

Note Modifications; Reorganizing Private Business; Trust Sale of Business Interests

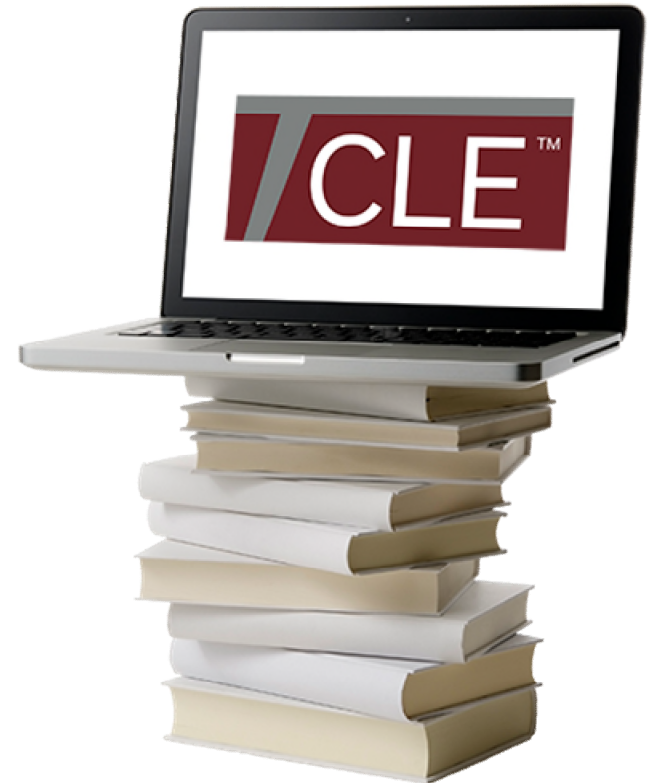
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Overview

- When note modification = exchange; payment in kind; discounting note
- Moving S corporation into partnership; isolating business liabilities; IRS Practice Units
- ESBT/QSST issues re: sale of an S corporation

Note Modification (II.G.32.)

- Reg. § 1.1001-3 - “Modifications of debt instruments” - whether modification is exchange for purposes of Reg. § 1.1001-1(a)
- Significant modification is exchange of original debt instrument for modified instrument differing materially either in kind or in extent

Note Modification (II.G.32.)

- Modification - any alteration of the payor's or payee's legal rights or obligations, unless change per note terms and not per se modification
- Significant only if alter legal rights or obligations in economically significant manner

Note Modification (II.G.32.)

A change in the yield of significant if yield varies from the annual yield on unmodified instrument by more than the greater of:

- $\frac{1}{4}$ of one percent (25 basis points), or
- 5% of the annual yield of the unmodified instrument ($.05 \times$ annual yield)

Note Modification (II.G.32.)

- Material deferral of scheduled payments is significant modification unless falls in safe harbor
- Deferral may occur by extending final maturity date or deferring payments before maturity

Note Modification (II.G.32.)

- Safe-harbor period begins on original due date of first scheduled payment that is deferred
- Safe harbor extends for a period equal to the lesser of 5 years or 50% of original term of the instrument
- If period during which payments are deferred is less than full safe-harbor period, unused portion of period remains safe-harbor period for any future deferrals

Note Modification (II.G.32.)

- Change in obligor (trust division?) or security
- Change in nature of debt instrument
- Accounting or financial covenants

Polling Question

Payment in Kind (III.B.1.a.i.(e).)

Code § 1058 loan of securities (II.A.1.d.i.) must:

- Return to transferor of securities identical to securities transferred
- Provide payments to transferor of all interest, dividends, and other distributions which the owner of securities is entitled to receive
- Not reduce transferor's risk of loss or opportunity for gain in the securities transferred
- Meet other requirements in any regulations

Payment in Kind (III.B.1.a.i.(e).)

- If securities are sold to trust for a note expected to be repaid with those securities and IRS successfully asserts that sale was essentially a loan of the securities, could IRS assert that any payment less than equity return constituted gift?
- Make cash flow projections showing realistically how the note will be repaid?
- Keep in privileged file until needed – don't want to show IRS schedule differing from actual payments

Valuing Notes (III.B.5.b.)

- Discount promissory notes?
- Reduced basis means principal taxable when collected to the extent of discount
- Ordinary income or capital gain
- Federal and state income tax rates may very well exceed estate tax rates
- Provoke IRS examiner when one takes full credit for note for gift tax purposes and reports a lower value for estate tax purposes

Proposed Legislation

- Any exchange with irrevocable grantor trust subjects parties to income tax consequences
- “Contributions,” which may very well include exchanges, would taint grandfathered irrevocable grantor trusts
- Consider whether any outstanding notes involving irrevocable grantor trusts are likely to be paid – in cash - within their current schedule
- If not, consider modification or other transaction to avoid any repercussions from the note not being paid – in cash - within current schedule

Reorganizing Private Businesses

- Why to migrate S corporation to partnership
- How to migrate S corporation to partnership
- Letter Ruling 202102007 - how to isolate risky elements of a business from less risky components
- IRS Practice Units

Partnership vs. S Corporation

- Some say they are equivalent, but they are not
- Transfer of partnership interest by sale or death allows buyer or beneficiary to get inside and outside basis step-up
- Basis step-up → more depreciation/less gain on sale if partnership sells assets
- S corporation might replicate if it sells all assets and liquidates in the same year

First, Illustrate S Corporation

Problem (ll.Q.8.e.iii.(a).)

- S corporation has assets with zero basis and \$1,000,000 value
- Sam Sucker buys 50% of stock for \$500,000
- Assets are sold
- S corporation gives Sam a K-1 for his \$500,000 share of the gain
- Sam is the proud owner of a \$1,000,000 basis in his stock (\$500,000 purchase price plus \$500,000 K-1) that is worth \$500,000

Next, Illustrate Partnership Solution (II.Q.8.e.iii.(a).)

- Smart Sally finds a partnership with the same characteristics - assets with zero basis and \$1,000,000 value
- Sally buys 50% partnership interest for \$500,000
- Partnership makes a Code § 754 election, giving Sally a \$500,000 in her half of its assets
- Assets are sold
- Sally has no gain on that sale and is content with her \$500,000 basis
- If assets are not sold, Sally is happy with any depreciation on her share of assets

Basis Step-Up Issues: Depreciable Real Estate in an S Corporation (Sale to Third Party) (II.H.8.)

Sale to Third Party (Zero basis, \$1M value)

Proceeds from sale	\$ 1M
Basis of real estate	<u>\$ 0</u>
Gain on K-1	<u>\$ 1M</u>

Basis Step-Up Issues: Depreciable Real Estate in an S Corporation (Sale to Third Party) (Cont'd)

Sale to Third Party (Zero basis, \$1M value)

Stock basis after death	\$1M
Gain on K-1	<u>\$1M</u>
Stock basis after sale of real estate	<u>\$2M</u>

Basis Step-Up Issues: Depreciable Real Estate in an S Corporation (Sale to Third Party) (Cont'd)

Sale to Third Party (Zero basis, \$1M value)

Liquidation proceeds	\$ 1M
Stock basis	<u>(\$ 2M)</u>
Loss on liquidation	<u>(\$ 1M)</u>

Basis Step-Up Issues: Depreciable Real Estate in an S Corporation (Sale to Third Party) (Cont'd)

Sale to Third Party (Zero basis, \$1M value)

Long-term capital gain on K-1	\$ 1M
Long-term capital loss on liquidation	<u>(\$ 1M)</u>
Net long-term capital gain (loss)	<u>\$ 0</u>

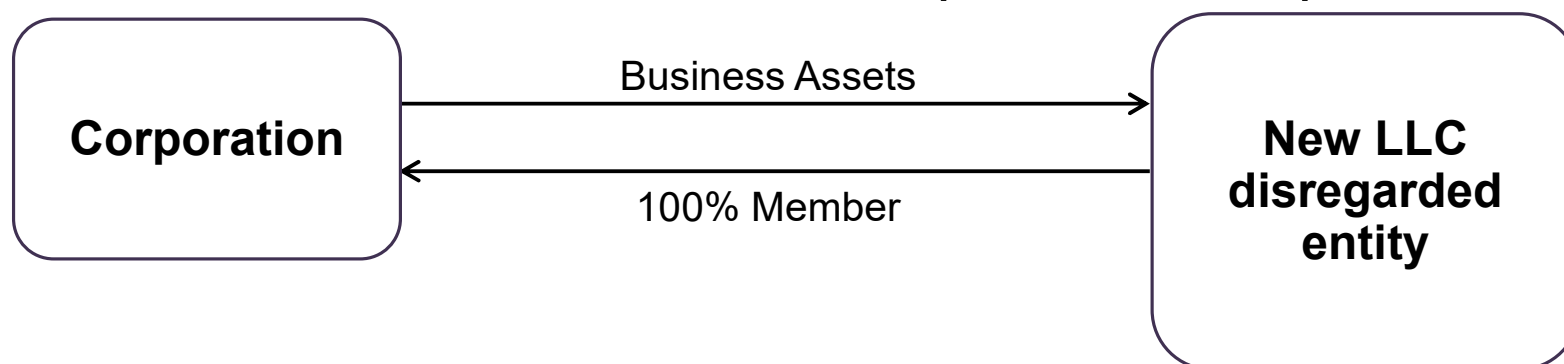
Basis Step-Up Issues: Depreciable Real Estate in an S Corporation (Sale to Third Party) (Cont'd)

- Sale to third party required if depreciable or amortizable property (ll.H.8.b)
- State income tax disconnect (ll.H.8.a.ii.)

Migrating Existing Corporation into Preferred Structure (II.E.7, II.E.7.c.i.(a).)

Corporation Forms New LLC – Two Options

Direct Formation of LLC (1st option)



Migrating Existing Corporation into Preferred Structure

Corporation Forms New LLC

Direct Formation of LLC (1st option)

Advantages

- 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

Migrating Existing Corporation into Preferred Structure

Corporation Forms New LLC

Direct Formation of LLC (1st option)

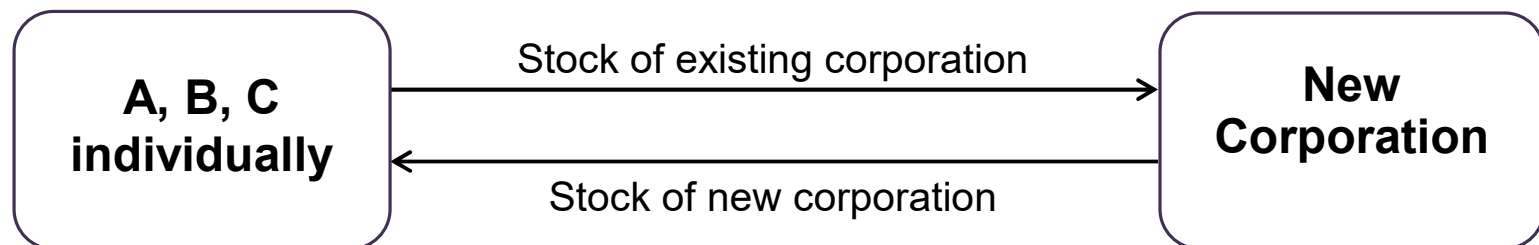
Disadvantages

- Piecemeal Transfer of Assets
- Some Assets Not Readily Transferable

Migrating Existing Corporation into Preferred Structure (I.P.3.h.)

Corporation Forms New LLC

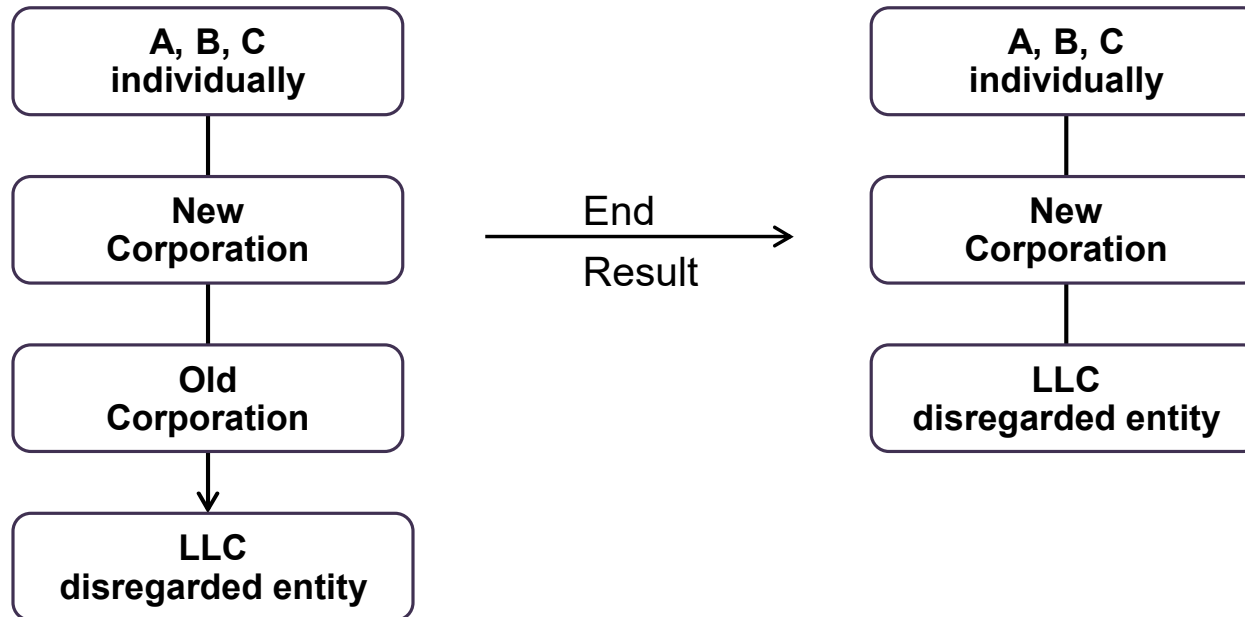
Use F Reorganization to Form LLC (2nd option)



Migrating Existing Corporation into Preferred Structure (II.E.7.c.)

Corporation Forms New LLC

Use F Reorganization to Form LLC (2nd option)



Migrating Existing Corporation into Preferred Structure

Corporation Forms New LLC

Use F Reorganization to Form LLC (2nd
option)

Advantage

- Moves all assets in one fell swoop

Migrating Existing Corporation into Preferred Structure

Corporation Forms New LLC

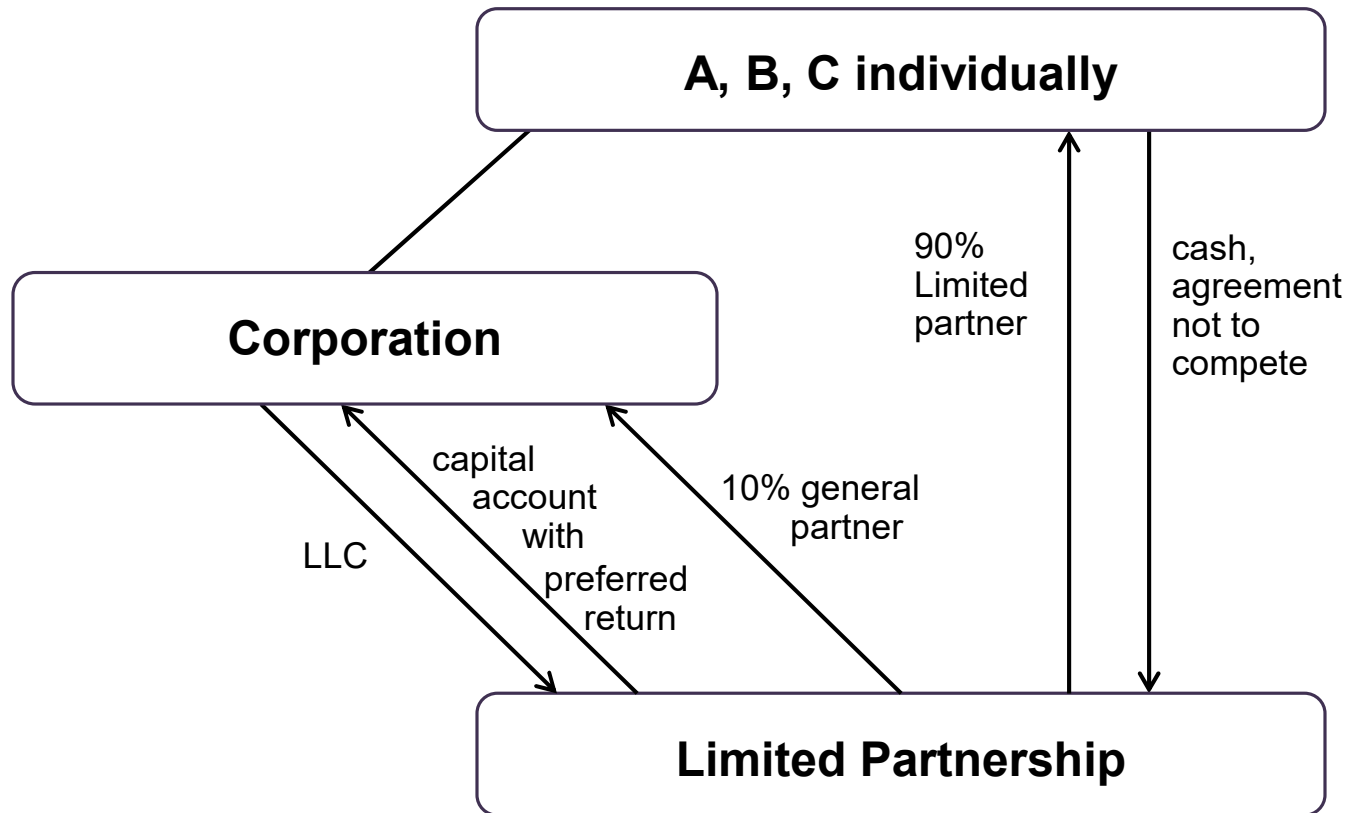
Use F Reorganization to Form LLC (2nd option)

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

Migrating Existing Corporation into Preferred Structure (II.E.7.c.ii., II.Q.7.h.)

Migrating LLC to LP



Polling Question

Basis Step-Up/Down for Partnership's Assets (II.Q.8.e.iii.(c).)

- Code § 743 provides new basis upon partner's death or sale or exchange of a partnership interest if a Code § 754 election is in place
- If a Code § 754 election is in place, deadline is partnership return for the year in which the death or the sale or exchange occurred
- What if miss deadline?

Basis Step-Up for Partnership's Assets

- Liquidate partnership
- Private letter ruling
- Sale or exchange of partnership interest

Basis Step-Up for Partnership's Assets

“Sale or exchange” includes nontaxable transfers (ll.Q.8.e.iii.(b).) and Reg. § 1.755-1(b)(5):

- Contribute to new partnership
- Contribute to corporation
- Distribute as part of trust funding (ll.Q.8.e.i.)
- Deemed distribution of a partnership interest in an assets-over merger (ll.Q.8.e.v.) of two partnerships - TAM 201929019 (ll.Q.8.e.i.)

No need to worry about technical termination, which 2017 tax reform repealed

Basis Step-Down for Partnership



Assets (ll.Q.8.e.iii.(c).)

- Unrealized inside loss of more than \$250,000 generates basis adjustment on partner's death or sale or exchange of partnership interest, even if a Code §754 election is not in place. Same if any transferee partner's share of unrealized loss is more than \$250,000.
- Selling enough loss assets to avoid a substantial built-in loss would generate current deduction and avoid basis step-down

Letter Ruling 202102007 (II.P.3.h.)

- Corporation had risky elements and a profitable subsidiary
- New parent corporation was formed
- Old corporation merged into a disregarded-for-tax-purposes LLC owned by the new corporation, thereby giving the new corporation the old corporation's tax attributes

Letter Ruling 202102007 (ll.P.3.h.)

- After new corporation agreed to keep the LLC solvent, the LLC then distributed the corporate subsidiary to the new corporation
- At the end of the day, new corporation had old corporation's tax attributes and owned profitable corporate subsidiary and risky LLC.

IRS Practice Units (II.G.2.e.)

- Liquidating Distributions of a Partner's Interest in a Partnership
- Reasonable Cause and Good Faith
- Sale of a Partnership Interest
- Determining Liability Allocations
- Recourse vs. Nonrecourse Liabilities

IRS Practice Units (II.G.2.e.)

- **Exiting From or Dividing a Partnership**
(II.Q.8)
- **Allocating Liabilities (Including Debt)**
(II.C.3)
- [Wyden's proposals](#)

Polling Question

Overview

- Turning off grantor trust status in anticipation of the sale and related post-sale reporting of income (main topic)
- Participation in light of net investment income (NII) tax
- QSST opportunities after-the-fact

Tax Allocations upon

Change of Interest in a Business (III.B.2.j.)

- Tax Allocations on the Transfer of Stock in an S Corporation (III.B.2.j.ii.)
- Tax Allocations upon Change of Interest in a Partnership (III.B.2.j.iii.)
- Changing Grantor Trust Status (III.B.2.j.i.)
- Income Tax Reimbursement Clause (III.B.2.j.iv.)

Tax Allocations on the Transfer of Stock in an S Corporation (III.B.2.j.ii.)

- General Rules for Tax Allocations on the Transfer of Stock in an S Corporation (III.B.2.j.ii.(a))
- Transfer of Less Than Shareholder's Entire Interest (III.B.2.j.ii.(b))
- Transfer of Shareholder's Entire Interest (III.B.2.j.ii.(c))
- Death of a Shareholder (III.B.2.j.ii.(d))
- Change in Qualification of Trust to Hold S corporation Stock During Taxable Year (III.B.2.j.ii.(e))
- Distribution after Transfer (III.B.2.j.ii.(f))

General Rules for Tax Allocations on the Transfer of Stock in an S Corporation

(III.B.2.j.ii.(a))

- Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation; Possible Way to Attain Basis Step-Up (II.H.8.)
- Pro rata, per-share, per-day is normal rule for S corporation; exception discussed further below
- Big increases in income (such as from the sale of significant capital asset) toward the end of a taxable year can cause problems for a shareholder whose stock is transferred before the sale
- Some states impose deadline for declaring a dividend of 1-2 months after the record date

Transfer of Less Than Shareholder's Entire Interest (III.B.2.j.ii.(b))

- Each corporate item is assigned, in equal portion, to each day of the taxable year
- That portion is divided pro rata among the shares outstanding on that day
- Grantor is treated as a shareholder for the day of disposition, including the day of his or her death

Transfer of Shareholder's Entire Interest (III.B.2.j.ii.(c))

Accounting cut-off (if available):

- Books will be treated as if the taxable year consisted of two taxable years, the first of which ends on the close of the day in which the grantor's entire interest in the S corporation is terminated
- Requires consent of the shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the taxable year

Transfer of Shareholder's Entire Interest (III.B.2.j.ii.(c))

- When grantor transfers the entire S corporation interest, use the daily proration rule unless elect accounting cut-off
- Election available on the occurrence of any event through which a shareholder's entire stock ownership in the S corporation ceases, including:
 - Sale, exchange, or other disposition of all of the stock held by the shareholder
 - Gift under section 102(a) of all the shareholder's stock
 - Spousal transfer under section 1041(a) of all the shareholder's stock
 - A redemption, as defined in section 317(b), of all the shareholder's stock, regardless of the tax treatment of the redemption under section 302
 - The shareholder's death

Transfer of Shareholder's Entire Interest (III.B.2.j.ii.(c))

- Conversion from grantor trust to nongrantor trust does NOT qualify for accounting cut-off
- Thus, switch between QSST and ESBT does NOT qualify for accounting cut-off
- Generally, termination of grantor trust status due to death might or might not qualify for accounting cut-off; however, a Code § 645 election will qualify because the shareholder becomes an estate, not a trust

Death of a Shareholder (III.B.2.j.ii.(d))

- If shareholder dies (or is estate or trust that terminates) before corporation's taxable year ends, pro rata share taken into account on shareholder's final return, with date of death being reported on the decedent's final individual income tax return
- Items from portion of the corporation's taxable year after the shareholder's death taken into account by estate or other person acquiring the stock
- Executor may consent to cut-off for decedent

Change in Qualification of Trust to Hold S Corporation Stock During Taxable Year

(III.B.2.j.ii.(e))

- First day that a QSST or an ESBT is treated as an S corporation shareholder is the effective date of the QSST or ESBT election
- No accounting cut-off available (discussed above)

Distribution after Transfer

(III.B.2.j.ii.(f))

- Consider whether the donor or other transferor will need to receive distributions after the transfer and whether state law permits such transfers
- May need distribution to pay taxes but might not know how much until after the corporate income tax return for the year is filed
- Some state laws limit how far back record date can go; even if permitted, need internal approval
- Consider agreement that transferee pay appropriate tax distributions to transferor

Changing Grantor Trust

Status (III.B.2.j.i.)

- No accounting cut-off for S corporation
(III.B.2.j.ii.(b))
- Partnership does not have these complex rules regarding change in trust status (III.B.2.j.iii.)
- Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation (III.B.2.d.i.(b))

Tax Allocations upon Change of Interest in a Partnership (III.B.2.j.iii.)

- Special rules apply if a partnership interest is created by gift (family partnership rules) (III.B.1.a.iv.(b))
- Rev. Rul. 72-352: trust's distribution of partnership interest to remainderman on termination of the trust did not terminate partnership's taxable year overall but did close for trust as partner, so trust includes distributive share of partnership items and any guaranteed payments as though partnership year had ended on trust's termination date
- Consider that ruling in the context of regulations (below) adopted after that ruling but do not expressly refer to that ruling

Transfer of Less Than a Partner's Entire Interest (III.B.2.j.iii.(a))

- Generally, partnership's taxable year does not close with respect to a partner who sells or exchanges less than entire interest or whose interest is reduced (whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise); even a transfer of a partner's entire interest by gift does not close the taxable year
- Each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year are determined by the use of any method prescribed by regulations which takes into account the varying interests of the partners in the partnership during such taxable year

Transfer of Less Than a Partner's Entire Interest (III.B.2.j.iii.(a))

But pro rata for any “allocable cash basis item”:

- Interest
- Taxes
- Payments for services or for the use of property
- Any other item of a kind specified in regulations if appropriate to avoid significant misstatements of the partners' income

Allocation of Specific Items

(III.B.2.j.iii.(e))

- Applies whether transfer part or all of partnership interest
- Certain agreements among the partners to allocate are respected
- Special rules for extraordinary items
- If cut-off or proration is elective, presumption of accounting cut-off unless partners agree to pro rate

Participation in Light of NII Tax

- Application of 3.8% Tax to Business Income (II.I.8.)
- Passive Activity Recharacterization Rules (II.I.8.a.i.)
 - Significant participation activities (more than 100 hours of participation)
 - Certain rental activities
 - Certain rules relating to the disposition of substantially appreciated property formerly used in nonpassive activity
 - Recharacterized as a nonpassive activity and is further characterized as portfolio income under certain provisions

Material Participation for Business or Rental Activities (II.J.4.e.)

- General idea: Passive (II.K.) = NII (II.I.8.)
- Document trustee's participation
- Even if trust taxed to deemed owner under grantor trust rules, consider having trustee participate (discussed below)
- Beneficiary's participation can trigger depreciation (II.J.11.a.ii.(b).)

Material Participation for Trusts

<u>Trust Type</u>	<u>Participant</u>
QSST (normal operations)	Beneficiary
QSST (stock or asset sale)	Trustee*
ESBT	Trustee

* Per proposed regulations and IRS' litigation position on trust material participation

See II.K.2.

Material Participation for Business or Rental Activities (II.J.4.e.)

- QSST beneficiary taxed as deemed owner of S corporation stock except for gain on sale of stock or business assets, which allows beneficiary to run through all the lower brackets before getting to higher brackets
- Applying 3.8% Tax to Trusts Owning Businesses Other than S Corporations If the Beneficiary is Active But the Trustee Is Not (II.J.13)
- Application of 3.8% NII Tax to ESBTs (II.J.14.)
- QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items (II.J.15.)
- Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets (II.J.16.)
- Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax (II.J.17.)

Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Trust Accounting Rules (II.J.12.)

- QSST beneficiary bears tax on all reinvested income
- ESBT beneficiary bears no tax on income distributed to beneficiary
- Other cases tax beneficiary only to extent distributions received; trust payment of tax on reinvested income reduces cash available for trust to distribute
- When trust sells interest in passthrough, consider allocating gain to income as an equitable adjustment to make up for tax on reinvested income (if appropriate); may allow full run-up in individual income tax brackets
- Mandatory income trust equitable adjustment can be done any time before the tax return is filed; discretionary income trust would need to follow 65-day rule

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](#)
- January 25 webinar for Third Quarter Newsletter
- Other [free Thompson Coburn LLP resources](#)