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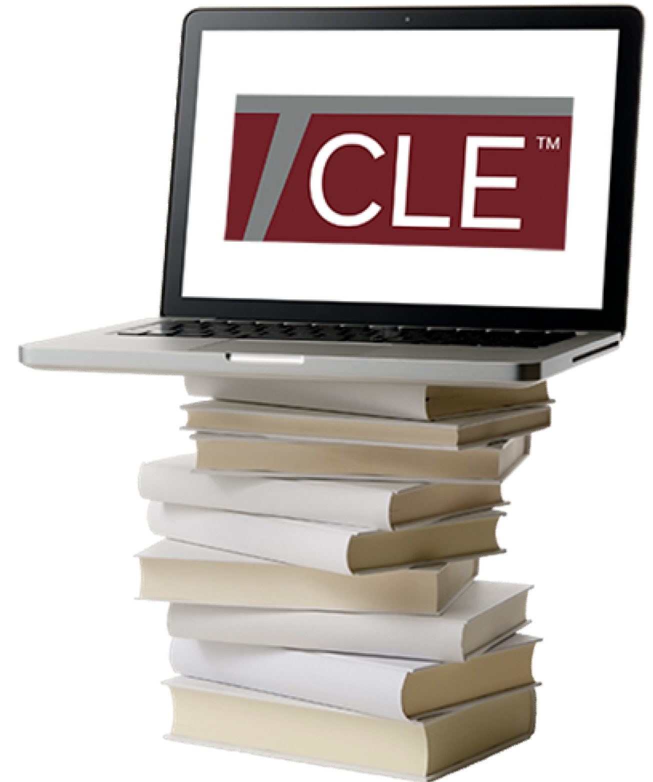
Overview of Loss Limitations; Family Office Partnership; Sale to Spousal Grantor Trust

Steve Gorin
sgorin@thompsoncoburn.com
314.552.6151
http://thompsoncoburn.com/people/steve-gorin
http://thompsoncoburn.com/insights/blogs/business-succession-solutions



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Overview

- Business loss limitations – several layers of rules; CARES Act temporary loosening
- Family office investment expenses – structural issues when deducting
- Sale to spousal grantor trust – issues and comparison to other tools

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Business Loss Limitations

(II.G.4.)

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- First, we will review how deductible business losses can lead to a reduction in – or refund of – income tax and how March 27, 2020 relief for the coronavirus pandemic upended 2017 tax reform temporarily
- Next, we will consider various rules limiting the current deduction of business losses, how a 2020 IRS memo explained the effect of these limits on self-employment tax, and how a 2018 case informs remedies when events in a subsequent year merit a refund of taxes paid

Business Loss Limitations
(II.G.4.)

- Net Operating Loss (NOL) Carrybacks (II.G.4./.iii.)
- Basis Limitations for Deducting Partnership and S Corporation Losses (II.G.4.c.)
- At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities) (II.G.4.j.)
- Passive Loss Rules (II.K.)

Business Loss Limitations
(II.G.4.)

- Self-Employment Tax Interaction with Various Rules Limiting Losses - CCA 202009024 (II.L.2.a.i.)
- Code § 1341 Claim of Right Deduction - *Mihelick* (2019) (II.G.4.m.i.)
- Equitable Recoupment - *Emery Celli* (2018) (II.G.4.m.ii.)

Net Operating Loss (NOL) Carrybacks (II.G.4./.iii.)

- Tax accounting period - report the income, deductions, and other taxable items and compute the resulting tax for each accounting period - generally the calendar year
- What happens when income and deductions are spread over more than one year?

Net Operating Loss (NOL) Carrybacks (II.G.4./.iii.)

- Each year must stand on its own
- Relief from unevenness only for business income and loss
- If a business is big enough to be sophisticated, income tends be accelerated and deductions tend to be deferred, making relief across the years potentially be more important

Net Operating Loss (NOL) Carrybacks (II.G.4./.iii.)

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- Business loss from one year may be carried to another year
- 2017 tax reform prevents net operating losses (NOLs) from being carried back and allows NOLs to offset only 80% of taxable income of future years, undermining the laudable goal of using NOLs to smooth taxable income

Net Operating Loss (NOL) Carrybacks (II.G.4./.iii.)

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- CARES Act (3/27/2020) authorizes carrying any NOL arising in a tax year beginning in 2018, 2019, or 2020 to be carried back five years and to offset as much as 100% of taxable income from the prior years
- Carrying back the 2018 and 2019 losses may generate tax refunds

Net Operating Loss (NOL) Carrybacks (II.G.4./.iii.)

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- The big tax benefits will tend to come from 2020 losses, which will not be determined until returns are filed in the spring of 2021
- Those businesses that owe tax from 2019 might try getting an installment agreement from the IRS to defer paying that tax, then use the 2020 loss carrybacks to prior taxable years to generate a refund to apply to the installment agreement

Net Operating Loss (NOL) Carrybacks (II.G.4./.iii.)

- In re: *Somerset Regional Water Resources, LLC*, 949 F.3d 837 (3rd Cir. 2020), allowed a lender to collect on the pledge of a refund of an NOL carryback refund, interpreting an ambiguous pledge agreement in favor of providing the security the lender reasonably expected
- Loan was to keep debtor afloat while in bankruptcy and was done to try to protect existing debt

Net Operating Loss (NOL) Carrybacks (II.G.4./.iii.)

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- Lenders should engage tax lawyers to make the pledge unambiguous and counsel them on what process to use to make sure the debtor does not cash the refund check himself
- For joint returns, the lender should make sure that the tax refund does not somehow transmute into tenancy by the entirety property

How a Deductible Business Loss Even Occurs

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- C corporation is a silo, and any loss it incurs merely offsets other income it generates
- Owners of a partnership or S corporation (a "pass-through entity") seek to use the losses on their K-1s against other income the owners generate
- This use of losses may be referred to as "sheltering" their income, and if the owners can generate these losses without having to invest much cash then the pass-through entities may be pejoratively referred to as "tax shelters"

How a Deductible Business Loss Even Occurs

- This concept of losses without investing cash comes in part simply from borrowing money but also arises from depreciation deductions
- Depreciation is intended to reflect the fact that tangible assets wear out over time

Depreciation

- Depreciation measures real decreases in value of personal property
- But accelerated depreciation – as much as 100% in the first year under 2017 tax reform – generates losses or artificially reduced income in early years and phantom income in later years
- Later years immediate expensing may not be available (because the 2017 tax law sunsets) even though cash is being invested in replacing machinery

Depreciation

- Real estate is even more problematic – although the building may wear out over time, real estate values often increase due to inflation or growth in the surrounding area, sometimes making land and the fully depreciated building worth more than the original purchase price
- Real estate investor might use depreciation deductions to avoid tax on the net cash flow used to pay down the mortgage, then the investor sells the building and pays capital gain rates, which are lower than rates on other business income or on wages and self-employment income

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“Tax Shelters"

- Our tax laws provide these somewhat artificial incentives to encourage investment with the hope that this investment will provide jobs
- But then along come owners of pass-through entities and borrow the capital, so that they get deductions without putting out most of the cash needed for the business
- When these deductions are gone, they sell the business at capital gain rates
- This is how our system produces tax shelters and facilitates the wealthiest individuals paying taxes at lower rates than the rest of us

“Tax Shelters"

- Responding to concerns about this system that seems rigged in favor of the wealthy, Congress provided limits on what it perceived to be tax shelters, while still providing very nice incentives for entrepreneurs who are risking their financial security and dedicating themselves to building thriving businesses
- These limits are the basis, at-risk, and passive loss rules

Basis Limitations for Deducting Partnership and S Corporation Losses (II.G.4.c.)

- Basis Limitation for Shareholders in an S Corporation (II.G.4.d)
- Basis Limitations for Partners in a Partnership (II.G.4.e)
- Comparing C Corporation Loss Limitations to Those for Partnership and S Corporation Losses (II.G.4.f.)

Basis Limitation for Shareholders in an S Corporation (II.G.4.d.)

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- When an S corporation borrows from a third party, its owners do not get basis for the borrowing, even if they provide very strong guarantees to the lenders
- Owner gets basis from a loan only if the owner is the lender

Basis Limitation for Shareholders in an S Corporation (II.G.4.d.)

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- If an owner borrows from a lender and loans that money to the S corporation, the owner gets basis (a back-to-back loan)
- The owner may take a security interest in the company's assets and then assign that security interest to the lender, so that the lender has a security interest in the company's assets
- By choosing between a back-to-back loan and a direct loan from a lender to the company, the owner can determine how much basis is available to absorb losses

Basis Limitations for Partners in a Partnership (II.G.4.e.)

- When a partnership borrows from a third party, its owners are allocated the liabilities and get basis for the borrowing
- Guarantees may change how the liabilities are allocated among the owners, but they do not change whether the liabilities are allocated to the owners as a whole

Effect of Nontaxable Items on Basis in Pass-Through Entities (new) (II.G.4.c.ii.)

- Nontaxable income provides basis
- It does not provide AAA (concern for S corp that is former C corporation)
- Expenses allocable to nontaxable income are not deductible (Code § 265)
- Query effect of no taxable income from forgiveness SBA Paycheck Protection Program (PPP) loan

At Risk Rules (II.G.4.j.)

- The at-risk rules limit the extent to which partners can use debt basis to support losses
- Example - a partner who is allocated a liability but has not guaranteed or otherwise become subjected to paying that liability out-of-pocket may be prevented that from deducting losses against the basis created by that liability
- Sometimes partners guarantee liabilities to support losses (which guarantees the IRS will respect only if real), but the most common guarantees are required by lenders

Caution re Basis Limitations

- Suppose a nongrantor trust owns an interest in an S corporation or a partnership that incurs losses suspended by the basis limitation
- When the trust terminates, the suspended losses are lost forever, with no tax benefit
- This reinforces my inclination to draft trusts that last the beneficiary's lifetime, with the beneficiary becoming trustee when appropriate, rather than terminating and artificially forcing the issue of suspended losses going away

Passive Loss Rules (II.K)

- Apply to whatever losses are not suspended by the basis and at-risk rules
- General idea - anyone who does not spend sufficient time working in a business should not use losses from that business to offset other income
- If the owner becomes sufficiently active or sells his or her entire interest in the business to an unrelated party, then the owner may use the losses

Passive Loss Rules (II.K)

- Suspending a loss and using it against income in a high-earning year may be better than using the loss right away against modest income or income that the standard deduction or itemized deductions already protect from tax
- See parts II.K.2.d Effect of Death of an Individual or Termination of Trust on Suspended Losses and II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good

Self-Employment Tax (FICA) (II.L.)

- CCA 202009024 mentions that, generally, an individual's "net earnings from self-employment" (NESE) is gross income from any trade or business carried on by that individual, less the deductions allowed for income tax purposes which are attributable to such trade or business, plus the individual's distributive share of income or loss from any trade or business carried on by a partnership of which the individual is a member (II.L.2.a.i.)

Self-Employment Tax (FICA) (II.L.)

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- 202009024 explains that the basis, at-risk, and passive loss rules described above for income tax purposes also apply for self-employment tax purposes
- When those suspended losses are triggered, they are reported directly on the schedules of an individual income tax return that determine NESE

Self-Employment Tax (FICA) (II.L.)

- Contrast that with an NOL, which is not deductible against NESE
- Therefore, to the extent that reducing NESE helps, one would rather have suspended losses under the basis, at-risk, or passive loss rules than have that loss converted to an NOL

Code § 1341 Claim of Right Deduction (II.G.4.m.i.)

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Taxpayer can essentially undo the income inclusion if:

- If an item was included in gross income for a prior taxable year because it appeared that the taxpayer had an unrestricted right to such item
- A deduction is allowable for the taxable year because it was established after the close of such prior taxable year that the taxpayer did not have an unrestricted right to part or all of the item, and
- The amount of such deduction exceeds $3,000

Code § 1341 Claim of Right Deduction (II.G.4.m.i.)

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Mihelick v. U.S., 927 F.3d 1138 (11th Cir. 2019):

- Taxpayer and her husband divorced
- She was forced to repay him half of the income he had returned to settle a dispute over his prior compensation that was included in a joint return
- She was able to obtain relief even though she reimbursed her ex-husband rather than directly paying the person who had paid her husband the compensation

Equitable Recoupment (II.G.4.m.ii.)

- Judicially created doctrine that may allow a litigant to avoid statutory of limitations that ran
- Prevents an inequitable windfall to a taxpayer or to the government that would otherwise result from the inconsistent tax treatment of a single transaction, item, or event affecting the same taxpayer or a sufficiently related taxpayer
- Defense that may be asserted by a taxpayer to reduce the Commissioner's timely claim of a deficiency, or by the Commissioner to reduce the taxpayer's timely claim for a refund
- When benefits taxpayer, allows taxpayer to recoup time-barred tax overpayment by allowing the overpayment to offset a deficiency if certain requirements are met

Equitable Recoupment (II.G.4.m.ii.)

Party must prove the following elements:

- The overpayment or deficiency for which recoupment is sought by way of offset is barred by an expired period of limitation
- The time-barred overpayment or deficiency arose out of the same transaction, item, or taxable event as the overpayment or deficiency before the court
- The transaction, item, or taxable event has been inconsistently subjected to two taxes, and
- If the transaction, item, or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers subject to the two taxes that the taxpayers should be treated as one

Equitable Recoupment (II.G.4.m.ii.)

Emery Celli Cuti Brinckerhoff & Abady v. Commissioner, T.C. Memo. 2018-55, held that, when the same four individuals owned a law firm operated as a PC and another as an LLP and a payroll tax error caused the wrong entity to pay payroll taxes, a recovery of taxes against the correct entity generated equitable recoupment for taxes paid by the wrong entity

Family Office Partnership

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- Family Office As a Trade or Business discusses tax issues (II.G.4.l.i.(e))
- Family Office – Securities Law Issues discusses certain regulation of family offices (not a focus here) (II.G.4.l.i.(f))
- Whether Managing Investments Constitutes a Trade or Business (II.G.4.l.i.(d))

Whether Managing Investments Constitutes a Trade or Business (II.G.4.I.i.(d))

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- Managing one's own investments (or the investments of one's spouse and children) does not constitute a trade or business, unless one is a day trader or something similar
- Managing another person's investments may constitute a trade or business, whether one's compensation is expressed as a fixed payment or a profits interest
- However, a C corporation may deduct expenses of managing investments

Family Office As a Trade or Business (II.G.4.I.i.(e))

- Giving a C corporation that incurs investment management expenses a profits interest in an investment partnership allows the investors to deflect profits to the C corporation instead of trying to deduct investment fees themselves
- However, a conservative approach of complying with proposed regulations regarding service partners adds significant complexity, making this planning complex from a financial and tax viewpoint

Family Office As a Trade or Business

(II.G.4.l.i.(e))

- *Lender Management, LLC v. Commissioner*, T.C. Memo. 2017-246, involved one branch of a family managing the investments of the other branch in a very professional manner; see last segment of April 24, 2018 webinar
- *Hellman v. Commissioner* was later settled with substantial income tax payments

Hellman v. Commissioner

(II.G.4.l.i.(e))

- GFM is a family office that managed investment assets for four family members who lived in the same metropolitan area and were on good terms
- GFM received performance-based compensation keyed to the success of the investments it made
- One investor had authority over day-to-day investment decisions
- Unlike in *Lender Management*, all of the other investors were also owners of the management company, with each investor holding a 25% profits interest in GFM

Hellman v. Commissioner

(II.G.4.l.i.(e))

Besides the manner in which the family office was compensated for its services, relevant factors may include but are not necessarily limited to:

- Nature and extent of the services provided by the family office employees
- Relative amounts of expertise possessed and time devoted by family office employees versus outside investment managers and consultants
- Individualization of investment strategies for different family members with differing investment preferences and needs
- Proportionality (or lack thereof) between the share of profits inuring to each family member in his or her capacity as an owner of the family office and the share of profits inuring to that same individual in his or her capacity as an investor in the managed funds

Hellman v. Commissioner

(II.G.4.I.i.(e))

- Tax Court asked nine questions to develop facts about the family office's business activities and the investors
- Identity of ownership and selection of family member to run family office seemed to be major factors
- Taxpayer capitulated to a large degree

Family Office As a Trade or Business
(II.G.4.l.i.(e))

- C corporation does not need to prove trade or business – investment motive suffices
- Give family office a profits interest in one or more investment partnerships it manages
- Does the profits interest look like a true partner or more like a fee?
- Informed by part II.C.8.a Code § 707 - Compensating a Partner for Services Performed

Family Office As a Trade or Business – Service Partner (II.G.4.I.i.(e))

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- Budgeted annual profits interest should be reasonable
- Consider weighing the possibility of making a gift in granting a vested interest that might exceed annual reasonable compensation against what might seem like a third party at-will relationship if the profits interest is terminable at will or is constantly being tinkered with

Family Office As a Trade or Business – Service Partner (II.G.4.l.i.(e))

- Ultimately, I favor allowing termination or periodic adjustments
- Partnership needs a business reason for the investment management company's continued involvement, such as wanting a management company with a stable leadership team invested in the partnership's ongoing success
- Adjustments should not happen too frequently

Family Office As a Trade or Business – Service Partner (II.G.4.l.i.(e))

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- Preferred profits interest is consistent with the partnership income tax rules generally
- However, the IRS might argue that such an interest in a marketable securities partnership reduces entrepreneurial risk
- IRS might argue that an absolute cap on a profits interest resembles a fee
- Consider, a straight pro rata percentage of all partnership items

Family Office As a Trade or Business – Service Partner (II.G.4.I.i.(e))

- The government is concerned about a service partner being able to manipulate the annual profits to generate a steady fee
- Service partner might decide how to time capital gains and losses
- Consider making distributions (other than tax distributions) be based on the lesser of cumulative realized net income or cumulative combined realized and unrealized net income

Family Office As a Trade or Business – Service Partner (II.G.4.l.i.(e))

- Considering unrealized losses introduces some complexity
- Distributions of income earned and taxed in one year might be suspended due to unrealized losses and need to be made up in a future year when any unrealized losses are reversed (through being recognized or through growth in value)

Family Office As a Trade or Business – Service Partner (II.G.4.l.i.(e))

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- Suppose the partnership starts off well and the investment management company receives significant distributions, then the partnership doesn't do so well but the management company keeps the money
- The IRS suggested that such an arrangement would seem like a fee, rather than the management company facing an entrepreneurial risk of loss
- The preamble and proposed regulations introduced the idea of clawback – the investment management company must repay the distributions

Family Office As a Trade or Business – Service Partner (II.G.4.l.i.(e))

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- Clawback idea does envision the investment management company keeping tax distributions, which would be only fair considering that it cannot get a refund by carrying back a net operating loss and generally a capital loss is not deducible in excess of capital gains
- Preamble and proposed regulations do not specify when the repayment of distributions must occur; perhaps it could occur when the partnership terminates, but query whether it should occur much sooner to feel more "real"

Family Office As a Trade or Business – Service Partner (II.G.4.I.i.(e))

- Issuing a pure profits interest is a nontaxable event for income tax purposes, presumably because the holder will be earning income each year as profits are received
- The structure described above distributes profits to all parties out of the same pool
- However, it may be desirable to distribute profits in tiers, each of which has different allocations; this is called a preferred profits interest

More Caveats (II.E.1.)

- Double tax generally will apply, when the earnings come out, sooner or later, making them more expensive in the long run (depending on the time value of money) than pass-through entities (II.E.1)
- However, if the investment management firm is spending its income on providing investment management services, then it might not accumulate much income to distribute

More Caveats (II.G.4.l.i.(e))

- If the investment management firm is owned by family members who also own the investment partnership but is not owned in the same proportion as the investment partnership, an unexpected gift may be deemed (III.B.7.c.)
- I expect this gift to be minimal, because the profits interest is annually renewable, but calculations under the regulations under Code § 2701 may generate gifts beyond reasonable expectations
- If a QTIP trust participates, consider Code § 2519

More Caveats (II.G.4.I.i.(e))

- Partnership needs to account for built-in gain and loss not only with respect to assets contributed to the partnership but also for assets that the partnership owns when partners come and go (II.P.1.a.i.(b))
- Contributions of cash within two years before or after a distribution of property raises issues - disguised sale from partnership to partner (II.Q.8.b.i.(c))
- Contributions of property within two years before or after a distributions of cash raises issues - disguised sale from partner to partnership (II.M.3.e)

More Caveats (II.G.4.l.i.(e))

- If the corporation provides personal services that do not relate to managing investments, be sure to charge for them
- Failure to charge can constitute a constructive dividend, cause the expenses to be disallowed at the corporate level and incur a taxable dividend to the shareholder (II.Q.7.a.iv.)

Sale to Spousal Grantor Trust

(III.B.2.i.xiv)

- Funding trust
- Grantor trust issues
- Other income tax issues
- Transfer tax issues

Sale to Spousal Grantor Trust

(III.B.2.i.xiv)

- Client's spouse establishes an irrevocable trust for the client
- The trust would be a grantor trust, taxable to the spouse under Code § 677 (with perhaps a swap power included)
- The client sells assets to the trust

Sale to Spousal Grantor Trust

(III.B.2.i.xiv)

- Whereas beneficiary grantor trusts tend to be thinly funded, with no more than $5,000 initially, a spousal irrevocable grantor trust can be well-funded
- However, when making gifts to the trust (to seed it or otherwise), to avoid Code § 2038 the donor spouse should avoid using property that the beneficiary spouse gifted to the donor (III.B.8)

Sale to Spousal Grantor Trust

(III.B.2.i.xiv)

- Just as a sale to a beneficiary deemed-owned trust, the beneficiary could be a trustee authorized to make distributions for his or her support
- A trustee not appointed by the beneficiary or an independent trustee appointed by the trustee should be able to make distributions for the beneficiary's welfare, which the beneficiary might use to pay the grantor-spouse's income taxes

Sale to Spousal Grantor Trust

(III.B.2.i.xiv)

- These concerns parallel those for beneficiary grantor trusts (III.B.2.i.)
- However, in this case, the beneficiary's spouse, not the beneficiary, is subject to income tax
- With the repeal of Code § 682, the spousal grantor has no way to turn off the Code § 677 power that may apply via Code § 672(e) spousal attribution, even after divorce (III.B.2.h.viii)
- Thus, a grantor tax-reimbursement provision may be much more important to consider (III.B.2.j.iv.(a), III.B.2.h.v)

Sale to Spousal Grantor Trust

(III.B.2.i.xiv)

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- Code § 1041 protects selling spouse from recognizing gain on the sale of property to a spousal grantor trust under, even if the grantor spouse dies while the note is outstanding
- If the selling spouse sells property to the trust for full and adequate consideration, the selling spouse has not made a taxable gift to the spousal grantor trust and the spousal grantor trust should not be included in the selling spouse's estate for estate tax purposes

Sale to Spousal Grantor Trust

(III.B.2.i.xiv)

- Interest payments will be taxable to the selling spouse and may be deductible by the grantor spouse, the latter depending on the nature of what is purchased (II.C.3.d.)
- Could sell without stated interest but higher principal – not my preference

Sale to Spousal Grantor Trust

(III.B.2.i.xiv)

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Running SOL on Sale to Trust (III.B.4.)

- Reg. § 301.6501(c)-1(f)(4) applies only to a “completed transfer” - but no definition what a “completed transfer” is
- If beneficiary sells to trust, any gift portion may be a wholly incomplete gift
- Consider formula sale (III.B.3) but not giving power of appointment over 10%

Sale to Spousal Grantor Trust

(III.B.2.i.xiv)

Compare to sale to irrevocable grantor trust where settlor is seller

- Can turn off grantor trust powers unless spouse is a beneficiary
- Can give power of appointment to primary beneficiary for 100% and still run SOL
- Seller does not have any power of appointment

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Sale to Spousal Grantor Trust

(III.B.2.i.xiv)

Compare to sale to beneficiary grantor trust where beneficiary is seller, under which:

- Cannot turn off grantor trust powers (one exception during settlor's life – Code § 678(b))
- Same issue re power of appointment as sale to spousal grantor trust
- Funding tends to be minimal, perhaps making sale more risky for estate tax and creditor purposes

Conclusion

- February 12, 2019 webinar Fiduciary Income Tax Refresher and Update 2020
- Blog: Business Succession Solutions
- Reports on Heckerling: http://www.thompsoncoburn.com/forms/gorin-heckerling
- Gorin's Business Succession Solutions
- July 28 webinar for Fourth Quarter Newsletter