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Sales Between Trusts; Writing Off Business Interests; Partnership Audit Rule Update

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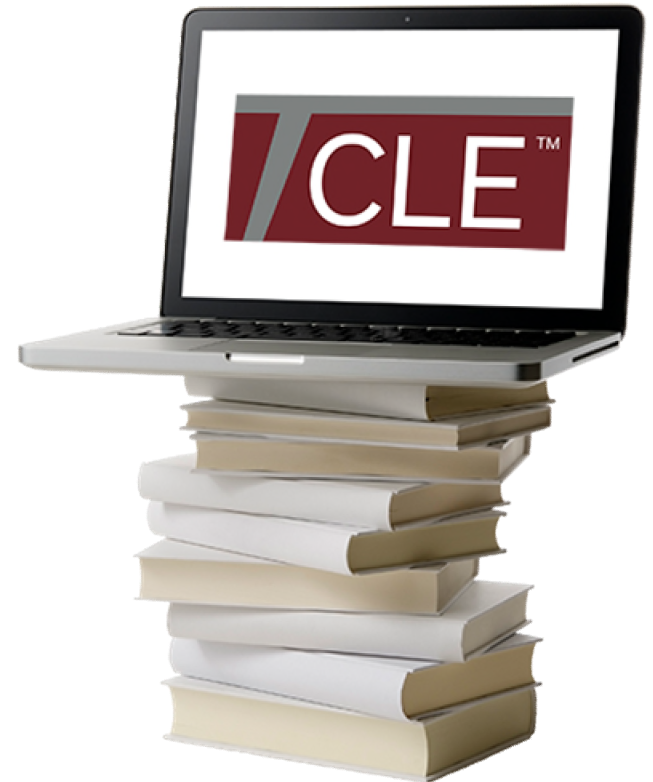

KNOWLEDGE WHERE YOU ARE™

Overview

- Sales Between Trusts
- Writing Off Business Interests
- Partnership Audit Rule Update

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Sales Between Trusts

- Income tax
- Gift tax statute of limitations
- GST inclusion ratio
- Alternative of terminating trust and beneficiaries do their own estate planning

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Sales Between Trusts

- If trusts are grantor trusts with the same deemed owner, no tax unless grantor trust status terminates before any note between trusts is sufficiently repaid (III.B.1.c.i.(a) – bargain sale)
- If seller is a nongrantor trust, consider making the seller the deemed owner of the buyer (III.B.2.i) to avoid income taxation

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Seller Deemed Owner of Buyer (III.B.2.i.)

- Any non-beneficiary funds new trust by placing up to $5,000 in a non-interest-bearing account and allocates GST exemption to the trust
- Old trust has right to withdraw the initial gift for 30 days +/-
- No further gift to new trust
- Code § 678(a)(1) this slide; Code § 678(a)(2) next slide

Seller Deemed Owner of Buyer (III.B.2.i.)

- Trustee of new trust has absolute discretion to distribute to old trust, so that Code § 677 would have applied if old trust had been the grantor
- Many of us believe that private letter rulings approving swap power held by beneficiary are wrong and that they trigger Code § 678(b)

Seller Deemed Owner of Buyer (III.B.2.i.)

- Because the buyer trust is thinly funded, consider loan guaranty from trust that has beneficial interests as close as possible to the buyer trust so that a guaranty fee is not needed
- The guarantor trust might be an old-and-cold trust or might be a new one

Formula Clause (III.B.3.)

- Defined transfer (don’t know how much business interest is transferred) vs. defined purchase price (don’t know amount of note)
- “Finally determined for gift purposes” is more challenging because of who must file and whether any transfer between trusts would be a completed gift (cont’d)

Formula Clause (III.B.3.)

- If any gifts would be made in a transfer from one trust to another, it would be from the beneficiaries of the transferor trust when the statute of limitations for challenging the trustee's actions expires
- Could be a totally incomplete gift, a partially incomplete gift (but beware Code § 2702), a completed gift with Code § 2036 implications, or a completed gift without any estate inclusion

Formula Clause (III.B.3.)

- To run the gift tax statute of limitations, each beneficiary would need to have made, at least in part, a “completed transfer” referred to by Reg. § 301.6501(c)-1(f)(4), and to report it using adequate disclosure (III.B.4.)
- If any part of the transfer is complete and the beneficiary retains an interest in the transferee trust, the beneficiary may have made a gift equal to the entire beneficial interest transferred (III.B.7.d.) and may have Code § 2036 inclusion (III.B.8.)

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Formula Clause (III.B.3.)

- If we can't get gift tax finality, can we get GST finality? (III.B.1.d.)
- GST transfers depend on not having gift or estate tax event; if no finality for that for any years, then can we even get GST finality?
- GST statute of limitations runs the later of running the statute of limitations (SOL) on the transferor's estate tax return or on a GST return reporting the transfer to a slip person (III.B.3.b.)

GST "Transferor" (III.B.1.d.iii.)

- If a trust has more than one transferor, the portions of the trust attributable to the different transferors are treated as separate trusts for GST purposes. Reg. § 26.2654-1(a)(2).
- Thus, if more than one beneficiary is treated as transferring to the transferee trust, each deemed separate trust's GST statute of limitations would need to run to finally determine the inclusion ratio.
- Who is the transferor determines who is a "skip person"

Formula Clause (III.B.3.)

- Running the gift or GST tax statute of limitations regarding a transfer between trusts seems dicey
- Perhaps give up on finality and use a formula based on the appraised value, which appraisal is conclusive absent any errors of fact or analysis
  - *Nelson v. Commissioner*, T.C. Memo. 2020-81, respected the formula according to the appraisal but did not permit subsequent adjustments because the formula did not mention them
  - Uncertain whether a court would respect "absent any errors of fact or analysis"

Sales Between Trusts

- Gift and estate tax audits ask about transfers made by the donor or decedent, whereas the transfer is made by the trustees in a sale between trusts
- GST returns do not ask about transfers to the trust or for evidence of inclusion ratio
- Should one just make a good faith sale and hope for the best? An alternative is on the next slide.

Sales Between Trusts

- Consider distributing to the beneficiaries and then the beneficiaries do their own estate planning, the latter then triggering the statute of limitations
- Consider whether the distribution to the beneficiaries may trigger income tax or gift tax, the trustee's exposure for making the distribution, and the trade-off between that exposure and any step-transaction attack

Sales Between Trusts

- Whether distributions to beneficiaries trigger none, one, or both of gift tax or income tax depends on authority for distributions (II.J.18., III.B.1.b.)
- Could distribute to a trust where a beneficiary of the former trust is the nominal (and arguably actual) settlor and is also a beneficiary with an inter vivos and testamentary general power of appointment exercisable only with the consent of a trusted nonadverse party (II.H.2.k.)
- Gorin safeguard for trustee to avoid release (II.J.4.j.)

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Sales Between Trusts

- If new trust is considered a continuation of the old trust, then query whether the transferor has changed (III.B.1.d.iii)
- Even if the transferor has not changed, any sale from the incomplete gift trust to a new, completed gift trust created by the beneficiary would have consequence of running the statute of limitations, because any gift element would be the beneficiary releasing a general power of appointment (II.J.4.j.)

Writing Off Business Interests
(II.G.8.)

- How to prove that a business interest is worthless
- Income tax consequences of worthlessness, including IRC § 1234A
- *MCM Investment Management, LLC v. Commissioner*, T.C. Memo. 2019-158

Writing Off Business Interests
(II.G.8.)

- "Section 165(a) allows a deduction for any loss sustained during the tax year and not compensated for by insurance or otherwise."
- "To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the tax year."

Writing Off Business Interests
(II.G.8.)

- "'worthlessness' is a stand-alone justification for a deduction under section 165(a), and a taxpayer may deduct a loss from an investment in a partnership if the partnership interest becomes worthless during the tax year"
- Stipulated no "abandonment" of partnership interest (discussed later)

Writing Off Business Interests
(II.G.8.)

- "Taxpayer must demonstrate its 'subjective determination of worthlessness in a given year, coupled with a showing that in such year the asset in question is in fact essentially valueless….'"
- Must be "essentially" valueless, so "taxpayer does not have to prove that a given asset is absolutely, positively without any value whatsoever"

Writing Off Business Interests
(II.G.8.)

Subjective proof

- Taxpayer took the position on its tax return that the business interest was worthless
- Owners and management testified credibly at trial that they believed asset became worthless during taxable year, pointing to objective facts regarding the business' struggles

Writing Off Business Interests
(II.G.8.)

Objective proof, per prior case

- "The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through the foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss."

Writing Off Business Interests
(II.G.8.)

Objective proof, per prior case

- "The loss of potential value, if it exists, can be established ordinarily with satisfaction only by some 'identifiable event' in the corporation's life which puts an end to such hope and expectation."

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Writing Off Business Interests
(II.G.8.)

Objective proof, per prior case

- "There are, however, exceptional cases where the liabilities of a corporation are so greatly in excess of its assets and the nature of its assets and business is such that there is no reasonable hope and expectation that a continuation of the business will result in any profit to its stockholders. In such cases the stock, obviously, has no liquidating value, and since the limits of the corporation's future are fixed, the stock, likewise, can presently be said to have no potential value. Where both these factors are established, the occurrence in a later year of an "identifiable event" in the corporation's life, such as liquidation or receivership, will not, therefore, determine the worthlessness of the stock, for already 'its value had become finally extinct.'"

Writing Off Business Interests
(II.G.8.)

Objective proof, per prior case

- "Balance sheet insolvency at the entity level is not necessarily required when preferred equity interests are involved, however. A subordinate equity interest may become worthless if the company cannot satisfy a senior equity interest holder's preferential claim in liquidation…."

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Writing Off Business Interests
(II.G.8.)

Back to current case:

- "The hope and expectation that an equity interest may become valuable in the future can be foreclosed when certain 'identifiable events' occur in the company's life that effectively destroy the potential value…. Identifiable events include, e.g., bankruptcy, the cessation of business, liquidation, or the appointment of a receiver…. The evidence 'may vary according to circumstances and conditions….' In some instances a taxpayer can demonstrate that its equity interest does not have potential future value, even in the absence of an identifiable event, if the company becomes hopelessly insolvent…."

Writing Off Business Interests
(II.G.8.)

- The court rejected the IRS' purported foreclosure requirement
- The court rejected the IRS' argument that expert testimony was required
- The case teaches us that a court will respect a family's attempts to keep its operating business going, including heroic efforts to prevent foreclosure by lenders, until the case becomes hopeless and any new investments are required to be held in a separate structure

Writing Off Business Interests
(II.G.8.)

- If sell a capital asset at a loss, resulting capital loss is deductible only against capital gain
- In addition to limiting the amount of loss that any taxpayer can take, for individuals (including owners of S corporations and partnerships) this rule causes such losses to offset favorably taxed capital gain, which is not as beneficial as offsetting highly taxed ordinary income
- One exception is Code § 1341 Claim of Right Deduction (II.G.4.m.i.)

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Writing Off Business Interests
(II.G.8.)

- Abandonment is an alternative to proving worthlessness and can generate ordinary loss
- The IRS views abandonment for purposes of claiming an ordinary loss as requiring "(1) an intention to abandon the asset, and (2) an affirmative act of abandonment"
- If a partnership interest subject to liabilities is abandoned, the partnership interest is treated as having being sold for the liabilities rather than abandoned

Writing Off Business Interests
(II.G.8.)

- Code § 1234A taxes as a capital gain or loss the "cancellation, lapse, expiration, or other termination" of certain rights or obligations "with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer" or a qualified straddle
- The right to a Code § 1231 asset does not qualify for Code § 1234A treatment, notwithstanding that the underlying asset's sale would have triggered long-term capital gain treatment

Writing Off Business Interests

(II.G.8.)

Pilgrim's Pride Corp. v. Commissioner:

- When a taxpayer abandoned stock to obtain an ordinary loss rather than sell the stock for $20 million and have a capital loss, the Tax Court held that Code § 1234A applied to make the loss a capital loss, but the Fifth Circuit allowed an ordinary loss
- The Tax Court's decision seems consistent with the motivation for Code § 1234A, but the Fifth Circuit followed the statute's actual language

Writing Off Business Interests

(II.G.8.)

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Hurford v. Commissioner:

- When phantom stock passed to the employee's surviving spouse, who then contributed it to a partnership, the contribution to the partnership triggered taxation as income in respect of a decedent, converting the contract right to a capital asset in the partnership's hands
- When the former employer paid on the contract, Code § 1234A applied to the proceeds

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Partnership Audit Rule Update

(II.G.20.c.)

- How the partnership audit rules work
- Electing out of the partnership audit rules
- Drafting for the partnership audit rules

Partnership Audit Rule Update

(II.G.20.c.)

- How the partnership audit rules work
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- Drafting for the partnership audit rules

How the Partnership Audit Rules Work (II.G.20.c.)

- If tax impact relatively small, pay the tax at top rate and don't burden the partners with the effects (II.G.20.c.ii)
- Push the adjustments out to those who were partners in the audited year to include on their current year returns (II.G.20.c.iv)

How the Partnership Audit Rules Work (II.G.20.c.)

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- Partners amend their prior year returns to report adjusted items, they remove those items from the partnership-level adjustments (II.G.20.c.iii.)
- Partners to use own tax attributes - such as excess deductions, losses, or credits or simply their lower tax brackets – to blunt the severity of the audit's effects

How the Partnership Audit Rules Work (II.G.20.c.)

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- Amended returns must go through the process of an administrative adjustment request (AAR) and is accountable for making sure that the partners amend their returns (II.G.20.c.i.)
- But, if the partnership return is not yet due, the changed return is instead a "superseding return" and AAR N/A
- Partnerships might extend their returns in case notice any mistakes before extended due date

Electing Out of the Partnership Audit Rules (II.G.20.c.v.(a).)

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Eligible partners:

- an individual
- a C corporation
- any foreign entity that would be treated as a C corporation were it domestic
- an S corporation, or
- an estate of a deceased partner as to that deceased partner's partnership interest

Electing Out of the Partnership Audit Rules (II.G.20.c.v.(a).)

Ineligible partners:

- Trust – even if a grantor trust (revocable or irrevocable) deemed owned solely by a person who is an eligible partner
- Disregarded entity - such as a single member LLC – even if treated as owned solely by a person who is an eligible partner
- Partnership

Electing Out of the Partnership Audit Rules (II.G.20.c.v.(a).)

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- Audit not necessarily coordinated among the partners, because TEFRA does not apply
- Partners must amend own prior year returns, which opens them up to examination for other issues
- Perhaps audit less likely?

Drafting for the Partnership Audit Rules (II.G.20.c.vi.)

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- "Partnership representative" has absolute authority to deal with the IRS, with partners' only recourse being against the partnership representative
- Make the partnership to be the partnership representative, so that the partnership agreement can control decisions
- Partnership names a "designated individual," who has absolute authority to deal with the IRS but must ministerially follow the partnership's decisions

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Drafting for the Partnership Audit Rules (II.G.20.c.vi.)

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- Sample form requires partners to cooperate with Partnership Representative
- Should Partnership Representative able to require partners to amend prior year returns, or should they simply reimburse the partnership if they don't?
- Consider partnership right to be reimbursed, with self-help if partner does not reimburse
- Survival of obligations when partners leave or partnership dissolves

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
- February 18 TCLE Fiduciary Income Tax Refresher
- April 27 webinar for First Quarter Newsletter
- Other free Thompson Coburn LLP resources