest that the trustee make an adjustment, allocating the entire expense to income, which might

---

the trust is a permitted shareholder of the S corporation under section 1361(c)(2)(A)(i), and A is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *Transfers to QTIP trust where husband and wife divorce*. Assume the same facts as in paragraph (i) of this Example 10, except that A and B divorce on May 2, 1997. Under section 682, A ceases to be treated as the owner of the trust under section 677(a) because A and B are no longer husband and wife. Under section 682, after the divorce, B is the income beneficiary of the trust and corpus of the trust may only be distributed to B. Accordingly, assuming the trust otherwise meets the requirements of section 1361(d)(3), B must make the QSST election within 2 months and 15 days after the date of the divorce.

(iii) *Transfers to QTIP trust where no corpus distribution is permitted*. Assume the same facts as in paragraph (i) of this Example 10, except that the terms of the trust do not permit corpus to be distributed to B and require its retention by the trust for distribution to A and B's surviving children after the death of B. Under section 677, A is treated as the owner of the ordinary income portion of the trust, but the trust will be subject to tax on gross income allocable to corpus. Accordingly, the trust does not qualify as an eligible shareholder of the S corporation because it is neither a qualified subpart E trust nor a QSST.

Paragraph (iii) illustrates two points. First, to qualify as a wholly owned grantor trust (see part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust), the trust must have not only its income but also its principal deemed owned wholly by the same individual (see part III.A.3.a.ii How a Trust Can Fall Short of Being Wholly Owned by One Person, especially fn. 4966); therefore, when drafting a trust for a spouse that holds stock in an S corporation for which an ESBT election is not in effect, one should consider including a grantor trust power beyond merely Code § 677, to make sure that the entire trust is taxed to the grantor (see part III.B.2.h How to Make a Trust a Grantor Trust). Second, no part of a QSST may be deemed owned by a person other than the beneficiary; see fn. 5049.

Paragraph (ii) offers insight into the application of Code § 677(a) after divorce. See part III.B.2.h.viii Code § 682 Limitations on Grantor Trust Treatment, the result of which is that, if distributions are made after separation, the trust no longer qualifies as a wholly owned grantor trust and a QSST election is unavailable; therefore, an ESBT election must be made (but note that Code § 682 is being repealed by 2017 tax reform). For the interaction of divorce with Chapter 14, see parts III.B.7.b.iv Divorce Planning to Avoid Code § 2701 and III.B.7.d Code § 2702 Overview, especially the text accompanying fns. 6262-6267.

[5057] Reg. § 1.1361-1(j)(5).

[5058] Especially fn 5786 in part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest.

[5059] Section 501 of the Uniform Principal and Income Act, which can be found at http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008).

be authorized under either state law[5060] or the governing instrument.[5061] If the business or the stock is sold later, the proceeds are taxable to the trust, rather than the beneficiary; at that time, some of the proceeds might be allocated to income to make up for these prior allocations of administrative expenses, which would help move taxable items from the trust's high rates to the beneficiary's potentially lower rates.[5062]

A trust that has substantially separate and independent shares, each of which is for the sole benefit of one beneficiary, may qualify as a QSST with respect to each separate share.[5063] For example, a grantor sets up an irrevocable trust for the benefit of his four children, who are the only children he will ever have. Each child receives one-fourth of the income and corpus distributions. Each child would be considered the owner of one-fourth of the stock owned by the trust.[5064] This could also work well for a vested trust for a grandchild, which qualifies for the GST annual exclusion;[5065] see part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust for an example of a vested trust.

[5060] See part II.J.8.c.i.(a) Power to Adjust.

[5061] See parts II.J.8.c.i.(d) Exceptions in the Governing Instrument and II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law, especially fns. 2290-2295 (language that might be included in one's forms authorizing such an adjustment, as well as the consequences of using such language).

[5062] See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets. See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act. For form language that might facilitate this allocation, see fn. 2290, found in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

[5063] Code § 1361(d)(3). Although the statute cites to the separate share rules under Code § 663(c) (see part II.J.9.a Separate Share Rule), the test is more stringent than that. Code § 663(c) provides for that distributions to other beneficiaries be ignored in determining separate share treatment if the possibility of distribution is remote. Rev. Rul. 93-31 holds:

> A substantially separate and independent share of a trust, within the meaning of section 663(c) of the Code, is not a QSST if there is a remote possibility that the corpus of the trust will be distributed during the lifetime of the current income beneficiary to someone other than that beneficiary.

For example, if an inter vivos QSST includes a clause requiring the payment of estate tax if the grantor dies during the beneficiary's life, and that payment clause might benefit the grantor's estate beyond whatever applicable law would provide but for that clause, the IRS' view is that mere possibility of such a diversion might disqualify the QSST from inception. Letter Ruling 201451001 (which I obtained to obtain inadvertent termination relief at the insistence of the CPAs for the company that was acquiring my client). However, paying transfer tax on the beneficiary's death should not cause any QSST problem. Letter Ruling 9014008 (GST tax).

[5064] However, it would not work if trust provided that the birth of another child after the trust is created would cause the trust to be divided five ways, essentially diverting one-fourth of each existing trust. Rev. Rul. 89-45.

[5065] Code § 2642(c)(2) provides that the GST annual exclusion applies to a trust that uses *Crummey* withdrawal rights only if the grandchild (or other skip person) is the sole beneficiary of the trust, and the trust's assets must be includible in the beneficiary's gross estate upon her death. Code § 2654(b) provides that substantially separate and independent shares of different beneficiaries shall be treated as separate trusts under the GST rules. Suppose a grantor sets up an irrevocable trust for the benefit of his four grandchildren. Each grandchild receives one-fourth of the income and corpus distributions; the trust distributes all of its income each year; and each of the four living grandchild would be considered the owner of one-fourth of the stock owned by the trust. If a grandchild who dies before or after trust termination holds

To avoid the requirement that all of the trust income – not just its S corporation income – be distributed to the beneficiary, it is not uncommon for a trust agreement to divide the trust so that the QSST is a separate trust. For inter vivos QSSTs, this approach might have additional state income tax benefits; see part II.J.15.b QSSTs and State Income Tax Issues. On a separate but related note, suppose a QSST holds investments (such as partnerships) that generate taxable income without necessarily generating trust accounting income. Can the nongrantor trust portion of the QSST take an income distribution deduction with respect to the distributions to the beneficiary of trust accounting income derived from S corporation? The QSST regulations[5066] do not address it, but the grantor trust regulations provide some support for my preliminary view that the nongrantor trust portion cannot get credit for those distributions.[5067]

The beneficiary of a QSST is taxed on all of the QSST's K-1 income and losses from the S corporation[5068] (although the trust still needs to get its own tax ID).[5069] However, when the QSST sells the stock, the trust itself is taxable on any gain on the sale,[5070] including any gain the corporation incurs after adopting a plan of complete liquidation[5071] or from the deemed asset sale resulting from a Code § 338(h)(10) election.[5072] If the corporation actually sells its assets without adopting a plan of liquidation, I am unsure of the result. For additional planning issues, see parts II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI), and II.J.15.a QSST Treatment of Sale of S Stock or Sale of

---

a general power of appointment over one-fourth of the trust's assets, the trust will qualify for the GST annual exclusion and as a QSST.

[5066] Reg. § 1.1361-1(j).

[5067] Reg. § 1.671-3(a)(2) provides:

> If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code.

"Items" refers to "items of income, deduction, and credit against tax attributable to or included in that portion," so I can't say with absolute certainty what the answer is. However, I think that the "better" answer is that distributions from the trust of S corporation trust accounting income would be attributable to the grantor trust portion. This is consistent with the IRS' general approach in CCA 201327009, discussed in the text accompanying fns 5183-5185 in part III.A.3.e.vi.(a) Grantor Trust Issues Involved in a Sale of S Stock to a QSST.

[5068] Code § 1361(d)(1)(B). Reg. § 1.1361-1(j)(7)(i) provides:

> The income beneficiary who makes the QSST election and is treated (for purposes of section 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

Reg. § 1.1361-1(j)(8) further provides:

> If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made.

[5069] Reg. § 1.671-4(b)(6)(iii).

[5070] Reg. § 1.1361-1(j)(8). However, for purposes of recognizing any losses suspended due to the at-risk rules of Code § 465 or the passive activity rules of Code § 469, the regulation treats the beneficiary as having sold the stock so that the suspended losses can be triggered. For more details on such sales, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

[5071] Letter Rulings 9721020 and 199905011. This includes gain from the actual sale of assets as well as gain on the Code § 336 deemed sale of assets distributed to shareholders. Of course, Code § 331 gain on the deemed sale of stock on dissolution is also taxed to the trust.

[5072] Letter Rulings 9828006, 199920007, and 201232003.

Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). From the above, one can glean that depreciation recapture on the actual or deemed sale of personal property is ordinary income that is principal but might be best taxed to the beneficiary, who might either be in a lower tax bracket or might have losses from operations during the year of sale passing through the grantor trust portion to offset; thus, consider including in one's trust the flexibility to distribute principal or to reallocate principal to income.[5073]

The beneficiary must make a separate QSST election with respect to each corporation whose stock the trust holds.[5074]

See part II.A.2.d Estate Planning Strategies Available Only for S corporation Shareholders for a brief introduction to a QSST's unique benefits. To explore a QSST's unique attributes as a grantor trust deemed owned by its beneficiary, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

Also note that a QSST election might enhance (or perhaps reduce) the trust's ability to deduct charitable contributions made by the S corporation.[5075]

III.A.3.e.i.(b). QSST Issues When Beneficiary Dies

QSSTs have excellent post-mortem planning flexibility:

- A QSST may hold stock for two years after the beneficiary's death without making any election at all.[5076]

- If a QSST continues as separate QSST-eligible shares for each beneficiary after termination but before the new QSST trusts are actually funded, no new election is required until actual funding of the new trusts; in other words, the QSST election stays in effect, with the individual remaindermen taxed as the QSST beneficiaries until actual post-mortem trust funding occurs.[5077]

The latter is a very important tool. Consider what happens after the beneficiary dies and before the stock is retitled in the remaindermen's names. If the S corporation does not distribute all of its taxable income, the trust might not be able to obtain an income distribution deduction to carry out all of the income to the remaindermen, thereby trapping the income[5078] at the trust's

---

[5073] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, which includes parts discussing allocating to income what otherwise would be principal receipts.
[5074] Reg. § 1.1361-1(j)(6)(i). Inadvertent termination relief is available when the trust acquires stock in another S corporation if a timely QSST election is not made with respect to that other S corporation. Letter Ruling 201618003.
[5075] See part II.Q.7.c S corporations Owned by a Trust Benefitting Charity, especially the text accompanying fn. 4092.
[5076] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S corporation, especially part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.
[5077] See Reg. § 1.1361-1(j)(9)(ii), contrasting Example (1) with Example (2).
[5078] See parts III.A.4 Trust Accounting Income Regarding Business Interests and III.D.2 Trust Accounting and Taxation.

presumably higher income tax rates.[5079] Keeping the QSST election intact post-mortem before stock retitling to make sure that individual beneficiaries are taxed directly on the S corporation's K-1 income might save income tax during that period.

However, challenges arise when the remaindermen are not the residual beneficiaries of the beneficiary's estate plan. The S corporation might make distributions to pay the shareholders' income taxes after the beneficiary dies, and then how will the beneficiary's estate pay tax on the beneficiary's allocable share[5080] of the S corporation's income? What happens when a QSST's beneficiary dies, the beneficiary's estate is taxed on pre-mortem income, and the remaindermen are different than the beneficiaries of the beneficiary's estate? This might occur, for example, in a second marriage situation. Although the Uniform Principal and Income Act discusses issues along these lines to a certain extent,[5081] drafting to address this issue would be advisable:

- If the beneficiary does not control disposition of the trust's assets, the beneficiary might consider negotiating income tax reimbursement provisions with the trustee as a condition of making the QSST election.

- If the beneficiary does control disposition, the beneficiary might consider exerting that control to require that the remaindermen reimburse the beneficiary's estate for income tax on the pre-mortem income. On the other hand, if the QSST's remaindermen are the same as under the beneficiary's estate plan generally, the opportunity to create a debt (taxes on the earned but undistributed income) on the beneficiary's estate tax return might prove beneficial. In the latter case, the beneficiary might exercise any power of appointment he or she might have to provide for the QSST election to remain in place after the beneficiary's death during trust administration before the trust is divided.

One might consider a provision along the following lines:

(1) If the individuals to whom the S corporation stock is allocated do not share in the residue of the deceased beneficiary's estate (in this Agreement, Article 5 determines the sharing of the residue of my estate, because my will bequeaths my estate to the Revocable Trust and Article 5 bequeaths the residuary trust assets), then any distributions the S corporation makes to pay its shareholders' taxes with respect to their distributive shares of taxable income before the date of death shall be treated as income earned before the beneficiary's death and paid to the beneficiary's estate.

(2) If and to the extent that paragraph (1) does not apply, during trust administration, after the beneficiary's death and before separate trusts can be funded, the trust will not terminate but rather will continue as a single trust with separate shares pursuant to U.S. Treas. Reg. section 1.1361-1(j)(9)(ii), Example (1), and the trusts for the beneficiaries will be amended under [the QSST provisions].

[5079] Note, however, that trapping income inside trusts might be beneficial. See parts II.J.3 Strategic Fiduciary Income Tax Planning and III.A.3.e.ii.(c) When ESBT Income Taxation Might Help, the latter not directly on point but having some helpful ideas.
[5080] See part III.B.2.j Tax Allocations upon Change of Interest, especially part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S corporation.
[5081] Section 201 of the Uniform Principal and Income Act (last amended or revised in 2008; see http://www.uniformlaws.org/shared/docs/principal%20and%20income/upia_final_08_clean.pdf) addresses actions when a trust terminates.

Such a provision would not cause any marital deduction problems for the trust that is terminating.[5082] However, if the trust is included in the beneficiary's estate and the beneficiary is bequeathing the stock to a QTIP trust and income otherwise payable to the QTIP trust is diverted, query whether that violates the requirement that QTIP exclusively benefit the surviving spouse.

The amount of income allocated before and after death is also potentially subject to considerable uncertainty, unless an election to close the corporation's books is made, as described in part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S corporation, especially part III.B.2.j.ii.(d) Death of a Shareholder.

If the stock is bequeathed to a person other than the persons receiving the trust's residue, consider the issues in part III.A.3.d Special Fiduciary Income Tax Issues Regarding Bequeathing S corporation Stock and Partnership Interests, which addresses timing issues relating to distributions to pay taxes on the trust's distributive share of the entity's income.

III.A.3.e.ii. ESBTs

III.A.3.e.ii.(a). Qualification as an ESBT

After determining eligibility to make an "electing small business trust" (ESBT) election, see part III.A.3.c.iii Deadlines for QSST and ESBT Elections.

To qualify to make an ESBT election,[5083] the trust cannot have as a beneficiary any person other than an individual, an estate, a charity within certain definitions.[5084] "Beneficiary" includes a person who has a present, remainder, or reversionary interest in the trust.[5085] A distributee trust is the beneficiary of the ESBT only if the distributee trust is a Code § 170(c)(2) or (3) organization.[5086] In all other situations, any person who has a beneficial interest in a "distributee trust" is a beneficiary of the ESBT, rather than the trust itself being considered to be a beneficiary.[5087] A "distributee trust" is a trust that receives or may receive a distribution from the ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.[5088]

If an impermissible shareholder might become a potential current beneficiary, one might consider taking steps to exclude that person from being a potential current beneficiary ("PCB") of the ESBT portion.[5089] Generally, a PCB is any person who at any time during the taxable year is entitled to,

---

[5082] Rev. Rul. 92-64 generally allows income earned during the surviving spouse's life but paid after the surviving spouse's death to be paid to either the surviving spouse's estate (if allowed under state law) or the successor beneficiary. State corporate law often limits the gap between record date (the date on the shareholder actually owned the stock) and payment date; generally, an LLC taxed as an S corporation would not face this problem. Of course, in a trust situation, with either type of entity the trust would receive the distribution and then direct it according to the beneficiaries' respective interests, if the ownership interest was not transferred between death and date of the distribution from the corporation.

[5083] Code § 1361(e)(1)(A)(iii) authorizes the election.

[5084] Code § 1361(e)(1)(A)(i). Permitted charities include an organization described in Code § 170(c)(2), (3), (4), or (5) or, if it has a contingent interest in the trust and is not a potential current beneficiary, a Code § 170(c)(1) organization.

[5085] Reg. § 1.1361-1(m)(1)(ii)(A).

[5086] Reg. § 1.1361-1(m)(1)(ii)(B).

[5087] Reg. § 1.1361-1(m)(1)(ii)(B).

[5088] Reg. § 1.1361-1(m)(1)(ii)(B).

[5089] Letter Ruling 200913002 held that such a modification did not affect GST grandfathering.

or in the discretion of any person may receive, a distribution from the principal or income of the trust;[5090] the deemed owner of a grantor trust is also a PCB.[5091] A potential trap applies when an ESBT terminates in favor of trusts (the "downstream trusts"). After the event terminating the ESBT (such as the primary beneficiary's death) and before the trust distributes its assets to the downstream trusts, the downstream trusts might become PCBs, applying the following rules:

(1) Generally, a trust that exists is a distributee trust if it becomes entitled to, or at the discretion of any person, may receive a distribution from principal or income of an ESBT.[5092] A trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit.[5093] A trust that is not yet funded not currently a distributee trust.[5094]

(2) If the trust qualifies a trust described in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S corporation, then the persons who would be its PCBs if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT.[5095] However, if the distributee trust is a former grantor trust[5096] or is a testamentary

---

[5090] Code § 1361(e)(2). Reg. § 1.1361-1(m)(4)(i) provides:

> *Generally*. For purposes of determining whether a corporation is a small business corporation within the meaning of section 1361(b)(1), each potential current beneficiary of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of this paragraph (m)(4), a potential current beneficiary generally is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust. A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust. No person is treated as a potential current beneficiary solely because that person holds any future interest in the trust.

Reg. § 1.1361-1(m)(4)(iii) further provides:

> *Special rule for dispositions of stock*. Notwithstanding the provisions of paragraph (m)(4)(i) of this section, if a trust disposes of all of the stock which it holds in an S corporation, then, with respect to that corporation, any person who first met the definition of a potential current beneficiary during the 1-year period ending on the date of such disposition is not a potential current beneficiary and thus is not a shareholder of that corporation.

Reg. § 1.1361-1(m)(4)(v) also provides:

> *Contingent distributions*. A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a potential current beneficiary until such time or the occurrence of such event.

For the effect of a power of appointment, see fn 5105.

[5091] Reg. § 1.1361-1(m)(4)(ii) provides:

> *Grantor trusts*. If all or a portion of an ESBT is treated as owned by a person under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code, such owner is a potential current beneficiary in addition to persons described in paragraph (m)(4)(i) of this section.

[5092] Reg. § 1.1361-1(m)(4)(iv)(A).

[5093] Reg. § 1.1361-1(m)(4)(iv)(A).

[5094] Reg. § 1.1361-1(m)(4)(iv)(A). Letter Rulings 200816012 and 200913002 approved as an ESBT a trust prohibiting distributions to a nonresident alien for so long as (1) the trust has an ESBT election in effect, and (2) a non-resident alien is not permitted to be a PCB of an ESBT under the Code and Regs. (I do not know why the rulings cited Reg. § 1.1361-1(m)(4)(iv) instead of Reg. § 1.1361-1(m)(4)(v). I wonder whether that is a typo.) However, starting in 2018, a nonresident alien may be a beneficiary of an ESBT. See part II.A.2.f Shareholders Eligible to Hold S corporation Stock, especially fns 140-136.

[5095] Reg. § 1.1361-1(m)(4)(iv)(C).

[5096] See part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death.

trust,[5097] in either case during the special initial 2-year period, then the relevant estate is treated as the ESBT's PCB during that period.[5098]

(3) If the distributee trust is not a trust described in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S corporation, then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates.[5099] However, if the distributee trust would be a valid QSST or ESBT if the relevant election were made and the election is not made because the trust does not hold S stock, then the distributee trust does not count as a PCB,[5100] and the distributee trust's PCBs would count as PCBs of the trust that does hold the S stock.[5101] Another option is for the main trust

---

[5097] See part III.A.3.b.iii A Trust with Respect to Stock Transferred to It Pursuant to The Terms of a Will (or a Qualified Revocable Trust When a Code § 645 Election Terminates), But Only for the 2-Year Period Beginning on The Day on Which Such Stock Is Transferred to It.

[5098] Reg. § 1.1361-1(m)(4)(iv)(C).

[5099] Reg. § 1.1361-1(m)(4)(iv)(B).

[5100] Reg. § 1.1361-1(m)(4)(iv)(D) provides:

> For the purposes of paragraph (m)(4)(iv)(C) of this section, a trust will be deemed to be described in section 1361(c)(2)(A) if such trust would qualify for a QSST election under section 1361(d) or an ESBT election under section 1361(e) if it owned S corporation stock.

Letter Ruling 200912005 approved a distributee trust that would have been eligible to make an ESBT election even though its sole remainderman was a charity (it did not, as drafted, qualify as a charitable remainder trust).

Reg. § 1.1361-1(m)(8), Example (6) provides:

> (i) *Distributee trust that would itself qualify as an ESBT*. Trust-1 holds stock in X, an S corporation, and has a valid ESBT election in effect. Under the terms of Trust-1, the trustee has discretion to make distributions to A, B, and Trust-2, a trust for the benefit of C, D, and E. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. Under paragraph (m)(4)(iv) of this section, Trust-2's potential current beneficiaries are treated as the potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Thus, A, B, C, D, and E are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Trust-2 itself will not be counted as a shareholder of Trust-1 for purposes of section 1361(b)(1).
>
> (ii) *Distributee trust that would not qualify as an ESBT or a QSST*. Assume the same facts as in paragraph (i) of this Example 6 except that D is a nonresident alien. Trust-2 would not be eligible to make an ESBT or QSST election if it owned S corporation stock and therefore Trust-2 is a potential current beneficiary of Trust-1. Since Trust-2 is not an eligible shareholder, X's S corporation election terminates.
>
> (iii) *Distributee trust that is a section 1361(c)(2)(A)(ii) trust*. Assume the same facts as in paragraph (i) of this Example 6 except that Trust-2 is a trust treated as owned by A under section 676 because A has the power to revoke Trust-2 at any time prior to A's death. On January 1, 2003, A dies. Because Trust-2 is a trust described in section 1361(c)(2)(A)(ii) during the 2-year period beginning on the day of A's death, under paragraph (m)(4)(iv)(C) of this section, Trust-2's only potential current beneficiary is the person listed in section 1361(c)(2)(B)(ii), A's estate. Thus, B and A's estate are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1).

Reg. § 1.1361-1(m)(8), Example (6)(ii) is outdated, in that starting in 2018 a nonresident alien may be a beneficiary of an ESBT. See part II.A.2.f Shareholders Eligible to Hold S corporation Stock, especially fns 140-136.

[5101] Reg. § 1.1361-1(m)(4)(iv)(B) provides:

> If the distributee trust is a trust described in section 1361(c)(2)(A), the persons who would be its potential current beneficiaries (as defined in paragraphs (m)(4)(i) and (ii) of this section) if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT. Notwithstanding the preceding sentence, however, if the distributee trust is a trust described in

to partially fund the distributee trust and have the distributee trust then qualify as a shareholder.[5102]

Each potential current beneficiary is treated as a shareholder for the purposes of the 100-shareholder limitation.[5103]

Regulations had provided that an open-ended inter vivos power of appointment violates the 100-shareholder limitation; however, Congress modified that provision for years beginning after December 31, 2004 to provide that powers of appointment are considered during a period only to the extent exercised during that period,[5104] and the regulations now reflect this change.[5105] If a

---

section 1361(c)(2)(A)(ii) or (iii), the estate described in section 1361(c)(2)(B)(ii) or (iii) is treated as the potential current beneficiary of the ESBT for the 2-year period during which such trust would be permitted as a shareholder.

See Reg. § 1.1361-1(m)(8), Example (6), parts (i) and (iii), reproduced in fn. 5100.

[5102] Reg. § 1.1361-1(m)(8), Example (5) provides:

Potential current beneficiaries and distributee trust holding S corporation stock. Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to make distributions to A directly or to any trust created for the benefit of A. On January 1, 2003, M creates Trust-2 for the benefit of A. Also on January 1, 2003, the trustee of Trust-1 distributes some S corporation stock to Trust-2. A, as the current income beneficiary of Trust-2, makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1. Trust-2 itself will not be counted toward the shareholder limit of section 1361(b)(1)(A). Additionally, because A is already counted as an S corporation shareholder because of A's status as a potential current income beneficiary of Trust-1, A is not counted again by reason of A's status as the deemed owner of Trust-2.

[5103] Code § 1361(c)(2)(B)(v).

[5104] Code § 1361(e)(2).

[5105] Reg. § 1.1361-1(m)(4)(vi)(A) provides:

(A) *Powers of appointment*. A person to whom a distribution may be made during any period pursuant to a power of appointment (as described for transfer tax purposes in section 2041 and § 20.2041-1(b) of this chapter and section 2514 and § 25.2514-1(b) of this chapter) is not a potential current beneficiary unless the power is exercised in favor of that person during the period. It is immaterial for purposes of this paragraph (m)(4)(vi)(A) whether such power of appointment is a ``general power of appointment'' for transfer tax purposes as described in §§ 20.2041-1(c) and 25.2514-1(c) of this chapter. The mere existence of one or more powers of appointment during the lifetime of a power holder that would permit current distributions from the trust to be made to more than the number of persons described in section 1361(b)(1)(A) or to a person described in section 1361(b)(1)(B) or (C) will not cause the S corporation election to terminate unless one or more of such powers are exercised, collectively, in favor of an excessive number of persons or in favor of a person who is ineligible to be an S corporation shareholder. For purposes of this paragraph (m)(4)(vi)(A), a ``power of appointment'' includes a power, regardless of by whom held, to add a beneficiary or class of beneficiaries to the class of potential current beneficiaries, but generally does not include a power held by a fiduciary who is not also a beneficiary of the trust to spray or sprinkle trust distributions among beneficiaries. Nothing in this paragraph (m)(4)(vi)(A) alters the definition of "power of appointment" for purposes of any provision of the Internal Revenue Code or the regulations.

(B) *Powers to distribute to certain organizations not pursuant to powers of appointment*. If a trustee or other fiduciary has a power (that does not constitute a power of appointment for transfer tax purposes as described in §§ 20.2041-1(b) and 25.2514-1(b) of this chapter) to make distributions from the trust to one or more members of a class of organizations described in section 1361(c)(6), such organizations will be counted collectively as only one potential current beneficiary for purposes of this paragraph (m), except that each organization receiving a distribution also will be counted as a potential current beneficiary. This paragraph (m)(4)(vi)(B) distribution can be made to an existing trust, that trust must be qualify under the general rules for trusts as S corporation shareholders;[5106] similar to the power of appointment rule, that rule does not apply until the distributee trust has been created.[5107]

An ESBT cannot have a beneficiary whose interest was acquired by purchase.[5108] This prohibition does not have anything to do with whether the trust has purchased or might later purchase S stock.[5109]

> shall not apply to a power to currently distribute to one or more particular charitable organizations described in section 1361(c)(6). Each of such organizations is a potential current beneficiary of the trust.

5106 Reg. § 1.1361-1(m)(4)(iv)(B).

5107 Reg. § 1.1361-1(m)(4)(iv)(A), which further provides:

> For this purpose, a trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit. Thus, if a trust instrument provides for a trust to be funded at some future time, the future trust is not currently a distributee trust.

5108 Code § 1361(e)(1)(A)(ii). For whether a change in a beneficiary's interest in a trust might cause an interest in the trust to be obtained by purchase in violation of this rule, see Potter, Trust Decanting of S corporation Shareholders: Avoiding Inadvertent Termination of the Company's S Election, *TM Memorandum* (BNA) (12/29/2014) or *TM Estates, Gifts and Trusts Journal* (BNA) (3/12/2015).

Letter Ruling 201834007 ruled:

> A is causing A's grantor trust to transfer the shares of X stock to the Trust pursuant to the divorce Decree, and the amount of the liabilities assumed plus the liabilities that the property transferred is subject to does not exceed the adjusted basis of the property transferred.
>
> Accordingly, based on the facts submitted and representations made, provided that the transfer of the shares of X stock to the Trust occurs within six years of the entry of final judgment and the terms of the Trust as executed by A and B remain materially identical to those submitted, we conclude that § 1041(a) applies and A and B will not recognize any gain or loss on the transfer of the shares of X stock from A's grantor trust to the Trust.
>
> Further, § 1041(b) applies such that the transfer is treated as a gift under § 1041(b). As such, B's acquisition of B's lifetime distribution rights in the Trust for consideration is not a purchase within § 1361(e) because the sale is not governed by § 1012(a). Accordingly, B's acquisition of B's distribution rights will not disqualify Trust from being an ESBT.

Letter Rulings 201436006 and 201436007 ruled that the following transactions did not constitute a prohibited purchase of an interest in a trust:

> X created Trust 1 on D1. Trust 1 is a grantor trust wholly owned by X. X proposes to create Trust 2 which will be a grantor trust wholly owned by X. X proposes to contribute S corporation stock to Trust 2 and sell the Trust 2 remainder interest to Trust 1. Trust 2 will elect to be an electing small business trust (ESBT) under 1361(e) upon creation.
>
> ....
>
> [W]e conclude that the sale of the Trust 2 remainder interest to Trust 1 will not disqualify Trust 2 from being an ESBT under § 1361(e) during the period when Trust 1 is a grantor trust as to X because the sale of the remainder interest is not a purchase within the meaning of § 1361(e). The sale of the remainder interest is not a purchase within the meaning of 1361(e) because the sale is not governed by § 1012(a). However, to the extent that the sale is treated as a gift, the sale will be covered by § 1015(a). In addition, we conclude that Trust 2 will not cease to be or fail to qualify as an ESBT after the termination of Trust 1's grantor trust status because Trust 1's acquisition of the remainder is not a purchase within the meaning of § 1361(e).

5109 Reg. § 1.1361-1(m)(1)(iii) provides:

> *Interests acquired by purchase*. A trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. Generally, if a person acquires an interest in the trust and thereby becomes a beneficiary of the trust as defined in paragraph (m)(1)(ii)(A), and any portion of the basis in the acquired interest in the trust is determined under section 1012, such interest has been

III.A.3.e.ii.(b). ESBT Income Taxation - Overview

ESBT income taxation is complicated. An ESBT is treated as two separate trusts for purposes of chapter 1 of subtitle A of the Code.[5110] The portion that consists of stock in one or more S corporations is treated as one trust, and the portion that consists of all the other assets in the trust is treated as a separate trust.[5111] The grantor trust rules trump this treatment.[5112] However, the ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return.[5113]

The income from the Schedule K-1 that the S corporation files for the trust is separately taxed to the trust at the highest individual income tax rate for that type of income.[5114] Very few deductions are allowed against this income, and the income distribution deduction is not available;[5115] the

> acquired by purchase. This includes a net gift of a beneficial interest in the trust, in which the person acquiring the beneficial interest pays the gift tax. The trust itself may acquire S corporation stock or other property by purchase or in a part-gift, part-sale transaction.

T.D. 8994 (5/13/2002) stated:

> Two commentators requested clarification on whether a trust is eligible to be an ESBT if it acquires property in a part-gift, part-sale transaction, such as a gift of encumbered property or a net gift, in which the donor transfers property to a trust provided the trust pays the resulting gift tax. Section 1361(e)(1)(A)(ii) provides that a trust is eligible to be an ESBT only if "no interest in the trust was acquired by purchase." Section 1361(e)(1)(C) defines purchase as "any acquisition if the basis of the property acquired is determined under section 1012." The proposed regulations provide that if any portion of a beneficiary's basis in the beneficiary's interest is determined under section 1012, the beneficiary's interest was acquired by purchase. The final regulations clarify that the prohibition on purchases applies to purchases of a beneficiary's interest in the trust, not to purchases of property by the trust. A net gift of a beneficial interest in a trust, where the donee pays the gift tax, would be treated as a purchase of a beneficial interest under these rules, while a net gift to the trust itself, where the trustee of the trust pays the gift tax, would not.

The Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96), December 18, 1996 (Blue Book), stated:

> No interest in the trust may be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis (determined under sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc. The trust itself may acquire property (including stock of an S corporation) by purchase.

[5110] Code § 641(c); Reg. § 1.641(c)-1(a).
[5111] Reg. § 1.641(c)-1(a).
[5112] Reg. § 1.641(c)-1(a).
[5113] Reg. § 1.641(c)-1(a).
[5114] Code § 641(c)(1); Reg. § 1.641(c)-1(e).
[5115] Code § 641(c)(2).

IRS has taken the position that net operating losses (NOLs) are not allowable deductions,[5116] but capital loss carryforwards appear to be allowable.[5117]

State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion are taken into account by the S portion.[5118] These items may be allocated in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the trustee's practice with respect to the trust if it is reasonable and consistent.[5119] Note that the $10,000 limit on state income tax deductions[5120] would apply separately to the S portion and the non-S portion,[5121] allowing the trust to deduct up to $20,000 in state income tax.

Complications arise if the ESBT is a grantor trust in whole or in part or if the trust is a charitable lead trust or other trust eligible for a charitable income tax deduction. The charitable deduction applies only the charitable contributions passing through a K-1 from the S corporation to the trust and not to contributions made by the trust.[5122] Effective for tax years beginning after

---

[5116] The IRS has taken the position that a net operating loss (NOL) carryover arising from pre-ESBT activity is not deductible because an NOL carryover is not one of the specifically enumerated expenses. CCA 200734019 (consider whether the logic in that CCA might also be applied to NOLs generated from post-ESBT activity).

Making a Code § 645 election for a revocable trust to be taxed as an estate avoids this issue for short-term post-mortem planning, since estates can hold S stock during a reasonable administration period, whereas revocable trusts are limited to two years under Code § 1361(c)(2)(A)(ii). Trusts created under a revocable trust are considered trusts created under wills pursuant to Reg. § 1.1361-1(k)(1), Example 3, paragraph (ii) if a Code § 645 election is in place and therefore can hold S stock for up to two years after funding before making an ESBT or QSST election, flexibility that is not present absent a Code § 645 election.

See also the text accompanying fn. 5125 for how to avoid the ESBT generating an NOL when it has significant losses from its S corporation stock; this generally requires advance planning.

[5117] Reg. § 1.641(c)-1(d)(3)(i) disallows deductions for losses capital losses that exceed gains by more than $3,000 under Code § 1211(b) but does not refer to capital loss carryforwards under Code § 1212. Nothing directly addresses whether capital losses incurred before making an ESBT election but relating to S corporation items can be deducted against capital gain incurred while an ESBT.

[5118] Reg. § 1.641(c)-1(d)(4)(i), which is specifically authorized by Code § 641(c)(2)(C)(iii).

[5119] Reg. § 1.641(c)-1(h).

[5120] For the $10,000 limit, see the text accompanying fn 2080 in part II.J.3.d Who Benefits Most from Deductions. Because Reg. § 1.641(c)-1(d)(4)(i).says that these taxes are "taken into account," rather than "deducted," the regulation does not appear to provide an independent basis for a deduction.

[5121] See fns 5110-5111 in this part III.A.3.e.ii.(b).

[5122] The charitable deduction is not allowed against ESBT income if made directly by the trust. See Code § 641(c)(2)(C) and Reg. § 1.641(c)-1(d)(1), disallowing all deductions except those expressly listed (but the deduction should be allowed against the non-S portion of the trust). However, Reg. § 1.641(c)-1(d)(2)(ii) describes charitable deductions passing through a K-1 the ESBT receives from an S corporation:

> *Special rule for charitable contributions*. If a deduction described in paragraph (d)(2)(i) of this section [referring to K-1 items] is attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1) [the unlimited charitable deduction for trusts]. The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion.

Code § 512(e)(1)(B)(i) provides all S corporation K-1 income is per se unrelated business income, so Code § 681 and Reg. § 1.681(a)-2(a) would apply the individual contribution limits, rather than the unlimited

December 31, 2017, an ESBT's contribution deduction does not apply Code § 642(c) but rather uses the Code § 170 limits based on the rules that apply to individuals,[5123] which means that the charitable deduction generally is based on the fair market of property donated, in contrast to the Code § 642(c) deduction being limited to the property's adjusted basis.[5124] For other differences between Code §§ 170 and 642(c), see part II.J.4.c Charitable Distributions.

For application of the passive loss rules to ESBTs, see part II.K.2.b.v Electing Small Business Trusts (ESBTs) and the Passive Loss Rules. In light of the IRS' position on NOLs for ESBTs,[5125] consider whether the trustee should be passive, as discussed in part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good (and note that an ESBT avoiding NOLs might be at the cost of incurring the 3.8% tax on net investment income).[5126]

Regarding the Code § 199A deduction, which generally is 20% of qualified business income, see part II.E.1.f Trusts/Estates and the Code § 199A Deduction, especially part II.E.1.f.iii Electing Small Business Trusts (ESBTs).

If the nongrantor trust portion of an ESBT is included in a person's estate, the ESBT election might prevent a basis step-up of depreciable property.[5127]

III.A.3.e.ii.(c). When ESBT Income Taxation Might Help

ESBT income taxation can be favorable in the right circumstances. For example:

- The trust's income might be taxed at lower state income rates (or not at all) inside the trust than in the beneficiary's hands, or

- The beneficiary might be in the top income tax bracket, and reporting additional income would cause the beneficiary to lose some itemized deductions, AMT exemption, or personal exemptions.

In either case, the ESBT can make distributions to the beneficiary without passing S corporation income to the beneficiary. To maximize this flexibility, the trustee might consider dividing the

---

Code § 642(c), to such deductions. For more information about Code § 681, mentioned in the last sentence of this regulation, see part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.

[5123] Code § 641(c)(2)(E) provides:

(i) Section 642(c) shall not apply.

(ii) For purposes of section 170(b)(1)(G), adjusted gross income shall be computed in the same manner as in the case of an individual, except that the deductions for costs which are paid or incurred in connection with the administration of the trust and which would not have been incurred if the property were not held in such trust shall be treated as allowable in arriving at adjusted gross income.

The Senate report adopting this rule said:

> The Senate amendment provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

[5124] See fn 4076 in part II.Q.7.c.i.(a) Contribution Must Be Made from Gross Income.

[5125] See fn. 5116.

[5126] See part II.I 3.8% Tax on Excess Net Investment Income (NII), especially parts II.I.8 Application of 3.8% Tax to Business Income and II.J.14 Application of 3.8% NII Tax to ESBTs.

[5127] See part II.J.11.a.ii.(c) Trust vs. Separately Recognized Business Entity Holding Depreciable Property, particularly fns. 2391-2392.

ESBT into two separate trusts – one that holds S stock and one that holds any distributions that the trustee intends to reinvest, based on the following analysis:

1. Distributions from a trust that generates investment income (other than S corporation K-1 income) will carry out income to the beneficiary.

2. If the investments are held in a separate trust, that trust can accumulate income and trap the investment income.

3. Therefore, when the trustee of the trust that holds S stock receives a distribution, the trustee would retain enough to pay income tax and administrative expenses, distribute to the beneficiary as appropriate, and then transfer the balance of the cash to the trust that generates investment income.

This three-part analysis applies when the S corporation distributes all of its income. It would not apply if the corporation distributes only enough for its shareholders to pay tax and uses the rest to grow the business (or its marketable securities portfolio). For trusts that are somewhere in between, it might or might not be helpful.

III.A.3.e.iii. Comparing QSSTs to ESBTs

A QSST tends to be used when:

- The trust is a marital trust or other trust whose income is required to be distributed currently to one beneficiary with no other current beneficiary. Under the marital trust rules,[5128] all income must be distributed annually, which means that, under normal trust rules, the income that the spouse is required to receive is taxable to her, just like any other mandatory income beneficiary.[5129]

- The beneficiary's income tax rate is lower than the trust's income tax rate. Because trust income above a modest threshold is taxed at the highest possible rates that apply to individuals,[5130] a beneficiary in a lower bracket should save taxes.

A QSST is not the best for trusts intended to accumulate their income, including trusts with multiple current beneficiaries. In most such cases, such trusts should be ESBTs.

ESBTs might avoid the 3.8% NII tax[5131] by appointing a trustee who is active in the business if the beneficiary is not active in the business.[5132] A QSST's income is not subject to the 3.8% NII tax if the beneficiary is active in the business[5133] or has income below the threshold;[5134] however,

---

[5128] Code §§ 2056(b)(1) and 2523(b).
[5129] Code § 651.
[5130] Code § 1(e)(2).
[5131] For the 3.8% tax on net investment income (NII), see II.I 3.8% Tax on Excess Net Investment Income. For calculating the tax on an ESBT, see fn 2408 (which also refers to an example in the proposed regulations) and the accompanying text.
[5132] See parts II.K.2.b.i Participation by a Nongrantor Trust: Authority and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[5133] A QSST is a grantor trust deemed owned by the beneficiary. The 3.8% tax looks to the character of the income in the hands of the deemed owner; see fn. 1902.
[5134] See part II.I.3 Tax Based on NII in Excess of Thresholds.

because the trustee's participation is what counts when the QSST sells the stock, consider making the trustee active well in advance of a potential sale.[5135] Also note that, if the trust directly or indirectly owns real estate that is rented to the S corporation, a QSST election might complicate a trust's qualification for the self-rental exception, which exception would enable the taxable rental income avoid the 3.8% NII tax, so the trustee might consider retaining some stock in an ESBT, rather than moving all of the stock into a QSST.[5136] See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good.

See part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, for a discussion of various issues one should consider when a beneficiary makes a QSST election.

Other than possible complexity regarding taxes on the earned but undistributed income, a QSST generally has more flexibility than an ESBT. A QSST offers options for deferring S corporation trust tax elections.[5137] If the trustee of an irrevocable grantor trust makes an ESBT election as a protective measure,[5138] the trust's ESBT taxation continues after death,[5139] in effect springing into place without any of the savings that other former irrevocable grantor trusts (including QSSTs) have.[5140]

On the other hand, ESBTs might provide more flexibility that QSSTs in avoiding adverse taxation of certain related party sales of depreciable or amortizable property or in replicating an inside basis step-up if the stock receives a basis step-up. For related party sales, see part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).[5141] For inside basis step-up opportunities,[5142] see part II.H.8 Lack

---

[5135] See part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S corporations in Light of the 3.8% Tax.

[5136] See part II.I.8.g Structuring Businesses in Response to 3.8% Tax, particularly the text accompanying fns. 2042-2043.

[5137] See text accompanying fns. 5076-5077.

[5138] A trustee cannot make a conditional ESBT election. Reg. § 1.1361-1(m)(2)(v). If the trustee of a grantor trust makes an unconditional current ESBT election, the election is in effect but does not control the trust's taxation to the extent trumped by the grantor trust rules. Reg. § 1.641(c)-1(c). T.D. 8994 (5/13/2002) includes the government's response to the idea that a protective ESBT election should be available:

> One commentator suggested that grantor trusts should be permitted to make protective ESBT elections in light of the uncertain status of some trusts that may be grantor trusts under section 674. The IRS and the Treasury Department continue to believe that a conditional ESBT election that only becomes effective in the event the trust is not a wholly-owned grantor trust should not be available. A conditional ESBT election should not be allowed because the ESBT election must have a fixed effective date. If, in the absence of a conditional ESBT election, the trust is an ineligible shareholder, relief under section 1362(f) may be available for an S corporation. In addition, a trust that qualifies as an ESBT may make an ESBT election notwithstanding that the trust is a wholly-owned grantor trust.

[5139] Reg. § 1.1361-1(m)(8), Example (4).

[5140] part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S corporation, especially part III.A.3.b.ii A Trust That Was a Grantor Trust with Respect to All of Its Assets Immediately Before the Death of The Deemed Owner and Which Continues in Existence After Such Death regarding a grantor trust's continuing eligibility to hold S stock for two years after the deemed owner's death. Normal trust income tax rules, which generally are more favorable than ESBT income tax rules, apply during that time. See text accompanying fns. 5114-5117 for ESBT taxation.

[5141] For a comparison of ESBTs and QSSTs, see text accompanying fn. 4198.

[5142] Part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S corporations explains such issues.

of Basis Step-Up for Depreciable or Ordinary Income Property in S corporation, explaining how to replicate an inside basis step-up for property to the extent that Code § 1239 is not triggered, as well as state income tax issues that can complicate matters when the taxpayer is not a resident of the state in which the property is located.[5143]

A QSST complicates purchases made out of earnings, as described in part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST. In ESBTs, interest on the promissory note is deductible only for tax years beginning after December 31, 2006.[5144] A better solution is a trust taxable to its beneficiary under Code § 678.[5145] Also, it might be possible for the income beneficiary to sell S corporation stock to the QSST and not recognize gain or loss on the sale.[5146]

III.A.3.e.iv. Flexible Trust Design When Holding S corporation Stock

Consider a GST-exempt trust with only one beneficiary, with discretionary distributions of income and principal under an ascertainable standard. An independent person is authorized to direct that, for a period of no less than 36 months, all of the income is required to be distributed, based on the following:

- The minimum period of time between ESBT and QSST conversions is 36 months. This minimum period applies between conversions but does not apply to the first conversion. In other words, once the first ESBT or QSST election is made, a conversion to the alternate form (QSST or ESBT) can be made at any time. However, once one converted from a QSST to an ESBT or vice versa, the 36-month period applies in reversing the conversion.[5147] But for this process, Reg. § 1.1361-1(m)(6) provides:

  > An ESBT election may be revoked only with the consent of the Commissioner. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request under the appropriate revenue procedure.

- Mandatory distributions ensure no missteps in distributing income to maintain QSST status, because mandatory income trusts are not required to prove actual distributions of all of the income. However, a trust that actually distributes all of its income qualifies even without a mandatory distribution clause.[5148]

- Before converting, split the trust if it has assets other than S corporation stock, so that the other assets are not subjected to the QSST distribution scheme.

- The independent person would also be authorized to turn off the mandatory income direction for any trust taxable year that begins after the date the mandatory income

[5143] See part II.H.8.a.ii State Income Tax Disconnect.
[5144] Reg. § 1.641(c)-1(d)(4)(ii) provides, (ii) *Special rule for certain interest*. Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion. This was repealed for tax years beginning after December 31, 2006 by Code § 641(c)(2)(C)(iv).
[5145] See fn 4951.
[5146] See part III.B.2.i.xiii QSST as an Alternative Form of Beneficiary Grantor Trust.
[5147] Reg. §§ 1.1361-1(j)(12)(iii), 1.1361-1(m)(7)(iii).
[5148] See fn. 5054.

direction is turned off. (Otherwise, the IRS might argue that the mandatory income provision is illusory because it could get turned off at any time during the year.)

This would open up the opportunity to toggle between QSST and ESBT taxation, while allowing any ESBT income to accumulate inside an environment protected from estate taxes and creditors. After a trust has been an ESBT for 36 months, it may be divided into a separate trust for each beneficiary, and each new trust can separately either continue as an ESBT or become subject to a QSST election.[5149] Thus, every three years the trustee can consider how much of the trust should be a QSST and how much an ESBT and then ask the independent person to adjust the mandatory income direction as appropriate. This toggling decision would take into account the expected annual S corporation income, the beneficiary's adjusted gross income, and the beneficiary's participation in the business (see below).

Note that toggling only affects whether income distributions to that beneficiary are mandatory or discretionary; the beneficiary must remain the trust's sole beneficiary of income[5150] and principal[5151] during the beneficiary's life.[5152] Thus, if the beneficiary has an inter vivos limited power of appointment, the beneficiary can hold the power of appointment during an initial ESBT period,[5153] but once the trust converts to a QSST the beneficiary must permanently renounce the power of appointment.[5154]

S corporation business income is free from the 3.8% tax on net investment income (NII) if the recipient significantly participates in the S corporation's business activity.[5155] For a QSST, one would look to the beneficiary's participation, whereas for an ESBT the IRS would look to the participation of a trustee;[5156] however, for a QSST, the IRS would look to trustee participation when the trust sells S corporation stock or the S corporation sells substantially all of its business assets.[5157] If the beneficiary materially participates in the business, then either QSST or ESBT taxation could avoid the tax, the latter if the beneficiary is appointed as a trustee for purposes of holding the S corporation stock and satisfies the rules for trustee participation.[5158] If the beneficiary does not materially participate in the business, the S corporation income would constitute NII; however, the beneficiary might be in a sufficiently low tax bracket that the 3.8% tax on NII might not apply to the beneficiary at all.

[5149] Letter Ruling 201122003.
[5150] Code § 1361(d)(3)(A)(i).
[5151] Code § 1361(d)(3)(A)(ii).
[5152] Rev. Rul. 93-31 provides that even a remote possibility of these conditions not being met would disqualify the trust from being a QSST. See fn 5063 in part III.A.3.e.i.(a) QSSTs Generally.
[5153] See text accompanying fns. 5104-5105.
[5154] See fm. 5049.
[5155] See part II.I.8 Application of 3.8% Tax to Business Income (application of the 3.8% tax on net investment income), especially part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[5156] See parts II.J Fiduciary Income Taxation (application of the 3.8% tax on net investment income) (particularly fn. 1902 and later sections of part II.J dealing with the sale of QSST or ESBT stock) and II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business (determining when a trust materially participates).
[5157] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).
[5158] See parts II.K.2.b.i Participation by a Nongrantor Trust: Authority and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.

Additionally, if the beneficiary already owns stock in the S corporation, the trust might buy the stock from the beneficiary, perhaps without any capital gain tax on the sale.[5159]

Finally, QSSTs provide more post-mortem tax options than ESBTs, so pre-mortem toggling to QSST status can provide this enhanced flexibility.[5160]

III.A.3.e.v. Converting a Multiple Beneficiary ESBT into One or More QSSTs

III.A.3.e.v.(a). Strategic Issues

Every dollar of ESBT income is taxed at 37% federal income tax and 3.8% tax on net investment income ("NII").[5161] The beneficiaries' federal income tax brackets might be significantly lower,[5162] and the NII tax would not apply except to the extent that their modified adjusted gross income exceeds $200,000 for a single individual or $250,000 for a married person filing jointly.

However, any trustee and tax preparation fees might be deductible by the beneficiaries as miscellaneous itemized deductions (and disallowed for AMT purposes) rather than being deducted directly against the S corporation income.[5163]

This might increase the state income tax on the business income. As an ESBT, only the trust's state income tax posture is considered. Depending on the ESBT's state of residence, the ESBT might not be responsible for tax on the trust's income (particularly investment income) that is not sourced to a particular state. If the trust is converted to QSSTs, each beneficiary would need to file an income tax return for each state in which the S corporation does business, reporting his or her share of each state's income, thereby complicating each beneficiary's income tax return preparation. Additionally, each beneficiary who lives in a state with income tax would need to pay state income tax on his or her share of income, ameliorated in whole or in part by a credit for income taxes paid to other states.

The ESBT might have been accumulating income or perhaps distributing income to separate GST-exempt trusts for beneficiaries, the latter so that each beneficiary decides on a case-by-case basis whether to accumulate income in a protected trust. This accumulation might be important for estate tax reasons, as well as perhaps for nontax reasons. Now, however:

- With the $5+ million estate tax exemption, this accumulation strategy has less estate tax benefit, if the beneficiaries do not have estates near the exemption.

- Trusts that accumulate income face the same increase in federal income tax and NII tax as described above if they are ESBTs or have more than $12,000[5164] in taxable income, so the accumulation strategy would have additional income tax costs.

[5159] See part III.B.2.i.xiii QSST as an Alternative Form of Beneficiary Grantor Trust.
[5160] See text accompanying fn. 5137.
[5161] See part II.I 3.8% Tax on Excess Net Investment Income. It's possible that some ESBT income might be below the adjusted gross income threshold. See part II.J.14 Application of 3.8% NII Tax to ESBTs.
[5162] Consider the effect of phase-outs based on adjusted gross when evaluating the beneficiaries' income tax rates.
[5163] Reg. § 1.67-2T(b)(1).
[5164] $12,150 in 2014; $12,300 in 2015 per Rev. Proc. 2014-61, Section 3.01, Table 5; $12,400 in 2016 per Rev. Proc. 2015-53, Section 3.01, Table 5; presumably higher in future years.

III.A.3.e.v.(b). Implementation

The trustee might consider the following:

- Evaluate the trustee's authority to divide trusts and to convert separate trusts into QSSTs. If the trust has beneficiaries of more than one generation (*e.g.*, children and grandchildren), the trustee needs to consider any fiduciary duties to the lower generations (*e.g.*, grandchildren) in dividing the trust into separate trusts for the upper generation (*e.g.*, children). The trustee might obtain ratification from all adult beneficiaries to protect the trustee. The parent (who is not a beneficiary) of any minor or unborn descendant would sign on behalf of that descendant; this can be problematic if the child who is a beneficiary is divorced or otherwise having marital troubles. A consent by a beneficiary might raise Code § 2702 issues; this is less of a concern if the beneficiary had not been receiving distributions and never expected to receive distributions before that beneficiary's parent's death.

- If centralized management is a concern:

    - Determine whether the trustee is authorized to commingle the QSSTs, treating them as separate shares.[5165] The trustee might maintain a single new bank account for new deposits, which would then either distribute anything it receives or reimburse the existing account for administrative expenses the trust incurs. The division of shares would be done simply by recording the shares on a spreadsheet.

    - See whether the beneficiaries have the right to change the trustees of their separate trusts, which rights they might not have had in the main trust.

- Determine whether paying 100% of annual trustee fees and administrative expenses regarding the QSST portion out of income reasonably and fairly balances the interests of the income and remainder beneficiaries, as the trust might not have another source to pay those fees; the trustee would want to reserve the right to allocate them to principal in the year of sale.[5166] Normally such fees and expenses are allocated one-half to income and one-half to one-half to principal.[5167] Perhaps the corporation would pay the fees, but note that the payment might need to be a separately stated K-1 item, if the character of the fees would change on a beneficiary's income tax return.[5168]

[5165] This is permitted under the last sentence of Code § 1361(d)(3) and Reg. § 1.1361-1(j)(3).

[5166] Gain on sale of stock, including any gain reported on a K-1 form the S corporation issues reporting gain by reason of a Code § 338(h)(10) election to treat a stock sale as an asset sale, is taxable to the trust, rather than the being taxable as the grantor trust portion. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and III.A.3.e.i QSSTs, particularly the text accompanying fns. 5070-5072, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale. For additional planning issues, see parts II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI). Of course, the trust might obtain a distribution deduction by distributing the sale proceeds; see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI), especially part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus.

[5167] Section 501 of the Uniform Principal & Income Act.

[5168] See text accompanying fn. 5163 and Code § 1366(a)(1)(A).

III.A.3.e.v.(c). Timing Tax Deductions in Year of Conversion

Consider which expenses would be better deductions against ESBT or QSST income and pay them in the appropriate time period.

K-1 items need to be pro-rated.[5169]

Presumably, administrative expenses relating to S corporation income would be allocated to the time before and after the conversion and any expenses allocable to the QSST portion would be deductible by the beneficiary.

III.A.3.e.vi. QSST as a Grantor Trust; Sales to QSSTs

Because the beneficiary pays tax on not only the S corporation's distributed income but also its undistributed income, a QSST can be a way to:

- Avoid high trust income tax rates and take advantage of a full run through the beneficiary's graduated tax rates.

- Allow the beneficiary to deduct a loss before the trust's termination, if the stock has sufficient basis.

- Have the beneficiary pay tax on any reinvested earnings used to grow the S corporation, increasing the trust's value and reducing the beneficiary's gross estate.

- Prevent the grantor of a trust for a spouse from being taxed on any reinvested taxable income after divorce.[5170] If the beneficiary/former spouse may also receive principal distributions, the beneficiary may elect to treat the trust as a QSST, thereby ensuring that the taxable items of the trust's assets inside an S corporation owned by the trust are taxable to the beneficiary, whether or not actually distributed to the beneficiary.[5171]

- Allow the beneficiary to sell S corporation stock (and, indirectly, other assets) to the trust on what appears to be a tax-free basis.[5172] A sale to an irrevocable grantor trust is a powerful estate planning technique.[5173] Clients sometimes balk at selling assets to a trust where they are not beneficiaries, because they might need the assets for their living expenses. For a client who refuses to part with all of the enjoyment of sufficient assets, consider suggesting that he or she sell assets to a trust in which he or she is a beneficiary and is the deemed owner - a beneficiary grantor trust.[5174]

[5169] See part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S corporation.

[5170] Code § 677 treats the grantor as owners of any items that can be distributed to or held for eventual distribution to the grantor or the grantor's spouse. Code § 672(e)(1)(A) treats as the spouse any individual who was the spouse of the grantor at the time of the creation of such power or interest. Thus, divorce does not terminate grantor trust treatment. However, Reg. § 1.682(a)-1(a)(1) provides that the grantor is not taxed as the owner to the extent that income is paid, credited, or required to be distributed and therefore taxed to the former spouse.

[5171] See fn. 5056, noting the contrast between paragraphs (ii) and (iii) within Example (10).

[5172] See part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls).

[5173] See part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

[5174] See part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

The grantor trust aspects can be powerful planning techniques but are also subject to some significant disadvantages.[5175]

Beneficiary grantor trusts involve complex tax issues, including the risk that the Internal Revenue Service, which generally has stopped issuing private letter rulings regarding such trusts,[5176] might at some point take a position inconsistent with its many past favorable private letter rulings. The complexity involved often includes a sale being highly leveraged (sometimes using a trust funded with no more than $5,000), which might invite IRS scrutiny.

QSSTs do not face the funding issues that apply to many other beneficiary grantor trusts. They can be funded very substantially and still be entitled to grantor trust treatment.

III.A.3.e.vi.(a). Grantor Trust Issues Involved in a Sale of S Stock to a QSST

If a QSST buys the beneficiary's stock from the beneficiary after making a QSST election for its then-existing S stock (issued by the same corporation), that would be a disregarded transaction for income tax purposes, following the general principle under Rev. Rul. 85-13 that a transaction between a trust and its deemed owner (for income tax purposes) is disregarded (for income tax purposes).[5177]

The regulation that treats the beneficiary as the Code § 678(a) provides that the trust's <u>selling</u> or <u>distributing</u> the stock is attributable to the trust, not the beneficiary,[5178] but does not discuss the consequences of the trust <u>buying</u> S corporation stock. This regulation overrode Rev. Rul. 92-84, which applied grantor trust treatment to a QSST's sale of S corporation stock; however, the logic of Rev. Rul. 92-84 might continue to apply (as a matter of good analysis, not as a matter of precedent) to the extent that the regulation is silent. The preamble to the regulation[5179] overrode Rev. Rul. 92-84 for practical reasons: if the trust no longer holds S stock during the deferred consummation of an installment sale, how could QSST treatment apply? That should not be a concern when the trust is <u>buying</u> stock. Although the IRS might have concerns about the asymmetry involved (the trust buying stock from the beneficiary having a different result than the trust selling stock to the beneficiary), those concerns would not appear to be supported by the IRS' official pronouncements.[5180]

5175 See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

5176 Rev. Proc. 2015-3, Section 4.01(39), provides that ordinarily the IRS will not rule on:

> Whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under § 671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of § 2041, if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.

5177 Code § 1361(d)(1)(B) provides, for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the [QSST] election … is made.

5178 For gain on sale of stock or assets and for related planning opportunities, see text accompanying fns. 5070-5072.

5179 T.D. 8600.

5180 This asymmetry already exists under Rev. Rul. 85-13. In that ruling, initially the trust was not a grantor trust. The grantor bought stock from the trust in exchange for an unsecured promissory note. The note's existence is what made the trust a grantor trust deemed owned by its grantor and caused the transaction

If an income beneficiary who sells S corporation stock to an existing QSST that already owns stock in the same S corporation, the above analysis might be more comfortable. Three companion private letter rulings, in approving the merger of one QSST into another, used analysis that supports this concept:[5181]

> Under 1.1361-1(j)(7), the X shares which make up the corpus of Exempt QSST A and Exempt QSST B are treated as directly owned by Y. Any transfer of the X shares, pursuant to a merger under Article 5.6, would effectively be a transfer of the shares from Y to Y.

What is the tax treatment of interest payments on a promissory note a QSST uses to buy stock in an S corporation?[5182] The IRS has taken the position that, when the QSST buys stock from a

---

to be disregarded. On the other hand, if the trust had bought stock from its grantor, its grantor would have recognized gain on the sale, because a promissory note owed by the trust to the grantor would not have triggered grantor trust status. This asymmetry did not prevent that ruling from becoming the IRS' formal position.

Notice 97-24 points out that Rev. Rul. 85-13 avoids assets receiving a basis step-up. In the case of a beneficiary selling to a QSST, if the beneficiary did not pay capital gain tax on the sale to the trust, then the stock the trust acquires, which will be outside of the estate tax system, will not receive a new basis and therefore will be taxed more highly to the trust if sold after beneficiary's death (or after any other event terminating grantor trust status).

Based on a long line of law, Rev. Rul. 85-13 held that the deemed owner was the deemed owner of the trust's property. See fn. 5521.

The bottom line is that the beneficiary would be deemed to own the stock that the beneficiary sells to the trust both before and after the proposed transaction. One cannot have a recognition event when one sells closely-held business stock, which Rev. Rul. 90-7 expressly held is deemed owned by a trust's deemed owner, to oneself. Rev. Rul. 85-13 recognized this longstanding principle when it reasoned:

> A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. See *Dobson v. Commissioner*, 1 B.T.A. 1082 (1925).

The *Dobson* case itself involved closely-held business stock. Rev. Rul. 2007-13 reaffirmed this concept, and it should be applied to the sale to a QSST as well.

[5181] Letter Rulings 200441013, 200441014, and 200441015.

[5182] In all fairness, the beneficiary should get the deduction, especially in light of the separate share rules under Code § 663. However, an argument can be made that only S corporation K-1 items are treated as part of the Code § 678 share allocated to the beneficiary. Code § 1361(d)(1)(B) provides, "for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made...." On the other hand, Code §§ 1361(d)(1)(B) and 641(c)(1)(A) use very similar language. Therefore, when an issue is not expressly addressed by authority, the ESBT and QSST rules should be read consistently. The principle behind the ESBT regulation quoted in fn 5144 tends to support the beneficiary's deduction of interest under Code § 1361(d)(1)(B) (or a disregard of the interest income and deduction under Code § 678 if the seller is the beneficiary), because the Regulation's allocation of the interest to the S portion remains intact.

Furthermore, often a trust that holds stock in an S corporation is split off as a separate QSST, which never accumulates any income, because all of the income is distributed to the beneficiary. Allocating income to a nonexistent non-S portion would not make sense in those situations. That contrasts with ESBTs, where generally there is no reason for the S stock to be held in a separate trust.

Allocating the interest deduction to the non-S corporation portion of the trust would result in a mismatch, in that the interest the trust pays is allocated to income that the beneficiary, not the trust, is treated as owning for income tax purposes. It would appear to run counter to the spirit of the debt-tracing rules of Reg. § 1.163-8T, which would characterize the interest as related to the S corporation. If the interest is allocated to the non-S corporation portion of the trust, its deductibility should relate to the nature of the income passing through on the K-1 the trust receives from the company. To the extent the K-1 income is third party using a promissory note, the note is part of the S corporation portion that is deemed owned by the QSST's beneficiary and therefore is deductible by the beneficiary.[5183] Informal conversations indicated that this position was the result of discussions at the highest levels of IRS policy-makers. Interest expense is deductible on Schedule E, Part II of the beneficiary's individual income tax return.[5184]

This position - that the promissory note is part of the S corporation portion that the beneficiary is deemed to own - gives me confidence that a beneficiary's sale to a QSST would be disregarded under Rev. Rul. 85-13 because the beneficiary would be considered to be selling to himself or herself.[5185]

III.A.3.e.vi.(b). Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made)

Using QSSTs involves challenges that do not apply to other Code § 678 trusts. Consider the disadvantages of an S corporation as an investment vehicle that is shared among family members:

---

income from a trade or business, presumably the interest would be expense from trade or business that would generate a net operating loss carryover if the trust did not have sufficient other income. Reg. § 1.163-8T(a)(4)(i). Notice 89-35 supports this approach:

> In the case of debt proceeds allocated under section 1.163-8T to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and the associated interest expense shall be allocated among all the assets of the entity using any reasonable method. Reasonable methods of allocating debt among the assets of a passthrough entity ordinarily include a pro-rata allocation based on the fair market value, book value, or adjusted basis of the assets, reduced by any debt of the passthrough entity or the owner allocated to such assets.

If the trust generates a net operating loss (NOL) carryforward due to the interest expense, be sure not to make an ESBT election, as Chief Counsel Advice 200734019 takes the position that the NOL carryforward is not deductible against ESBT income.

[5183] CCA 201327009 allows the beneficiary to deduct the interest when the QSST buys from a third party using a promissory note. The IRS declined to rule on the loan's effect under the at-risk rules out of concern that taxpayers would set up a Code § 465(c)(4) device to limit liability. Because the trust had no other assets, debt tracing was not a concern, and all of the interest was allocated to the S corporation activity. The IRS also declined to address the passive loss rules.

[5184] The 2013 instructions to Form 1040, Schedule E, Part II say:

> Interest expense relating to the acquisition of shares in an S corporation may be fully deductible on Schedule E. For details, see Pub. 535.

Publication 535, for use in preparing 2013 returns, says to report interest expenses from S corporation business borrowing on Schedule E (Form 1040), line 28, entering interest expense and the name of the S corporation in column (a) and the amount in column (h). Presumably this would also apply to loans to a QSST to acquire stock in an S corporation.

[5185] This background on CCA 201327009 results from informal discussions with an attorney, who has since left the IRS, when I asked whether the IRS would consider approving a sale to a QSST. The IRS informally indicated that it would decline to issue such a ruling if I sought it, because it was not totally certain of the result and does not wish to encourage sales to Code § 678 trusts. It was suggested that the IRS never would have approved a sale to an irrevocable grantor trust if it had realized that the technique would become so popular.

- Inability to Divide S corporation. An S corporation that does not engage in a trade or business would not be able to be divided income-tax free under Code § 355.[5186] This would trap all family members in a single investment entity, unable to manage investments suitable for each person's goals.

- Tax Cost of Distributing Investments. A distribution of investments would be taxed as a sale.[5187] Thus, distributing marketable securities to family members so that they go their separate ways would subject them to capital gain tax on the deemed sale of the investments. Distributing depreciable property might subject them to tax on ordinary income.[5188]

  However, pre-mortem planning might help. Suppose the trust is a credit shelter trust or a GST-exempt trust and the beneficiary's estate is subject to estate tax. If the QSST sells its investments that have unrealized gain, the income (capital gain) tax liability will be a debt deductible on the beneficiary's estate tax return. Harvesting gain would prevent the distribution of securities from being a taxable event at the shareholder level. However, the distribution of securities in a corporation would generate income tax to the extent that the fair market value of the distribution exceeds the basis (and might generate dividend income if and to the extent the corporation had been a C corporation and the distribution constituted a distribution of earnings and profits); on the other hand, the recognition of gain on the sale of securities would increase the stock's basis.[5189] Just be sure that the pre-mortem gain harvesting is not pursuant to a plan of liquidation[5190] or a sale of stock combined with a Code § 338(h)(10) election;[5191] either event would subject to sale of assets to stock at the trust's level, rather than the beneficiary's level.[5192]

- Inability to Swap. Although a beneficiary does not recognize gain or loss when selling S corporation stock to a QSST, the trust would recognize income on selling S corporation stock back to the beneficiary.[5193]

- All Income Must Be Distributed. A QSST must distribute to its beneficiary all of its trust accounting income. This can be controlled by the S corporation not making distributions to the trust. The IRS might argue that the beneficiary's failure to compel the trustee to compel a distribution from the S corporation constitutes a gift. Note, however, that the IRS considers 3%-5% to be a reasonable range for income distributions, so the IRS should view any distributions within than range as sufficient.[5194] If distributions were below this range, the IRS

[5186] See part II.Q.7.f Corporate Division, including part II.Q.7.f.iii Active Business Requirement for Code § 355.
[5187] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.
[5188] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property.
[5189] See part II.Q.7.b Redemptions or Distributions Involving S corporations.
[5190] See fn. 5071, found within part III.A.3.e.i.(a) QSSTs Generally. This is important because an S corporation that used be a C corporation can avoid dividend taxation by engaging in a liquidation; see fn. 4032, found within part II.Q.7.a.vii Corporate Liquidation.
[5191] See fn. 5072, found within part III.A.3.e.i.(a) QSSTs Generally.
[5192] In addition to the citations within fns. 5190 and 5191, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).
[5193] Reg. § 1.1361-1(j)(8); see fns. 5070-5072.
[5194] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text accompanying fn. 2289.

would argue that the lapsing withdrawal right 5-and-5 safe harbor of Code § 2514(e) that appears to protect such a small lapse is calculated in a way that does not provide much protection.[5195]

- Personal Use Assets. Placing personal use assets inside an S corporation would require the charging of rent. The S corporation would recognize rental income, and those paying rent would not be able to deduct that rent. If the beneficiary uses a trust asset for personal purposes, he does not need to pay rent, since the point of the trust is to benefit him.

These limitations are not imposed on Code § 678(a)(2) trusts. When their assets are divided among family members, the division is done on a tax-free basis and they can each go their separate ways quite easily.

Consider who pays income tax for the year in which the beneficiary dies.[5196] These considerations also apply when the beneficiary of a Code § 678(a)(2) trust dies, although the beneficiary of the latter has a broader power of appointment than the former.

Income tax difficulties in splitting an S corporation after the beneficiary's death might be addressed as follows:

- Form a Partnership. By forming an entity taxed as a partnership with the beneficiary, other family members, or other trusts, a QSST might be able to access investment opportunities not otherwise available to it or might be able to facilitate their access to investment opportunities not available to them. Although such a partnership could preserve the expected annual cash flow, the commitment to retaining funds in the partnership would reduce the fair market value of the S corporation's partnership interest. This value reduction would also reduce the tax if the corporation distributes some or all of assets when the QSST divides upon the beneficiary's death. Such a partnership should be formed well in advance of the beneficiary's death.[5197] When the beneficiary dies, perhaps the S corporation would distribute some of its partnership interests right away so that the trust could immediately fund part of the bequests; then, later, after the trustee is satisfied that all tax and other fiduciary liabilities have been resolved, the S corporation could distribute the remaining partnership interests.[5198] Furthermore, the

---

[5195] *Fish v. U.S.*, 432 F.2d 1278 (9th Cir. 1970), held that Code § 2514(e) measures the lapse of a right to income by multiplying the income, rather than the trust's value, by 5%. *Fish* cited Senate Report No. 382, 82nd Cong., 1st Sess., pp. 6-7 (2 U.S. Code Congressional and Administrative News (1951) 1530, 1535). Here is an excerpt to which it may have been referring:

> The committee amendment provides an annual exemption with respect to lapsed powers equal to $5,000 or 5 percent of the trust or fund in which the lapsed power existed, whichever is the greater. Thus, for example, if a person has a noncumulative right to withdraw $10,000 a year from the principal of a $200,000 trust fund, failure to exercise this right will not result in either estate or gift tax with respect to the power over $10,000 which lapses each year prior to the year of death. At his death there will be included in his gross estate the $10,000 which he was entitled to draw for the year in which his death occurs, less any sums which he may have taken on account thereof while he was alive during the year. However, if, in the above example, the person had had a right to withdraw $15,000 annually, failure to exercise this right in any year prior to the year of death will be considered a release of a power to the extent of the excess over 5 percent of the trust fund.

[5196] See part III.A.3.d Special Fiduciary Income Tax Issues Regarding Bequeathing S corporation Stock and Partnership Interests.

[5197] See part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially fn 4231.

[5198] Distributing in stages would tend to alleviate the concerns described in fn 4231.

partnership could later divide in a variety of ways on a tax-free basis,[5199] so that each family member can implement his or her own investment strategy over time; however, if the family members do not have strategies that either are consistent with each other's or complement each other's, pursuing different investment strategies would rend to require asset sales that might generate capital gain tax.[5200]

- Create Separate Corporations. Suppose a trustee decides to contribute its assets to an S corporation with the expectation that the beneficiary will make a QSST election. Instead, consider forming a separate S corporation for the future benefit of each of the beneficiary's children. When the beneficiary dies, each of the beneficiary's children will be allocated a separate S corporation, thereby eliminating the need to divide the corporation or distribute its assets. This solution merely postpones the issue, because these issues would need to be addressed when a child of the beneficiary dies (or if a child predeceases the beneficiary, but that postponement might be sufficiently beneficial to address concerns for a while).

See also parts II.A.2.d.ii Estate Planning and Income Tax Disadvantages of S corporations, II.A.2.d.iii Which Type of Entity for Which Situation? and III.A.3.d Special Fiduciary Income Tax Issues Regarding Bequeathing S corporation Stock and Partnership Interests.

III.A.3.e.vi.(c). Required Structure for a Sale to a QSST (Including Possible Pitfalls)

In QSSTs, all income must be distributed to the beneficiary.[5201] Therefore, at first glance, it would appear impossible for a QSST to use its S corporation distributions to buy stock.

However, if a QSST buys stock in a secured sale in which it pledges all of its S corporation distributions, the trust never receives the distributions, so the trust has no income receipts to pay

---

[5199] See part II.Q.8 Exiting From or Dividing a Partnership.

[5200] If the strategies are consistent with each other's, then the partnership could simply divide pro rata. If the strategies complement each other's, then each person could take the assets that interest him or her. Anything else would require post-division adjustments, most likely accomplished through sales.

[5201] Reg. § 1.1361-1(j)(1)(i) provides

> All of the income (within the meaning of § 1.643(b)-1) of the trust is distributed (or is required to be distributed) currently to one individual who is a citizen or resident of the United States. For purposes of the preceding sentence, unless otherwise provided under local law (including pertinent provisions of the governing instrument that are effective under local law), income of the trust includes distributions to the trust from the S corporation for the taxable year in question, but does not include the trust's pro rata share of the S corporation's items of income, loss, deduction, or credit determined under section 1366….

to the beneficiary.[5202] Private letter rulings have readily accepted this theory for mandatory income trusts;[5203] this theory should apply to a discretionary income trust.[5204]

A significant disadvantage is that this method might take twice as long as a normal sale to a grantor trust. In most states, the trustee must transfer from principal to income an amount equal to the income paid to reduce the principal balance of the note (as used in this part III.A.3.e.vi.(c), the "adjustment amount").[5205] Thus, although note payments complete the sale (the obligation to the beneficiary in the beneficiary's capacity as a creditor), they create an obligation that the trust owes to the beneficiary as a beneficiary:

- Worst Case Scenario – Simplistic view. In other words, first the trust repays the note, then the trust repays the beneficiary the income that was diverted from the beneficiary (as a beneficiary) to pay the note. Thus, the original note principal is not removed from the estate tax system until both the note and the adjustment amount to the beneficiary are fully paid. However, if the adjustment amount is not expected to paid made for a while, consider that the possible inclusion of the adjustment amount in the beneficiary's estate might very well be the present value of that principal distribution, which might be significantly less than the amount of the principal that is owed.

- Actual Law – Not So Bad? The trust's obligation is to transfer to income principal equal to the adjustment amount. This means that, when the trust receives cash generally classified as principal, it must reclassify that cash as income, to the extent of the adjustment amount. That

[5202] The trust would need to pay any future cash receipts of principal to the beneficiary to make up for this diversion of amounts that would otherwise constitute trust accounting income. Adopting Section 502(b) of the Uniform Principal and Income Act (last amended or revised in 2008; see http://www.uniformlawcommission.com/Act.aspx?title=Principal and Income Amendments (2008)), RSMo section 469.453.2 provides:

> If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee shall transfer from principal to income an amount equal to the income paid to the creditor in reduction of the principal balance of the obligation.

[5203] This accounting treatment is consistent with Letter Rulings 200140040 (which not only diverted dividends to repay the seller but also required that the trust pay additional purchase price if it resold the stock within a certain period of time after buying the stock), 200140043, and 200140046 (trust's purchases from another shareholder), as well as 9140055 (distributions used to pay bank loan used to buy stock), which rulings essentially treated the repayment of principal on the notes as income disbursements rather than principal disbursements. See also Letter Ruling 9639013, permitting the use of income to repay notes on a seller-financed sale to QSSTs, CCA 201327009 did not expressly consider this issue. However, based on the facts and conclusion, it implicitly assumed that the use of S corporation distributions to repay the note was permitted.

Other rulings dealing with principal and income issues include Letter Rulings 9140055 (beneficiary repayment of trust distribution to pay interest QSST owed bank), 200446007 (deemed dividend is not fiduciary accounting income and therefore not required to be distributed), and 200451021 (redemption treated as distribution for income tax purposes, but proceeds were principal not required to be distributed).

[5204] What if the trust would be relying on the payment of actual income to satisfy Code § 1361(d)(3)(B) and Reg. § 1.1361-1(j)(1)(i)? One might be concerned that the trust would be receiving no income and therefore would be making no distributions of income. On the other hand, all of the company's distributions that are payable to the trust would in fact wind up in the hands of the trust's sole beneficiary; it will simply get there as a note repayment, rather than as a distribution. Thus, relying on the payment of actual income would not appear to violate the spirit of Code § 1361(d)(3)(B) and Reg. § 1.1361-1(j)(1)(i).

[5205] See fn. 5202.

principal receipt might never happen during the beneficiary's life, and the trust might never be required to pay the beneficiary.

Consider the following ways to repay this additional obligation, if it exists:

1. Suppose the trust is a discretionary income trust. Perhaps an independent trustee would be able to toggle on and off the mandatory income feature (which, of course, is not possible in a one-lung QTIP plan[5206] but might be possible using a *Clayton*-QTIP plan).[5207] After the note is repaid, the independent trustee might turn off the mandatory income obligation. If the beneficiary never needs the income under the standards provided by the trust, the trust might accumulate funds thereafter and never pay cash equal to the full adjustment amount. However, the IRS might argue that such a modification undermines the point of recharacterizing the principal as income,[5208] so consider a compromise: Instead of the trustee accumulating income under the discretionary standards and perhaps never paying the adjustment amount, the trustee and beneficiary come to the following agreement: The trustee agrees to pay future income to the beneficiary to the extent of the adjustment amount, notwithstanding the fact that the trustee has determined that the beneficiary would not receive income under the trust's new distribution standards. That income is payable until the earlier of the beneficiary's death or amounts equal to the adjustment amount have been paid. The trustee might sign a revocable letter directing the company to pay the beneficiary directly any distributions of income (up to the adjustment amount) that normally would have gone to the trust.

2. If the trust is a mandatory income trust, see whether the corporation will make a distribution to all shareholders in partial liquidation of the entity or merely redeem the trust's stock, depending whether it is important to keep proportionate stock ownership. Such a distribution or redemption might very well constitute a nontaxable return of AAA (reinvested S corporation taxable income).[5209] For example, a partial liquidation would be a principal distribution for trust accounting purposes (even if it is a distribution of AAA for income tax purposes) that could then be used to repay the principal obligation.

3. If the trust has other assets, then gain from the sale of other assets would be used to repay this principal obligation. Being transferred to income[5210] or being used to determine a distribution[5211] should cause the capital gain to be taxed to the beneficiary.

When drafting a trust that might engage in such a transaction, keep in mind the above issue. Perhaps the trustee might have some flexibility in allocating receipts and disbursements between

---

[5206] For an explanation of a one-lung plan, including some of its advantages and disadvantages, see part II.H.2.a Free Basis Step-Up When First Spouse Dies.
[5207] For a description of a *Clayton*-QTIP plan, see the paragraph accompanying fn. 5223.
[5208] Reg. § 1.643(b)-1 provides, "Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized." See part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law, especially the text accompanying fn. 2288.
[5209] See part II.Q.7.b Redemptions or Distributions Involving S corporations.
[5210] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law.
[5211] See part II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.

principal and income?[5212] Perhaps the trust might have a provision requiring the trustee to give the beneficiary notice of a right to principal and provide that the right to that principal adjustment lapses as provided in Code § 2514(e)?

Consider whether the IRS might attack the sale as follows: The IRS might argue that stock's value exceeded the sale price; therefore, the IRS might argue, the seller made a gift to a trust that benefits the seller, triggering Code § 2036 inclusion. One might consider using a defined value clause,[5213] instructing the trustee to distribute any excess value to a separate share of the trust, of which 10% would be structured as a completed gift (no power of appointment over the remainder) and 90% would be structured as an incomplete gift (power of appointment over the remainder - perhaps even a presently exercisable withdrawal right). With adequate disclosure, the gift tax statute of limitations would run regarding how much comprises the completed gift and incomplete gift portions.[5214] The separate share of the trust would be treated as a separate trust for QSST purposes; however, the separate share's treatment as a grantor trust as to the seller[5215] would make a QSST election unnecessary during the seller's life.

Such a possible Code § 2036 attack may deter using this technique. If one is trying to move miscellaneous assets by contributing them to an S corporation and selling the S corporation stock to a trust, consider instead using a preferred partnership.[5216] However, if one has an operating business in an S corporation, a preferred partnership is not available[5217] unless the transferor is the sole owner or all of the owners have the same estate planning goal.[5218]

III.A.3.e.vi.(d). Using a QSST to Buy Stock When Using a "One-Lung" Marital Deduction Plan

One of my favorite estate planning tools for married couples is to bequeath the entire residue into a trust that can qualify to the QTIP marital deduction. The executor may elect a marital deduction with respect to none, part, or all of the trust. For an explanation of some of the advantages and disadvantages of such a plan, see part II.H.2.a Free Basis Step-Up When First Spouse Dies.

More recently, I have been including in the trust the authority for an independent trustee to make distributions for the surviving spouse's welfare. If the surviving spouse is the trustee, he or she may appoint as a co-trustee a person who is not a related or subordinate party,[5219] who could make a distribution for welfare and then resign.

5212 For flexibility in allocating between income and principal, see part II.J.8.c.i Capital Gain Allocated to Income Under State Law, which includes a sample general clause (not geared toward the QSST sale issue) as well as the regulations governing such allocations.
5213 See part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.
5214 See part III.B.4 Adequate Disclosure on Gift Tax Returns.
5215 Code § 677.
5216 See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.
5217 A partnership is not an eligible owner of a S stock. Code § 1361(b)(1)(B); see part II.A.2.e.v Relief for Late S corporation and Entity Classification Elections for the Same Entity.
5218 If the transferor is the sole owner or all owners have the same estate planning goals, the S corporation itself could contribute its assets to a preferred partnership. See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.
5219 As fn. 5674 explains, the spouse's power to appoint a trustee who can distribute for the spouse's welfare will not cause the spouse to hold a general power of appointment if the trustee is not a related or subordinate party, as defined in Code § 672(c) (see fn. 2097).

Suppose the decedent's estate tax exemption is insufficient to cover all of the decedent's S corporation stock. Some S corporation stock is allocated to a trust excluded from the estate tax system (a "nonmarital trust"), and the rest is allocated to a marital deduction trust (a "marital trust"). The surviving spouse elects QSST treatment for each trust.[5220] The marital trust distributes its S corporation stock to the surviving spouse, who then sells it to the nonmarital trust in exchange for a promissory note.

If the client has an independent trustee who is quite comfortable with the surviving spouse and the remainderman, one might consider using *Clayton*-QTIP planning.[5221] *Clayton*-QTIP planning is where the portion that is not elected QTIP goes to a trust that has different dispositive provisions than the portion that is elected QTIP.[5222] In the nonmarital trust, an independent trustee would be able to distribute income for the surviving spouse's welfare (in addition to any other desirable discretionary distributions for the surviving spouse). This would help address a particular drawback to sales to QSSTs.[5223]

III.A.3.e.vi.(e). Converting Existing Trust to a QSST to Obtain Beneficiary Grantor Trust Status

Suppose the client is the beneficiary of an existing GST-exempt trust with discretionary distributions. Consider converting the trust into a QSST, by whatever legal means are available to do so. Consider the ideas discussed in parts III.A.3.e.iv Flexible Trust Design and III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs.

Then the client can sell the client's S corporation stock to the QSST.

If the client does not have an S corporation, the client could contribute assets to an S corporation and then sell the S corporation stock to the trust. Alternatively, an existing GST-exempt trust with only one beneficiary might simply form an S corporation and the beneficiary make a QSST election, effectively converting the trust to a beneficiary grantor trust.[5224] However, in either case, be sure to consider exit strategies upon the client's death, as described in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

III.A.3.e.vi.(f). QSST to Convert Terminating Trust to GST-Exempt Life Trust

Suppose the client created a trust for children that terminates at various ages. The client could create a QSST for each adult child.

See part III.A.3.e.vi.(e) Converting Existing Trust to a QSST for considerations involved in using this strategy.

[5220] Using this strategy, a QSST election is required for the nonmarital trust but not for the marital trust. However, making such an election for the marital trust tends to simplify income tax issues.

[5221] Authorizing an independent trustee to be the executor with authority to make the QTIP election should avoid any attack the IRS might make whether a spouse who is the executor had made a gift to the extent that failure to make a QTIP election causes the surviving spouse to lose his or her mandatory income rights.

[5222] Reg. § 20.2056(b)-7(d)(3) authorizes this in response to case law.

[5223] See fn. 5207.

[5224] This would be ideal if the trust is already a mandatory income trust. If the trust is not a mandatory income trust, then complying with the requirement to distribute all income might be tricky.

III.B.2.b. General Description of GRAT vs. Sale to Irrevocable Grantor Trust

For a company whose value is so high that its stock cannot be transferred merely by annual exclusion gifting, we often transfer S stock to irrevocable grantor trusts – trusts whose assets are, or will be later, excluded from the grantor's estate, but whose income is currently taxable to the grantor. Two types of transfers most commonly used are:

- Gift to Grantor Retained Annuity Trust (GRAT).[5476] The grantor gives property (nonvoting stock)[5477] to the trust and receives an annuity for a fixed term of years in exchange for the transfer of property. Usually, the annuity is expressed as a specific percentage of the initial value of the trust's assets.[5478] This initial value is the value determined for federal tax purposes,[5479] and adjustments to payments are required if the initial value is incorrectly determined.[5480] The amount of the gift is the excess of the gifted property's value over the present value of the retained annuity, determined using Code § 7520 interest rates.[5481] If the IRS increases the initial value, the annuity also increases, allowing the grantor to report a gift that is either zero or close to zero. GRATs have become more popular since a 2000 court decision on valuing retained annuities.[5482]

- Sale to Irrevocable Grantor Trust. The grantor establishes an irrevocable trust that is excluded from the grantor's estate for estate tax purposes but treated as owned by the grantor for income tax purposes.[5483] The grantor makes a gift[5484] equal to at least one-ninth of the value of the property the grantor is going to sell.[5485] The grantor sells property (nonvoting stock) to

---

[5476] This is just a summary of certain features of a GRAT that help determine its financial success. The technical requirements are beyond this article's scope. If a GRAT fails to meet the terms required by the statute or regulations, consider a reformation, as occurred in fn. 5381.

[5477] See part II.A.2.i.i.(b) Why Nonvoting Shares Are Needed for Estate Planning.

[5478] Code § 2702(b)(2).

[5479] Reg. § 25.2702-3(b)(1)(ii)(B).

[5480] Reg. § 25.2702-3(b)(2).

[5481] Code § 2702(a)(2)(B).

[5482] Reg. § 25.2702-2(a)(5), giving credit for an annuity payable to an estate, amended in response to *Walton v. Commissioner*, 115 T.C. 589 (2000), *acq*. IRS Notice 2003-72.

[5483] A power commonly used to make a trust be a grantor trust is under Code § 675(4)(C): a power, exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value.

[5484] Arguably the trust should not grant withdrawal rights (*Crummey* rights) to the beneficiaries. The argument is that Code § 678(b) provides that a grantor's rights to income supersede a beneficiary's right to income for grantor trust purposes, but do a grantor's rights to income supersede a beneficiary's right to principal for grantor trust purposes? Letter Rulings 200603040 and 200606006 and numerous rulings before and after those rulings have read Code § 678(b) in the context of taxable income, rather than fiduciary accounting income, so including *Crummey* rights should be OK.

[5485] *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, approved a gift of LLC interests followed by a sale for promissory notes three days later using this structure.

the trust and receives a promissory note.[5486] While the trust is a grantor trust, income tax does not apply to the sale.[5487]

The gift to a GRAT is safer than a sale to an irrevocable grantor trust, in that the grantor can ensure that the gift is close to zero, even if the IRS tries to adjust the property's value; I often use formula sales to mitigate the risk of a sale to an irrevocable grantor trust, but formula sales remain a point of contention.[5488] A sale to an irrevocable grantor trust triggers income tax if the grantor trust powers are turned off;[5489] to the extent that the note's principal exceeds the basis of the trust's assets, a bargain sale is likely to have occurred.[5490] It also does not require an up-front gift, which can cause complexity when the grantor tries to sell stock to an irrevocable grantor trust and does not have enough gift tax exemption available to provide sufficient funding.[5491] Finally, GRATs have a 105-day grace period in the event of a late payment.[5492]

A word about zero gifts: don't do them. To avoid income tax on the annuity payment (GRAT) or on the sale and note payments (sale to irrevocable trust), the taxpayer needs to establish that the trust is a grantor trust. See part III.B.2.h.i Who Is the Grantor. Having even a small gift should satisfy that requirement. In the grand scheme of things, having a $100 or $1,000 taxable gift isn't going to make a material difference in the taxpayer's estate/gift tax exclusion amount. For a sale to an irrevocable grantor trust, if the taxpayer has not opened a bank account before the sale, see whether the trust might have provided for nominal consideration and whether the trustee might have that cash in hand without having opened a bank account. I prefer, however, that, for a sale to an irrevocable grantor trust, the funding be more substantial than that, if possible, as mentioned above.

[5486] If somehow the IRS successfully recharacterizes the note described below as equity, then the Code § 2701 rules come into play. Code § 2701 assigns at least a 10% minimum value to the junior equity, which would be represented by the initial gift to the trust. For example, if the property to be sold is worth $9M, then the gift would be $1M, so that the junior equity would be worth 10% ($1M divided by the $10M total in the trust). This 1/9 funding also provides more substance to the trust. Finally, the trust should make all interest payments on time, and the 1/9 funding provides funding in case corporate cash flow to the shareholders is insufficient (due to a temporary downturn in business, for example).

[5487] Rev. Rul. 85-13.

[5488] Formula sales are described in part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.

[5489] The sale might qualify for installment sale treatment; see Code §§ 453, 453A. Note that the transfer of an installment obligation upon termination of a trust accelerates remaining gain. See part II.G.14 Limitations on the Use of Installment Sales.

Letter Ruling 200722027 asserted that:

- A partnership interest does not qualify for installment sale treatment to the extent that it represents income attributable to Code § 751(c)(2) unrealized receivables for payment for services rendered.
- The seller may report the balance of the income realized from the sale of the partnership interest using the installment method of reporting.

[5490] See fn. 5581, found in part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

[5491] Loan guarantees are commonly used to shore up trusts that are thinly funded; see fn. 5494 regarding thinly funded trusts. For tax consequences of loan guarantees, see part III.B.1.a.ii Loan Guarantees. Although I believe that paying a reasonable guarantee fee is not required to avoid a gift (with which not everyone agrees), it may be helpful to provide a nontax reason why the guarantor provided the guarantee. See part III.B.2.i.v Funding the Trust with Small Gifts. The guarantee fee would be income to the guarantor but not deductible, the latter result because the sale does not exist for income tax purposes. As a practical matter, the appraiser valuing the business should also be able to recommend a guarantee fee.

[5492] Reg. § 25.2702-3(b)(4).

A sale to an irrevocable grantor trust has several advantages over GRATs, if one is willing to take gift tax audit risks:

- Payments back to the grantor are lower and more flexible than in a GRAT.[5493]

- If the grantor dies during the term, the assets in the trust should not be brought back into the grantor's estate[5494] (unlike a GRAT).[5495] On the other hand, if one is using low basis assets and the grantor dies before significant estate tax savings are realized, the tax benefit of the basis step-up from the GRAT's includability might very well exceed the tax detriment of estate tax on the growth. Life insurance might help take some of the sting out of this lack of basis step-up. Also, having a business interest included in one's estate may generate estate tax deferral under Code § 6166, whereas a promissory note is not eligible for that deferral.[5496]

- The grantor can apply GST exemption up front on a highly leveraged basis (in other words, using a small amount of GST exemption relative to the property transferred to the trust);

[5493] A sale uses the applicable federal rate (§ 1274), and a GRAT uses the § 7520 rate, which is 120% of the annual mid-term rate (rounded to the nearest 0.2%). A sale can have interest-only payments with a balloon payment upon maturity, with optional principal prepayments. A GRAT must have relatively even payments, with any year's payment no greater than 120% of the prior year's payment. Reg. § 25.2702-3(b)(1)(ii). Thus, a GRAT requires higher payments up-front, which leaves less in the trust to grow.

[5494] If the promissory note is considered an interest in the trust and is worth less than the stock sold, the IRS might argue that the sale was not for adequate and full consideration and attempt to include the trust in the grantor's estate under Code § 2036(a)(1). The IRS' argument would be that the only source of payment was the transferred property and that the grantor retained an interest in the trust. This has been a point of contention in sales for private annuities, as described in fn. 5448, found in part III.B.1.g.i Private Annuities: Estate Planning Implications. This issue generally does not arise when selling to an individual, as shown by Rev. Rul. 77-193 (but in a more complex set of facts):

> In addition, since B's promise to pay for the timber rights is a personal obligation of B as transferee, the obligation is not chargeable to the transferred property, and the payments are wholly independent of whether or not the transferred property produces income for the transferee. Thus, no part of the transferred property is includible in the transferor's gross estate under section 2036(a)(1) of the Code. See the following footnote in *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U. S. 274, 280 (1958), 1958-1 C.B. 557, 559:
>
> > Where a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for his life-time, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent. *E.g.*, *Estate of Sarah A. Bergan*, 1 T.C. 543, *Acq.*, 1943 Cum. Bull. 2; *Security Trust & Savings Bank, Trustee*, 11 B.T.A. 833; *Seymour Johnson*, 10 B.T.A. 411; *Hirsh v. United States*, 1929, 35 F.2d 982, 68 Ct. Cl. 508; *cf. Welch v. Hall*, 1 Cir. 134 F.2d 366. In these cases the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made.
>
> Accordingly, it is held that section 2036 of the Code does not apply to the transaction under which A conveyed timber rights to B for a term of years in exchange for a cash payment and promissory notes, not all of which had reached maturity at the time of A's death, and A subsequently conveyed all of his interest and estate in the land to C.

[5495] If the grantor dies while receiving payments from a GRAT, then all or part of the GRAT will be included in the grantor's estate under Code 2036(a)(1). In FSA 200036012, the IRS took the position that all of a GRAT is included under Code § 2039, but the better view is that Code § 2039 should not apply, the latter which is now confirmed by Regs. §§ 20.2036-1(c)(2), 20.2039-1(e).

[5496] See part III.B.5.d.ii Code § 6166 Deferral.

whereas, to make a GRAT exempt the grantor would apply GST exemption at the end of its term, based on the trust's asset's values at that time:[5497]

- o If the grantor and spouse split gifts, then each may allocate GST exemption at the back end.[5498] Generally, gifts that may be included in the donor's estate should not be split, because the consenting spouse's gift tax exemption is not restored if the asset is included in the donor's estate. However, splitting GRATs that are nearly zeroed out would make any loss of gift tax exemption be nominal.

- o One might consider the remaindermen selling their interest in the GRAT to a GST-exempt trust when the GRAT is created, so that the GRAT remainder becomes GST-exempt, an approach implicitly rejected by Letter Ruling 200107015 (charitable lead annuity trust, not a GRAT). Commentators have questioned Letter Ruling 200107015, some rejecting and some accepting its result as applied to GRATs;[5499] note that the trustee can make a distribution to a skip person, file the appropriate forms to run the statute of limitations (SOL) on the inclusion ratio, and resolve the issue of inclusion ratio when the SOL runs.[5500] However, also consider whether such a sale might result

[5497] Code § 2642(f). One should opt out of automatic allocation of GST exemption to a GRAT upon inception. Although Reg. § 26.2632-1(c)(1)(i) provides, A direct skip or an indirect skip that is subject to an estate tax inclusion period (ETIP) is deemed to have been made only at the close of the ETIP, Reg. § 26.2632-1(c)(2)(ii)(A) provides that the value of transferred property is not considered as being subject to inclusion in the gross estate of the transferor or the spouse of the transferor if the possibility that the property will be included is so remote as to be negligible. A possibility is so remote as to be negligible if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the property will be included in the gross estate. A counter-argument to this is that the proceeds from annuity payments will be part of the grantor's gross estate no matter when the grantor dies; given that Reg. § 26.2632-1(c)(1)(iii) provides that an ETIP applies to the entire trust if any part of it is subject to an ETIP suggests that the less than 5% so remote as to be negligible exception will not apply to a GRAT until all of the annuity payments have been paid. Rather than choosing which argument is right, I take the easy route and opt out. Letter Ruling 201705002 allowed a donor to opt out late when she instructed the gift tax return preparer to opt out and the preparer inadvertently failed to elect out of the automatic allocation of GST exemption.

[5498] Code § 2652(a)(2); Reg. § 26.2652-1(a)(4), the latter which provides:

> *Split-gift transfers*. In the case of a transfer with respect to which the donor's spouse makes an election under section 2513 to treat the gift as made one-half by the spouse, the electing spouse is treated as the transferor of one-half of the entire value of the property transferred by the donor, regardless of the interest the electing spouse is actually deemed to have transferred under section 2513. The donor is treated as the transferor of one-half of the value of the entire property. See § 26.2632-1(c)(5) Example 3, regarding allocation of GST exemption with respect to split-gift transfers subject to an ETIP.

See also Reg. § 26.2632-1(c)(2), applying ETIP regarding the life of a spouse even if no gift splitting occurred.

[5499] See Harrington, Plaine & Zaritsky, ¶ 9.12[5] Assignments of Remainder Interests—Uncharted Waters (found within ¶9.12. Examples of Deferring or Minimizing the Application of the Generation-Skipping Transfer Tax), *Generation-Skipping Transfer Tax* (WG&L). But see Bramwell and Weissbart, The Dueling Transferors Problem in Generation-Skipping Transfer Taxation, *ACTEC Law Journal*, Vol. 41, No. 1 (Spring 2015) (concluding that the sale strategy does not work because the sale does not change the transferor).

[5500] See part III.B.3.a.ii Sale from One Trust to Another, especially the text accompanying fn. 5922.

in the IRS arguing that the purchaser trust is included in the seller's estate if the seller is a beneficiary.[5501]

S corporation stock can work very well for a GRAT or sale to an irrevocable grantor trust over a 5-10 year period. Frequently, S corporation stock is valued at 4-5 times earnings, so it is easy to pay for the sale. For example, suppose an S corporation generates $200,000 of net cash flow per-year and distributes $90,000 each year to the shareholders so that they can pay their taxes. The corporation is worth $1 million (5 times earnings). In the first year, the promissory note payments from the trust to the grantor are $90,000, which the grantor uses to pay taxes as usual. The $90,000 payments are $60,000 interest (using a 6% AFR) and $30,000 principal. If the corporation distributes all of its earnings to get estate tax matters taken care of, then it distributes $200,000 in the first year, which the trust could use to pay $60,000 interest and $140,000 principal. In the second year, the trust could use the $200,000 distribution to pay $51,600 interest and $148,400 principal. The note could easily be paid off in 5-10 years, even if the corporation's earnings do not increase.

Thus, a sale of an interest in an entity taxed as a partnership or S corporation to an irrevocable grantor trust works especially well because the entity makes distributions to its owners to pay taxes and the trust itself does not pay taxes and can use that distribution to pay the note. Contrast that to a C corporation, where the corporation pays its own taxes and avoids paying dividends to avoid double taxation on earnings.[5502]

For hard-to-value assets, a GRAT that does not have a lot of cash flow might require payments be made in kind. The IRS might argue that the payments back to the grantor were overvalued, so that the grantor really did not receive a large enough annuity payment. To reduce this possibility, consider using do an increasing annuity with enough liquid assets to be sure to pay the first three years of payments, the GRAT borrowing from a bank to make the distributions, or using a formula distribution equal to the annuity payment.

[5501] See *Estate of Magnin v. Commissioner*, 184 F.3d 1074 (9th Cir. 1999) (not included in seller's estate), *rev'g* T.C. Memo. 1996-25; *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997) (not included in seller's estate), *rev'g* 77 A.F.T.R.2d 96-1411 (W.D. Tex. 1996); *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309 (3rd Cir. 1996) (not included in seller's estate), *rev'g* 105 TC 252 (1995), *cert. denied* 1997 WL 134397 (5/19/1997). *D'Ambrosio* distinguished *Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd* 897 F.2d 516 (Fed. Cir. 1990), and *Pittman v. United States*, 878 F.Supp. 833 (E.D. N.C. 1994), with the Fifth Circuit stating:

> In support of its equilibrium rule, the *Gradow* court cited precedent in the adequate and full consideration area, most notably *United States v. Allen*, 293 F.2d 916 (10th Cir.), *cert. denied*, 82 S.Ct. 378 (1961).
>
> ….
>
> The problem with the *Gradow* dicta is that, in its effort to escape the hypothetical posed by the taxpayer, it lost sight of the very principle the court was trying to apply; namely, the notion that adequate and full consideration under the exception to section 2036(a) requires only that the sale not deplete the gross estate. *Gradow* was correct in observing that it is not unreasonable to require that, at a minimum, the sale accomplish an equilibrium for estate tax purposes. *Gradow*, 11 Cl. Ct. at 813-14. Indeed, *United States v. Allen*, 293 F.2d 916, when properly construed, stands simply for that proposition.

CCM 201745012 listed other reasons why it believes that that a deathbed purchase by the grantor of a GRAT of the remainder interest for its actuarial value did not work.

[5502] For other issues comparing C corporations to pass-through entities, see part II.E.2.a Transferring the Business.

For a sale to an irrevocable grantor trust involving an asset that does not generate much cash flow, consider how the note will be repaid; if one cannot develop a solid plan for repaying the note consider alternative strategies. Consider instead using a GRAT or sale to an irrevocable grantor trust to generate cash flow, which then might be used to buy that non-cash-flowing asset. GRATs and sales to irrevocable grantor trusts can also be used to roll out of a split-dollar arrangement, which generally require an exit strategy.[5503]

For marketable securities, consider using a rolling, asset-splitting GRAT strategy, which is as follows:[5504] The grantor divides the grantor's marketable securities portfolio into baskets that move in different directions. For the sake of developing an example, consider using four different baskets and starting with four separate two-year GRATs.[5505] Each GRAT distributes roughly half of the initial value of its assets on its first anniversary and a slightly larger one on the second anniversary on its second anniversary. If anything is left at the GRAT's termination, it might continue in an irrevocable grantor trust for the grantor's children or might be distributed to them.[5506] If a GRAT does well, the children get the excess growth; if it does not do well, the grantor absorbs the loss. If an asset hits a peak during the GRAT's term, the grantor might swap it out for a stable asset to lock in the gain. Each year, when the grantor receives roughly one-half of the initial value of the assets, the grantor places them in another GRAT. Thus, the grantor starts with four GRATs, but after the first year creates another set of four two-year GRATs. Thus, generally the grantor would have eight GRATs. Because each GRAT's funding should occur on a single day, consider using an LLC to hold a basket, so that asset transfers can be done using assignments of LLC interests instead of moving assets. Each LLC will be disregarded for income tax purposes so long as all of the owners are GRATs or other revocable or irrevocable grantor trusts owned by the same person.[5507]

With either technique, if the grantor's spouse is also the parent of the grantor's descendants who are beneficiaries of the trust, the grantor might consider including the spouse as a beneficiary (sometimes known as a SLAT – spousal limited access trust). A disadvantage of this approach would be the inability to turn off the grantor trust status, in whole or in part; authorizing an independent trustee to make distributions for the spouse's welfare might ease the pain of unrelenting grantor trust status.

Finally, if the asset being transferred is an interest in a closely-held business, consider liquidity to pay estate tax. If the grantor dies during the initial GRAT term, any business interest that is included in the grantor's estate is potentially eligible for long-term estate tax deferral.[5508] If the grantor dies holding a note from a sale to an irrevocable grantor trust, the note is a passive asset for which estate tax deferral is not available. The grantor might consider term life insurance to fund any estate tax incurred on the note. The parties might also prepare in advance documents to effectuate a sale of the business asset from the irrevocable grantor trust back to the grantor in exchange for the remaining balance on the note, so that the sale back to the grantor could be

---

[5503] See part II.Q.4.f Split-Dollar Arrangements.
[5504] I first heard of this strategy listening to Carlyn McCaffrey lecture at Heckerling in 2001.
[5505] Ideally, one would have separate GRAT for each asset. However, the strategy needs to be practical to work. Whether one should have more or fewer baskets depends on the client's situation.
[5506] Generally my preference would be an irrevocable grantor trust, but consider GST complexity in doing this. Many permutations of back-end strategies might constitute reasonable approaches.
[5507] See fn. 293.
[5508] See part III.B.5.d.ii Code § 6166 Deferral.

effectuated on short notice if the grantor is about to die.[5509] The sale back to the grantor might not only provide a chance of estate tax deferral but also might generate a basis step-up in the reacquired assets.[5510]

III.B.7.b. Code § 2701 Overview

Code § 2701 applies for gift tax purposes.[6148]

Rev. Rul. 83-120 provides general rules for valuing preferred stock (or presumably an interest in a preferred partnership). Also, if a recapitalization of a closely held corporation causes a shift in the value of the interests of the beneficiaries of trusts that own stock in the corporation, the shift is treated as a transfer for estate and gift tax purposes.[6149] With these general rules as background, consider that Code § 2701 imprints an additional layer of rules when preferred stock or an interest in a preferred partnership is involved.

Furthermore, it treats as held by an individual any equity interest "to the extent the interest is held indirectly through a corporation, partnership, estate, trust, or other entity."[6150]

Also note that Code § 2701 does not apply for purposes of the tax on generation-skipping transfers.[6151]

Practical uses of preferred partnerships include:

- Part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.
- Migrating from a corporation into the structure described in part II.E Recommended Structure for Entities. See parts II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure and II.Q.7.h Distributing Assets; Drop-Down into Partnership, the latter including part II.Q.7.h.viii Value Freeze as Conservative Alternative.

Code § 2036 should not apply to a transaction covered by Code § 2701.[6152]

III.B.7.b.i. Code § 2701 Definitions

Code § 2701(a)(1) values "transfers" when a transferor or "applicable family member" (the older generation) holds an "applicable retained interest" (a preferential distribution or liquidation right)

[5509] The sale might be a formula sale, buying back the portion of business assets having a value equal to the remaining value of the note, as finally determined for federal gift tax purposes. See part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.
[5510] For the latter, consider whether Code § 1014(e) might apply and whether the assets should therefore be bequeathed to persons other than the irrevocable grantor trust.
[6148] See fn. 1744, found in part II.H.2.j Effect of Chapter 14 on Basis Step-Up.
[6149] Rev. Rul. 86-39.
[6150] Reg. § 25.2701-6(a)(1), which goes on to say, If an equity interest is treated as held by a particular individual in more than one capacity, the interest is treated as held by the individual in the manner that attributes the largest total ownership of the equity interest.
[6151] See part II.H.11.e Using Preferred Partnership that Intentionally Violates Code § 2701, especially fn. 1827
[6152] See fn. 1812.

after making a transfer of an interest in a corporation or partnership[6153] to a "member of the transferor's family" (a younger generation); an example of such a transfer is a preferred stock or preferred partnership freeze.[6154] Let's examine the meaning of these quoted terms and consider exceptions to these rules.

"Transfer" generally includes a contribution to capital, a capital structure transaction such as redemption, recapitalization, or other change in the capital structure of a corporation or partnership, or certain terminations of an indirect holding in the entity.[6155] However, it does not include:[6156]

[6153] Prop. Reg. § 25.2701-2(b)(5)(i) would provide:

> For purposes of section 2701, a controlled entity is a corporation, partnership, or any other entity or arrangement that is a business entity within the meaning of § 301.7701-2(a) of this chapter controlled, immediately before a transfer, by the transferor, applicable family members, and/or any lineal descendants of the parents of the transferor or the transferor's spouse. The form of the entity determines the applicable test for control. For purposes of determining the form of the entity, any business entity described in § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B) is a corporation. For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. In the case of any business entity that is not a corporation under these provisions, the form of the entity is determined under local law, regardless of how the entity is classified for federal tax purposes or whether it is disregarded as an entity separate from its owner for federal tax purposes. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under whose laws the entity is created or organized.

[6154] For more information on preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

[6155] See Code § 2701(e)(5) and Reg. § 25.2701-1(b)(2)(i), the latter providing:

> *In general*. Except as provided in paragraph (b)(3) of this section, for purposes of section 2701, transfer includes the following transactions:
>
> (A) A contribution to the capital of a new or existing entity;
>
> (B) A redemption, recapitalization, or other change in the capital structure of an entity (a capital structure transaction), if-
>
> (1) The transferor or an applicable family member receives an applicable retained interest in the capital structure transaction;
>
> (2) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest that is junior to the applicable retained interest (a subordinate interest) and receives property other than an applicable retained interest; or
>
> (3) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity (other than a subordinate interest) and the fair market value of the applicable retained interest is increased; or
>
> (C) The termination of an indirect holding in an entity (as defined in § 25.2701-6), (or contribution to capital by an entity to the extent an individual indirectly holds an interest in the entity), if-
>
> (1) The property is held in a trust as to which the indirect holder is treated as the owner under subchapter J of chapter 1 of the Internal Revenue Code; or
>
> (2) If the termination (or contribution) is not treated as a transfer under paragraph (b)(2)(i)(C)(1) of this section, to the extent the value of the indirectly-held interest would have been included in the value of the indirect holder's gross estate for Federal estate tax purposes if the indirect holder died immediately prior to the termination.

[6156] Reg. § 25.2701-1(b)(3).

- A capital structure transaction, if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction.[6157]

- A shift of rights due to a Code § 2518 qualified disclaimer.

- A shift of rights occurring upon the release, exercise, or lapse of a nongeneral power of appointment, except to the extent the release, exercise, or lapse would otherwise be a transfer for gift tax purposes.

For most purposes of Code § 2701, "applicable family member" means "the transferor's spouse, an ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor."[6158] ***Multigenerational partnerships can be quite tricky, in that every transfer the second generation makes needs to consider the interests retained by not only the second generation but also the first generation.***

"Member of the family" means "the transferor's spouse, a lineal descendant of the transferor or the transferor's spouse, and the spouse of any such descendant."[6159]

"Applicable retained interest" includes the following:

- <u>A "distribution right," but only if, immediately before the transfer, the transferor and applicable family members "control" the entity</u>:[6160]

    - A "distribution right" is a right to distributions from an entity with respect to stock in a corporation or a partner's interest in a partnership.[6161] However, it does not include:[6162]

        - a right to distributions with respect to an interest that is of the same class or subordinate to the transferred interest,

        - an extraordinary payment right (a liquidation, put, call, or conversion right), or

        - a right to receive guaranteed payments from a partnership of a fixed amount.

    - "Control" means:

        - In the case of a corporation, at least 50%, by vote or value, of the corporation's stock.[6163] To be considered, voting rights must extend beyond the right to vote in liquidation, merger, or a similar event.[6164] A person is considered to own a voting right if that person can exercise that right alone or in conjunction with another person.[6165]

[6157] See part III.B.7.b.iii Capital Structure Transaction, If Each Individual Holds Substantially the Same Interest After the Transaction as That Individual Held Before the Transaction.
[6158] Code § 2701(e)(2); see Reg. § 25.2701-1(d)(2).
[6159] Code § 2701(e)(1); see Reg. § 25.2701-1(d)(1).
[6160] Code § 2701(b)(1)(A); Reg. § 25.2701-2(b)(1)(ii).
[6161] Code § 2701(c)(1)(A).
[6162] Code § 2701(c)(1)(B); Reg. § 25.2701-2(b)(3).
[6163] Code § 2701(b)(2)(A).
[6164] Reg. § 25.2701-2(b)(5)(ii)(B).
[6165] Reg. § 25.2701-2(b)(5)(ii)(B).

Permissible recipients of income from the equity interest and other beneficiaries, rather than the trustee, are considered to hold voting rights that are in trust.[6166] Voting rights subject to a contingency that has not occurred do not count unless the holder of the right can control the contingency.[6167]

- In the case of a partnership:[6168]
  - At least 50% of the capital or profits interests, or
  - In the case of a limited partnership, any interest as a general partner.[6169]
- Under proposed regulations,[6170] for any other entity:
  - Holding at least 50% of either the capital interests or the profits interests in the entity or arrangement, or
  - Holding any equity interest with the ability to cause the liquidation of the entity or arrangement in whole or in part.

The above excludes any Code § 707(c) guaranteed payment of a fixed amount.[6171]

Solely for purposes of this "control" test, "applicable family member" includes any descendant of any parent of the transferor or the transferor's spouse.[6172]

- An extraordinary payment right.[6173] Generally, an extraordinary payment right includes a liquidation, put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or non-exercise of which affects the transferred interest's value.[6174] A "call right" includes any warrant, option, or other right to acquire one or more equity interests.[6175]

[6166] Reg. § 25.2701-2(b)(5)(ii)(B).
[6167] Reg. § 25.2701-2(b)(5)(ii)(B).
[6168] Code § 2701(b)(2)(B). See Letter Ruling 9639054 for one limited partnership scenario, involving ownership of the corporate general partner. Jonathan Blattmachr said that he obtained it after bringing in the author of the regulations and holding four meetings.
[6169] Reg. § 25.2701-2(b)(5)(iii).
[6170] Prop. Reg. § 25.2701-2(b)(5)(iv).
[6171] Reg. § 25.2701-2(b)(5)(iii). See text accompanying footnote 6179. For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.
[6172] Code § 2701(b)(2)(C).
[6173] Reg. § 25.2701-2(b)(1)(i), (b)(2); see Code § 2701(b)(1)(B).
[6174] Reg. § 25.2701-2(b)(1)(i), (b)(2).
[6175] Reg. § 25.2701-2(b)(2).

Notwithstanding the above, certain rights are not applicable retained interests:[6176]

- A mandatory payment right.[6177] This is a right to receive a payment at a specific time (including a date certain or the holder's death) for a specific amount.

- A liquidation participation right.[6178] This is a right to participate in a liquidating distribution. However, generally the right to ***compel*** liquidation is treated as if it did not exist if the transferor, members of the transferor's family, or applicable family members have the ability to compel liquidation.

- A right to a guaranteed payment of a fixed amount under Code § 707(c).[6179] The time and amount of payment must be fixed. The amount is considered fixed if determined at a fixed rate, including a rate that bears a fixed relationship to a specified market interest rate.

- A non-lapsing conversion right.[6180] This is a non-lapsing right to convert an equity interest:

    - Into a fixed number or fixed percentage of shares in a corporation that are the same class as the transferred interest.

    - Into a specified interest in the partnership (not represented by a fixed dollar amount) that is the same class as the transferred interest.

In both cases:

- Differences in voting rights are ignored.

- The conversion right must be subject to proportionate adjustments:

    - For a corporation, such adjustments must be made with respect to splits, combinations, reclassifications, and similar changes in capital stock.

    - For a partnership, the equity interest must be protected from dilution resulting from changes in partnership structure.

In testing who holds an applicable retained interest, consider the broad attribution rules of Reg. § 25.2701-6, which attribute an interest held indirectly through a corporation, partnership, estate, trust, or other entity,[6181] even to the extent of attributing an interest held through a grantor

[6176] Reg. § 25.2701-2(b)(4).
[6177] Reg. § 25.2701-2(b)(4)(i). Letter Ruling 9535026 conditioned the non-application of Code § 2701 to a sale for a note on the note not being characterized as equity; however, the ruling did not address that notes would be excluded from Code § 2701 as mandatory payment rights.
[6178] Reg. § 25.2701-2(b)(4)(ii).
[6179] Reg. § 25.2701-2(b)(4)(iii). For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.
[6180] Reg. § 25.2701-2(b)(4)(iv).
[6181] Reg. § 25.2701-6(a)(1).

trust in which the grantor holds no beneficial interest.[6182] Grantor trust attribution takes first priority in determining who owns applicable retained interest but takes a back seat to the actual transferee in determining who owns subordinate interests.[6183]

III.B.7.b.ii. Certain Exclusions from Code § 2701

Code § 2701 does not apply to:

- Transferred interests that are marketable securities.[6184]
- Applicable retained interests that are marketable securities.[6185]
- A capital structure transaction, if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction.[6186] Letter Ruling 9321046 held that this exception did not apply to an irrevocable trust that was deemed owned by the grantor, because attribution rules deem the grantor to own any senior interests and the trust to own any subordinate interests.[6187]

[6182] Reg. § 25.2701-6(a)(4)(ii)(C). And, if one has a beneficial interest in a trust, one must assume maximum exercise of the trustee's discretion in the beneficiary's favor. See the text accompanying fn 6261, found in part III.B.7.d Code § 2702 Overview, but also see fn. 6183 for limitations on that.

[6183] Reg. § 25.2701-6(a)(5) provides:

(i) *Applicable retained interests*. If this section attributes an applicable retained interest to more than one individual in a class consisting of the transferor and one or more applicable family members, the interest is attributed within that class in the following order—
  (A) If the interest is held in a grantor trust, to the individual treated as the holder thereof;
  (B) To the transferor;
  (C) To the transferor's spouse; or
  (D) To each applicable family member on a pro rata basis.

(ii) *Subordinate equity interests*. If this section attributes a subordinate equity interest to more than one individual in a class consisting of the transferor, applicable family members, and members of the transferor's family, the interest is attributed within that class in the following order—
  (A) To the transferee;
  (B) To each member of the transferor's family on a pro rata basis;
  (C) If the interest is held in a grantor trust, to the individual treated as the holder thereof;
  (D) To the transferor;
  (E) To the transferor's spouse; or
  (F) To each applicable family member on a pro rata basis.

[6184] Reg. § 25.2701-1(c)(1).

[6185] Reg. § 25.2701-1(c)(2).

[6186] Reg. § 25.2701-1(b)(3)(i).

[6187] See fn. 6183. Zaritsky & Aucutt, ¶ 2.02[4] Indirect Transfers, *Structuring Estate Freezes: Analysis With Forms* (WG&L), refer to the Letter Ruling as a fascinating and informative application of the indirect-holdings and indirect-transfer rules. Note that the ruling held, The taxpayer is treated as making a gift to the extent that the value of her life estate in the common stock held by her prior to the recapitalization exceeds the value of her life estate in the preferred and common stock received in the recapitalization, not mentioning the possible application of Code § 2702 to the transferor's retained interest in the trust. However, Code § 2702 might be unnecessary to protect the government's interest in a Code § 2701 case. See the text accompanying fn 6261, found in part III.B.7.d Code § 2702 Overview, but also see fn. 6183 for limitations on that.

- A retained interest that is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest.[6188]

- A transfer by an individual to a member of the individual's family of equity interests to the extent the transfer by that individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer.[6189]

III.B.7.b.iii. Capital Structure Transaction, If Each Individual Holds Substantially the Same Interest After the Transaction as That Individual Held Before the Transaction

Among various exceptions, a capital structure transaction is not subject to Code § 2701 if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction.[6190] For this purpose, common stock with non-lapsing voting rights and nonvoting common stock are interests that are substantially the same.

Letter Ruling 9427023 invoked this exception when partners in a straight-up partnership made additional capital contributions in proportion to their then-current interests. Letter Ruling 200026011 invoked this exception when an S corporation underwent a Code § 368(a)(1)(E) recapitalization in which the shareholders received one share of voting and ten shares of nonvoting common stock for every share of voting common stock currently held. Letter Rulings 9414012 and 9414013 invoked this exception when an S corporation issued nonvoting stock and when the senior generation gave nonvoting stock (with identical distribution and liquidation rights) to the next generation. None of the above letter rulings sheds any light on this exception, because all of these entities were straight-up: each ownership interest had identical distribution and liquidation rights, so Code § 2701 really did not apply anyway.

In Code § 355 spin-offs involving applicable retained interests, Letter Ruling 9843010 invoked this exception because "the shareholders will have substantially the same interests, rights, and limitations in the new entities and in Corporation, and with respect to the underlying assets of each, as each shareholder had before the transaction."

Letter Ruling 9309018 invoked this exception to approve a reverse split intended to avoid Delaware franchise tax:

> In the instant case, each preferred stockholder would hold the same percentage of the issued and outstanding preferred stock and the same overall percentage interest in the equity of the corporation after the proposed recapitalization as he or she would prior to the proposed recapitalization. In similar fashion, each common stockholder would hold the same percentage of the issued and outstanding common stock and the same overall

---

[6188] See Reg. § 25.2701-1(c)(3), reproduced in the text accompanying fn. 6224 and further analyzed in part III.B.7.c.iii Same Class Exception - Possible Application to Profits Interest.

[6189] Reg. § 25.2701-1(c)(4), which further provides:

> Thus, for example, section 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P's child in a manner that reduces each interest held by P and any applicable family members, in the aggregate, by 10 percent even if the transfer does not proportionately reduce P's interest in each class. See § 25.2701-6 regarding indirect holding of interests.

[6190] Reg. § 25.2701-1(b)(3)(i).

> percentage interest in the equity of the corporation after the proposed recapitalization as he or she would prior to the proposed recapitalization. Thus, each stockholder of [the corporation] would hold substantially the same interest in the corporation after the proposed transaction as he or she did prior to the proposed transaction.

Letter Ruling 199947034 invoked this exception to approve a Code § 368(a)(1)(F) reorganization of a C corporation, that had a complicated capital structure, from corporate form to an LLC so that:

> Taxpayer and the other shareholders of Corporation will exchange their shares in Corporation for an identical number of units in LLC with rights, preferences, and restrictions identical to the rights, preferences, and restrictions each shareholder held in Corporation before the transfer.

In ruling that Code § 2701 did not apply, the IRS reasoned:

> In this case, each share of stock held by Taxpayer carries the same rights and restrictions as every other share of stock held by Taxpayer including voting rights that will lapse if that share is transferred. Thus, because Taxpayer's entire interest in the Corporation is an interest in one class, if Taxpayer transfers less than Taxpayer's entire interest in the Corporation, the retained interest will be of the same class as the transferred interest.

The Conference Committee Report on which this exception presumably is based said:

> The conference agreement provides, however, that the provision would not apply to a change in capital structure other than a contribution to capital if the interests held by the transferor, applicable family members, and family members are substantially identical before and after the change. The provision would not apply, for example, to a recapitalization not involving a contribution to capital if all shareholders held substantially identical interests both before and after the recapitalization. Nor would it apply to a change in corporate name. In addition, the conferees intend that the addition of capital to an existing partnership or corporation would result in the application of these rules only to the extent of such contribution.

This exception is in some ways similar to the exception invoked when the retained interest that is of the same class of equity as the transferred interest, which is described in part III.B.7.c.iii Same Class Exception - Possible Application to Profits Interest.

III.B.7.b.iv. Divorce Planning to Avoid Code § 2701

The lack of family relationship between former spouses can create planning opportunities. Consider this example:[6191]

> If two individuals who are married to each other want to use this planning device for the benefit of their children, a divorce prior to implementing the plan would avoid the disadvantages of § 2701. For example, if spouse A owns preferred and common stock in corporation X, a divorce from spouse B would enable him or her to sell the preferred stock

[6191] C. McCaffrey & J. McCaffrey, *Obergefell* and the Authority of the IRS to Challenge Valid Marriages and Divorces, *Steve Leimberg's Estate Planning Email Newsletter*, No. 2345 (9/21/2015).

to B while simultaneously giving the common to their children because B will no longer be a family member of A.

See also part III.B.6.d Divorce as an Opportunity to Transfer.

III.B.7.c. Code § 2701 Interaction with Income Tax Planning

How does Code § 2701 inform the discussion further above on ways to plan for entity transfers? Below is a qualitative analysis; quantifying these amounts using the complicated subtraction method[6192] is beyond the scope of these materials, although an application is described in part III.B.7.c.i.(b) CCA 201442053 Discusses Profits Interest in a Partnership That Was a Straight-Up Partnership before the Transfer.

Our discussion begins with profits interests, which are favorable treated for income tax purposes and are not subject to the restrictions that Code § 409A places on deferred compensation.[6193] When we discover the Code § 2701 problems they present, we will discuss alternatives, which themselves can present challenges of Code § 409 or 2703.

III.B.7.c.i. Profits Interest in a Partnership that Was a Straight-Up Partnership before the Transfer

Some take the position that Code § 2701 would not apply to the issuance of profits interests.[6194] In planning, I would rather explore the IRS' possible arguments and work around the problem than argue which approach is correct.

III.B.7.c.i.(a). General Discussion of Implications of Profits Interest in a Partnership that Was a Straight-Up Partnership before the Transfer

Suppose a parent transfers a profits interest to a child and retains the parent's capital account. The IRS would argue that the parent's capital account would be an applicable retained interest, valued at significantly less than its face amount, so that the transfer to the child will be treated as a transfer of much of the parent's capital account as well.[6195] However:

- This rule will not apply if the following, added together, are less than 50% of the partnership's income and less than 50% of the partnership's capital:
  - The parent's and child's interests, and
  - Interests of any combination of:

[6192] Reg. § 25.2701-3(b). The lack of family attribution under the *Bright* case, which the IRS conceded in Rev. Rul. 93-12, was decided after this regulation was issued, so presumably that trumps certain aspects of the subtraction method. The person who pointed this out to me said that he has prepared Form 8275-R taking this position one time, and the tax return was not audited.
[6193] See part II.M.4.f Issuing a Profits Interest to a .
[6194] Dees, Profits Interests Gifts under Section 2701: 'I Am Not a Monster,' *Tax Notes* 5/11/2009, also found at http://www.mwe.com/info/pubs/profits.pdf. For a less optimistic view, see Wendel and Hatcher, How to Profit without Getting Carried Away: Carried Interests, Profits Interests, Or Black Holes? 2009 *ACTEC Annual Meeting* (paper dated 1/14/2009).
[6195] In determining the value of the payment of the retained capital account, one must ignore the family's right to compel liquidation. See text accompanying footnote 6178.

- Applicable family members (the parent's spouse, an ancestor of the parent or of the parent's spouse, and the spouse of any such ancestor), and

- Descendants of the parents of the parent or the parent's spouse (in other words, the parent's and parent's spouse's siblings and the descendants of the parent, of the parent's spouse, or of such siblings).

- The parent may reduce the gift based on the discounted present value of the right to receive the capital account if either:

  - The partnership must pay the capital account to the parent at a "specific time," such as a specific date or the parent's death, or

  - One does not rely on liquidation (at which time the capital account would be paid to the parent) being compelled by any combination of:

    - The parent,

    - Members of the parent's family (the parent's spouse, a descendant of the parent or the parent's spouse, and the spouse of any such descendant), and

    - Applicable family members (the parent's spouse, an ancestor of the parent or of the parent's spouse, and the spouse of any such ancestor).

The parent can enhance the retained capital account's present value by retaining a cumulative distribution right with respect to the capital account. For example, if the partnership were required to pay the parent annually 7% of the parent's capital account and that right either was not contingent on profits[6196] or was cumulative,[6197] then the parent could also reduce the gift on account of the present value of that payment right.

The value of a junior equity interest cannot be valued at less than 10% of the sum of the total value of all equity interests in the partnership and the total amount of the partnership's indebtedness to the parent and other applicable family members.[6198] In a partnership, "junior

[6196] Thereby constituting a guaranteed payment right under Reg. § 25.2701-2(b)(4)(iii). Instead of using 7% (arbitrarily selected for this example), one could use the prime rate or some other market rate.
[6197] Thereby constituting a qualified payment under Code § 2701(c)(3)(C)(i) (first sentence) and Reg. § 25.2701-2(b)(6)(ii). The transferor or an applicable family member who holds a distribution right that does not qualify may nevertheless treat the right as a qualified payment if he or she makes a special election under Code § 2701(c)(3)(C)(i) (second sentence) and Reg. § 25.2701-2(c)(4). Finally, additional gift tax may be imposed under Code § 2701(d) if the qualified payment is not made within the four-year grace period allowed under Code § 2701(d)(2)(C).
[6198] Code § 2701(a)(4); Reg. § 25.2701-3(c). Such indebtedness does not include short-term indebtedness incurred with respect to the current conduct of the entity's trade or business (such as amounts payable for current services); indebtedness owed to a third party solely because it is guaranteed by the transferor or an applicable family member; amounts permanently set aside in a qualified deferred compensation arrangement, to the extent the amounts are unavailable for use by the entity; or a qualified lease. Reg. § 25.2701-3(c)(3). A lease of property is not indebtedness, without regard to the length of the lease term, if the lease payments represent full and adequate consideration for use of the property. Lease payments are considered full and adequate consideration if a good faith effort is made to determine the fair

equity interest" means any partnership interest under which the rights to income and capital are junior to the rights of all other classes of partnership interests.[6199] Although a profits interest typically would be junior with respect to capital, generally it would not be junior with respect to income.[6200] Thus, generally the 10% minimum value rule would not apply to profits interests. However, as a practical matter, often appraisers of qualified retained interests require junior interests to be worth at least 20% of the entity to give full valuation effect to the stated payments, so avoiding the 10% minimum value rule would not necessarily be helpful.

On the other hand, if one needs to go through all of this complexity, one might consider abandoning the profits interest idea and instead using a GRAT.[6201] If the parent wants to transfer only a small portion, the parent could transfer a vertical slice (described further below) of what the parent owns and place a ceiling on the amount that is ultimately transferred to the child. If the parent's goal in transferring a profits interest is to incentivize the child, the GRAT's ceiling could be based on objective business performance measures.

- The issuance of a pure profits interest[6202] does not have Code § 409A implications.[6203] The Code § 409A analysis is not affected by whether the profits interest is junior to another interest.

- Suppose the partnership issues the interest to the child, instead of the parent transferring the interest. Code § 2701 applies to a "change in the capital structure" of a partnership or corporation in certain situations.[6204] However, Code § 2701 applies to a change in capital structure only if:[6205]

  (1) The transferor or an applicable family member receives an applicable retained interest in the capital structure transaction;

  (2) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest that is junior to the applicable retained interest (a "subordinate interest") and receives property other than an applicable retained interest; or

  (3) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity (other than a subordinate interest) and the fair market value of the applicable retained interest is increased.

---

rental value under the lease and the terms of the lease conform to the value so determined. Arrearages with respect to a lease are indebtedness.

[6199] Code § 2701(a)(4)(B); Reg. § 25.2701-3(c)(2).

[6200] However, if the parent retained a cumulative distribution as recommended above, then the profits interest would be junior as to income, and presumably the 10% minimum value rule would apply.

[6201] The author remembers the late Mil Hatcher for his creativity in suggesting the GRAT alternatives described here.

[6202] By pure profits interest the author means a partnership interest that would be allocated nothing if liquidation were to occur at the time of transfer of such interest.

[6203] See II.M.4.f Issuing a Profits Interest to a .

[6204] Code § 2701(e)(5).

[6205] Reg. § 25.2701-1(b)(2)(i)(B).

In this variation, the parent does not hold an applicable retained interest before the transaction. Thus, we look to paragraph (1) and not to paragraphs (2) or (3). Because the parent has retained the capital account that he had before the transaction, rather than receiving a capital account,[6206] has the parent "received" an applicable retained interest in the transaction?

Suppose a client has acquired a preferred interest in a partnership controlled by the next generation, but lots of others have invested in the partnership? Although Code § 2701 applies, the transaction might not constitute a gift, because it was done in the ordinary course of business.[6207] I would not plan a partnership assuming that exception applied, because the facts-and-circumstances nature makes the result uncertain, but it can provide relief when taxpayers business-motivations predominate.

III.B.7.c.i.(b). CCA 201442053 Discusses Profits Interest in a Partnership That Was a Straight-Up Partnership before the Transfer

Code § 7872 generally does not apply to transactions between partnerships and partners. See part II.G.3.a.i Loans to Businesses – Whether AFR Is Required.

CCA 201442053[6208] was essentially an attempt to make a 20-year interest-free loan to children using a partnership. The CCA applied Code § 2701 to fulfill the role of Code § 2701 in backstopping Code § 7872. After reviewing what the IRS said, this memo will discuss why this attempt was such a bad idea and that the taxpayers would have been better off simply loaning the money instead of messing around with a partnership structure.

In CCA 201442053, after forming and operating a straight-up partnership:

> …at a time when Donor held an X percent ownership interest, Child A and Child B each held a Y percent ownership interest and Donor's grandchildren collectively held the remaining Z percent ownership interest, Company was recapitalized. In exchange for the agreement of Child A and Child B to manage Company, the operating agreement was amended to provide that henceforth all profit and loss, including all gain or loss attributable to Company's assets, would be allocated equally to Child A and Child B. After the recapitalization, Donor's and the grandchildren's sole equity interest in Company was the right to distributions based on their capital account balances as they existed immediately prior to the recapitalization.
>
> The gift tax liability of the grandchildren is not at issue herein, and will not be further discussed.

The CCA concluded that the shifting of the profits interests constituted a gift:

> For purposes of § 2701, a transfer includes a recapitalization or other change in the capital structure of an entity if the transferor holding an applicable retained interest before the capital structure transaction surrenders a subordinate interest and receives property other

[6206] This approach cannot be taken if done in conjunction with a contribution to capital. Reg. § 25.2701-1(b)(2)(i)(A).

[6207] See text accompanying fns. 6146 (ordinary course of business exception is subject to Chapter 14) and 6147 (when the exception has or has not been applied).

[6208] I have heard that, although this is designated a CCA, it really was an informal legal memorandum, without any input from the taxpayer or other procedural safeguards.

than an applicable retained interest. Section 25.2701-1(b)(2)(B)(2).[6209] An applicable retained interest is an interest in a family-controlled entity with respect to which there is a distribution right. Section 25.2701-2(b)(1)(ii). A subordinate interest is an interest as to which an applicable retained interest is a senior interest. Section 25.2701-3(a)(2)(iii). A senior interest is an interest that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest. Section 25.2701-3(a)(2)(ii). The term "property" includes every species of right or interest protected by law and having an exchangeable value.

Here, at all relevant times, Donor and her family controlled Company. On Date 3, Company was recapitalized and Donor surrendered her right to participate in future profit and loss, including future gain or loss attributable to Company's assets. Both before and after the recapitalization, Donor held an applicable retained interest, an equity interest in Company coupled with a distribution right.[6210] Donor's interest, which carried a right to

---

[6209] [my footnote, not the CCA's:] Dees, Is Chief Counsel Resurrecting the Chapter 14 'Monster'? *Tax Notes* (12/15/2014 at p. 1279), argues that the regulations exceed their statutory mandate by applying Code § 2701 to this recapitalization. Judge for yourself by reading Code § 2701(e)(5), which provides:

> Except as provided in regulations, a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership shall be treated as a transfer of an interest in such entity to which this section applies if the taxpayer or an applicable family member—
>
> (A) receives an applicable retained interest in such entity pursuant to such transaction, or
>
> (B) under regulations, otherwise holds, immediately after such transactions, an applicable retained interest in such entity.
>
> This paragraph shall not apply to any transaction (other than a contribution to capital) if the interests in the entity held by the transferor, applicable family members, and members of the transferor's family before and after the transaction are substantially identical.

[6210] [my footnote, not the CCA's:] Dees, Is Chief Counsel Resurrecting the Chapter 14 'Monster'? *Tax Notes* (12/15/2014 at p. 1279), criticizes the CCA for referring to Donors' equity interest as an applicable retained interest. His analysis correctly points out that the CCA's fails to discuss extraordinary payment rights (EPRs) in its shorthand description of the definition an applicable retained interest (ARI). However, let's look past that sloppy shorthand and apply the definition of an ARI to the original interest and to the retained interest; refer to the analysis in part III.B.7.b.i Code § 2701 Definitions.

ARI means an equity interest with respect to which there is either an EPR ***or*** a distribution right, so all the CCA needed to find was either an EPR or a distribution right. Reg. § 25.2701-2(b)(1). Key to his analysis regarding the original rights is Reg. § 25.2701-2(b)(3)(i), which says that distribution right does not include any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest. In this case, the original interest was a right to receive a capital account on liquidation, coupled with a right to profits. The transferred interest was a right to profits. Using the same reasoning as in fn. 6211, the original interest is not subordinate to the transferred interest. Thus, the remaining question in determining whether the original interest included a distribution right is whether it is the same class as the transferred interest. Dees views them as the same class, presumably because both interests have rights in the same assets and have no payment preferences. However, the IRS might argue that Dees' approach is too narrow, because Reg. § 25.2701-1(c)(3) seizes on any differences whatsoever other than voting rights and limitations on liability:

> A class is the same class as (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability).

Presumably, the IRS would argue that the rights to the original and transferred interests were not identical, and that they were not proportional because the zero capital account associated with the transferred interest did not bear the same relationship to profits as the capital account of the original interest had to profits. Dees has a lot of background and experience with Code § 2701 and the regulations and, upon audit, would

> distributions based upon an existing capital account balance, is senior to the transferred interests, which carried only a right to distributions based on future profit and gain. Donor received property in the form of the agreement of Child A and Child B to manage Company. Accordingly, the recapitalization constitutes a transfer by Donor for purposes of § 2701.

The statement, "Donor's interest, which carried a right to distributions based upon an existing capital account balance, is senior to the transferred interests, which carried only a right to distributions based on future profit and gain," is an incorrect conclusion. Although the original interest had more rights than the transferred interest, the original interest had no rights that entitled it to payment earlier (higher in priority) than the transferred interest.[6211]

---

make a persuasive argument for the approach he takes. However, at the planning stage, I would not assume that they are the same class.

The donor retained no rights to ongoing distributions after the recapitalization, so I agree with Dees that the CCA erred in calling the retained interest a distribution right and that the only analysis of it is as an EPR. See Reg. § 25.2701-1(a)(2)(ii) (an example of a distribution right is a right to receive dividends), combined with the exclusion of EPRs from the definition of distribution rights. Dees argues that bells and whistles need to attach to a set of rights to make them constitute EPRs. He does not view the retained capital account as an EPR. His view would be correct if the capital account was not required to be paid by a date certain and therefore would, absent any distribution tights, have a value for regular gift tax purposes approaching zero. However, in the CCA, the LLC had a fixed 20-year term. The IRS might have been thinking that the donor retained the right to compel liquidation in 20 years, and the retained bare capital account was an EPR. On the other hand, the LLC's fixed terms could also be viewed as a mandatory payment right, which I view as being more correct. Weighing these two approaches, presumably the IRS would argue that an abuse that Code § 2701 wanted to prevent is saying that the entity had a term of a period of years, getting value ascribed to the retained right to payments on that liquidation, and then extending the term, claiming that the extension was not a gift; therefore, the IRS would argue, the right to receive the capital account at the end of the stated term is an EPR.

Thus, although Dees' arguments would be good ones to make in an audit and the IRS' view is probably wrong, for planning purposes one might be very conservative and assume that the CCA is correct in its conclusion that the original interest and the retained interests are ARIs.

[6211] Dees, Is Chief Counsel Resurrecting the Chapter 14 'Monster'? *Tax Notes* (12/15/2014 at p. 1279), criticizes the CCA for referring to the original interest as senior to the transferred interest. Let's compare this to Reg. § 25.2701-3(a)(2)(ii), which provides:

> Senior equity interest means an equity interest in the entity that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest.

The original interest and the transferred interest had identical rights to distributions of income, so the only distinction was a right to capital. Nowhere do the regulations define preferred. However, they refer to preferred stock in various places, and traditionally preferred stock carries the right to receive dividends before any dividends are paid to the holders of common stock. Therefore, I believe that the better reading is looking to see whether one interest in capital receives its payment of capital before another interest does. The CCA leaps to the conclusion that an interest that includes a current capital account balance is senior in capital to an interest that has a zero capital account, a conclusion that ignores the timing assumption that appears to be inherent in the word preferred. The CCA's facts state, "No member has priority over any other member as to … the return of capital contributions." Furthermore, the CCA inherently assumes that a profits interest never has a capital account. Although the pure profits interest transferred here had a zero initial capital account (see part II.M.4.f Issuing a Profits Interest to a), a partnership is required to maintain a capital account for each partner. Reg. § 1.704-1(b)(2)(iv)(a). When a partner is allocated profits, the allocation increases the partner's capital account. Reg. § 1.704-1(b)(2)(iv)(b)(3). Distributions of those profits decrease the partner's capital account. Reg. § 1.704-1(b)(2)(iv)(b)(4). It is not uncommon for a partnership to reinvest part of its earnings for contingencies or to expand its capital base (to grow the

The CCA calculated the gift applying the subtraction method of Reg. § 25.2701-3(b):

> If § 2701 applies to a transfer, the amount of the transferor's gift, if any, is determined using a subtraction method of valuation. Under this method, the amount of the gift is determined by subtracting the value of any family-held applicable retained interests and other non-transferred equity interests from the aggregate value of the family-held interests. In determining the value of any applicable retained interest held by the transferor or an applicable family member, any distribution right in a controlled entity (*e.g.*, a right to receive dividends) is generally valued at zero.
>
> Step 1 - Determine the fair market value of all family-held equity interests in the entity immediately after the transfer assuming that the interests are held by one individual, using a consistent set of assumptions. Here, all equity interests are held by Donor, her children, and her grandchildren, all of whom are members of Donor's family. The result of Step 1 is an amount equal to the fair market value of 100 percent of the Company interests valued as if they were held by a single holder.
>
> Step 2 - Subtract: (A) the sum of the fair market value of all family-held senior equity interests determined after the transfer as if all interests were held by a single holder; and (B) the value determined under § 25.2701-2 of all applicable retained interests held by the transferor and any applicable family members. A senior equity interest is an interest that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest. Section 25.2701-3(a)(2)(ii). The interests of Child A, Child B and the grandchildren are senior to the transferred interests in that each carried a right to distributions based upon an existing capital account balance, whereas the transferred interests did not. Accordingly, the amount determined in Step 1 is reduced by the fair market value of Child A's, Child B's and the grandchildren's interests. The amount determined in Step 1 is further reduced by the value of Donor's postrecapitalization applicable retained interest. In valuing Donor's interest, the distribution right, which does not constitute a qualified payment right, is valued at zero, and the liquidation participation right is valued as if the family's ability to compel liquidation did not exist.

The sentence, "The interests of Child A, Child B and the grandchildren are senior to the transferred interests in that each carried a right to distributions based upon an existing capital account balance, whereas the transferred interests did not," is incorrect (because there are no senior interests).[6212] Therefore, subtracting the value of the interests of Child A, Child B, and the grandchildren's interests is incorrect, and the CCA understates the value remaining to which Step 3 would apply.

The CCA continues:

> Step 3 - Allocate the remaining amount among the transferred interest and other non-transferred subordinate equity interests held by the transferor, applicable family members, and members of the transferor's family. A subordinate equity interest is an interest as to which an applicable retained interest is a senior interest. Section 25.2701-3(a)(2)(iii). Here, all applicable retained interests carried a distribution right based upon an existing capital account balance, whereas the interest transferred by the grandchildren did not.

---

business or to create economies of scale in investing marketable securities). Thus, Dees correctly criticizes the CCA for calling the original interest senior.

[6212] See fn. 6211.

This interest, which was not transferred by Donor, is a subordinate equity interest. Based on Donor and the grandchildren's relative ownership percentages immediately prior to the recapitalization, X / X+Z percent of the Step 2 amount is allocated to the transferred interest. Donor is treated as transferring one-half of this amount to Child A and one-half to Child B.

Again, the CCA errs by viewing certain interests as subordinate.[6213] Therefore, all of the remaining amount would be allocated to the retained interest.

Step 4 - If the value of the transferred interest determined without regard to § 2701 would be determined after application of a minority discount, the Step 3 amount is reduced by a pro rata portion of the fair market value of the family-held interests of the same class determined as if they were held by one person, over the fair market value of a transferred interest. The Step 3 amount is also reduced by the amount, if any, of any consideration in money or money's worth received by the transferor. Here, Donor transferred an interest to each of two transferees, implicating a minority discount. The reduction for each gift is the excess, if any, of a pro rata portion of the fair market value of the transferred interests determined as if all voting rights were held by a single holder over the fair market value of a single transferred interest. In the event that Donor establishes the value in money or money's worth of any consideration provided by either Child A or Child B, a further reduction may be appropriate.

The analysis of Step 4 appears correct and introduces an element not discussed in previous rulings. Let's read together the highlighted parts in the facts[6214] and in Step 4:

- Donor received property in the form of the agreement of Child A and Child B to manage Company.

- In the event that Donor establishes the value in money or money's worth of any consideration provided by either Child A or Child B, a further reduction may be appropriate.

These statements suggest to me that the fair market value of the children's services to be performed over the LLC's life will be subtracted at the end, if the Donor can prove that value. However, in this particular case, the children are benefitting only themselves by managing the partnership, so query how much value will be assigned to their services. This case represents an extreme example. Generally, a service provider in a venture capital arrangement receives a 2% management fee and then, after the investors have recovered their investment and a threshold rate of return, 20% of the profits.[6215]

Note in Step 2 that the Donor's right to receive the Donor's capital account – referred to as a "liquidation participation right" - is properly valued as if the family's ability to compel liquidation did not exist. However, if, contrary to the CCA's approach, the partnership's fixed term were construed as a mandatory payment right, it would set an outside date at which the partners would receive their capital accounts – in this case, 20 years. If an appropriate discount rate for equity

[6213] See fn. 6211.
[6214] Donor received property in the form of the agreement of Child A and Child B to manage Company.
[6215] Arrangements vary from deal to deal. To determine what is market, one should talk with a corporate lawyer who advises in a large number of venture capital cases or consult an online service, such as Thompson Reuter's *Practical Law* (formerly known as the Practical Law Company).

were 8%, the right to receive $100.00 in 20 years would be worth $21.45.[6216] Thus, whether or not the CCA's valuation approach applies, if Code § 2701 applies then the Donor has made a substantial gift.

Going through the complex subtraction method, obtaining the requisite appraisals, and using an equity rate of return to discount the Donor's interest might very well provide a much less favorable result than if the Donor had simply done a loan to the children at the AFR.

CCA 201442053 appears to shut the door on a potentially abusive transaction. It also illustrates how the IRS approaches the subtraction method. However, it is full of errors (and my understanding is that the IRS showed a lower Code § 2701 gift than one computed using the gift tax principles that would normally apply), making one wonder how the IRS will next attempt to apply Code § 2701. Profits interests do not fit neatly with the scheme of Code § 2701, so issuing them in a family-controlled partnership can generate uncertain results.

Partnerships play an important role in our economy, particularly in the venture capital/private equity area. However, for family transactions, they require applying a complex regime. Therefore, first try using AFR loans; then see whether a GRAT works; and, if those do not suffice, then perhaps consider using a partnership with commercially reasonable terms, making sure that the donor retains a preferred partnership interest, makes a Code § 2701(c)(3)(C) election, or retains Code § 707(c) guaranteed payments[6217] so that the donor can get credit for the donor's retained stream of payments.

III.B.7.c.ii. Profits Interest in a Partnership in Which Transferor and Applicable Family Members Initially Hold Only a Profits Interest

Suppose a parent is buying a partnership owned by an unrelated third party. The unrelated third party retains all of his capital interest and receives preferred payments of income in liquidation of the value of his interest in excess of his capital account. The parent is entitled to 100% of the profits in excess of the preferred payments. As discussion further above, preferred payments of income to the third party can be very beneficial to the parent who is buying the business, if the preferred payments are taxed to the third party as a distributive share of income under Code § 736(a) so that the parent is using pre-tax dollars to buy out the third party.

- Initially establishing this capital/income structure will not have Code § 2701 implications, because the parent is not a member of the third party's family.

- The partnership's capital/income structure could have Code § 2701 implications if the parent transfers an interest to his child or any other member of the parent's family.

  - Does the parent own at least "50% of the profits interests" that would be required for Code § 2701 to be considered (since the parent has no capital account yet) if the partnership is a general partnership? The statute and regulations do not clearly answer

[6216] As of October 2014, a typical preferred return would be 8% or 9%. That assumes an annual distribution. Where no distribution is made for 20 years, presumably the discount rate would be higher. Thus, the illustration of $21.45 value for every $100 probably overstates the value of the Donor's retained interest.

[6217] For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

the question.[6218] If the partnership is a limited partnership and the parent is a general partner, then Code § 2701 must be considered no matter what the parent's economic interests are.[6219] If the partnership is a manager-managed limited liability company, and the parent is a manager, would that be the same as being a general partner in a limited partnership?

- Even if one assumes that the parent's partnership interest is sufficient to make one consider Code § 2701, if the parent transfers a vertical slice of the parent's right to income and the same vertical slice of the parent's right to capital to his child, Code § 2701 should not apply to that transfer.[6220] Suppose, for example, that the parent owns 60% of the income and 10% of the capital and wants to give a vertical slice of 1/10 of his interest to his child.[6221] In that case, the parent would give the child a 6% income (60% multiplied by 1/10) and 1% capital interest (10% multiplied by 1/10) and would retain a 54% income and 9% capital interest. The vertical slice should be structured so that the child succeeds to 1/10 of every item of the parent's rights to distributions and financial obligations. For example, if the parent is obligated to leave a portion of his share of income in the partnership, the child should have a proportionate obligation to leave income in the partnership; the parent's leaving profits in the partnership might[6222] constitute a contribution to capital, triggering Code § 2701,[6223] in which case one needs to find an exception to Code § 2701, such as transactions involving proportionate vertical slices.

III.B.7.c.iii. Same Class Exception - Possible Application to Profits Interests and Other Situations

Not much guidance explains how to implement the regulations under Code § 2701. The "same class" exception provides:[6224]

> Section 2701 does not apply if the retained interest is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest. A class is the same class as (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability). For purposes of this section, non-lapsing provisions necessary to comply with partnership allocation requirements of the Internal Revenue Code (*e.g.*, section 704(b)) are non-lapsing differences with respect to limitations on liability. A right that lapses by

---

[6218] Code § 2701(b)(2)(B)(i); Reg. § 25.2701-2(b)(5)(iii).
[6219] Code § 2701(b)(2)(B)(ii); Reg. § 25.2701-2(b)(5)(iii).
[6220] See Reg. § 25.2701-1(c)(3), (4).
[6221] In the example, the parent starts with a pure profits interest and no capital. However, the parent is likely to leave some income in the partnership, especially since the reinvested income might be used to buy the third party's capital account. The cumulative effect would be to decrease the third party's capital account and increase the parent's capital account until the third party's capital account and income interest have decreased to zero.
[6222] The next paragraph of text suggests a difference between the parent transferring a partnership interest and the partnership issuing a partnership interest. Therefore, the author's concern about leaving profits in the partnership could be creating an issue where there is none, because the parent is not transferring property to the child. Thus, this recommendation is an attempt to be very conservative.
[6223] Reg. § 25.2701-1(b)(2)(i)(A).
[6224] Reg. § 25.2701-1(c)(3).

> reason of Federal or State law is treated as a non-lapsing right unless the Secretary determines, by regulation or by published revenue ruling, that it is necessary to treat such a right as a lapsing right to accomplish the purposes of section 2701. An interest in a partnership is not an interest in the same class as the transferred interest if the transferor or applicable family members have the right to alter the liability of the transferee.

Relying on Reg. § 25.2701-1(c)(3), the IRS has ruled that a merger that did not change the parties' economic rights did not cause Code § 2701 valuation to apply "because the transaction involves a mere change in the form of Taxpayer's holdings in the business activity."[6225]

Private Letter Ruling 9451051 applied this exception to a corporate arrangement that seems very much like a profits interest. The preferred stock did not have any preferences on dividends. The only preference was as follows:

> Upon liquidation, dissolution, or winding up of Corporation, the holders of the Class A preferred stock are entitled to be paid out of the assets of Corporation then available for distribution an amount equal to a liquidation preference of $10 per share. If after the payments have been made there remain assets available for distribution, then all of the assets are to be distributed pro rata among the holders of the common stock and the convertible preferred stock as if each share of convertible preferred had been converted into common stock. However, there shall be subtracted from any residual distribution to the holders of the Class A preferred an amount equal to the liquidation preference received by each holder.

The IRS ruled that the preferred stock was "substantially the same" as the transferred common stock.

This exception is in some ways similar to the exception described in part III.B.7.b.iii Capital Structure Transaction, If Each Individual Holds Substantially the Same Interest After the Transaction as That Individual Held Before the Transaction.

It has been suggested that a profits interest is analogous to common stock in this letter ruling and therefore are not subject to Code § 2701.[6226] However, in the letter ruling, after the preferred owners receive their preferred liquidation payment, the common would receive the proportionate make-up payments; whereas the holder of a profits interest would not receive make-up payments, absent a capital account. It might be possible to make up this difference by specially allocating to the holders of profits interests:

[6225] Letter Ruling 9352012 approved a merger of Corporation B into Corporation A under the following facts, in which the taxpayer held only preferred stock (and all the preferred stock):

> The rights with respect to Corporation B common and preferred stock are identical to the rights of the common and preferred stock of Corporation A except that the Corporation B preferred stock is entitled to receive 85 percent of par value upon liquidation and is redeemable by the corporation at 85 percent of par.
>
> Under the proposed merger, Taxpayer will exchange her Corporation B preferred stock for an equal number of shares of new Class C preferred stock to be issued by Corporation A. The rights of the Class C shareholder will be identical to those of the Corporation B preferred shareholders, and the Class C shares will be redeemable for 85 percent of par value. The common stockholders of Corporation B will exchange their stock for common stock of Corporation A of equal value.

[6226] Robinson, Business Succession Planning, Profits Interests and § 2701, *ACTEC Journal* (Spring 2009).

- Gain on liquidation to the holder of the profits interests. Whether that would make the profits interests close enough is unclear; presumably it would depend on the likelihood of that gain occurring.

- Current income first, then to gain on liquidation. That would certainly increase the likelihood of the capital accounts increasing until they are proportionate to those of the original partners. That would make the profits interests be preferred as to current income, but presumably the holders of the profits interests would be in a lower generation and therefore Code § 2701 would not apply to this reverse freeze.

One should also consider an earlier technical advice memorandum that refused to apply the same class exception:[6227]

> Underlying the statute and regulations, the legislative history states that a "retained interest is valued under present law if it is of a class which is proportionally the same as the transferred interest but for nonlapsing differences in voting power (or, in the case of a partnership, nonlapsing differences with respect to management and limitations on liability)." H.R. Rep. No. 101-964, at 1133 (1990). Further, the legislative history notes that section 2701 generally does not affect the valuation of a gift of a partnership interest if all interests in the partnership share equally in all items of income, deduction, loss and gain in the same proportion (i.e., straight-up allocations). See 136 Cong. Rec. 515681 (daily ed. October 18, 1990) (1990 Senate Report on Proposed Revision of Estate Freeze Rules). However, the legislative history also notes that the exception to the valuation rules of section 2701 "would not apply to a partnership with both a general and limited partner if one partner had a preference with respect to distributions." H.R. Rep. No. 101-964, at 1133 (1990). Thus, if either the transferred or applicable retained interest in Partnership enjoy a preference as to distributions, the applicable retained interest in Partnership will be valued under the rules of section 2701. See *Id.*
>
> In the present case, the Partnership Agreement provides that proceeds from capital transactions shall be distributed first to the limited partners until their Adjusted Capital Contributions are reduced to zero, then to the general partner until its Adjusted Capital Contribution is reduced to zero. The balance of any proceeds, if any, shall be distributed to the partners in proportion to their partnership interests. On its face, this provision in the Partnership Agreement is a preference enjoyed by the limited partner (Trust) with respect to distributions of proceeds from capital transactions. Thus, the transfers at issue are not excluded from the special valuation rules of section 2701(a)(1) because Donor's applicable retained interest is not of the same class of equity as the transferred interest, nor is Donor's applicable retained interest of a class that is proportional to the class of the transferred interest.

With this contrast, I would want to have a special allocation of profits to the holder of the profits interest as soon as possible, to try to make it look more like the letter ruling and less like the TAM, so long as that did not constitute an unacceptable change to the business deal.

I would still rather avoid the issue altogether, by using a loan to the service provider at the AFR so that the service provider could simply start with a proportionate capital account. The service provider could then have compensation incentives to enable him or her to repay the loan.

[6227] TAM 199933002.

III.B.7.c.iv. Transfers When Owner Holds Profits Interest/Carried Interest and Other Interests

How might one deal complexities of planning with profits interests discussed in part III.B.7.b Code § 2701 Overview and the discussion in the previous parts of this part III.B.7.c Code § 2701 Interaction with Income Tax Planning? (Generally, a "carried interest" is a profits interest that provides an interest in profits only after the partners who provided the capital have received cash as part of an agreed-upon return.)

One method would be transferring all of the person's interest into a single entity, such as an LLC, so that the person's interest is held as a single package. Then one might transfer an interest in that single entity, to satisfy the vertical slice exception described in part III.B.7.c.iii Same Class Exception - Possible Application to Profits Interest.

An owner can combine this vertical slice planning with transfers that include more than just a straight gift. For example, an owner might place the LLC into a GRAT[6228] or transfer it in exchange for a note or an interest in preferred partnership.[6229]

III.B.7.c.v. Income Tax Dynamics of Using Deferred Compensation Instead of Profits Interest

Suppose that the moneyed partners – who we will call the service recipient (SR) – agree to pay compensation to the partner who is providing the services – the service provider (SP), instead of giving the SP a profits interest.

The SR would receive any capital gain treatment from the SP's portion of the profits. However, they would be able to use the tax benefits from an ordinary deduction to gross-up the SP's payment.

Suppose, for example, that ordinary income were taxable at a 40% rate and capital gain at a 20% rate. For every $100 the SP would receive, the SP would have expected to net $80, after subtracting $20 capital gain tax. Instead, the partnership pays the SP $133. The SP receives the same $80, which consists of $133 minus $53 (40% of $133) ordinary income tax. The SR receives a $133 ordinary income tax deduction, which costs the SR only $80 ($133 minus $53 ordinary income tax benefit); this $80 cost to the SR matches the $100 sale proceeds the SR receives less the $20 capital gain tax that the SR pays.

Thus, the lack of capital gain treatment to the SP should not an obstacle to the transaction. This assumes that the SR has other ordinary income against which to deduct the payment to the SP. If that is not the case, the benefit of the deduction might be at capital gain rates that are less than the ordinary income tax that the SP would be required to pay.

One would also want to compare whether the deduction to the SR is against the SR's self-employment income and whether the payment to the SP is subject to self-employment tax.

[6228] The late Mil Hatcher suggested this idea to me. For information on GRATs, see part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.

[6229] See Angkatavanich and Stein, Going Non-Vertical with Fund Interests - Creative Carried Interest Transfer Planning When The 'Vertical Slice' Won't 'Cut It,' *Trusts and Estates* (11/2010), saved as Thompson Coburn LLP document no. 6174249.

Because changes to deferred compensation plans must meet certain requirements or trigger significant tax consequences, using a profits interest is much more flexible than paying deferred compensation.

III.B.7.c.vi. Deferred Compensation

Although deferred compensation is not equity, it reduces the entity's value for many purposes and makes it easier to sell; it also creates an income stream for the older generation without constituting an asset subject to estate tax (assuming that the deferred compensation payments are spent and do not promote the recipient's other assets to grow to exceed the recipient's unused estate tax exemption).[6230] It is realistically available only if the entity earns sufficient income. For draconian rules that apply to deferred compensation, see part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

Suppose a parent is 55 years old and wants to retire in 10 years. The business entity (same analysis whether partnership or corporation) agrees to make the following series of payments:

- Retirement Payment. $100,000 per year for life,[6231] but only if the parent continues to work for the entity until the parent attains age 65.[6232] This should not violate Code § 409A; of course, to satisfy other tax issues, the retirement payment must, when combined with other compensation, constitute reasonable compensation for future services.[6233] Similarly, as a payment that is fixed in amount at a specific time, it is not subject to Code § 2701,[6234] whether or not the IRS attempts to classify it as equity.

- Disability Payment. The parent receives $100,000 for life if the parent becomes disabled before attaining age 65. If disability is defined consistent with Code § 409A(a)(2)(A)(ii) & (a)(2)(C) and the pronouncements thereunder, the payment would not violate Code § 409A. Unfortunately, this definition is more stringent than most good disability policies, and one might consider paying a bonus to the parent so that the parent can buy disability insurance instead.[6235]

[6230] For a married couple, the survivor's interest in the deferred compensation automatically qualifies for the marital deduction. Code § 2056(b)(7)(C).

[6231] If instead the payment were for a fixed period of years instead of for life, more planning opportunities are available if the arrangement provides at all times that the right to the series of installment payments is to be treated as a right to a series of separate payments. Reg. § 1.409A-2(b)(2)(iii).

[6232] When the parent reaches 65, the present value of the retirement payments vests for FICA purposes, and a lump-sum FICA tax payment is due. Reg. § 31.3121(v)(2)-1(c)(2). Although this might sound onerous, it is actually quite beneficial. See discussion at part II.Q.1.d Nonqualified Deferred Compensation

[6233] In this example, the requirement that the parent work for 10 years is an attempt to spread the period of earning the compensation for the purposes of determining reasonable compensation.

[6234] Reg. § 25.2701-2(b)(4)(i) (in the case of a corporation) or (iii) (in the case of a partnership).

[6235] A good disability policy will provide benefits if the disabled person cannot work in his or her ***own occupation***. Contrast this with Code § 409A(a)(2)(C), which provides (emphasis added):

> For purposes of subparagraph (A)(ii), a participant shall be considered disabled if the participant—
>
> (i) is unable to engage in ***any substantial gainful activity*** by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or
>
> (ii) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months,

- Death Benefit. A death benefit to replace the disability and retirement payments would not violate Code § 409A.

The discussion below of creative bonus arrangements convinces the author that none of the above would constitute an equity interest. Therefore, such arrangements would not constitute an "applicable retained interest" that would taint a transfer by the parent to a child.[6236]

III.B.7.c.vii. Stock Options

Stock options exercisable at a price that is at least the underlying stock's value on the date of grant generally are not subject to Code § 409A.[6237] Similar rules apply to partnerships.

In addition to being subject to FICA, nonqualified stock options are subject to tax under the Railroad Retirement Tax Act.[6238]

For purposes of Code § 2701, the IRS tends to view options as compensation, not equity:[6239]

> Until the options are exercised, the holder of the option has no right to receive dividends and no right to vote shares of the corporation. The holder has only the right to purchase an equity interest (i.e., shares of stock). In purchasing the shares of stock, the holder would then obtain an equity interest in which he would have these rights. The holder of the options, thus, does not hold an equity interest in the corporation and a transfer of the options is not subject to section 2701 of the Code.

Income tax cases have held than an option to acquire a partnership interest does not constitute an equity interest in the partnership.[6240] The author has not discovered Code § 2701 cases addressing that question.

---

receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the participant's employer.

[6236] Code § 2701 applies only when the parent or a member of the parent's family holds an applicable retained interest. An applicable retained interest includes only a right to equity. See Code § 2701(b), (c)(1), (c)(2).

[6237] See part II.M.4.f.iv Alternative If a Prospective Partner Wants a Capital Interest Instead of a Profits Interest.

[6238] *Wisconsin Central Ltd. v. U.S.*, 118 A.F.T.R.2d 2016-XXXX (N.D. Ill. 7/8/2016), in holding that nonqualified stock options are subject to the RRTA, stated:

> Similar suits have been filed in recent years. See *BNSF Ry. Co. v. United States*, 775 F.3d 743 (5th Cir. 2015); *Union Pac. R.R. Co. v. United States*, No. 8:14-cv-00237, slip op. (D. Neb. Jul. 1, 2016) (reproduced at Doc. 35-1); *CSX Corp. v. United States*, No. 3:15-cv-00427 (M.D. Fla. filed Apr. 3, 2015). In the two judgments issued thus far, the Fifth Circuit in *BNSF Railway* and the District of Nebraska in *Union Pacific* both upheld the Treasury Department's interpretation of any form of money remuneration to include non-qualified stock options. For the following reasons, this court reaches the same result.

[6239] Letter Ruling 199952012 and CCA 199927002; see Letter Ruling 9616035. The IRS also compares the stock with respect to which the option is granted with the stock that the transferor retained. See Letter Ruling 9725032 (option related to publicly traded stock, and such stock is not subject to Code § 2701) and 9722022 (stock subject to option was same class as stock the transferor retained, so Code § 2701 did not apply).

[6240] *Dorman v. U.S.*, 296 F.2d 27 (9th Cir. 1961) (option was a capital asset but not a partnership interest); *Vestal v. U.S.*, 498 F.2d 487 (8th Cir. 1974) (option was neither a capital asset [because its value was too

However, options are subject to Code § 2703, which deals primarily with buy-sell agreements.[6241]

Code § 1014(a) applies to a testamentary option to buy stock for less than fair market value, so that the option has basis and any stock bought in exercising it receives basis equal to the option's basis and exercise price.[6242] However, a lapse of the option is treated as having been disclaimed or renounced.[6243] This treatment would also apply to real estate.[6244]

III.B.7.c.viii. Creative Bonus Arrangements

Suppose an employee who is a family member is entitled to receive a bonus based on the entity's profitability. If the bonus is required to be paid on March 15 following the calendar year the results of which are being measured, the bonus plan generally would not be subject to Code § 409A. If this bonus is based on the entity's income, would the bonus plan constitute an equity interest?

The author is not aware of Code § 2701 cases addressing this issue, so the author has summarized selected income tax cases.

As in other areas, state law determines rights, but tax law determines the effect of those rights; whether a partnership exists depends on a weighting of several factors.[6245]

Some very entrepreneurial taxpayers have been treated as employees and not as owners when they:

- Received salary plus 50% of the profits.[6246]

- Developed a new product line, not only thinking of the idea but also reducing it to practical application and sales to the general public, receiving a percentage of sales.[6247]

The above tests all assume that the service provider is an employee. In a corporate setting, a shareholder who works in the business has two different capacities: an owner and an employee. The author is aware of only one situation in which the IRS combined the two concepts, and that was a clearly abusive situation.[6248] The discussion further above about S corporations compensating employees with stock options provide insight about when, for income tax purposes,

---

speculative] nor a partnership interest); *Mayhew v. Commissioner*, T.C. Memo. 1992-68 (option and right to bonus did not constitute a profits interest).

6241 See text accompanying footnotes 3780-3786.

6242 Rev. Rul. 67-96.

6243 Rev. Rul. 67-96.

6244 Letter Ruling 200340019 applied Rev. Rul. 67-96 to a testamentary option to buy a house. Regarding options involved in Code § 1031 tax-free exchanges of real estate, see Rev. Rul. 84-121, discussed in fn. 1345 in part II.G.15 Like-Kind Exchanges.

6245 See part II.C.9 Whether an Arrangement (Including Tenancy-in-Common) Constitutes a Partnership.

6246 *Friednash v. Commissioner*, 209 F.2d 601 (9th Cir 1954); *Duley v. Commissioner*, T.C. Memo. 1981-246.

6247 *Luna v. Commissioner*, 42 T.C. 1067 (1964). This is one of many cases in which insurance agents unsuccessfully attempted to treat as the sale of a capital asset payments commuting their future commissions or similar contract rights.

6248 In TAM 9352001, son-in-law was given an employment contract that paid him cash of at least three or four times the market value of his services, for a management position for which he was not qualified, as well as issuing him a control block of voting stock as part of his compensation. The IRS ruled that the stock was cumulative preferred stock, with the excess compensation constituting the preference.

an option constitutes equity in the corporation. Absent guidance in a Code § 2701 setting, the author suggests relying on the income tax principles, possibly requesting a Letter Ruling in appropriate situations.

Contrast that with a partnership setting: For income tax purposes, all partner compensation is considered in conjunction with the partner's equity interest. See part II.C.8.a Code § 707 - Compensating a Partner for Services Performed. The author suggests the following guidelines for partnerships:

- If the service provider has a clearly-defined vested[6249] equity interest in the partnership, any additional compensation constituting a guaranteed payment will be reported on the service provider's Schedule K-1.[6250] If the IRS audits an applicable family member's estate tax return and obtains partnership income tax returns, an agent is likely to argue that the service provider's guaranteed payments are part of the service provider's total equity interest and might argue that a testamentary or prior transfer of equity to the service provider should have been valued considering this additional compensation. One should carefully consider the extent to which the service provider has the right as a partner to make these payments to himself/herself.

- Contrast this to a corporate setting, where these incentive payments are reported on Forms W-2. The IRS' main inquiry is likely to be whether the incentive payments constituted reasonable compensation. Although the IRS might argue that the payments were part of the service provider's rights as a shareholder, in most corporate settings the shareholder would need to elect a director to protect his/her interest, and then prove that the director would have conspired with the other directors to order the corporation's president to pay such compensation.[6251]

III.B.7.c.ix. Debt vs. Equity

Generally, for gift tax purposes courts look to income tax cases to determine when a transaction rises to the level of granting an equity interest. For income tax principles, see part II.G.19, Debt vs. Equity.

[6249] See text accompanying fn. 3121 in part II.M.4.f.ii Tax Effects of Profits Interest for issues relating to a wholly unvested interest in partnership capital and profits.

[6250] See footnote 463.

[6251] Many states have statutory close corporation provisions allowing a corporation to abolish such formalities; see fn 968. Furthermore, a shareholders' agreement can purport to lock-in such arrangements; however, the general rule is that no agreement can legally bind future directors to a particular course of action.