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Business Opportunities; Taxpayer Asserts Substance over Form; Unincorporated Entity as S Corporation

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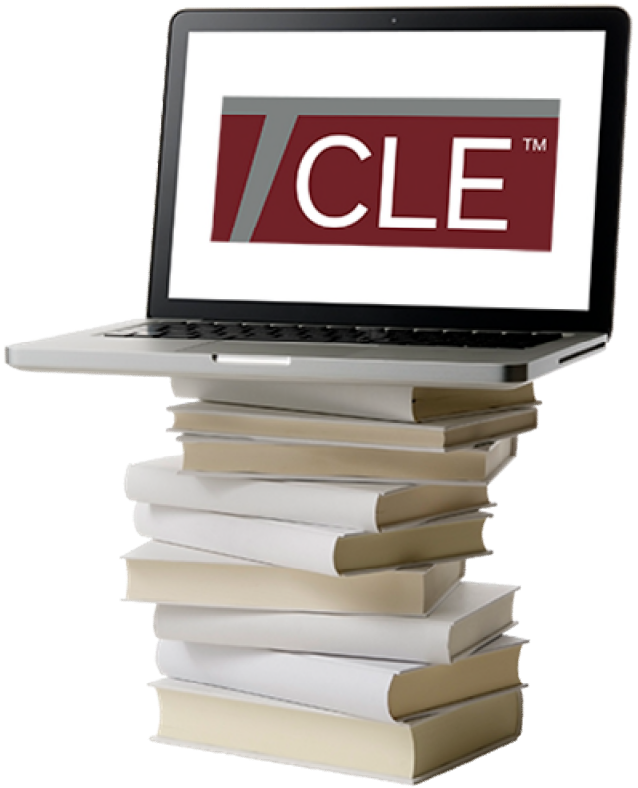

KNOWLEDGE WHERE YOU ARE™

Overview

- Business Opportunities
- Taxpayer Asserts Substance over Form
- Unincorporated Entity as S Corporation

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Business Opportunities (III.B.1.a.)

- Gifts of services and taxation of related employee benefits
- Gifts of business opportunities
- Developments in capital markets that sharpen discussion

Gifts of Services (III.B.1.a.iii., III.B.1.a.v.)

- Gifts of services
- Taxation of related employee benefits

Gifts of Services (III.B.1.a.iii., III.B.1.a.v.)

- Gifts of services that generates property transfer
- Taxation of related employee benefits
- Gift of services not accompanied by property transfer

Gifts of Services (III.B.1.a.v.(b).)

Dodge and other situations:

- Employee or other service provider bargains
- Employer or service recipient to pay or otherwise transfer property rights to a third party
- Result is payment of compensation, followed by gift to the third party

Gifts of Services (III.B.1.a.iii., III.B.1.a.v.)

- Employer provides benefit
- Employee designates recipient
- Benefit is compensation to the employee and a gift (complete or incomplete) to the recipient
- Common example: split-dollar life insurance

Gifts of Services (III.B.1.a.iii., III.B.1.a.v.)

- If an employer provides a benefit where the employee cannot designate (and has not previously irrevocably designated) the recipient, that benefit may or may not have tax consequences
- *DiMarco*: merely going to work was not a "transfer" for gift tax purposes
- Acts of independent significance (III.B.1.i.)

Attacks on Compensatory Property Rights

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Profits interests (II.M.4.f)

- Some require 3-year holding period to receive long-term capital gain rates (II.M.4.f.ii.(b))
- Recharacterized under Code § 707 as compensation income (and the payment may or may not be deductible) if payments lack sufficient entrepreneurial risk (II.C.8.a)
- Disguised sale rules (II.M.3.e)

Attacks on Compensatory Property Rights

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- Profits interests and Code § 2701 (III.B.7.c)
- Profits interest in a partnership that was a straight-up partnership before the transfer (III.B.7.c.i)
- Profits interest in a partnership in which transferor and applicable family members initially hold only a profits interest (III.B.7.c.ii)
- Same class exception - possible application to profits interests and other situations (III.B.7.c.iii)
- Transfers when owner holds profits interest/carried interest and other interests (III.B.7.c.iv)

Stock Options (II.M.4.g., III.B.7.c.vii.)

Rev. Rul. 98-21: transfer to a family member, for no consideration, of a nonstatutory stock option, is a completed gift under section 2511 on the later of:

- the transfer, or
- the time when the donee's right to exercise the option is no longer conditioned on the performance of services by the transferor

Stock Options (II.M.4.g., III.B.7.c.vii.)

Rev. Rul. 98-21 is wrong:

- Stock options were transferred in an a legally enforceable transaction in which the donor totally relinquished control
- Rev. Ruls. 79-384 and 80-186 held that gifts were complete when the donor's relinquishment of rights became enforceable
- In Rev. Rul. 98-21, relinquished rights when transferred option, not when performed services

Stock Options (II.M.4.g., III.B.7.c.vii.)

Rev. Rul. 98-21 is wrong:

- IRS' concern that option may have had no value when transferred because it was not exercisable at the time of the transfer is an argument that *Di Marco* rejected
- Different than split-dollar, which involves an up-front transfer and then ongoing transfers
- In Rev. Rul. 98-21, employer not making further transfers of property after issuing stock option

Gifts of Business Opportunities

- Loans (III.B.1.a.i.) and Loan Guarantees (III.B.1.a.ii.)
- Family Partnerships (III.B.1.a.iv.)
- Sending Business or Performing Services (III.B.1.a.v.)
- Asset Transfers to Children or Their Businesses (III.B.1.a.vi.)

Gifts of Business Opportunities (III.B.1.a.v., III.B.1.a.vi.)

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- Code § 2501 taxes "transfer of property by gift"
- *Crowley* (*acq.* 1961):
  - Dad owned bank
  - Partnership with bank for four children to handle appraisal fees, insurance fees, and title commissions
  - son could not have obtained appraisal work without Dad's help
  - Held that income taxable to partnership, not to Dad, so no gift

Gifts of Business Opportunities (III.B.1.a.v., III.B.1.a.vi.)

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Alabama-Georgia Syrup Co. v. Commissioner (*acq*. 1962)

- Brother directed business to suppliers for whom his sister was broker
- That fact did not require a conclusion that the income from the brokerage commissions was in substance that of the brother's corporation
- Slight nod to *Crowley* in opinion

Gifts of Business Opportunities (III.B.1.a.v., III.B.1.a.vi.)

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Bross Trucking, Inc. v. Commissioner (2014)
(II.Q.7.h.v)

- Lack of non-compete precluded corporate goodwill regarding owner-officer's relationships
- Owner's sons developed relationships with owner's customers when owner shut down owner's business due to regulatory hassles and sons started new corporation
- Workforce intangible not deemed transferred when only 50% of the employees of the old corporation worked for the new corporation

Gifts of Business Opportunities (III.B.1.a.v., III.B.1.a.vi.)

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- Does goodwill belong to the business or to its owners or employees? (II.Q.1.c.iii)
- *Estate of Adell v. Commissioner* (2014)
  - lack of non-compete precluded corporate goodwill regarding owner-officer's relationships
  - customers did business with owner's son because they trusted the son personally
  - son was qualified to run the business

Gifts of Business Opportunities (III.B.1.a.v., III.B.1.a.vi.)

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Business expansion into new location (III.B.1.a.vii.)

- New branch operations in new entity?
- Real estate leasing
- Equipment leasing (unrelated example of helping make arrangements)

Developments in Capital Markets

Deal with unrelated parties:

- Client, irrevocable trusts for the client's family, or some combination could invest and participate
- Investment required to start the business is relatively small compared to the business' value if the client and his/her cohorts put together profitable deals for the business
- All investors lose if the deals are not put together, but those putting together the deals have a great track record of success

Developments in Capital Markets

Deal with unrelated parties:

- Is granting the opportunity to invest a gift? Not according to *Crowley* and *Alabama-Georgia Syrup Co.*
- How about when third party investors pour in funds, increasing the value of all of the original investors' investments? Relative ownership of the client and the trusts does not change due to the third party investors, so this is all growth in business value
- Ongoing services required to produce this result, but failure to work does not cause forfeiture

Developments in Capital Markets

Deal with unrelated parties:

- *Dodge* and split dollar regs are transfers by third parties that are compensation to service provider and gifts from service provider to the person(s) benefitting from the transfer, and we have a third party influx of cash here
- Some estate planners are uncomfortable with this rapid influx of value into the trusts, believing that the nature of the deal is different than the real estate and equipment deals described above
- I do not share their discomfort but pass it along to you so that you can find your own comfort zone

Taxpayer Asserts Substance over Form

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- When a taxpayer may disavow form
- Practical applications of disavowing form
- Tax issues on business formation

When a Taxpayer May Disavow Form (II.G.34.)

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Complex Media, Inc. v. Commissioner, T.C. Memo. 2021-14:

> ... In *Danielson v. Commissioner* … we wrote: "We are unwilling to abdicate our judicial responsibility of examining the substance of a transaction. We are not bound by its form."

When a Taxpayer May Disavow Form (II.G.34.)

Complex Media, Inc. v. Commissioner, T.C. Memo. 2021-14:

> And in *Schmitz v. Commissioner* … (1968) …, in addition to declining to adopt the Third Circuit's Danielson rule, we suggested that the substance-over-form doctrine is equally available to taxpayers and the Commissioner….

When a Taxpayer May Disavow Form (II.G.34.)

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Complex Media, Inc. v. Commissioner, T.C. Memo. 2021-14:

> In *Estate of Rogers v. Commissioner*, … we accepted that "a taxpayer may go beyond what appears on the face of an agreement, just as the Commissioner may do so…." But, we observed, "the so-called 'two-way street' seems to run downhill for the Commissioner and uphill for the taxpayer…." "The Commissioner must be permitted to go beyond mere form to substance in order to protect the revenue", we explained, "but taxpayers have the opportunity at the outset to choose the most advantageous arrangement…."

When a Taxpayer May Disavow Form (II.G.34.)

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Complex Media, Inc. v. Commissioner, T.C. Memo. 2021-14:

> In *Glacier State Elec. Supply Co. v. Commissioner*, 80 T.C. 1047 (1983), we suggested that the higher burden faced by a taxpayer seeking to disavow the form of its transaction might be an evidentiary one….
>
> In *Glacier State Elec. Supply*, however, we did not clearly articulate just what the taxpayer should have to prove by more than a preponderance of the evidence. We ultimately rejected the taxpayer's substance-over-form argument on the grounds that "the substance of the transaction coincides with the form employed…."

When a Taxpayer May Disavow Form (II.G.34.)

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Complex Media, Inc. v. Commissioner, T.C. Memo. 2021-14:

> In *Coleman v. Commissioner* …, we suggested that a taxpayer faces a particularly high threshold in seeking to disavow the form of a transaction chosen to allow another party tax benefits (even under foreign tax law) that are inconsistent with the treatment the taxpayer seeks before us….

When a Taxpayer May Disavow Form (II.G.34.)

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Complex Media, Inc. v. Commissioner, T.C. Memo. 2021-14:

> In *Estate of Durkin v. Commissioner* … (1992), we identified other factors that tend to weigh against a taxpayer who seeks to disavow a transaction's form. The taxpayers in Estate of Durkin took a position contrary to their own tax reporting of the transactions in issue after the Commissioner had challenged their reporting. The taxpayers' "disavow[al] [of] their own tax return treatment", their failure to "show 'an honest and consistent respect for the substance of … [the] transaction", and their "unilateral[] attempt[]" to recast the transaction only "after it has been challenged" all weighed against our acceptance of their proposed step transaction recast…. "A party disavowing the form of a transaction may be unjustly enriched, particularly where the party was acting on tax advice, because the price may be influenced by tax considerations. If a party disavows the form of a transaction, the Commissioner may be whipsawed between one party claiming taxation based on the form, and the opposite party claiming taxation based on the substance…."

When a Taxpayer May Disavow Form (II.G.34.)

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Complex Media, Inc. v. Commissioner, T.C. Memo. 2021-14:

> *Dyess v. Commissioner*, T.C. Memo. 1993-219, 1993 WL 170147, at *10, *aff'd without published opinion*, 26 F.3d 1119 (5th Cir. 1994), similarly involved the rejection of a step transaction argument made by a taxpayer who, we concluded, had "met neither the strong proof test nor the Danielson test". Our conclusion rested in part on the taxpayer's failure to explain why the transaction structure employed was chosen over a considered-and-rejected alternative that would have achieved the tax results the taxpayer sought.…

When a Taxpayer May Disavow Form (II.G.34.)

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Complex Media, Inc. v. Commissioner, T.C. Memo. 2021-14:

> ... The taxpayer, we concluded, "cannot now disavow the route he in fact followed for a different route he might have but did not take…." The taxpayer had "met neither the strong proof test nor the *Danielson* test…." Therefore, the taxpayer could not "successfully invoke the substance over form doctrine to disavow the manner in which the Foxfire partnership was structured and the limited partnership interests sold."

When a Taxpayer May Disavow Form (II.G.34.)

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Complex Media, Inc. v. Commissioner, T.C. Memo. 2021-14:

> In sum, as our caselaw has evolved, it has become more hospitable to taxpayers seeking to disavow the form of their transactions. While we no longer reject those arguments out of hand, as we did in *Swiss Oil Corp.*, *J.M. Turner & Co.*, and *Television Indus.*, we have repeatedly indicated that taxpayers may face a higher burden than the Commissioner does in challenging transactional form. On occasion, as in *Glacier State Elec. Supply*, we have suggested that the taxpayer's higher burden might be an evidentiary one. But we have not identified specific factual questions that should be subject to a higher burden than that imposed by Rule 142(a) or articulated the quantum of evidence necessary to meet that burden. Nor have we offered a clear justification for imposing on the taxpayer a higher burden to prove facts relevant to the disavowal of form than the generally applicable preponderance of the evidence standard.

When a Taxpayer May Disavow Form (II.G.34.)

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Complex Media, Inc. v. Commissioner, T.C. Memo. 2021-14:

> Therefore, we now conclude that the additional burden the taxpayer has to meet in disavowing transactional form relates not to the quantum of evidence but instead to its content—not how much evidence but what that evidence must show by the usual preponderance. The Commissioner can succeed in disregarding the form of a transaction by showing that the form in which the taxpayer cast the transaction does not reflect its economic substance. For the taxpayer to disavow the form it chose (or at least acquiesced to), it must make that showing and more. In particular, the taxpayer must establish that the form of the transaction was not chosen for the purpose of obtaining tax benefits (to either the taxpayer itself, as in *Estate of Durkin*, or to a counterparty, as in *Coleman*) that are inconsistent with those the taxpayer seeks through disregarding that form. When the form that the taxpayer seeks to disavow was chosen for reasons other than providing tax benefits inconsistent with those the taxpayer seeks, the policy concerns articulated in Danielson will not be present.

Practical Applications of Disavowing Form

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- Sale or exchange of intellectual property - capital gain vs. ordinary income (II.G.19.b.)
- Whether payments relating to the transfer of a book of business are compensation or the sale of goodwill (II.L.2.a.i)
- Code § 754 election (II.Q.8.e.iii.(b), II.Q.8.e.iii.(d))
- A taxpayer unsuccessfully invoking Code § 2036 to try to get a basis step-up (II.A.2.i.i.(b))

Tax Issues on Business Formation (II.M.2., II.M.3.)

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- "Boot": a shareholder receiving assets other than stock (II.M.2.e.)
- *Complex Media* allocated basis to the assets deemed sold for boot
- Taxpayers successfully invoked substance-over-form and step transaction to allocate basis to assets received

Tax Issues on Business Formation (II.M.2., II.M.3.)

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- *Complex Media* allocated basis when the taxpayer failed to use the proper procedure to do so
- Its analysis reveals what arguments in allocating basis a court is likely to accept, including its approach to estimating values (II.M.2.e.)

Initial Incorporation (II.M.2.a.)

- Contribution to a corporation solely in exchange for stock is tax-free to all parties
- AM 2020-005 confirms that, if the transferor already owns at least 80% of the stock, the transferor does not need to be issued stock

Initial Incorporation (II.M.2.a.)

- When New Jersey paid the taxpayer's affiliates, *Brokertec Holdings, Inc. v. Commissioner*, T.C. Memo. 2019-32, held that the payments were nontaxable
- Third Circuit reversed in 2020, holding that unrestricted cash grants, calculated on the basis of the recipient's payment of wages, were not contributions to capital but rather were supplements to the company's income, because the payments were not intended to ""become a permanent part" of the taxpayer's "working capital structure."

Diversification of Investment Risk (II.M.3.b.)

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- Formation of partnership is taxable when it diversifies a contributing partner's investment
- Letter Ruling 202016013 describes looking through an investment to its components
- Partnership rules are based on corporate rules, but Tax Reform Act of 1986 changed paradigm so that corporate rules are looked to for partnerships more so than for corporations

Unincorporated Entity as S Corporation

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- Unincorporated entities making S election or owning S stock
- S corporation recent developments
- Using an S corporation to avoid Code § 2036 and estate planning implications of unincorporated entities making S election

Unincorporated Entity as S Corporation or Owning S Stock

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- How single class of stock rule affects LLC or partnership qualifying to make S election
- Estate planning issues unique to S corporations
- How being an LLC or partnership interacts with these planning issues

How Single Class of Stock Rule Affects Qualifying to Make S Election (II.B., II.A.2.i.)

- LLCs electing taxation as an S corporation file Form 2553 without needing to file Form 8832
- Generally, it's better to file only Form 2553 so that a failure of Form 2553 to be valid will revert the LLC back to a flow-through entity; this reversion applies to only the failure of the initial election and not to any subsequent terminating events, the latter which would convert the LLC to a C corporation unless cured

How Single Class of Stock Rule Affects Qualifying to Make S Election (II.B., II.A.2.i.)

- Every unit of ownership must have identical rights to distributions and liquidation proceeds
- If the LLC or partnership had been taxed as a partnership, make sure that distributions upon liquidation are made pro rata instead of according to capital accounts
- If an LLC or partnership with non-pro rata capital accounts is making an S election, consider issuing notes in the amount of the non-pro rata amounts

How Single Class of Stock Rule Affects Qualifying to Make S Election (II.B., II.A.2.i.)

- Various employment agreements and other side agreements among owners generally do not violate the single-class-of-stock rule, but that's because they are not part of the governing documents
- Make sure that such agreements are not part of the operating agreement, which may cause them to fall outside the scope of the regulations' protection

How Single Class of Stock Rule Affects Qualifying to Make S Election (II.B., II.A.2.i.)

- Letter Rulings are frequently issued to correct operating agreements and partnership agreements that violate the single-class-of-stock rule
- However, the IRS will not rule on whether a state law limited partnership violates the single class of stock rule

How Single Class of Stock Rule Affects Qualifying to Make S Election (II.B., II.A.2.i.)

- Issuing a profits interest would violate the single class of stock rule, but it can qualify for inadvertent termination relief
- If a profits interest is desirable, the S corporation should form an LLC subsidiary and have the LLC issue profits interests

Estate Planning Issues Unique to S Corporations (II.A.2.d.)

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QSST (III.A.3.e.vi):

- Tax the beneficiary on the trust's taxable income to avoid it being taxed at the trust's high income tax rates, a tax differential that has become more pronounced after 2012
- Sell the beneficiary's assets to a trust to freeze the beneficiary's estate while allowing the beneficiary to benefit from the assets' income

Estate Planning Issues Unique to S Corporations (II.A.2.d.)

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- Code § 2036 cases cause partnerships to be disregarded for estate tax purposes, artificially increasing the value included in the owner's estate unless the taxpayer proves that each entity was created for a "legitimate and significant nontax reason" (the *Strangi-Bongard-Powell* line of cases)
- This increase may cause double inclusion of the appreciation of the retained partnership interest
- S corporation owners can avoid this issue by retaining voting stock and transferring nonvoting stock (Rev. Rul. 81-15)

LLC or Partnership Impact on S Corp Planning Issues (II.A.2.d.)

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Pierre (2009):

To conclude that because an entity elected the classification rules set forth in the check-the-box regulations, the long-established Federal gift tax valuation regime is overturned as to single-member LLCs would be "manifestly incompatible" with the Federal estate and gift tax statutes as interpreted by the Supreme Court.

LLC or Partnership Impact on S Corp Planning Issues (II.A.2.d.)

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Pierre (2009) mentioned that Chapter 14 provided special rules in valuing business interests, then said:

> 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.

LLC or Partnership Impact on S Corp Planning Issues (II.A.2.d.)

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- *Pierre* (2009) valued property rights but did not specify how check-the-box rules may apply in the context
- Without addressing the check-the-box rules, *Mirowski v. Commissioner*, T.C. Memo. 2008-74, approved the nontax reasons for forming a single member LLC that was disregarded for income tax purposes, which approval was helpful when gifts of LLC interests were made later

LLC or Partnership Impact on S Corp Planning Issues (II.A.2.d.)

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Pierre:

> We do not find *Estate of Mirowski* to be controlling because the Commissioner did not rely on the check-the-box regulations with respect to the transfer of the LLC interests there in issue. However, we do note that in *Estate of Mirowski* we refused to adopt an interpretation that "reads out of section 2036(a) in the case of any single-member LLC the exception for a bona fide sale ...
>
> that Congress expressly prescribed when it enacted that statute."

LLC or Partnership Impact on S Corp Planning Issues (II.A.2.d.)

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- In light of *Mirowski* and *Pierre*, cannot rely on check-the-box regulations to cause Rev. Rul. 81-15 to protect an LLC or a partnership that makes an S election
- Consider converting to a state law corporation or making the LLC a subsidiary of one – both tax-free (II.P.3.h)

LLC or Partnership Impact on S Corp Planning Issues (II.A.2.d.)

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- Tiered structures create significant limitations on Code § 6166 and sometimes uncertainty as to whether the election is available
- However, a qualified subchapter S subsidiary (Qsub) is disregarded and should be for purposes of Code § 6166, because no regulation provides otherwise and check-the-box limit N/A
- No authority directly addresses this conclusion
- Query whether use Qsub instead of disregarded LLC (or LLC elects corporate treatment)

LLC or Partnership Impact on S Corp Planning Issues (II.A.2.d.)

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- S corporation per unrelated business income taxable to charity, whether items of K-1 from S corporation or the sale of stock
- If trust includible in decedent's estate passes to charity, then UBI issues
- Suggest liquidating S corporation immediately after death to avoid post-mortem UBTI
- If LLC taxable as S corporation, can do retroactive planning by unchecking-the-box up to 75 days after death

S Corporation Recent Developments (II.A.2.i.ii., II.A.2.i.iii.)

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- Disproportionate distributions that are not contemplated by the governing provisions do not necessarily violate the rules against a second class of stock
- They are often fixed by make-up distributions to those who received less
- In Letter Ruling 202103010, taxpayer represented that annual non-resident income tax payments to certain states created a second class of stock
- Taxpayer took corrective action, and IRS granted inadvertent termination relief
- Likely overreaction to assure a buyer

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Conclusion

- CPA Academy webinar page, including:
  - How to Shift Income to Beneficiaries
  - Pass-through Entities Held By Trusts
  - Beneficiary Deemed-Owned Trusts
  - Formula Transfers for Estate Planning
- Blog: Business Succession Solutions
- Reports on Heckerling: http://www.thompsoncoburn.com/forms/gorin-heckerling
- Gorin's Business Succession Solutions
- July 27 webinar for Second Quarter Newsletter
- Other free Thompson Coburn LLP resources