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Cahill 2036, 2038, 2703; *Mazzei* Disregards Corporate Arrangements; Investment Partnership Traps

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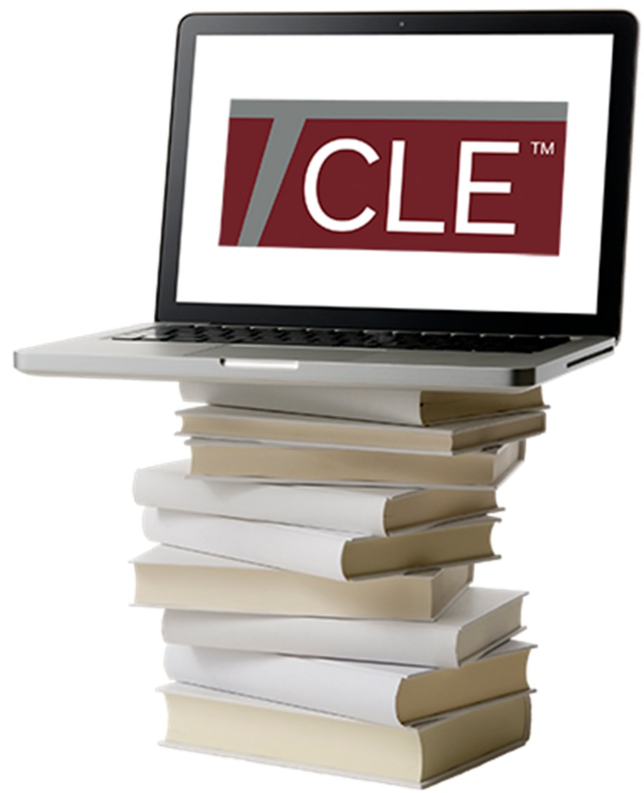

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WELCOME

Overview

- New split-dollar life insurance case, *Cahill*
- New Roth IRA case, *Mazzei*, disrespects corporate transactions
- Investment partnership receiving contributions and making distributions may run into several tax traps

Overview – *Cahill* and Split-Dollar Life Insurance Arrangements

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- How businesses and individuals use split-dollar arrangements to finance life insurance
- Income and gift tax effects of using split-dollar arrangements
- Regulations' failure to require consistent reporting for estate tax purposes

Overview – *Cahill* and Split-Dollar Life Insurance Arrangements (II.Q.4.f.)

- How these rules apply when different generations are involved
- How the taxpayer reporting a value of 2% of the amount of the split-dollar receivable led the Tax Court to reject the taxpayer's motion for summary judgment on IRC §§ 2036, 2038, and 2703
- Planning in light of *Morrissette* and *Cahill*

Using Split-Dollar Arrangements to Finance Life Insurance

Any arrangement between an owner and a non-owner of a life insurance contract when:

- Either party pays, directly or indirectly, all or any portion of the premiums
- At least one party is entitled to recover all or any portion of those premiums from (or is secured by) the life insurance contract
- The arrangement is not part of a group-term life insurance plan

Using Split-Dollar Arrangements to Finance Life Insurance

Economic benefit regime (Reg. § 1.61-22 – 9/11/2003):

- Employer or donor pays premiums
- Employer or donor collects greater of premiums paid or cash value when insured dies
- Employer is deemed to pay compensation to employee or donor is deemed to have made gift of one year term insurance on the difference
- Death benefit is income tax free

Using Split-Dollar Arrangements to Finance Life Insurance

Economic benefit regime (Reg. § 1.61-22):

- Imputed annual compensation or gift of one year term insurance becomes very expensive as insured gets older
- Also, if employer is involved, agreement usually terminates when employment terminates

Always need an exit plan for termination of agreement (rollout)

Using Split-Dollar Arrangements to Finance Life Insurance

Rollout may involve one or more:

- Employer cashes in policy and is taxed on excess, if any, over "investment in the contract"
- Employee pays employer the cash value, and employer has gain to extent exceeds basis, which IRS says is ordinary income; ideal switch is when cash value equals premiums paid
- Payment above may be in the form of a split-dollar loan (especially if no further premiums)

Income and Gift Tax Effects of Using Split-dollar Arrangements

Economic benefit model:

- Annual term cost is [compensation to employee followed by] gift from employee/donor to irrevocable life insurance trust
- If not pure, then full premium instead on annual term cost is counted
- Code § 409A concerns

Income and Gift Tax Effects of Using Split-dollar Arrangements

Economic benefit model:

- Rollout deemed transfer [from employer to employee then] from donor to donee
- "No inference" for grandfathered plans
- If hold until death, then zero tax on life insurance unless violate employer-owned life insurance or transfer-for-value

Income and Gift Tax Effects of Using Split-dollar Arrangements

Loan model:

- Each premium payment is a separate loan unless do big loan up front and pay premiums over time; modified endowment contract rules affect premium schedule
- Interest recognized under original issue discount rules even though not yet paid

Income and Gift Tax Effects of Using Split-dollar Arrangements

Loan model:

- Contingent payments disregarded
- Because split-dollar loans generally are nonrecourse, they may be contingent
- To guarantee recognition of loans, make election that requires consistency as well

Income and Gift Tax Effects of Using Split-dollar Arrangements

Hybrid:

- Start as economic benefit until premiums no longer required or cash value equals premiums paid
- Rollout using split-dollar loan regime
- Result – perhaps only one loan
- Will interest rates increase or decrease before switch?

Regulations' Failure to Require Consistent Reporting for Estate Tax Purposes

- Regulations do not tie estate tax treatment to income or gift tax treatment
- Use usual valuation principles re split-dollar obligation payee's risk from lack of control, lack of marketability, and any other factors.

How These Rules Apply When Different Generations Are Involved

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When an older generation advances premiums for a policy on the younger generation:

- In the economic benefit regime, the annual term cost is lower, allowing the arrangement to say in place longer
- On the payor's death, the split-dollar receivable is discounted

How These Rules Apply When Different Generations Are Involved

Reasons for discount:

- The funds are tied up for many years – much longer than a commercial loan
- Often, the payor has no control over the policy's investments
- The obligation is nonrecourse

How These Rules Apply When Different Generations Are Involved

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With split-dollar loan regime, consider character of the note repayment:

- Any payment from the life insurer to repay the note is treated as a payment from the insurer to the borrower and then from the borrower to the lender.
- To the extent of any accrued interest, the payment would be ordinary income if not yet taxed (but OID taxes annually). Query re accrued interest on grantor trust.

How These Rules Apply When Different Generations Are Involved

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With split-dollar loan regime, if the note is discounted so it has a low basis upon original holder's death, consider character of the note repayment: To the extent that a payment is principal and the payment exceeds basis, the payment would probably be taxed as capital gain to the original holder of the note or to a substituted basis transferee or ordinary income for any other holder.

How These Rules Apply When Different Generations Are Involved

Consequences of face amount in excess of basis in loan regime:

- If the decedent's estate is considered to be the issuer, then the estate and any beneficiary (except the recipient of a pecuniary bequest) should have capital gain.
- Otherwise, the gain would be taxed as ordinary income.

How These Rules Apply When Different Generations Are Involved

Economic benefit regime:

- If all parties hold until insured dies, no tax on death unless blow other life insurance rules
- On rollout:
  - Deemed owner before rollout has ordinary income to the extent proceeds exceeds “investment in the contract” (not basis) if contract is cashed in
  - If the deemed owner sells the policy, then use basis, and IRS asserts ordinary income to extent of cash value and capital gain beyond that

Very Significant Discounts Led to Adverse 2036, 2038, 2703 Rulings

- *Morrissette* – 75% discount, but no gift tax on creation of split-dollar arrangement; gift tax holding is a regular Tax Court opinion
- *Cahill* – 98% discount; no gift because followed *Morrissette*

Very Significant Discounts Led to Adverse 2036, 2038, 2703 Rulings

Cahill summary judgment:

"… the rights to terminate and recover at least the cash surrender value were clearly rights, held in conjunction with another person (MB Trust), both to designate the persons who would possess or enjoy the transferred property under section 2036(a)(2) and to alter, amend, revoke, or terminate the transfer under section 2038(a)(1)."

Very Significant Discounts Led to Adverse 2036, 2038, 2703 Rulings

Cahill summary judgment:

"On the basis of the undisputed facts, we conclude that under section 2703(a)(1) the split-dollar agreements, and specifically the provisions that prevent decedent from immediately withdrawing his investment, are agreements to acquire or use property at a price less than fair market value."

Very Significant Discounts Led to Adverse 2036, 2038, 2703 Rulings

Cahill summary judgment:

"Next, it is clear that under section 2703(a)(2) the split-dollar agreements, and specifically MB Trust's ability to prevent termination, also significantly restrict decedent's right to use the termination rights. The split-dollar agreements, taken as a whole, clearly restrict decedent's right to terminate the agreements and withdraw his investment from these arrangements."

Very Significant Discounts Led to Adverse 2036, 2038, 2703 Rulings

Separate materials included in the webinar meeting materials:

- Steve Akers' analysis
- *Levine* post-trial briefs

Planning in Light of *Morrissette* and *Cahill*

- Whether *Cahill* is right or wrong from a technical legal argument, it seems to signal that, at the very least, the Tax Court will apply a smell test to highly discounted split-dollar arrangements
- Based on *Cahill*, *Morrissette* denied the taxpayer's summary judgment motion re Code § 2036

Planning in Light of *Morrissette* and *Cahill*

- *Morrissette* involved life insurance to fund a buy-sell agreement between siblings
- However, an employee of the company owned by the donor's children was appointed as conservator and facilitated the split-dollar and the donor's revocable trust bequeathing the split-dollar receivable to the children's life insurance trust

Planning in Light of *Morrissette* and *Cahill*

- Consider various possible premium funding methods when arranging for business buy-sell life insurance
- If significant discounts are involved, be prepared to document for the IRS why split-dollar makes the most business sense and consider income tax exit strategy
- Watch for regulations on valuing notes

Overview – Roth IRAs in private businesses

- Ongoing saga of taxpayers investing their Roth IRAs in private businesses
- How the Tax Court's reviewed opinion in *Mazzei* re-cast statutorily-approved sales using a corporation as a dividend, followed by an excess Roth IRA contribution
- Language the IRS may try to use in other contexts against taxpayers with thinly-capitalized business entities

Taxpayers Investing Their Roth IRAs in Private Businesses

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- IRS tends to audit Roth IRA ownership of a business, requiring certain situations to be reported as “listed transactions” on special disclosure forms.
- IRS unsuccessfully tried to expand its Roth IRA attacks when a father’s business was discontinued and his son’s Roth IRAs started a new corporation engaging in what the IRS viewed to be a continuation of the old business

Taxpayers Investing Their Roth IRAs in Private Businesses

- IRA that invests in a business engages in a prohibited transaction when the business compensates the IRA's owner (even when the compensation is modest).
- If the business does not compensate the IRA's owner, the IRA's owner might be deemed to have received compensation and then made a contribution to the IRA.

Taxpayers Investing Their Roth IRAs in Private Businesses

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- When an IRA's owner guarantees the IRA's corporation's seller-financed purchase of business assets from an unrelated third party, the guarantee is a prohibited transaction that disqualifies the IRA.
- Thus, activities very common for start-up businesses – the owner or the owner's family working in the business and the owner guaranteeing loans – are forbidden to businesses owned by IRAs.

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Taxpayers Investing Their Roth IRAs in Private Businesses

- After two false starts, in *Summa Holdings, Inc. v. Commissioner* the IRS successfully attacked IRAs' use of a DISC (next slide) in Tax Court, before being rebuked by the Sixth Circuit
- The shareholders (the Benensons and a trust for their children) appealed to the First and Second Circuits, and the First Circuit applied logic similar to that of the Sixth Circuit in reversing the Tax Court

Taxpayers Investing Their Roth IRAs in Private Businesses

- A DISC (*Summa* above) or a foreign sales corporation (*Mazzei* below) is a shell corporation that receives commissions on exports (even if the corporation doesn't do anything to earn the commission).
- The shell corporation pays no federal income tax.
- Congress specifically authorized this contrivance to provide a tax subsidy to exports.
- A Roth IRA minimally capitalizing a shell corporation that receives money for doing nothing is attractive.

Mazzei Re-cast Statutorily-Approved Sales

- *Mazzei* is a reviewed Tax Court opinion with a strong dissent
- *Mazzei* involves a foreign sales corporation (FSC), which is similar to DISCs and was replaced by DISCs
- The majority took an approach similar to the Tax Court opinion in *Summa Holdings*, but (unconvincingly in my view) claimed it was different and not inconsistent with the Sixth Circuit's decision in *Summa Holdings*

Mazzei Re-cast Statutorily-Approved Sales

Mazzei held:

"Furthermore, because petitioners (through various passthrough entities) controlled every aspect of the transactions in question, we conclude that they, and not their Roth IRAs, were the owners of the FSC stock for Federal tax purposes at all relevant times. The dividends from the FSC are therefore properly recharacterized as dividends from the FSC to petitioners, followed by petitioners' contributions of these amounts to their respective Roth IRAs."

Mazzei Re-cast Statutorily-Approved Sales

- *Mazzei* held, "All of these payments exceeded the applicable contribution limits and were therefore excess contributions."
- The court viewed the commission payments as voluntary, because the exporter was not obligated to contract with the FSC.

New IRS Ammunition against Thinly-Capitalized Business Entities

Mazzei stated, "… the Roth IRAs' formal purchase [issuance] of the FSC stock for $1 did not reflect the underlying reality; i.e., petitioners' capacity (through Injector Co.) and clear intention to direct Injector Co. to make large commission payments to the FSC. The form of the transactions the Roth IRAs entered into does not reflect the underlying related-party expectations and intentions…. We therefore disregard the purchase."

New IRS Ammunition against Thinly-Capitalized Business Entities

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Mazzei continued, “Furthermore, because petitioners (through various passthrough entities) controlled every aspect of the transactions in question, we conclude that they, and not their Roth IRAs, were the owners of the FSC stock for Federal tax purposes at all relevant times.”

New IRS Ammunition against Thinly-Capitalized Business Entities

The *Mazzei* dissent countered, “But the Code doesn't require a founding shareholder to take as his basis what he hopes the earnings on his investment will be—it requires him to take as his basis only the cost or amount of whatever he contributed…. And the Code certainly doesn't treat his corporation as a sole proprietorship if it turns out to be profitable.”

New IRS Ammunition against Thinly-Capitalized Business Entities

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The *Mazzei* dissent continued, “By the majority's reasoning, someone who created a business, incorporated it, issued himself 100% of the stock in exchange for a small capital investment, and continued to run the day-to-day operations wouldn't really own his corporation - especially if it was a success. We'd have to disregard the corporation because the initial investment was too small and didn't accurately predict the business's future earnings.”

New IRS Ammunition against Thinly-Capitalized Business Entities

The *Mazzei* majority countered, "This is nonsense…. At the initial point of capitalization, the fair market value and the substantive economic value would be identical and equal to the capital investment. As the day-to-day operations commenced, that initial value would begin to change in concert with changing expectations regarding future cashflows…. Petitioners' situation is different because at the moment of purchase petitioners' formal characterization of the purchase did not match the underlying substantive and related-party economics."

New IRS Ammunition against Thinly-Capitalized Business Entities

- Is the majority is contradicting itself?
- On one hand, it says that the FSC was worth a lot more than the original capital contribution, because it was in line to make lots of profits from dealing with the taxpayers' corporation.
- On the other hand, it said that the taxpayers' corporation controlled the contracts with the FSC such that the FSC really couldn't count on anything, so the payments to the FSC were really dividends followed by Roth IRA contributions.
- To me, more evidence of smell test dominating decisions.

Overview – Investment Partnership

- Unexpected tax results – this is not easy
- Why not to follow the letter of the regulations governing accounting for partnership investments
- Dangers posed by frequent contributions and distributions, including some that proponents of investment partnerships fail to emphasize

Unexpected Tax Results (II.M.3., II.Q.8)

Generally, partnership formation and distributions from a partnership are tax-free, but see:

- 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.

Unexpected Tax Results (II.M.3., II.Q.8)

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More exceptions:

- Contributions of cash within two years before or after a distribution of property - II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner
- Contributions of property within two years before or after a distributions of cash - II.M.3.e Exception: Disguised Sale Rules.

Code § 704(c) Responsibility (II.Q.8.b.i.(e))

Code § 704(c) provides responsibility for built-in gain or loss on non-cash contributions:

- Gain or loss when that asset is sold
- Gain or loss when asset is distributed within 7 years
- Code § 737 when contributing partner receives something else within 7 years

Regulations Governing Accounting for Partnership Investments (II.P.1.a.i.(b))

- Reverse-Code § 704(c) responsibility is the built-in gain or loss of the partnership's property when partnership interests change (which is common when a new partner is admitted to an existing partnership).
- Partnership needs to track Code § 704(c) and reverse-Code § 704(c) responsibility
- Tracking is cumbersome with large number of assets (such as securities portfolio)

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Regulations Governing Accounting for Partnership Investments (II.P.1.a.i.(b))

Rev. Proc. 2007-59, § 2:

- Partnership needs to track Code § 704(c) and reverse-Code § 704(c) responsibility
- Reg. §1.704-3(a)(2) provides that Code § 704(c) allocations are generally made on a property-by-property basis. Therefore, built-in gains and losses from different items of contributed or revalued property generally cannot be aggregated.

Regulations Governing Accounting for Partnership Investments (II.P.1.a.i.(b))

- For purposes of making reverse-Code § 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach that is consistent with the purpose of Code § 704(c).
- A partnership using an aggregate approach must separately account for any built-in gain or loss from contributed property.

Regulations Governing Accounting for Partnership Investments (II.P.1.a.i.(b))

Thus:

- Contributed assets with built-in gain/loss complicate accounting on a permanent basis
- Accounting for unrealized gain/loss on assets that occur while inside the partnership can be done on a streamlined basis

Also note that built-in gain responsibility follows the partnership interest, so having one person fund an LLC and then transfer member interests should avoid built-in gain/loss issues

Regulations Governing Accounting for Partnership Investments (II.P.1.a.i.(b))

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A partnership is a securities partnership if

- the partnership is either a management company that is registered with the SEC or an investment partnership, and
- the partnership makes all of its book allocations in proportion to the partners' relative book capital accounts (except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership).

Regulations Governing Accounting for Partnership Investments (II.P.1.a.i.(b))

A partnership is an investment partnership if:

- On the date of each capital account restatement, the partnership holds qualified financial assets that constitute at least 90% of the fair market value of the partnership's non-cash assets; and
- The partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach under Reg. § 1.704-3(e)(3), to make revaluations at least annually.

Regulations Governing Accounting for Partnership Investments (II.P.1.a.i.(b))

Partial netting approach - for each capital account restatement, the partnership:

- Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;
- Separately aggregates all tax gains and all tax losses from qualified financial assets since the last capital account restatement; and [continued next slide]

Regulations Governing Accounting for Partnership Investments (II.P.1.a.i.(b))

Full netting approach - on the date of each capital account restatement, the partnership:

- Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;
- Nets tax gains and tax losses from qualified financial assets since the last capital account restatement; and
- Allocates the net tax gain (or net tax loss) to the partners in a manner that reduces the book-tax disparities of the individual partners.

Regulations Governing Accounting for Partnership Investments (II.P.1.a.i.(b))

The character and other tax attributes of gain or loss allocated to the partners under these approaches must:

- Preserve the tax attributes of each item of gain or loss realized by the partnership;
- Be determined under an approach that is consistently applied; and
- Not be determined with a view to reducing substantially the present value of the partners' aggregate tax liability.

Regulations Governing Accounting for Partnership Investments (II.P.1.a.i.(b))

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- If a securities partnership adopts an aggregate approach under these rules and later fails to qualify as a securities partnership, it must make reverse-Code § 704(c) allocations on an asset-by-asset basis after the date of disqualification.
- However, it is not required to disaggregate the book gain or book loss from qualified asset revaluations before the date of disqualification when making reverse-Code § 704(c) allocations on or after the date of disqualification.

Regulations Governing Accounting for Partnership Investments (II.P.1.a.i.(b))

- The two aggregate approaches limit the assets that can be aggregated and require one to go to an asset-by-asset approach if one later fails to qualify.
- Consider using one of the approaches without formally adopting it. For example, one might use an aggregate approach in practice for marketable securities and an asset-by-asset approach for unmarketable assets.

Regulations Governing Accounting for Partnership Investments (II.P.1.a.i.(b))

Given that Reg. § 1.704-3(e)(3)(i) permits using any reasonable approach and given that the IRS views an aggregate approach as reasonable for marketable securities (or it would not have provided it), such a hybrid approach would seem to allow one to comply with the regulations without hamstringing one with the artificial rules that are imposed on using an aggregate method as a safe harbor.

Regulations Governing Accounting for Partnership Investments (II.P.1.a.i.(b))

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As a practical matter, given that using an aggregate method is intended as a reasonable shortcut to avoid laborious asset-by-asset tracking, an IRS examiner might need to do laborious asset-by-asset tracking to show that this method is unreasonable, going into such an ordeal with no reason to believe it would be productive.

Dangers Posed by Frequent Contributions and Distributions

Disguised sale rules presume a disguised sale when noncash assets move within two years of cash being moved:

- For noncash contributions, cash distributions within two years can take advantage of various exceptions
- Those exceptions do not apply when a partner contributes cash and receives noncash distributions within two years

Conclusion

- February 14 webinar Fiduciary Income Tax Refresher and Update 2018
- October 30 webinar for Third Quarter Newsletter
- Blog: Business Succession Solutions
- Reports on Heckerling: http://www.thompsoncoburn.com/forms/gorin-heckerling
- Gorin's Business Succession Solutions